GO Committee #1
May 5, 2011

MEMORANDUM

May 3, 2011

TO: Government Operations and Fiscal Policy Committee

FROM: Office of Legislative Oversight, Budget Project Team
Karen Orlansky, Aron Trombka, Craig Howard, Leslie Rubin & Sarah Downie

SUBJECT: **County Executive's FY12 Recommended Budget:**
Follow-up: Proposed Changes to County Government Employees' Retirement, Health, and Life Insurance Benefits

This memorandum provides follow-up information related to the GO Committee's discussion (4/25/11) of the County Executive's proposed changes to retirement, health insurance, and life insurance benefits for County Government employees. It also includes OMB's explanation of the Executive's FY12 Budget Adjustment (transmitted 4/26/11) related to proposed prescription drug plan changes.

Committee members are asked to bring GO Committee #3, 4/25/11. Copies are available from OLO's office or at http://www.montgomerycountymd.gov/content/council/pdf/agenda/cm/2011/110425/20110425_GO3.pdf

The information in this memo is organized as follows:

A. Action Item: Executive Recommended Budget Adjnstment

The Executive's package of FY12 recommended budget adjustments includes a cost decrease of $1,036,280 in the Self-Insurance Fund. This cost decrease results from three proposed prescription drug plan design changes – mandatory generics, increased copays for mail order drugs, and eliminating coverage for lifestyle drugs. (For descriptions of these proposed changes, see GO Committee #3, 4/25/11, page 22.)

OMB reports that this budget adjustment is a technical change to the FY12 recommended budget for the Health Insurance Self-Insurance Fund to align that budget with the savings from prescription design changes. This budget adjustment does not change the savings estimated by the County Executive from the prescription drug plan design changes in his FY12 Recommended Budget ($1.8 million out of the total $29.6 million in compensation-related savings).

The March 15th budget for the Self-Insurance Fund was based on an October multi-year valuation from the County's actuaries and therefore did not reflect the prescription plan design changes. Revised multi-year actuarial projections that reflect the plan design changes were not obtained until after March 15th.

The value of the budget adjustment ($1.036 million) is different from the Executive's original savings estimates for the prescription drug changes ($1.8 million). This is because the budget adjustment ($1.036 million) measures the savings from the prior year's approved total, i.e., the difference in the FY12 recommended total for prescription drugs vs. the FY11 approved total for prescription drugs. The Executive's March 15th savings estimate ($1.8 million) measures the difference in the FY12 recommended total for prescription drugs vs. the projected FY12 total if no changes were made.

Staff recommends approval of this budget adjustment.

B. Savings Estimates of Alternatives

This section provides fiscal impact information that OLO received since the April 25th worksession.

1. Retiree Health Benefits

The Executive's Recommended FY12 Budget did not propose any changes to retiree health benefits. For the two alternatives included in the packet (GO Committee #3, 4/25/11, pages 18-19), OLO had requested estimates from the County's actuary (Aon) for savings that would result from applying these alternatives to all employees hired on or after July 1, 2011.

County actuaries calculate an Annual Required Contribution or "ARC" that the County would have to set aside to fully fund the County's OPEB liability for current and future retirees. The current ARC of approximately $156 million includes a pay-as-you-go portion (approximately $32.5 million) plus a pre-funding portion (approximately $123.5 million). The Executive's Recommended Budget includes $32.5 million in pay-as-you-go funding and $26.1 million in OPEB pre-funding for FY12.

Aon reports that neither alternative would provide any savings in pay-as-you-go costs (i.e., the amount the County pays each year to provide retiree health benefits in that year). However, each alternative would reduce the County's overall future OPEB liability beginning in FY13, the first year after adoption of the change.

Alternative #1. Changing Eligibility Requirements for New Hires. Aon estimates that the OPEB savings (i.e., a reduction in the overall OPEB liability) under this alternative would be 1% in FY13, and the percent savings would gradually increase each year as new hires accrue more years of service. Based on the County Government's current OPEB annual required contribution of $123.5 million (excluding the pay-as-you-go portion), this alternative would reduce that amount by about $1.2 million in FY13 and progressively higher amounts in future years.

Alternative #2. Eliminate Retiree Health Benefits for New Hires. Aon estimates that the OPEB savings (i.e., a reduction in the overall OPEB liability) under this alternative would be 3.8% in FY13, and the percent savings would gradually increase each year as new hires accrue more years of service. Based on the County Government's current OPEB annual required contribution of $123.5 million (excluding the pay-as-you-go portion of the recommended contribution), this alternative would reduce that amount by about $4.7 million in FY13 and progressively higher amounts in future years.

2. Prescription Drug Plan Design

On April 25th, OLO had outlined two alternatives to the Executive's proposals for a mandatory generic requirement with no exceptions and to eliminate coverage for lifestyle ED drugs. (GO Committee #3, 4/25/11, page 26)

Alternative #1. Add Strict Waiver Provision to the Executive's Mandatory Generic Requirement: Caremark estimates that adding a letter of medical necessity waiver provision, as is done in MCPS' Caremark prescription plan, would reduce the estimated savings from this mandatory generic change by up to 5%. This alternative would reduce the Executive's estimated $1.2 million in FY12 savings to approximately $1.14 million, a $60,000 decrease.

Alternative #2. Limit Coverage for Lifestyle Drugs: Caremark estimates that limiting coverage of medications that treat erectile dysfunction to six doses per month, as is done in MCPS' Caremark prescription plan, would reduce the estimated savings from this change by one-third. This alternative would reduce the Executive's estimated $400,000 in FY12 savings to approximately $266,000, a $134,000 decrease.

3. Life Insurance

The Executive's proposed changes to basic life insurance benefits would reduce the benefit level for most County Government employees (from two times to one time annualized salary) and change the cost share split to achieve an estimated $1.2 million in FY12 savings. OLO had described one alternative to the Executive's proposal, which was to keep the life insurance benefit at twice an employee's salary. (GO Committee #3, 4/25/11, page 36)

Alternative: Keep Life Insurance Benefit at Two Times Annualized Salary. OHR staff report that the estimated savings from life insurance changes only reflects the change in coverage from two times to one time salary. The estimate does not include savings from the proposed cost share change as those savings would likely be canceled out by other factors. As a result, this alternative would eliminate the Executive's estimated $1.2 million in FY12 savings.

C. Additional Information Requested by Councilmembers

At the GO Committee's April 25th session, Committee members asked staff to provide additional information relating to employee benefits. This section responds to Committee members' information requests.

1. Retirement

a. Defined Benefit Plan Provisions

The GO Committee requested that OLO provide details on current and potential alternative plan provisions for County Government defined benefit plans. The table on the next page summarizes pension plan provisions for the groups in the Employees' Retirement System. The table on pages 5-7 compares current plan provisions to the changes proposed by the County Executive (2% increased employee contribution) and by OLO's alternatives (GO Committee #3, 4/25/11, pages 13-15).

Summary of the County Government Employees' Retirement System (ERS) Provisions for Employees Hired after June 30, 1978 (Mandatory Integrated Plan)

Employee Group	Employee Contribution (% of salary)	Vesting	Average Final Salary	Full Retirement	Early Retirement	Multiplier	COLAs
Mandatory Integrated (employees hired after June 30, 1978)							
Non-public safety hired pre-10/1/94	4% up to SSWB 6% over SSWB	5 years	Highest 36 consecutive months	30 years svc./55 y.o. 5 years svc./60 y.o.	50 y.o./15 years svc. 45 y.o./20 years svc.	Pre-SSRA: 2.0 At SSRA: 1.25	100% of the Consumer Price Index (CPI) up to 3%; plus 60% of CPI over 3% with a maximum annual increase of 7.5%; no cap over age 65 or for disabled retirees
Deputy Sheriff Corrections	4.75% up to SSWB 8.5% over SSWB	5 years	Highest 36 consecutive months	25 years svc./46 y.o. 15 years svc./55 y.o.	45 y.o./15 years svc. 41 y.o./20 years svc.	Pre-SSRA: 2.4 for yrs. 1-25 (2.0 for yrs. 26-31) At SSRA: 1.65	100% of the Consumer Price Index (CPI) up to 3%; plus 60% of CPI over 3% with a maximum annual increase of 7.5%; no cap over age 65 or for disabled retirees
Police	4.75% up to SSWB 8.5% over SSWB	5 years	Highest 36 consecutive months	25 years svc./any age 15 years svc./55 y.o.	45 y.o./15 years svc. 41 y.o./20 years svc.	Pre-SSRA: 2.4 At SSRA: 1.65	100% of the Consumer Price Index (CPI) up to 3%; plus 60% of CPI over 3% with a maximum annual increase of 7.5%; no cap over age 65 or for disabled retirees
Fire and Rescue	5.5% up to SSWB 9.25% over SSWB[1]	5 years	Highest 36 consecutive months	20 years svc./any age 15 years svc./55 y.o.	n/a	Pre-SSRA: 2.5 for yrs. 1-20 (2.0 for yrs. 21-31 yrs.) At SSRA: 1.71875 for yrs. 1-20 (1.375 for yrs. 21-31)	100% of the Consumer Price Index (CPI) up to 3%; plus 60% of CPI over 3% with a maximum annual increase of 7.5%; no cap over age 65 or for disabled retirees

[1] At 25 years, 4.75% up to SSWB; 8.5% over SSWB

Summary of FY12 Pension Alternatives for Montgomery County's ERS Mandatory Integrated Plan
(for employees hired after June 30, 1978)

