



# New Retirement Plan Options for Tennessee's Political Subdivisions

Analysis and Recommendations from

**The PFM Group**

Public Financial Management

PFM Asset Management LLC

January 2012

# Recommendations for Local Government Retirement Plan Options for New Hires

## Executive Summary

After a review of available options, PFM recommends that the state offer to local governments a menu of retirement plan options that would include the following choices for employers to offer their new hire employees:

1. Continuation of the current TCRS pension plan with no changes
2. A lower-cost revision of the current pension program that raises retirement ages to recognize increased longevity, offers more choices for employee contribution levels, and caps total pension benefits at \$80,000 adjusted hereafter for inflation.
3. A “hybrid” plan design option that enables an employer to supplement a reduced (1% multiplier) pension formula with a defined contribution of its choice. The DC component can be as simple as a voluntary deferred compensation plan which could be administered by the employer’s current provider or the state’s 401(k) and 457 plan
4. A pure defined-contribution plan option that includes access to the state’s highly flexible 401(k) plan and an optional sidecar 401(a) plan for tax-efficient mandatory contributions. Employees will have the option to convert these savings pre-tax into a life annuity at retirement, taxable when distributed.

PFM also recommends that the enabling legislation include these provisions:

- a. Local governments may hereafter declare by formal local action the legal right to modify retirement benefits and contribution rates for employees hired after the effective date of the legislative proposal. Employees will always retain vested rights to previously earned accrued benefits, but plan terms and future benefits can be changed prospectively if the employer makes this declaration.
- b. Employers who opt to provide a defined contribution plan as the primary benefit should be required to provide supplemental death and disability benefits.
- c. The current statutory cap of 3 percent for supplemental employer contributions to all retirement plans should be revised to an annual cap for the hybrid plan option (e.g. 6%-9%), and possibly for those affected by the pay cap under plan #2.
- d. The pension plans would include employer flexibility to select a pension-plan COLA/No-COLA option and three levels of employee contributions (0, 2.5% and 5%), except that the hybrid plan must include a COLA for the reduced (1% multiplier) pension.

## Background

Public Financial Management (PFM) and the retirement plan specialists at its affiliate PFM Asset Management LLC were engaged to review local government potential options for the state of Tennessee to offer its political subdivisions in a comprehensive package of retirement plan platforms to be offered to newly hired employees. With “pension reform” and the financial challenges facing state and local government retirement systems nationwide making newspaper headlines almost every day, the state treasurer’s office sought to review available local government plan design options -- and to develop a better understanding of local government alternatives the state could consider in both defined benefit pension plan designs as well as defined contribution plans.

Costs continue to escalate for local governments. Some local Tennessee governments pay more than the state. During the past two plan years, seven local governments have withdrawn or given notice to withdraw. With the Governmental Accounting Standards Board expected to soon require states and localities to display their net pension liabilities on the balance sheet, and to record pension expenses at often-higher levels under proposed new standards, pension fund financing will become highly visible. Local officials will be looking to the state for assistance and guidance in managing their liabilities and expenses. Nationwide, there is a recognized need to adjust basic pension plan benefits to recognize the increased longevity of the workforce, and public-sector retirement plan designs must be adjusted to assure wary taxpayers that the benefits and the employees’ share of costs are reasonable in light of what sometimes appears to be a growing disparity between benefits in the public and private sectors.

To balance the public’s and the employees’ interests in affordable and sustainable retirement benefits, local officials should also assure that their retirement plans provide sufficient benefits to provide adequate replacement income for the participating employees, and that the plan itself is soundly designed to operate prudently and efficiently. Under Tennessee law as interpreted by the attorney general, such changes in benefits design can generally apply only to new employees because of vested benefits rights of incumbent employees. In this context, the statewide system for retirement plan options for political subdivisions must be flexible enough to meet varying local conditions, and to provide options for local employers to offer reasonable, sufficient, affordable, sustainable and competitive benefits to their employees

Historically, the state’s primary retirement plan vehicle for political subdivisions has been the pension plan provided by the Tennessee Consolidated Retirement System (TCRS). Some local governments also operate and administer their own local defined-benefit pension systems. There have been times when their plans’ financial results have not been as favorable as the state’s plans because of their smaller size, or difficulties in governance or management. In addition to the employees’ primary pension benefit, many local governments also offer a supplemental IRS Section 457 deferred compensation plan through third-party administrators and a few have also offered Section 401(a) defined contribution plans to their employees.

