City of Ann Arbor
Employees' Retirement System
Board of Trustees

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To City Council Members:

A change from a defined benefit retirement program for City employees to a defined contribution program has been proposed by some members of City Council. Articulated reasons for the proposed change are a desire to conform to the private sector and to shift risk for retirement savings from the employer to the employee. Other Council members have indicated that employee benefit discussions belong at the bargaining table. At its most recent Board meeting, the Retirement Board of Trustees discussed plan designs and received comments from City management and employee representatives and legal counsel. The Board of Trustees recognizes that Council, in conjunction with Human Resources and City bargaining units, is responsible for benefits plan levels and design. The Board does have comments and concern as any change in design will impact Board investment and administrative strategies and processes. A key component of any review of Ann Arbor's retirement plan design is a clear understanding of the goals of a change to the Plan. Many comments below can be expanded with a more clear Board understanding of whether the purpose of plan design changes is to 1) reduce City pension contribution costs, 2) increase risk sharing between the employee and the City, 3) reduce the unfunded liability, 4) make the benefit more "portable," or other policy initiatives.

Defined Benefit (DB) Plan Comments

A defined benefit (DB) pension plan is a cost effective retirement design which can offer more benefits than a defined contribution (DC) plan on a dollar-for-dollar contribution basis. Ann Arbor's defined benefit program provides a lifetime monthly income stream to employees. The Retirement System has access to institutional funds with lower investment management fees than those available to most individual DC participants. Investments in a DB plan can be managed for the long term, and market volatility smoothed for retirees by pooling investment and longevity risk. In a DB plan, investment risk may be positive as well as negative; which could be advantageous or a disadvantage to the employer depending on the investment returns. The current retirement plan requires an employee contribution of 6%, plus imputed interest based on a ten year smoothing of the Plan's investment returns. The employee may withdraw all, or a portion, of his/her contributions plus accumulated interest upon retirement or termination. When the employee chooses to withdraw his/her contributions, the monthly total retirement benefit is reduced by the monthly actuarial value of those contributions. So the current plan could be considered to have some hybrid characteristics, since the risk of generating a portion of the retirement benefit now rests with the employee who withdrew a lump sum and must invest it in order to provide an income stream to supplement the City's remaining portion of the retirement allowance.

Defined Contribution (DC) Plan Comments

Straight defined contribution (DC) plans place all of the risk on the individual to fund his/her retirement, navigating market ups and downs and longevity risk. Numerous studies have shown that DC plan participants do not save enough, and in many cases cannot reasonably achieve the level of savings (10-15% of pay) needed to fund an adequate replacement ratio for income in retirement. DC plan participants may not be savvy investors, being either too conservative or too aggressive. Individual participants do not have access to all categories of institutional investment options, and experience higher fees for a retail investment slate, thus reducing benefit accumulation. DC plans are often cited as being portable, but DC plans also experience "leakage," which occurs when short term employees terminate employment, withdraw their retirement funds, and fail to roll those funds over to a qualified plan. The results are tax penalties and a loss of the compounding of investment earnings for these monies, with potentially greatly diminished DC balances by retirement age. The average 401(k) balance is about $89,000 as of 2013. People on the verge of retirement, ages 55 to 64 years old, increased their 401(k) balances to an average of $165,000 from $143,000 in 2012. These gains were fueled largely by stock market gains.[1] However; a 2013 study by the Employee Benefit Research Institute found that nearly half of workers had less than $10,000 saved. The higher "average" balances still fall far short of the accumulation of the recommended 10-12 times (or more) final annual salary that many financial advisers target. The volatility in an individual DC balance may impact the lifestyle of a retiree for decades, if the retiree must leave the workforce in a down market. Or, worst case, employees cannot afford to retire at all, creating "hidden pensioners" in an organization. DC plans' designs limit the provision of disability and death benefits, requiring separate plans for such benefits, essential especially to safety services employees who have a higher employment-related injury risk, and who do not participate in Social Security.

Hybrid Retirement Plan Comments

"Hybrid" retirement plans account for employee contributions and reflect some degree of market performance in the benefit account accumulation. Some examples are a split DB-DC combination, or a cash balance plan. Split DB-DC plans may provide a basic level of guaranteed benefit and an added market-driven contribution-based benefit. Cash balance plans define the retirement benefit in terms of a stated account balance and may have variable interest credits. A plethora of other plan designs could be explored. The administrative and employee communication requirements for such plans are likely to be more complex and costly.

Plan Design Comments

The City's Retirement Plan employee contributions have been increased from 5% to 6% in recent years. Additionally, recent Plan changes have included revising the vesting period to 10 years from 5 years and changing the definition of final average compensation to a 5 year average rather than a 3 year average. The Retirement System Board has taken action to improve the funded status of the Plan and decrease annual employer contribution costs by agreeing to change the amortization period for the unfunded actuarial accrued liability, which of course extended the payoff of the unfunded liability.

If the consensus is that costs and liabilities are still a concern, some other potential review could occur. Further increase of employee contributions for new hires or all employees could reduce the portion of the City's contribution to the "normal cost," the current amount needed to fund one year of service for all employees. The annual contribution required to amortize the unfunded liability has varied but is currently about 12-13% of payroll. Closing the DB plan to new hires and implementing a DC will result in an acceleration of the amortization of the unfunded liability, resulting in extra cost to the City in the near term.

Increased risk sharing between the employees and the City may be achieved by an increase in contributions, which would boost the balances in the individual contribution accounts. If a retiree withdraws contributions the risk transfer from the City to the retiree increases.

A risk sharing feature could include using a market-based interest credit method for the new hires for a portion of their benefit. Currently the total benefit is calculated and allocated between the employee funded portion and the City funded portion; but if the employee does not withdraw his contributions, the risk of the investments remains with the City.

There is a wide spectrum of pension plan designs available. Other possible changes in a DB plan that can impact current costs and liabilities while retaining the DB plan structure could include review of the definition of final average compensation to expand the years of compensation included, even to a career average (where all years of compensation are used in the average), review of normal retirement age, and early retirement subsidies.

The Board encourages City Council decision makers to explore all options for a plan design, if a change is contemplated. The Board would like to continue an open dialog with both City Council and Employee representatives and as always, the Board is available to communicate further and respond to any questions.

[1]Fidelity study http://money.cnn.com/2014/02/13/retirement/401k-balances/

Respectfully submitted on behalf of the Board of Trustees, by

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