	Current	Alternative	Employees Affected: Current	Employees Affected: Hired after June 30, 2011
Non-public Safety Employees Hired pre-10/1/94				
Employee Contribution	4% up to Social Security Wage Base (SSWB) 6% over SSWB	6% up to SSWB 8% over SSWB	✓	✓
Vesting	5 years	10 years		✓
Average Final Salary	Highest 36 consecutive months	Highest 5 consecutive years		✓
Cost-of-Living Adjustment	100% of the Consumer Price Index (CPI) up to 3%; plus 60% of CPI over 3% with a maximum annual increase of 7.5%; no cap over age 65 or for disabled retirees	1. 100% of CPI up to a maximum annual increase of 2.5%; or 2. 100% of CPI: • Up to 2.5% if the County Government meets its annual investment return assumption (7.5%); or • Up to 1% if the investment return assumption not met.	✓	✓
Police; Deputy Sheriff; Corrections Employees				
Employee Contribution	4.75% up to SSWB 8.5% over SSWB	6.75% up to SSWB 10.5% over SSWB	✓	✓
Vesting	5 years	10 years		✓
Average Final Salary	Highest 36 consecutive months	Highest 5 consecutive years		✓
Cost-of-Living Adjustment	100% of the Consumer Price Index (CPI) up to 3%; plus 60% of CPI over 3% with a maximum annual increase of 7.5%; no cap over age 65 or for disabled retirees	1. 100% of CPI up to a maximum annual increase of 2.5%, or 2. 100% of CPI: • Up to 2.5% if the County Government meets its annual investment return assumption (7.5%); or • Up to 1% if the investment return assumption not met.	✓	✓
Multiplier	**Deputy Sheriff/Corrections** Pre-Social Security Retirement Age (SSRA): 2.4 for yrs. 1-25 (2.0 for yrs. 26-31) At SSRA: 1.65 **Police** Pre-SSRA: 2.4 up to 36 yrs. At SSRA: 1.65	Pre-SSRA: 2.2 At SSRA: 1.65		✓

Summary of FY12 Pension Alternatives for Montgomery County's ERS Mandatory Integrated Plan
(for employees hired after June 30, 1978) (cont.)

	Current	Alternative	Employees Affected	
			Current	Hired after June 30, 2011
Fire and Rescue Employees				
Employee Contribution	5.5% up to SSWB 9.25% over SSWB	7.5% up to SSWB 11.25% over SSWB	✓	✓
Vesting	5 years	10 years		✓
Average Final Salary	Highest 36 consecutive months	Highest 5 consecutive years		✓
Cost-of-Living Adjustment	100% of the Consumer Price Index (CPI) up to 3%; plus 60% of CPI over 3% with a maximum annual increase of 7.5%; no cap over age 65 or for disabled retirees	1. 100% of CPI up to a maximum annual increase of 2.5%, or 2. 100% of CPI: • Up to 2.5% if the County Government meets its annual investment return assumption (7.5%); or • Up to 1% if the investment return assumption not met.	✓	✓
Multiplier	Pre-SSRA: 2.5 for yrs. 1-20 (2.0 for yrs. 21-31) At SSRA: 1.71875 for yrs. 1-20 (1.375 for yrs. 21-31)	Pre-SSRA: 2.2 At SSRA: 1.65		✓
Minimum Service for Full Retirement	20 years	25 years		✓

Source: Montgomery County Code

b. Savings from Changes to MCPS' Locally-Funded Pension System

The GO Committee requested information on the savings that would result from implementing changes to MCPS' locally-run and locally-funded pension system that correspond to pension plan changes recently adopted by the General Assembly for the Teachers' Retirement System. The Council's actuarial advisor, Thomas Lowman of Bolton Partners, estimates that MCPS could expect savings of approximately $9 million in FY12 from such changes – specifically, from implementing a parallel increase in employee contributions and parallel changes to the COLA provision.

Note that all MCPS employees receive a locally-funded pension supplement in addition to their core pension and contribute an additional amount for the supplement (regardless of whether an employee receives his/her core pension from the State plan or MCPS' locally-funded plan). If the Board of Education also increased employee contributions for the local pension supplement (corresponding to the State-required increase in employee pension contributions), Mr. Lowman estimates an additional savings of approximately $2.7 million in FY12.

All MCPS employees currently contribute 5% of salary for their core pensions. Employees in the State pension plan make their contributions to the State pension system and employees in MCPS' locally-funded pension plan contribute directly to the local plan. Based on the State's recent pension plan changes, MCPS employees in the State plan will contribute 7% of salary for their core pension beginning July 1, 2011.

In addition, all MCPS employees currently contribute an additional 0.5% of salary to MCPS' locally-funded plan to fund the local pension supplement (for a current total employee contribution of 5.5% of salary). Mr. Lowman's estimated $2.7 million in savings related to the pension supplement assumes a parallel increased employee contribution for this component, increasing from 0.5% of salary to 0.7%.

The table below summarizes Mr. Lowman's estimates of FY12 savings if the Board of Education applied the changes to the State pension system to MCPS' locally-funded core pension (#1), and the additional savings if the Board of Education were to make corresponding increases in the required employee contributions to MCPS' locally-funded pension supplement (#2).

Estimated FY12 Savings from Changes to MCPS' Locally-Funded Pension Plan

	MCPS Pension Component	State Pension Changes Applied to Local MCPS Plans beginning in FY12	FY12 Estimated Savings
1	Core	Increase employee contribution from 5% of salary to 7%; change COLA provision	$9.0 million
2	Supplement	Increase employee contribution from 0.5% of salary to 0.7%	$2.7 million

Source: Thomas Lowman, Bolton Partners, Inc.

c. Effect of State Pension Changes on Montgomery College

The GO Committee asked for information on how the recently adopted changes to the State-run pension plans apply to Montgomery College. Currently, Montgomery College pays annually for 285 employees to participate in State-run pension plans. The State pension system sets the rates paid by participating governmental units, like the College, for their employees to participate in State retirement plans. According to Montgomery College staff, the State pension system has not recalculated the FY12 contribution rates for participating governmental units to reflect savings from the General Assembly's changes to State pension plans. Accordingly, Montgomery College does not anticipate any savings in FY12 based on the State pension changes.

d. Level of Retirement Benefit

Four documents are attached for reference in response to the Committee's discussion on the "adequacy of a retirement benefit." The first document, *A Role for Defined Contribution Plans in the Public Sector*, is an Issue Brief from the Center for State & Local Government Excellence (see © 1 - 13). This April 2011 Issue Brief describes the costs of and risks to both employers and employees associated with defined contribution, hybrid, and defined benefit retirement plans. The Issue Brief also considers the plans' adequacy in the public sector.

The Issue Brief acknowledges the relatively higher costs associated with defined benefit pension plans and asks "how much risk should taxpayers bear for public employee retirement plans?" Taking into consideration a balance between employer and employee risk and the adequacy of retirement benefits, the author encourages public employers to examine "stacked" hybrid plans as an alternative to a purely defined contribution retirement plan.

The second document is a copy of OLO's March 17, 2011 memorandum, *Additional Information about Current Retirement Benefits* (see © 14 - 26). This OLO memo analyzes the primary factors that impact the level of employee retirement benefits in the County Government and Montgomery County Public Schools and includes retirement benefit calculations for four example employees.

For the example of the four retired employees with similar salaries and years of service, OLO found that the present value of a pension plan is worth more than twice as much as the value of a defined contribution plan. OLO also found that among the County Government and MCPS pension plans compared in the examples, a plan's value at retirement varies based on whether: a plan is integrated with Social Security; the plan's pension multiplier for years of service; and an employee's years of service.

The last two documents highlight the decades-old concept of the "three-legged stool," the idea that retirement income is based on three legs: an employer pension, Social Security, and private savings (see © 27 - 29). Recent writings on this topic emphasize that the applicability of the concept has diminished over the decades for many workers as more and more employers move away from providing defined benefit pension plans – one of the three foundations of the stool.

For County Government (and for other employers that provide traditional pensions), however, the concept is still relevant for the half of the workforce that still participate in defined benefit plans. Under the traditional "three-legged stool" concept, pension income is meant to provide workers with one source of retirement income. The pension is not meant to be a retiree's sole (or even majority) source of retirement income. Social Security provides a second source and workers themselves are expected to provide the third source through personal savings.

2. Health and Prescription Drug Benefits

a. Cost Comparison – Health and Prescription Drug Alternatives

The GO Committee asked for a comparison of the projected cost increase to County Government employees for medical, prescription, dental, and vision coverage in 2012 under the Executive's proposed changes and under the alternatives outlined in OLO's packet from the GO Committee's meeting on April 25. (See GO Committee #3, 4/25/11, pages 20-29.)

In comparing the cost impact of each proposal, it is important to keep in mind that the cost of health benefits, both for the County and its employees, is projected to increase by 9-10% annually even with no changes to plan design. Before taking into consideration any changes to the cost share structure, County Government employees, who in 2011 pay between $1,237 and $7,290 towards the cost of their health benefits, will see premium cost increases in 2012 ranging from around $111 to $656.

The table below shows the range of increase in employee health benefit costs (using projected calendar year 2012 premium rates) if employees stay in their current choice of medical, prescription, dental, and vision coverage under the Executive's proposal and each of the three alternatives presented by OLO to the GO Committee on April 25.

COMPARISON OF EMPLOYEE COST INCREASES UNDER HEALTH BENEFIT PRICING OPTIONS *

Employee Salary Level	Range of Cost Increase to MCG Employees in 2012 From...			
	CE's Proposal (updated with projected 2012 rates[2])	Alternative #1 – 5 point (max.) cost shift	Alternative #2 – 10 point (max.) cost shift	Alternative #3 – Fixed employer contribution
Under $50,000	$400 to $2,359	$24 to $1,180	$90 to $2,359	$24 to $3,109
$50,000-$89,999	$1,310 to $3,269			
$90,000+	$1,960 to $3,919			

* The range of cost increases under each proposal would be in addition to the 9-10% inflationary increase in health care costs projected by County actuaries.