In recent years, some local employers have elected to discontinue participation in the TCRS in order to replace the plan with a different design for a variety of reasons that may include cost, competitiveness, or the benefit structure. Discussions with local officials have emphasized the need for flexible plan designs rather than a one-size-fits-all approach to any additional options offered by the statewide system. Each employer may look differently at issues such as cost; employee recruitment, mobility and longevity; required contribution rates; flexibility in plan design; and the employees' share of total costs. In some cases, this flexibility may require an alternative to the traditional defined-benefit pension plan now available to political subdivisions.

The state also operates a Section 401(k) plan that was established prior to the 1986 federal tax law which closed the door to the creation of new freestanding local plans for municipal employees under that tax-code section. As part of this study, PFM was asked to evaluate whether the availability of the state's 401(k) plan to local governments is a potential benefit that would be helpful and valuable to these political subdivisions if they were to consider a defined contribution (DC) plan or some kind of a hybrid retirement plan that includes a defined-contribution benefit.



*continued*

## Plan Design Alternatives and Options That PFM Considered

PFM considered the following alternatives and options for plan design, among others:

- Modifications of the current defined benefit pension system, including benefit changes or contribution changes for current employees vs. new employees
- Various forms of TCRS-operated hybrid plans, including cash balance plans, floor-offset plans and various other alternatives to a combined defined benefit (DB) and defined contribution (DC) plan
- A collective defined contribution plan that could be operated and offered by the TCRS
- Hybrid DB-DC plan designs already installed in Utah and Washington states, adopted by law recently in Rhode Island and proposed in California
- Replacing the entire defined benefit system with defined contribution plans
- Offering all local employers a comprehensive defined contribution option
- Allowing all local employers to select their own defined contribution plans without a state-provided option

Our analysis throughout this study was guided by the four key concepts of sustainability, affordability, competitiveness and sufficiency, and was guided further by the state treasurer's explicit request to provide as much flexibility in plan design as feasible for local government employers while recognizing that the vast majority of employers are likely to remain within the existing pension system or a modestly reformed version thereof.

**Vested rights of current employees.** PFM reviewed legal opinions and case citations relevant to Tennessee law which are consistent with our experience in other states. Even putting aside the questions of constitutionality and political feasibility, we quickly determined that any efforts to compel plan changes for incumbent employees in this new-plan rollout would be controversial, litigation-prone and probably counter-productive. Therefore, our analysis was thereafter limited to plan design features that could be introduced for new employees only. However, we strongly urge that the legislative proposals include statutory language that enables local governments to thereafter formally reserve the right to modify retirement plan terms, benefits, structures and contribution rates for employees on a prospective basis. This approach for new hires would be consistent with federal pension law under the Employee Retirement Income Security Act (ERISA) which protects accrued vested benefits but permits plans to be frozen or modified prospectively. Nationally, we see this as an emerging trend in public pension reform, and a timely feature to include in the recommended legislation. Employers need not invoke this authority, and those governments who desire to do so are free to retain the status quo.

**Employer-controlled options.** PFM reviewed whether the optimal plan design would be a uniform statewide menu of options from which all local government employees could select statewide, or a menu of options from which employers would first choose (with perhaps one alternative to the primary plan offered). The latter format of employer plan design control was deemed most appropriate, and permits far greater customization at the local government level than any state-

designed menu of options for all employees. This format also simplifies employee education and communications at the local level. The state's defined contribution recordkeeper has the capacity to support this structure on an employer-by-employer basis. Participating employers should also be permitted to offer different plans to two different employee groups, so that the basic pension plan could be retained for public safety while general employees are offered the hybrid or the defined contribution option as their primary benefit, for example. PFM recommends against further proliferation of plans, however, to avoid undue complexity or potential charges of favoritism for selected sub-groups if employees are treated differently.