The current range for the actual percent of annual health insurance premiums paid by County Government employees' is 20% to 32%. The table below shows the actual cost share ranges (based on projected 2012 rates) under the Executive's proposal and the alternative options.

COMPARISON OF EMPLOYEE COST SHARE UNDER HEALTH BENEFIT PRICING OPTIONS (Based on Projected 2012 Rates)

CE's Proposal	Alternative #1 – 5 point (max.)	Alternative #2 – 10 point (max.)	Alternative #3 – Fixed employer contribution
30% to 56%	20% to 32%	25% to 37%	20% to 40%

[2] The range of cost increase under the Executive's proposal differ from those shown in the April 25th GO Committee packet because OLO updated the data using projected calendar year 2012 premium rates. This allows for a more accurate comparison with Alternative's #1-#3 that also use projected 2012 premium rates.

b. Taft-Hartley Plans

At the April 25 worksession, the GO Committee discussed "Taft-Hartley" health insurance plans. A Taft-Hartley Plan is a multi-employer health plan for the private sector. According to AFSCME, Taft-Hartley plans have five basic characteristics:

- One or more employers contribute to the plan;
- The plan is collectively bargained with each participating employer;
- Assets are placed in a trust fund;
- The plan and its assets are managed by a joint board of trustees made up of labor and management representatives;
- Mobile employees can change employers without losing health or pension coverage if the new job is with an employer who participates in the same Taft-Hartley fund.[3]

c. Generic Drug Waiver Provision

The GO Committee asked for information about how MCPS implements the waiver provision in its generic vs. brand name drug coverage policy.

The MCPS Caremark prescription drug plan requires that a doctor provide a letter of medical necessity for coverage of a brand drug when a generic equivalent is available. According to MCPS' *2011 Employee Benefit Plan Summary*, the letter must be written on the doctor's official letterhead and provide details on the medical reason for prescribing a brand name drug over its generic equivalent. Simply stating that in his/her medical opinion brand name drugs are better than generic drugs is not sufficient medical documentation. The prescription and the letter of medical necessity must be sent to Caremark's Department of Appeals, which will determine whether to approve coverage of the brand drug. Caremark requires yearly updates of medical necessity.

MCPS has had this provision for the past eight years. MCPS staff report that this provision has increased the use of generic drugs compared to the plan's previous practice (which was similar to the County's current practice of covering the brand name drug when a physician checked "dispense as written" on the prescription). MCPS staff also report that following initial employee concerns about the change, they have not received many complaints from employees about the current practice.

Over 40,000 employees and dependents are enrolled in MCPS' Caremark plan. In 2010, Caremark received 107 requests for exception to MCPS' mandatory generic provision. Of these, 98 were approved (92%).

3. County Government Average Salary Data

At the April 25 GO Committee meeting, Committee members asked for information on average salaries of County Government employees. The Office of Human Resources' Personnel Management Review (PMR) provides average annual salary data (excluding overtime, shift or holiday pay) for full-time employees overall by grade level. PMR data on 2010 average County Government salaries by grade level appears on © 30 - 31.

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[3] AFSCME website, http://afscme.org/publications/9727.cfm, "All for One and One for All: Taft-Hartley Health Insurance Plans," 2000, accessed 5/2/2011.

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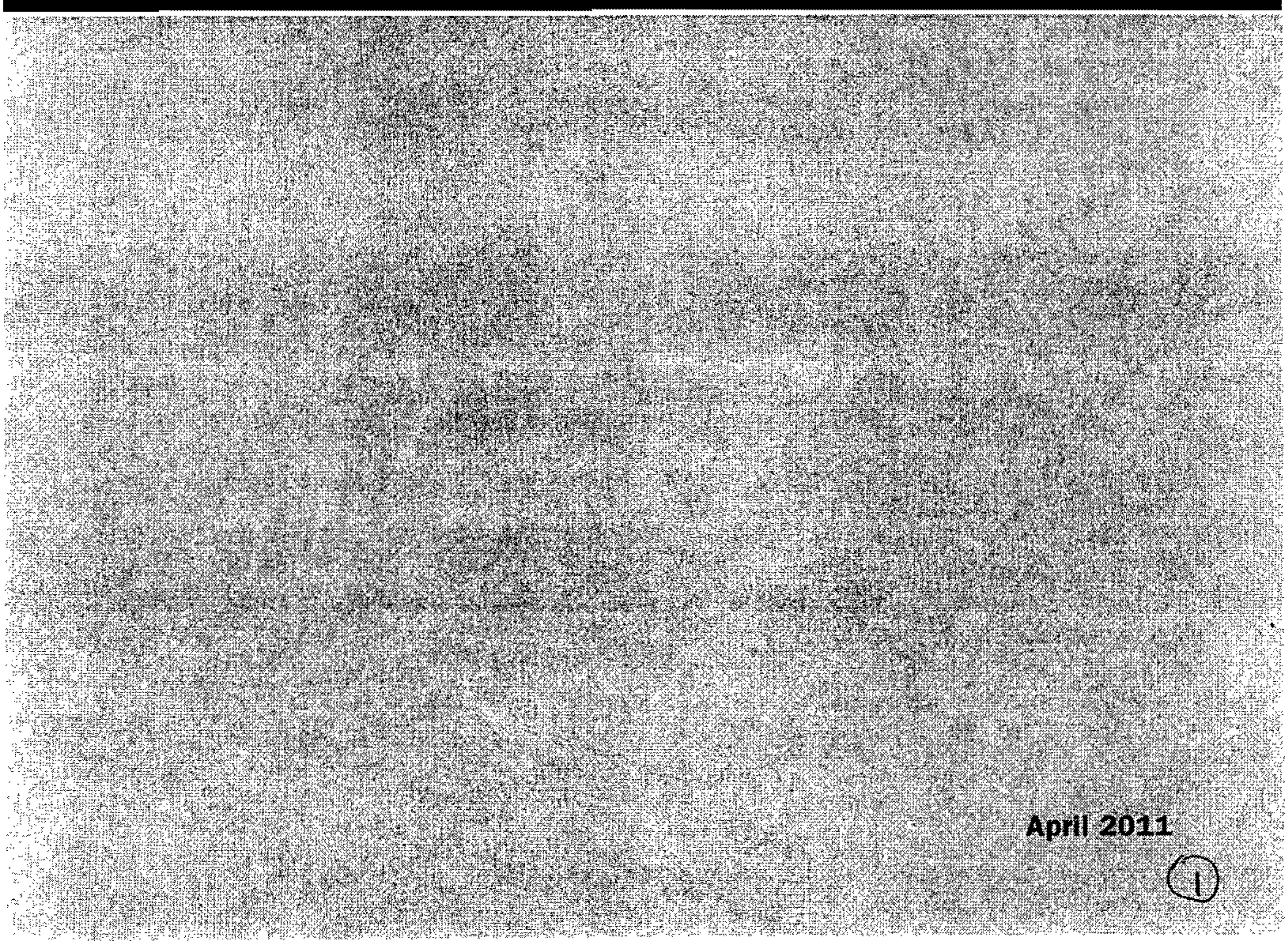
ISSUE BRIEF

A Role for Defined Contribution Plans in the Public Sector



April 2011

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What are the facts about defined contribution plans in the public sector? As you'll read in this issue brief, three new plans studied in Georgia, Michigan, and Utah combine elements of both defined benefit and defined contribution plans.

We know that state and local employees place a high value on retirement security and that a good benefit package is an asset to government recruiters, as salaries in the public sector tend to be lower than for comparable jobs in the private sector.

Unlike private sector employees, public employees typically contribute to their defined benefit plan. The authors remind readers that "in states where employees are covered by Social Security, the median contribution rate is 5 percent of earnings. In states without Social Security the median employee contribution rate is 9 percent." Many also participate in supplemental retirement savings plans when given the opportunity to do so.

The authors point out that "risk, cost, and human resource considerations are the real issues" to consider when making decisions about retirement plans. They suggest a novel alternative to the current hybrid plan designs: a "stacked" plan that would provide a defined benefit plan as the base, bnt would cap the benefit level at a fixed dollar amount. A defined contribution plan would be layered on top of the defined benefit plan for additional retirement savings, including for more highly compensated employees.

At the end of the day, policy leaders should focus on their human resources goals as they contemplate changes in the benefit plans that they offer.

The Center for State and Local Government Excellence gratefully acknowledges financial support from the ICMA Retirement Corporation to undertake this research project.

Elizabeth K Kellar

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A Role for Defined Contribution Plans in the Public Sector

By Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz, and Laura Quinby*

Introduction

In the wake of the financial crisis, policymakers have been talking about shifting from defined benefit plans to defined contribution plans in the public sector. Three states–Georgia, Michigan, and Utah–have taken action, joining the 10 states that had introduced some form of defined contribution plans before 2008. Interestingly, these new plans are "hybrids" that combine elements of both defined benefit plans and defined contribution plans. Such an approach spreads the risks associated with the provision of retirement income between the employer and the employee. This *brief* provides an update on defined contribution initiatives in the public sector and then discusses whether the hybrids that have been introduced are the best way to combine the two plan types.

The *brief* proceeds as follows. The first section discusses the issues involved with moving from a defined benefit plan to a defined contribution arrangement. The second section recaps the role that defined contribution plans played in the public sector before the financial crisis. The third section describes the new hybrid plans recently adopted in Georgia, Michigan, and Utah. And the fourth section suggests that a better type of hybrid might be one where defined contribution plans are "stacked" on the state's defined benefit plan rather than placed alongside of it. The fifth section concludes that defined contribution plans have a role in the public sector, but that role is supplementing, not replacing, defined benefit plans.

* Alicia H. Munnell is director of the Center for Retirement Research at Boston College (CRR) and the Peter F. Drucker Professor of Management Sciences at Boston College's Carroll School of Management. Jean-Pierre Aubry, Josh Hurwitz, and Laura Quinby are research associates at the CRR. The authors would like to thank Beth Almeida, David Blitzstein, Ian Lanoff, David Powell, and Nathan Scovronick for helpful comments.

Defined Benefit vs. Defined Contribution

A defined benefit plan provides employees with lifetime retirement income based on a formula that accounts for service and final average salary. Most defined benefit plans in the public sector adjust benefits, at least partially, for inflation after retirement. Both employees and employers generally contribute to public sector plans. Defined benefit plan assets are held in trust and managed by professional investors.

In contrast, defined contribution plans are like savings accounts. The employee and employer both contribute money to the account, and the employee selects the investments from a list of options provided by the plan. The benefit at retirement depends on the value in the account and how employees elect to take receipt of the money–lump sum, periodic payments, or an annuity.

Evaluating whether to shift from a defined benefit to a defined contribution plan involves consideration of risks, costs, and human resource goals.

Risks

The defining characteristic of defined contribution plans is that they shift all the responsibilities and all the risk from the employer to the employee. In terms of responsibilities, the employee must decide whether to join the plan, how much to contribute, how to allocate those contributions among different investment options, how to change those allocations over time, and how to withdraw the accumulated funds at retirement. Under a defined benefit plan, the sponsor retains these responsibilities. The plan requires participation, sets contribntion rates, invests the assets, and pays an annuity at retirement.

Leaving the responsibilities in the hands of employees means that they are exposed to the risks of saving too little, losing funds when financial markets fluctuate, seeing the value of their retirement income eroded by inflation, and outliving their resources since payment is generally not in the form of an annuity.

In a defined benefit plan, the sponsor bears the investment risk during the accumulation phase and then absorbs longevity risk and much of inflation risk after retirement. This arrangement means that if financial markets collapse, the sponsor–in the public sector, taxpayers–must come up with additional funds to cover promised benefits.[1] Public plan sponsors also face the "moral hazard" that benefit promises will not be funded. Participants, who believe that they will be paid regardless of funding, may not push for government contributions. And politicians are all too happy to address short-term priorities rather than put money aside for long-term funding needs. Similarly, legislatures sometimes make unfunded benefit improvements in good times that further aggravate the funding shortfall. As a result, future taxpayers and employees will be required to contribute not only to cover the accruing cost of benefits for current workers but also to cover benefits for retirees for whom insufficient funds have been put aside. A defined contribution plan avoids this type of "moral hazard," as the plans are fully funded by design.

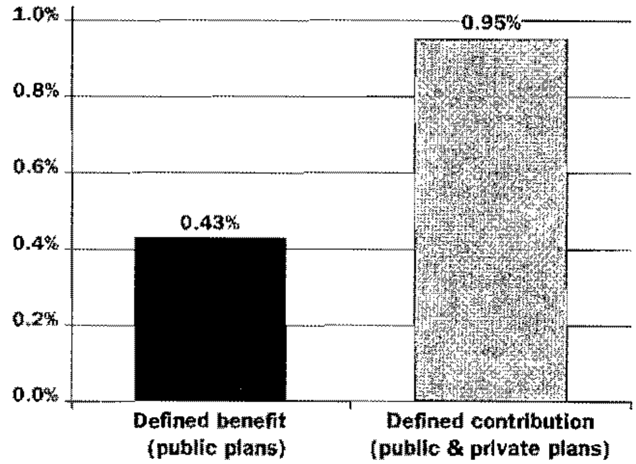
Costs

For any given level of benefits, defined contribution plans, which maintain individual accounts and typically update these accounts daily, have higher administrative expenses than defined benefit plans. In addition, most defined contribution plans use mutual funds or similar instruments as investment options–with an average expense ratio payable to the fund manager of about 0.60 percent for bond funds and about 0.67 percent for stock funds.[2] In contrast, defined benefit plans involve professionally-managed large investment pools with no individual account reporting. As a result, the annual cost of a defined contribution plan generally exceeds that of a defined benefit plan (see Figure 1).

Human Resource Issues

Defined benefit plans are designed to attract and retain qualified employees. As such, these plans become more valuable the closer the employee gets to the full retirement age, because accrual rates often increase with age, and the salary base is usually an average of the last three to five years of earnings. Vested employees who leave early forfeit significant retirement income because their accumulated credits are applied to their salary at termination rather than their salary at retirement.[3]

Figure 1. *Administrative and Investment Expenses as a Percent of Assets, by Plan Type, 2009*



Sources: U.S. Census Bureau (2008); and HR Investment Consultants (2009).

With a few exceptions, defined contribution plans were not initially created as retirement vehicles but rather as supplementary savings accounts.[4] Since the value of these plans increases more evenly over an employee's worklife, they provide no incentive to stay on the job. Similarly, they do not penalize employees who leave early. Mobile employees can take the funds in their account with them when they leave employment and roll them over into a new defined contribution plan or individual account.

Other Arguments and Counterarguments

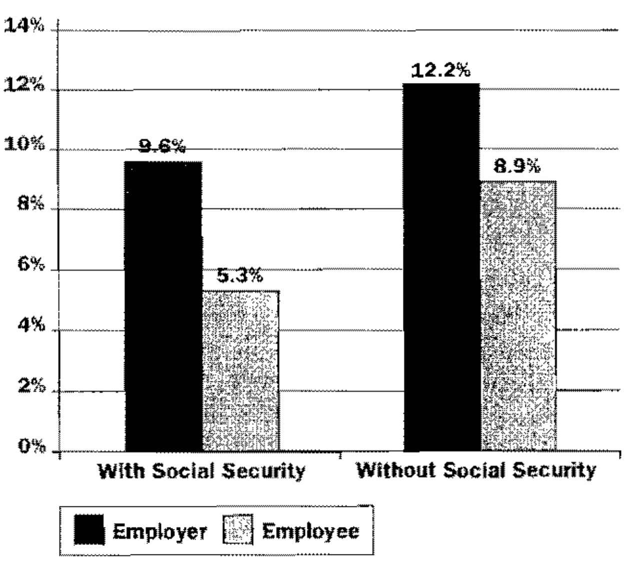
Risk, cost, and human resource considerations are the real issues relevant to deciding whether to shift from a defined benefit to a defined contribution plan. But other assertions also arise in the debate. Some supporters highlight the magnitude of the unfunded liabilities in public sector defined benefit plans as justification for switching to a defined contribution plan. The reality is that even with a new defined contribution plan, states and localities are still left to deal with past underfunding. A new plan only addresses pension costs going forward; it does not help close the current gap between pension assets and liabilities.[5]

Similarly, some contend that switching to a defined contribution plan would save money in the future.[6] But, as noted above, for any given level of benefits, defined contribution plans cost more.

Advocates may think that even if total costs increased, taxpayers could gain by shifting contributions from the government to the employee. Transferring the burden to the employee provided a major economic incentive in the private sector to move from defined benefit plans (where employees make no contributions) to 401(k) plans (where employees make the bulk of the contributions). But, in the public sector, many employees already make substantial contributions to their defined benefit pensions. In states where employees are covered by Social Security, the median contribution rate is 5 percent of earnings. In states without Social Security, the median employee contribution rate is 9 percent (see Figure 2). Therefore, state and local governments might meet significant resistance from public employees if they attempted to shift more of the cost to participants. Of course, moving to a defined contribution plan could be used as a mechanism to cut retirement benefits and thereby lower total employee compensation.

The main issue appears to be one of risk. From the perspective of sponsoring governments, shifting to a defined contribution plan would eliminate investment, inflation, and longevity risk from these entities and, thereby, taxpayers. These plans would be funded by definition and, when things go wrong in financial markets, the taxpayer would not be responsible for covering the shortfall. The other side of alleviating risks for taxpayers is that public employees must face the risk of saving too little, the risk of poor investment returns, the risk that inflation will erode the value of their income, and the risk that they might outlive their assets.[7]

Figure 2. *State and Local Employer and Employee Median Contribution Rates, 2009*



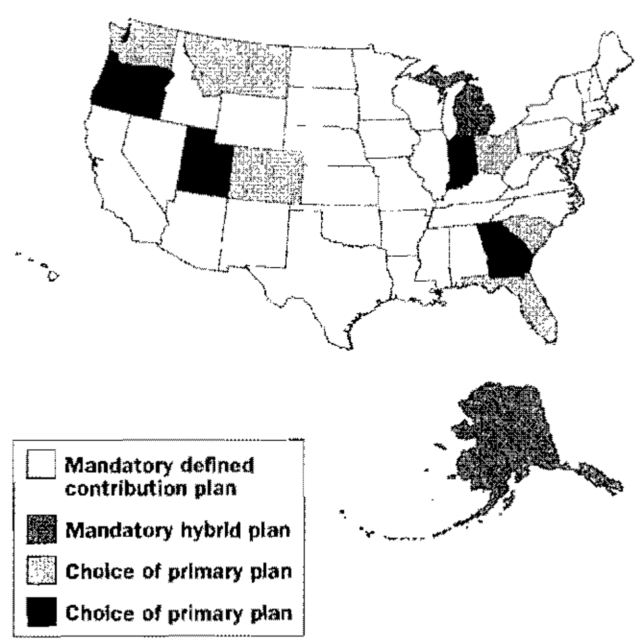
Source: Public Plans Database (2009).