PFM recommends that where employers offer the state's defined contribution benefit platform as the primary plan, the employer share should be invested in broadly diversified "balanced," "asset allocation" or "target date" funds approved by the state and selected by the employer from the plan's investment menu. This guidance would not be mandatory, however. Employees would be free to invest their own contributions in any fund allowed in the DC plan.

**Record-keeping considerations.** TCRS is presently actively implementing a systems conversion that will be completed in 2014. Although the new functionality for recordkeeping of various plan options and multiple plan designs will greatly enhance the system's capacity for flexible, multiple options for each employer, the systems capabilities of the state's incumbent outsourced defined contribution recordkeeper (and any national firm that might succeed them) are available immediately and are more robust from the perspective of permitting granular variations between multiple employers. Thus, a hybrid DB-DC structure -- one that combines simplified and standardized options for the defined benefit pension plan with more-complex options in the defined contribution components -- will offer the most robust array of plan options with the least processing complexity and minimal incremental costs. The defined contribution benefits features can then be modified easily in the future to give the overall hybrid far more flexibility for employers and employees than the pension-only options.

**Other hybrids and options were considered but not recommended.** PFM discussed the following alternative hybrid options for local governments with treasury department and TCRS personnel: cash balance plans, floor-offset plans, collective defined contribution plans, the Utah hybrid, the federal employees' FERS plan, the Washington state hybrid and recent proposals in other states such as Rhode Island and California. The FERS and Washington state plans are similar in many respects to the hybrid plan embodied in this report, if Tennessee's employers using the recommended hybrid structure were to provide a 5 percent defined contribution plan with or without an employer match, respectively. The Utah plan structure would potentially require additional employer as well as employee contributions which could invoke questions of unfunded mandates, and obligates the employer to a potentially irreversible contribution level of ten percent of pay, which is likely to exceed the affordable funding level for some local governments who would be interested in participating. It also creates complications in funding and budgeting when actuarial levels rise and fall, which require further communication and employer costs, as well as imposing unexpected contribution costs on employees who are not all likely to fully understand those obligations when they enroll at the time of hire. Local governments are encouraged to make informed decisions of their pension needs considering costs and other relevant factors.

Cash balance, floor-offset, collective defined contribution and other collective investment hybrids do have some merit-worthy aspects but they are more complex than most local government employers would want to explain to new hires, thus increasing the administrative burden at the time of enrollment. Also, outsourcing the 5% return is not practical for local government plans that may be used by only a portion of local governments. PFM also believes these structures require administrative complications that would be burdensome for the TCRS staff at present, relative to the benefits they would provide to a potential handful of local employers that might make voluntary elections into such systems. They also leave employers with contingent liabilities that are difficult for governing bodies to understand, and offer little more to enhance retirement income security than the recommended DB-DC hybrid structure if it is implemented with reasonable employer contributions. Recordkeeping for such formulaic hybrids would entail additional costs and efforts for TCRS personnel, as well as considerable additional actuarial expenses.

## **Recommended platform of additional retirement plan options for Tennessee's political subdivisions**

Of the many alternatives PFM evaluated, discussed with staff and considered independently, the structural platform proposed below is the simplest to implement and to understand. The recommended package of options requires no extensive changes in recordkeeping systems that would cause delays in implementation or substantial additional costs. The current local government pension plan remains intact for current employees, with no required additional costs to any public employer who wishes to preserve income security for employees in the traditional model. For new employees of those local governments who elect to do so, a modified option with full pension benefits consistent with current trends in pension reform nationwide is outlined. In addition, for electing employers seeking the "best of both worlds," a hybrid plan-design platform that blends the income-security benefits of a pension with the flexible cost-sharing and risk-sharing feature of defined contribution plans would become available statewide in a way that few local employers could achieve on their own. PFM has concluded that the TCRS system will definitely be able to progressively service the new options proposed here, and the state's current 457 and 401(k) plan recordkeeper is readily capable of supporting the defined contribution elements outlined above. Accordingly, a package of defined-contribution options is provided, for public employers who seek maximum flexibility in cost management, and to ultimately relieve their constituents from the risk of underfunded pension plans.