Pre-2008 Defined Contribution Activity

The fact that defined contribution plans put employees at such risk may help explain why before the financial crisis only a smattering of states had introduced these plans on a mandatory basis.[8] Importantly, only two states–Michigan and Alaska–required all new hires to participate solely in a defined contribution plan (see Figure 3).[9] The mandate applied only to new hires, because most states are constrained by their constitution or case law from reducing benefits for current employees. Two states–Oregon and Indiana–adopted "hybrid" plans, where employees are required to participate in both a defined benefit and a defined contribution plan. Another six states retained their defined benefit plan and simply offered the defined contribution plan as an option to their employees.[10]

The time line of the introduction of these defined contribution plans is interesting (see Figure 4). Some of the changes may have been a response to economics or politics, but much of the activity occurred in the wake of the fantastic performance of the stock market during the 1990s.[12]

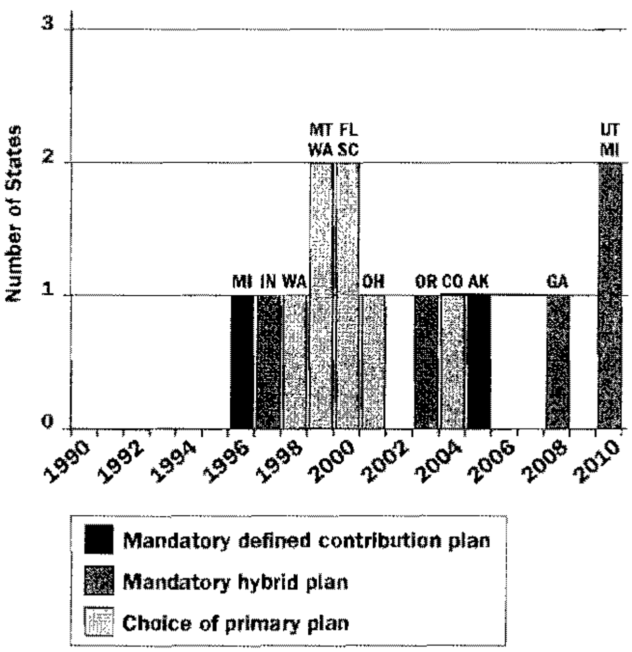
Figure 3. *Defined Contribution Plans, by State, 2011*



Note: For specific definitions of the classifications used in this figure, see footnote 11.

Sources: Various retirement systems' annual reports and websites of state legislatures.

Figure 4. *Introduction of State Defined Contribution Plans, by Year*



Note: For specific definitions of the classifications used in this figure, see footnote 11.

Sources: Various retirement systems' annual reports and websites of state legislatures

Since the plans are relatively new, the compulsory plans apply only to new hires, and the others are optional, the number of participants and amount of assets in defined contribution plans are modest (see Appendix).[13] To date, participants account for less than 5 percent of all state and local workers, and assets amount to less than 1 percent of total state and local pension assets.[14] ("Fact Sheets" on each of the mandatory defined contribution plans discussed in this *brief* are available at http://slge.org.)

Post-Crisis Developments

In the wake of the financial crisis, three states (Michigan, Georgia, and Utah) have introduced mandatory "hybrid" plans for new employees. Interestingly, none of the three has followed the Alaska-Michigan (SERS) model of relying solely on a defined contribution plan. Rather, each has adopted a plan where new employees accumulate retirement income under both a defined benefit and a defined contribution plan. An additional nine states are discussing defined contribution options.[15]

Today's hybrid plan model could be redesigned to work better.

Georgia

General state employees covered under Georgia's Employee Retirement System (ERS) hired after January 1, 2009, are covered under the new hybrid plan; existing ERS members had the option to join the new plan. New hires are automatically enrolled in the 401(k) plan (unless they affirmatively elect not to participate) and contribute 1 percent of salary with additional contributions up to 5 percent eligible for an employer match.[16] The match is 100 percent of the automatic contribution and 50 percent of optional contributions, for a maximum match of 3 percent of salary. Employees can contribute up to the Internal Revenue Service (IRS) limit, but will receive no further employer match.

The defined benefit plan will pay 1 percent for each year of service on the annual average of the highest 24 months of earnings.[17] Members contribute 1.25 percent of salary to the defined benefit plan, and the state contributes an actuarially-determined rate, which was 6.54 percent of payroll in 2009.

System communiqués indicate that the change was driven primarily by the preference of young workers, who constitute 62 percent of the state's workforce, for wages over benefits. In response, the State raised wages and introduced the smaller hybrid plan, with a 401(k) component so that young mobile workers would have something to take with them when they left state employment.

Michigan

As discussed above, since 1997 all new Michigan general state employees have been enrolled in a 401(k) plan. But when the time came to revamp the system for public school employees, the State decided to adopt a hybrid. Employees hired after July 1, 2010, automatically contribute 2 percent of salary to the 401(k) (unless they affirmatively elect not to participate), with optional contributions up to the IRS limit. The sponsor matches 50 percent of the employee's first 2 percent of contributions.[18]

The defined benefit plan for new hires will pay 1.5 percent for each year of service on the annual average of the highest 60 months of earnings. Employees will contribute 6.4 percent of salary to the plan. Whereas the accrual rate is the same as it was under the two existing defined benefit plans for school employees, the age and service requirements for this plan have been increased and the cost-of-living adjustment eliminated.

Press reports suggest that future employer costs (including required contributions for retiree health insurance) were a major motivation for the new plan.[19] Essentially, the new plan reduces the benefits compared to the existing defined benefit plan, and the defined contribution plan involves an extremely modest contribution from the employer.

Utah

State and local government employees hired after July 1, 2011, will have the option to participate in either a defined contribution plan or in a hybrid. In the case of the defined contribution plan, the employer will automatically contribute 10 percent for most public employees and 12 percent for public safety and firefighter members.[20] Employees can contribute up to the IRS limit. Employee contributions vest immediately, and employer contributions vest after four years. Members can direct the investment of their contributions immediately, and those of the employer after four years.

Under the hybrid plan, the employer will pay up to 10 percent of an employee's compensation toward the defined benefit component; employees will contribute any additional amount to make the required contribution. The defined benefit plan for new employees is less generous than the former plan: the accrual rate is reduced from 2.0 percent per year to 1.5 percent; the period for calculating final average salary was increased from high three years to high five; and the employee contribution increased from zero to the cost above 10 percent. For the defined contribution component of the hybrid plan, employers will contribute 10 percentage points minus the amount contributed to the defined benefit plan. For example, if they contribute 10 percent to the defined benefit plan, they will contribute nothing to the defined contribution plan.

Table 1 summarizes the provisions of the new hybrid plans. The pattern is quite similar in several respects. First, the combined cost of the new plan is significantly less than the pre-existing defined benefit plan. Second, the commitment to the defined contribution plan is minimal. Experience with 401(k)s in the private sector suggests that participants tend to stay where they are put.[21] So if automatic contributions are set at 1 percent or 2 percent of earnings, participants are likely to keep their contributions at that level. Low saving in the defined contribution component means that employees will be forced to rely primarily on the now-reduced defined benefit plan in retirement.

Table 1. *Provisions of New Hybrid Plans*

Provision	Georgia	Michigan	Utah
	Defined benefit plan		
Accrual rate	1.0%	1.5%	1.5%
COLA	Ad-hoc	None	CPI up to 2.5%
Contributions: Employer	6.54% (2009)	TBD	10% cap
Contributions: Employee	1.25%	6.4%	DB cost > 10%
	Defined contribution plan		
Automatic contribution	1%	2%	10% – DB cost
Employer match	100% on first 1%, 50% on next 4%	50% on first 2%	None

Note: Michigan Public Schools' 2010 Actuarial Valuation Report has not yet been released.

Sources: Various retirement systems' annual reports, legislation, and websites of state legislatures.

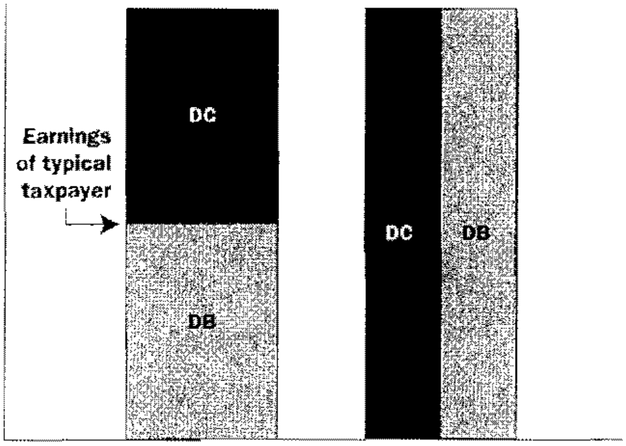
A Better Mousetrap?

The emergence of hybrid plans reflects an attempt to balance employee and taxpayer risk. But, to date, states are achieving this goal by reducing the government's contribution across the board rather than considering how best to use each plan type.

Defined benefit plans provide the most secure income for long-service employees. While some public sector employees leave in the first 10 years, many tend to remain for a full career.[22] Therefore, defined benefit plans are an effective mechanism for public sector employers to attract and retain employees. Defined benefit plans, however, put the taxpayer at risk if financial markets drop, inflation takes off, or retirees live longer than expected.

A fair question is how much risk should taxpayers bear? Utah answered that question by capping employer contributions at 10 percent of payroll. Such a cap, however, places lower paid and higher paid participants at equal risk of having to increase contributions. A better approach to limiting taxpayer risk is to cap the income covered by the defined benefit plan. Such a cap would prevent the situation where the typical taxpayer, earning $50,000, is forced to pay higher taxes when the stock market plummets to cover benefits for highly-paid public employees, such as university presidents. Therefore, the proposal would be to limit coverage

Figure 5. *"Stacked" Hybrid Plan versus "Parallel" Hybrid Plan*



Source: Authors' illustration.

under the defined benefit plan to earnings below, say, $50,000 (indexed for inflation).[23] Many public sector workers would still be covered in full nnder the defined benefit plan.

Earnings above $50,000 would be covered by a defined contribution plan. Thus, someone earning $100,000 would receive benefits based on the first $50,000 from the defined benefit plan and benefits on the second $50,000 from the defined contribntion plan. That is, instead of "parallel" plans where employees contribute to both a 401(k) and a defined benefit plan from the first dollar of earnings, "stacked" plans wonld maintain the defined benefit plan as a base and provide defined contribution coverage for earnings above some cutoff (see Figure 5). The stacked approach is a suggestion for a "better plan design" and could be wed with any desired size of the plan.

The advantage of the "stacked" approach is that it allows employees with modest earnings to receive the full protection of a defined benefit plan. This group would be the most vulnerable if required to rely on a 401(k) for a portion of their core retirement benefit. Indeed, the private sector experience with 401(k)s illustrates the concern. The typical private sector taxpayer approaching retirement (ages 55-64) had accumulated only $78,000 in 401(k) assets before the financial crisis.[24] So maintaining a full defined benefit plan for public employees such as elementary school teachers would be preferable. More highly-paid public employees would still have the protection of a defined benefit plan as a base and would then rely on the 401(k) for earnings replacement that exceeded the earnings of a typical private sector worker.[25] This overall arrangement offers a reasonable balance by providing adequate and secure benefits targeted to public employees who need them most while limiting the risk to taxpayers of covering large pension shortfalls.

One question is whether such a stacked approach would violate IRS non-discrimination rules. The legal answer is that tax-qualified governmental plans are generally not subject to non-discrimination provisions.[26] On a substantive level, the government contribution for the defined contribution plan could be less than for the defined benefit plan, so that the two plans taken as a whole do not favor higher-paid workers.

Conclusion

Defined contribution plans may well have a role in the public sector, but in combination with, not as an alternative to, defined benefit plans. The hybrids introduced in Georgia, Michigan, and Utah reflect sponsors' recognition of the need to balance the risks to employees and the risks to taxpayers. These hybrids consist of slimmed-down defined benefit plans and defined contribution plans operating in "parallel." A preferable approach may be a "stacked" arrangement. Meaningful defined benefit plans could remain as a secure base for the typical public employee, and defined contribution plans could be "stacked" on top to provide additional retirement income for those at the higher end of the pay scale. Such an approach would ensure a more equitable sharing of risks and would also prevent headlines generated by the occasional inflated public pension benefit.

Endnotes

1. Although, in theory, taxpayers bear the risk, in the wake of the recent financial collapse employers and employees have shared the burden. From 2008 to 2011, 20 states increased pension contributions for either new or existing employees, while five states reduced benefits for current employees and an additional three eliminated or reduced the cost-of-living adjustment for current retirees. In several instances–Colorado, Minnesota, and South Dakota are widely-publicized examples–the state's actions have been taken to court. See National Conference of State Legislatures (2008-2011) for more details.
2. The estimates of investment management expenses are from Lipper (2008).
3. Under many state plans, vesting does not occur for 10 years, and employees who leave receive only their contributions and some minimal amount of credited interest.
4. TIAA-CREF is a notable exception.

5. In many cases, closing an existing defined benefit plan to new hires and switching to a defined contribution plan increases short-term costs. The Governmental Accounting Standards Board (GASB) Statement Number 25 states that closed plans using the level percent of payroll method for calculating the annual required contribution (ARC) must acknowledge that covered payroll is decreasing. This recognition frontloads costs. As a result, most closed plans use the level dollar method of amortizing the unfunded liability. However, the ARC under the closed plan is still frontloaded relative to the ARC under the ongoing plan. Moreover, market gains from future new hire contributions that would have been used to offset the unfunded liability are now sequestered in the new defined contribution plan. See California Public Employees' Retirement System (2005); Michigan House Fiscal Agency (2009); Retirement Systems of Minnesota (2011), and The Segal Company (2010) for more information.
6. For a more detailed discussion of the cost efficiencies of defined benefit pension plans, see Almeida and Fornia (2008).
7. The defined contribution aspects described–individual investment direction, high expense compared to defined benefit plans, flexibility over payout, and lack of annuitization–reflect how most defined contribution plans are currently designed. A defined contribution plan could be designed to address many of the current downsides. For example, MyFRS in Florida is a low-fee defined contribution fund, while the Texas Municipal Retirement System is a cash balance plan that annuitizes the balances of individual member accounts.
8. Public sector workers often have optional 403(b) and/or 457 defined contribution plans that allow them to put aside a portion of their pay on a tax-deferred basis to augment their public pension. These supplementary plans are not the topic of this *brief*. Rather, the focus is on states where the nature of the *primary* plan has changed. For a discussion of early defined contribution activity, see Munnell et al. (2008).
9. In Nebraska, the primary Public Employee Retirement System was a defined contribution plan from 1967 to 2002. It was closed to new employees and replaced with a cash balance plan on January 1, 2003, over concerns that the defined contribution plan was producing lower returns than the defined benefit plans (see Nebraska Public Employees' Retirement Systems, 2002, for more details). A cash balance plan is a defined benefit plan that maintains notional individual accounts throughout the asset accrual phase. Similarly, the West Virginia Teachers plan, which became a primary defined contribution plan in 1991, switched back to a primary defined benefit plan in 2005. The Texas Municipal Retirement System maintains a cash balance plan. The District of Columbia requires its general government employees to join a primary defined contribution plan, but our analysis is limited to states.
10. These states were Colorado, Florida, Montana, Ohio, South Carolina, and Washington. Except in Washington and Ohio, the options are either a traditional defined benefit plan or a defined contribution plan. Washington offers a choice of a defined benefit plan or a hybrid plan. Ohio employees can choose from a defined benefit plan, a defined contribution plan, or a hybrid plan. In all cases, the defined benefit plan is the default for those who do not actively make a selection.
11. Mandatory defined benefit plans are primary plans that require employees to join. Mandatory defined contribution plans are primary plans that require employees to join. Mandatory hybrid plans require employees to join a plan with both a defined benefit and a defined contribution component. "Choice" plans typically allow employees to pick either a primary defined contribution plan or a primary defined benefit plan.
12. For example, from January 1, 1995, to December 31, 1999, the S&P 500 had an average annual return of nearly 30 percent. For a discussion of early defined contribution activity, see Munnell et al. (2008). This study looked at the effect of economic and political factors on the probability of introducing a defined contribution plan for public employees. It found that Republican leadership–with its emphasis on individual control over investments and plan portability–was the leading predictor of plan changes.
13. In the private sector, when a new plan is adopted, the existing defined benefit plan is generally frozen. Existing employees can retain the benefits earned but are not permitted to accrue any further service credits. In the public sector, when a new plan is adopted, existing employees generally have a legal right to continue to participate in the previous plan and only employees hired after the date the plan is adopted are required to participate in the new plan.
14. Authors' calculations from the U.S. Census Bureau (2008) and *Public Plans Database* (2009).
15. The issue is under discussion in Alabama, Connecticut, Nevada, North Carolina, Tennessee, and Wisconsin. Legislation to introduce a defined contribution plan for new hires recently passed the Kentucky Senate, but has not yet been acted on by the House of Representatives. Similar proposals are currently under consideration in Illinois and Oklahoma, while a defined contribution bill was defeated in North Dakota. See Frazier (2010); Fehr (2010), National Conference of State Legislatures (2011); Steyer (2010); and Preston and McNichol (2010).
16. In the public sector, the only 401(k)s are grandfathered plans that were established 5/6/86 or before, so Georgia had originally established a 401(k) plan before 1986 as an optional supplement to its primary defined benefit plan. See PlanMember Financial Corporation (2010).
17. The Board of Trustees can increase the benefit factor in the future up to 2 percent if funds are available.
18. Michigan House Fiscal Agency (2010).
19. Governor of Michigan (2010) and Michigan Association of School Boards (2010)
20. Liljenquist (2010).
21. Madrian and Shea (2001); Choi et al. (2004); and Gale, Iwry, and Orszag (2005).
22. Authors' estimates from the Actuarial Valuations of the 14 largest plans.
23. The Internal Revenue Code contains a maximum compensation limit for defined contribution plans. This limit is $245,000 in 2011. It is indexed for inflation and increased in $5,000 increments. A similar procedure could be used for stacked plans.
24. This figure, which comes from the Federal Reserve's 2007 *Survey of Consumer Finances*, also includes IRA assets as they typically come from 401(k)rollovers during a job switch.
25. A well-designed defined contribution plan would set the combined employee-employer contribution at a level to achieve, in combination with a defined benefit plan, a targeted replacement rate. It would also have the default payment at retirement be an annuity, with the ability of participants to opt out if such an arrangement did not meet their needs. One reviewer also suggested that the plan might guarantee the employee's contribution regardless of investment performance to encourage participation.
26. Most of the public sector defined contribution plans are 401(a) money purchase plans with mandatory employee contributions. As noted earlier, governments generally cannot have 401(k) plans, and since 457(b) plans are subject to contribution limits, sponsors may be reluctant to crowd out supplemental saving. See Powell (2011) for a more thorough discussion of the nondiscrimination tax rules for governmental plans.