No local government employer is required to make any changes unless it desires to do so, or to incur additional costs that would invoke local government mandated-cost issues. Local employers remain free to select their own defined contribution and deferred compensation plan administrators which need not be the state plan. To supplement the current TCRS pension plan and a new, state-of-the-art pension reform option for local government employers, the state will offer new options to provide an efficient and prudently designed plan menu with both professional and experienced fiduciary oversight that local officials can trust. This provides a robust and efficient array of choices for employers to consider as they customize their employee benefits and the retirement components of those plans.

**Continuation of the current TCRS political subdivision pension plan, unchanged.** First, the proposed multi-plan structure will continue the current pension plan structure entirely intact. PFM expects that all political subdivisions will retain the current plan for all their current employees and a majority will continue this program or its 2012 reform version (described immediately below) for many of their new employees. Any decision to elect an alternative plan design is purely voluntary. In addition to current (5% of salary) contributory rates for employees, the pension plan should be modified to also permit (new) employees to pay an intermediate rate of 2.5% of their compensation if the employer elects this level. This will improve plan flexibility for some employers without imposing a mandate on those who now offer a non-contributory plan.

**Modest modification of the current pension plan design, to align with nationwide trends in public plan demographics and pension reforms.** The second option slightly reduces the current pension plan multiplier (the percentages used in conjunction with years of service to calculate the retirement benefit) and raises the retirement age modestly to age 65 with 5 years of vesting service or the Rule of 90 for general employees, with age 57 with 5 years of service for employer-designated public safety employees. Early retirement for all occupations under this option could begin at ages 60 (general) and 55 (public safety) with 20 years of service, or for those who satisfy the Rule of 80, with a full actuarial benefits reduction. Under this option, employers could select an employee contribution rate of 0%, 2.5% or 5%, and can decide whether or not to provide a COLA benefit to retirees. This feature will reduce costs for some employers, and assure that the plan they offer is state-of-the-art in terms of prevailing public-sector pension reforms.

**More pure-pension plan designs are not recommended at this time.** PFM considered a variety of other pension plan benefits designs and benefits levels, but sees no advantage to offering more than those identified above as the core pension program. The above formulas are sustainable, affordable and sufficient for most employers and employees. The hybrid option and the defined contribution option, described below, should be the primary focus for structural changes and increased flexibility, as the defined contribution plans' recordkeeping systems are sufficiently robust to permit almost infinite variations without creating undue complexity for TCRS to administer and its actuaries to value and cost. With a large number of small employers, it is unwise to proliferate the number of defined-benefit pension plan options: simplicity in design is preferable, while allowing some reasonable employer flexibility.

**A new hybrid plan option.** As an alternative to the current pension plan structure and multipliers, a simplified, streamlined and standardized defined benefit plan option can be supplemented by a defined contribution benefit to create a hybrid DB-DC structure. Although other hybrid forms were considered, this is the easiest to implement, the easiest to customize locally, and the easiest for employers to communicate. When structured properly, employers and employees share investment risks and costs equitably as determined at the local level. Beginning with a 1% multiplier for the pension component and a mandatory (3% capped) COLA feature to assure a sufficient floor of guaranteed lifetime income, the employer can then elect any form of defined contribution benefit plan it desires, including a simple deferred compensation plan that receives only contributions from the employee. The employer is free to select from the same three levels of employee contributions for the limited pension benefit (0%, 2.5% or 5%), and can make contributions at any level it wishes to any defined contribution plan it may select, subject to a statutory maximum employer contribution (which we suggest be set at 6% to 9% of eligible compensation).

To achieve sufficient retirement replacement income, the defined contribution component of a local government's hybrid plan should generally include combined employer and employee contributions of at least 5% of salary, in addition to supplemental savings by employees in their deferred compensation or 401(k) voluntary contributions. PFM suggests that the state's plan should formally recommend, but not require, such minimum contributions levels through its educational programs. Investment education programs offered by the 401(k) contractor should include both employer and employee training in the basic math of retirement savings so that the parties do not rely

unrealistically on the 1% multiplier pension as the sole source of retirement replacement income. However, policymakers must recognize that some local government employers and employees may not be able to afford such contribution rates, and the local labor market may not require such levels to be market-competitive.