9

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Appendix. Primary Defined Contribution Plans

Table A1. *Characteristics of Primary Defined Contribution Plans, 2009*

Plan name	Legislative date	Participants 2007	Participants 2009	Assets ($ in millions) 2007	Assets ($ in millions) 2009
Mandatory defined contribution plans					
Alaska PERS	2005	2,862	7,516	9	41
Alaska TRS	2005	646	1,997	6	27
Michigan SERS	1996	24,043	26,044	2,547	2,207
Mandatory hybrid plans					
Georgia–GSEPS	2008	0	2,105	0	311
Indiana PERF–ASA	1997	213,984	223,561	2,707	2,669
Indiana TRF–ASA	1997	122,107	164,590	4,605	3,901
Michigan–MPSERS	2010	0	11,617	0	0
Oregon PERS–IAP	2003	43,541	59,073	1,877	2,109
Utah–Tier II Contributory Hybrid	2010	0	0	0	0
Choice of primary plan					
Colorado PERA–PERAChoice	2004	489	3,039	3	37
Florida RS–PEORP	2000	98,070	121,522	3,687	4,075
Montana PERS–DCRP	1999	1,913	2,345	41	44
Ohio PERS–Combined Plan	2002	6,905	7,354	157	223
Ohio PERS–Member Directed Plan	2002	8,579	9,824	124	201
Ohio STRS–Member Directed and Combined Plans	2001	11,863	12,829	283	297
South Carolina–ORP	2000	26,873	31,968	502	561
Utah–Tier II Defined Contribution	2010	0	0	0	0
Washington PERS–3	1999	27,605	31,123	1,348	1,188
Washington SERS–3	1998	37,854	38,585	1,052	918
Washington TRS–3	1998	57,667	60,146	3,971	3,419
Total		**685,001**	**815,238**	**22,916**	**22,230**

Note: Michigan SERS 2009 assets reflect 2008 levels. MPSERS has not yet reported 2009 asset levels. Ohio STRS does not separate assets for the Member Directed and Combined Plans in its financial reports.

Source: Public Plans Database (2007 and 2009).

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M E M O R A N D U M

March 17, 2011

TO: Councilmembers

FROM: Aron Trombka, Senior Legislative Analyst AT
Leslie Rubin, Legislative Analyst
Office of Legislative Oversight

SUBJECT: Follow-up to OLO Report on Achieving a Structurally Balanced Budget: Additional Information about Current Retirement Benefits

This memorandum responds to Councilmember Elrich's request for additional information about retirement plan benefits currently provided to employees of the County Government and Montgomery County Public Schools (MCPS). It is organized as follows:

- Part A provides an overview of defined benefit, defined contribution, and hybrid retirement plans;
- Part B summarizes the current retirement plans for County Government and MCPS employees;
- Part C presents calculations of the income from retirement benefits for four hypothetical examples of employees who elect to retire on July 1, 2011; and
- Part D contains a series of questions and answers that explain the different retirement benefit amounts illustrated by the examples presented in Part C.

In sum, the primary factors that drive the amount of an employee's retirement benefits are the structure of the retirement plan the employee belongs to and the amount of time an employee has been enrolled in the plan.

A. Overview of Defined Benefit, Defined Contribution, and Hybrid Retirement Plans

Defined Benefit Plans. A defined benefit plan provides a retired employee with a sum of money paid regularly as a retirement benefit (i.e., a pension) from the time of retirement until death. A retiree's annual pension is determined by a formula that takes into account the employee's final earnings, years of service,[1] and a pension "multiplier."[2] In addition, defined benefit plans often include a provision to annually increase the dollar amount of the pension (post-retirement) with a cost-of-living adjustment (COLA).

[1] Defined benefit plans often allow members to count earned sick leave toward their years of service for retirement purposes.

[2] A pension multiplier is the percent of wages used to calculate an annual pension.

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To fund defined benefit plans, employers make annual contributions into a retirement trust fund[3] based on the projected funding needed to pay promised pensions to both current and future retirees. Plans often require employees to contribute a set percent of salary each year to help fund their future retirement benefits. The money in the retirement trust fund is managed by the employer (often at the direction of an independent board). A combination of employee contributions, employer contributions, and the trust fund's investment earnings pay for employees' pensions.

In defined benefit plans, employees are required to work a minimum number of years before they become eligible to receive a pension (called "vesting"). If an employee separates from the employer before vesting, the employer typically refunds the employee's contributions to the plan. If an employee vests but separates from the employer before qualifying for retirement, typically the employee can either receive a refund of his or her own contributions plus interest or receive a pension at a later date – when the employee would have been eligible for retirement from the employer.

Defined benefit plans place the financial risk for funding pensions on the employer. The employer remains responsible for paying participating employees an annual pension amount upon their retirement, regardless of the balance in the retirement trust fund.

Factors that Affect Pension Benefits. In most defined benefit plans, the following factors determine the amount of a retiree's annual pension:

- Final salary: An employee's final salary is one of the three main components in calculating a pension.
- Multiplier: The multiplier, which reflects a percent of wages used to calculate an annual pension, is the second of the three main pension formula components.
- Length of service: The length of an employee's service with an employer is the third of the three pension formula components.
- Social Security integration: Social security integration refers to whether a pension plan lowers the pension amount that a retiree collects when the retiree reaches Social Security retirement age (SSRA). In an integrated plan, the pension amount decreases when an employee reaches SSRA. In a non-integrated plan, the pension amount does not decrease.

The equation below shows one example of how an employee's final salary and years of service are combined with a multiplier to calculate the amount of an employee's pension.

Final Earnings	x	Multiplier	x	Years of Service	=	Annual Pension
$70,000	x	2%	x	30	=	$42,000

Defined Contribution Retirement Plans. In a defined contribution plan, an employee contributes a set percent of his or her salary to a retirement account. Often an employer also will make contributions to the employee's retirement account – either contributing a set percent of an employee's salary or matching a percent of an employee contribution. The employee guides investment of the funds in the retirement account and bears the entire risk of changes in investment returns. The employer's financial responsibility ends after making any required contribution to an employee's retirement account.

[3] The amount of the annual contribution required by the employer typically is determined by an actuary.

Unlike defined benefit plans, defined contribution plans are portable. This means that upon separation, employees can take retirement funds in a defined contribution plan with them and transfer the funds to a new retirement account. Upon retirement, the employee's benefit is the total of the employee and employer contributions and any investment income earned on the joint contributions.

Factors that Affect Defined Contribution Retirement Benefits. The following factors determine how much money an employee will accumulate in a defined contribution retirement account.

- <u>Annual salary</u>: Employer and employee contributions to defined contribution plans are often calculated as a percent of an employee's annual salary.
- <u>Employer/employee contribution rate</u>: Employer and employee contribution rates determine the amount of money (e.g., percent of salary) deposited annually into an employee's retirement account.
- <u>Length of service</u>: Length of service affects both the total amount contributed to an employee's retirement account and the length of time to earn investment income for the account.
- <u>Investment choices and market performance</u>: The size of a defined contribution account is a function of the market return of the investment choices selected by the employee.

Hybrid Plans. Hybrid plans have characteristics of both defined benefit and defined contribution plans. Some hybrid plans have a defined benefit component and a defined contribution component, while others have different structures entirely. With a hybrid retirement plan, the financial risk is shared between the employer and the employee, with the specific division of risk varying by the details of the funding and benefit structure of the hybrid plan.

B. Summary of County Government and MCPS Retirement Plans

1. County Government.

The County Government provides all three types of retirement plans, and County law outlines which employees are covered by which plans. The table below summarizes each plan and the employees covered. Participation is required for full-time employees, and optional for part-time employees.

Summary of County Government Retirement Plans

Retirement Plan	Plan Type	Active Members*	Covered Employees
Employees' Retirement System (ERS)	Defined Benefit	4,635	• Employees hired before October 1, 1994 • Represented public safety employees regardless of date of hire
Employees' Retirement Savings Plan (RSP)	Defined Contribution	3,272	• Non-public safety employees hired on or after October 1, 1994 • Non-represented public safety employees hired on or after October 1, 1994
Guaranteed Retirement Income Plan (GRIP)	Hybrid	942	

* This is the number of active MCG employees enrolled in the retirement plan as of October 2010.

Employees' Retirement System (ERS) – Defined Benefit. As shown in the table above, employees hired before October 1, 1994 and all represented public safety employees belong to the County Government's defined benefit pension plan. These employees are divided into seven different pension groups determined by their bargaining unit and date of hire. Each group has a separate set of variables used to calculate pensions (e.g., multiplier, average final salary, etc.) and different requirements for retirement eligibility (combination of age and/or years of service).

The ERS is integrated with Social Security, meaning that retirees receive a smaller pension (determined by a formula that varies by group) once they reach Social Security retirement age. The County Government's Board of Investment Trustees manages and invests ERS funds.

Retirement Savings Plan (RSP) – Defined Contribution. The County Government opened its defined contribution plan in 1994 when it closed its defined benefit plan to non-public safety and non-represented employees hired after October 1, 1994. For most employees in the RSP, the County currently contributes 8% of salary and the employee contributes 4% of salary annually.[4] Employees in this plan direct the investment of the funds in their retirement account and can take their funds with them when they leave County Government service.

Guaranteed Retirement Income Plan (GRIP) – Hybrid. The County Government created its hybrid plan, the GRIP, in 2009. The GRIP is open to all employees who are eligible for the RSP. New hires must choose between the two plans and existing RSP members were given a one-time option to transfer to the GRIP.