Under the hybrid option, the state will offer all local governments access to its 401(k) plan which allows employees to make any level of voluntary tax-deferred contributions they may wish in any given year. Every local employer will have the right to select its own defined contribution plan provider, or to simply retain its current deferred compensation plan as its DC component in the hybrid system. For example, an employer could provide for a 100 percent match of employee contributions up to 5 percent in the 457 plan to achieve its retirement replacement income target. This open architecture in the plan design provides maximum flexibility and maximum competition in the intergovernmental retirement system. The only requirement under PFM's recommended statutory structure for the hybrid plan is that the employer must offer *some* form of a defined contribution plan, which may be as simple as a supplemental deferred compensation plan (with or without employer contributions), or a more comprehensive combination of the state's 401(k) plan, a 401(a) plan as described below, and supplemental deferred compensation plans. The requirement to include a DC plan of some kind is important to assure that the total benefit plan, with Social Security, provides a clear path to a sufficient retirement benefit which the 1% pension formula alone will not provide to employees at some income levels.

Employers can set the employee contribution rates for the hybrid plan's pension benefit option at any of the three previously cited levels (0%, 2.5% and 5%).

**Pure defined contribution option.** The final component of the overall statewide plan structure for local governments would be a purely defined contribution plan option. The state would make its IRS-grandfathered 401(k) defined contribution plan available to the political subdivisions which are otherwise unable to establish a 401(k) plan of their own because of 1986 tax laws prohibiting new freestanding plans in local governments. Some employers may wish to supplement the state's 401(k) plan with other options that the state can make available, including a fixed-contribution 401(a) plan and access to the state's own 457 deferred compensation plan.

All participants in the DC plan should have the option to convert their accumulated savings at retirement into a lifetime annuity, which assures they will not outlive their savings while relieving the state of actuarial risk for that feature. PFM explored the concept of permitting the TCRS system to offer such an annuitization through its system at what might be higher-yielding annuity rates consistent with the pension fund's discount rate, but rejected that option as administratively unfeasible in light of the Tennessee system's history of individually valued retirement plans.

PFM suggests that the authorizing legislation should include a requirement for local government employers offering the pure defined contribution option to provide pension-equivalent death and disability benefits. (The hybrid option's pension component could continue to provide sufficient D&D benefits regardless of the multiplier, by a formula based on the employee's current salary.) Such insurance is available commercially and can also be provided through a joint powers

arrangement by local government associations if desired. Typically, claims for disability benefits are more rigorously reviewed through such arrangements, which help mitigate abuses in the system.

**Tax and compliance considerations.** PFM favors the use of the state's grandfathered 401(k) plan by political subdivisions, and has conferred with legal counsel at Ice Miller and internal staff to ascertain that regulatory considerations have been sufficiently studied and will be formally addressed before this program would be rolled out. The 401(k) platform is the industry's most flexible plan design, enabling employers and employees to make variable contributions and elective changes in contribution rates with fewer regulatory complications.

PFM further recommends that for tax efficiency, the program should include an elective companion 401(a) money purchase plan option for local employers. Certain higher -income professionals who exhaust the elective tax-deferral limits of the 401(k) and 457 plans would benefit from this facility, and the state plan can provide it almost effortlessly because the contractual recordkeeper has this capability and can provide a prototype plan document if needed. Companion 401(a) plans are commonplace in the public sector, especially when the defined contribution plan is the primary benefit or the pension plan is non-contributory. Their availability has proven to be a valuable recruitment and retention tool for public employers with little or no cost to taxpayers. By requiring specified levels of employee contributions, such mandatory savings are exempt from the IRS elective contribution limits. Only some employers and a small cadre of employees will be interested in this option, but it is worthwhile to include the feature in the overall plan if the incumbent DC recordkeeper is willing to provide this available capacity without substantial incremental expense to employers and participants.