Like the RSP defined contribution plan, the County currently contributes 8% of salary and the employee contributes 4% of salary to an employee's GRIP account for most employees. Like a defined benefit plan, the County guarantees a fixed rate of return (currently 7.25% annually) on funds in employees GRIP accounts. If GRIP investments earn less than the guaranteed return annually, the County is responsible for making up the difference. Investments that earn more than the guaranteed return offset part of the cost of the County's annual contribution to the GRIP accounts.

Summary of Retirement Plan Factors. The table on the next page summarizes the key provisions that determine the amount of pension/retirement benefits for the different County Government's retirement plans.

[4] A small number of non-represented public safety employees participate in the RSP and GRIP. For these employees, the County contributes 10% of the employee's salary and the employee contributes 3%.

Summary of County Government Retirement Plans:
Key Provisions that Determine the Amount of an Employee's Pension/Retirement Benefit

Defined Benefit Plans

	FY11 Contribution (percent of salary)		Minimum Age / Years of Service		Multiplier	Final Salary Calculation	Social Security Integration
	Employee	Employer	Any Age	Or			
Non-public safety hired pre 10-1-94	4%	24.9%	30 years	60 years old/ 5 years of service	2.0%	Average of highest 3 consecutive years	Integrated for employees hired after July 1, 1978
Police	4.75%	31.9%	25 years	55 years old/ 15 years of service	2.4%		
Deputy Sheriff/Corrections	4.75%	35.85%	25 years	55 years old/ 15 years of service	2.4%		
Fire	5.5%	38%	20 years	55 years old/ 15 years of service	2.5%		

Defined Contribution Plan / Hybrid Plan

Employees hired on or after October 1, 1994	FY11 Contribution (percent of salary)	
	Employee	Employer
Non-Public Safety	4%	8%
Non-Represented Public Safety	3%	10%

Source: Montgomery County Code Chapter 33; Montgomery County Employees' Retirement System 2009 Actuarial Valuation Report

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2. Montgomery County Public Schools

All MCPS employees participate in a defined benefit retirement plan. Approximately three quarters of MCPS employees participate in a defined benefit plan funded and administered by the State of Maryland. All other MCPS employees participate in a locally-funded defined benefit plan that is identical to the State plan. MCPS refers to these plans (whether State-funded or MCPS-funded) as the employees' Core Pension.

In addition to the Core Pension, State law requires MCPS to provide a Pension Supplement to employees in the State pension plan.[5] MCPS provides the Pension Supplement to all MCPS employees, regardless of whether they are in the State- or locally-funded plan. The Pension Supplement that MCPS provides is 150% higher than required by State law. The Core Pension multiplier of 1.8% combined with the 0.2% Pension Supplement provides MCPS employees with an overall 2.0% pension multiplier.

The table below summarizes the key factors that determine the amount of an MCPS employee's pension benefits.

Summary of MCPS Pension Plans: Key Provisions that Determine the Amount of an Employee's Pension*

Core pension paid by...	Active Employees+	FY11 Contribution (percent of salary)		Minimum Age / Years of Service		Multiplier	Final Salary Calculation	Social Security Integration
		Employee	MCPS	Any Age	Or			
State	16,923	5.5%	1.92%	30 years	60 years old/ 5 years service	2%	Average of highest 3 consecutive years	Non-Integrated for service after 7-1-98
MCPS	4,956	5.5%	20.49%					

* For employees hired on or after July 1, 1998
\+ This is the number of active MCPS employees enrolled in the pension plan as of September 2010
Source: MCPS' *Understanding Your Retirement* (October 2009)

C. Income from Retirement Benefits – Four Examples

OLO calculated the pension/retirement income that four <u>hypothetical employees</u> who elect to retire on July 1, 2011 would receive under current retirement plan designs. OLO calculated retirement benefit income for one MCPS employee and three County Government employees (listed below) who were chosen to illustrate (1) differences between MPCS and County Government pension plans, (2) the impact on retirement income from retiring after 20 years compared to 30 years, and (3) the difference in retirement income from a defined benefit plan compared to a defined contribution plan.

Example (1): MCPS Teacher with Master's Degree and 30 years of service
Example (2): Master Firefighter with 30 years of service
Example (3): Firefighter III with 20 years of service
Example (4): Child Welfare Case Worker with 30 years of service

To calculate the income from retirement benefits, OLO needed to make certain assumptions about the hypothetical employees. For the four calculations, OLO assumed the employees:

- Had similar starting salaries;
- Began employment with the agency (County Government or MCPS) at age 24; and
- Retired at the maximum salary for their grade.[6]

[5] State law requires MCPS to provide a Pension Supplement of a 0.08% multiplier. MCPS adds an additional 0.12%, for a total multiplier of 0.2%. Montgomery County is the only Maryland county required to supplement State teacher pensions.

[6] Based on past pay adjustments, employees who work in the same job class until they are eligible for normal retirement will have reached the maximum salary for that grade.

In addition, the calculations:

- Assume Social Security benefit amounts based on the scenario that a retiree does not take another paid job after leaving County service and will be eligible for benefits beginning at age 62; and
- Present all dollar amounts in pre-tax, current year dollars.

With the exception of the Firefighter III example, OLO calculated benefits for an employee who retired after 30 years of service. Because firefighters are eligible for normal retirement after 20 years of service,[7] OLO calculated the retirement benefits for a Firefighter III who served 20 years.

A complete list of assumptions used to calculate retirement benefit income appears on page 11. Of course, changing the assumptions would alter the calculations.

Example (1): Teacher with Master's Degree. Teachers participate in the State retirement system and receive a supplemental pension benefit from MCPS. As shown in the table below, a teacher who retires after 30 years of service on July 1, 2011, would receive an annual pension equal to 48.5%[8] of average final salary.[9] At the current maximum salary of $96,966, the teacher would retire with an annual pension of $47,009.

At age 62, the retiree would begin receiving an annual Social Security benefit of $17,724. Because MCPS' pensions do not integrate with Social Security, the Teacher receives a Social Security benefit of $17,724 in addition to his/her annual pension of $47,009, for a total retirement benefit of $64,733. Under current law, the Teacher's pension and Social Security benefits are both adjusted annually to account for inflation.

Annual Pension Payments for an MCPS Teacher with Master's Degree Retiring at Maximum Salary in July 2011 (Current Year $)

Years of Service	30
Age at Retirement	54
Final Salary	$96,966
Annual Retirement Benefit (until age 62)	**$47,009**
Pension	$47,009
Social Security	$0
Annual Retirement Benefit (age 62+)	**$64,733**
Pension	$47,009
Social Security	$17,724

The table above shows that the amounts of the annual pension ($47,009) and of the Social Security benefit ($17,724) remain constant over time. The amounts remain constant because they are shown in current year dollars and OLO assumed that future cost of living adjustments will approximate the future rate of inflation, canceling each other out. For example, future cost of living adjustments will raise the Teacher's annual pension income above $47,009. However, the increases will be offset by inflation, keeping the value of future payments equal to $47,009 when measured in current year dollars.

[7] Firefighters at age 55 or older are eligible for normal retirement with 15 years of service.

[8] Teachers receive an annual pension equal to 1.28% of average final salary for each year of service before FY99 and 2.00% of average final salary for each year of service from FY99 onward.

[9] Average final salary equals the mean of the employee's highest three consecutive years of salaries.

Example (2): Master Firefighter. Firefighters participate in the County Government's Employees' Retirement System. After 30 years of service, a firefighter receives an annual pension equal to 70% of his/her average final salary. At the current maximum Master Firefighter salary of $87,422, the employee would retire with an annual pension of $58,382.

Because the County Government's pension integrates with Social Security, when the retired Master Firefighter reaches age 62, s/he will receive a Social Security benefit of $17,028 and will receive a reduced pension of $40,138 per year. Under current law, the Master Firefighter's pension and Social Security benefits are both adjusted annually to account for inflation.

Annual Pension Payments for Master Firefighter Retiring at Maximum Salary in July 2011 (Current Year $)

Years of Service	30
Age at Retirement	54
Final Salary	$87,422
Annual Retirement Benefit (until age 62)	**$58,382**
Pension	$58,382
Social Security	$0
Annual Retirement Benefit (age 62+)	**$57,166**
Pension	$40,138
Social Security	$17,028

The amounts of the annual pre-Social Security ($58,382) and post-Social Security pensions ($40,138) as well as the Social Security benefit ($17,028) remain constant over time. The amounts remain constant because they are shown in current year dollars and OLO assumed that future cost of living adjustments will approximate the future rate of inflation, canceling each other out. For example, future cost of living adjustments will raise the Master Firefighter's annual pre-Social Security pension income above $58,382. However, the increases will be offset by inflation, keeping the value of future payments equal to $58,382 when measured in current year dollars.

Example (3): Firefighter III. Firefighters who retire after 20 years of service receive an annual pension equal to 50% of average final salary. At the current maximum Firefighter III salary of $74,272, the employee would retire with an annual pension of $37,318.

Because the County Government's pension integrates with Social Security, when the retired Master Firefighter reaches age 62, s/he will receive a Social Security benefit of $12,336 and will receive a reduced pension of $25,656 per year. Under current law, the Firefighter's pension and Social Security benefits are both adjusted annually to account for inflation.

Annual Pension Payments for Firefighter III
Retiring at Maximum Salary in July 2011
(Current Year $)

Years of Service	20
Age at Retirement	44
Final Salary	$74,272
Annual Retirement Benefit (until age 62)	**$37,318**
Pension	$37,318
Social Security	$0
Annual Retirement Benefit (age 62+)	**$37,992**
Pension	$25,656
Social Security	$12,336

The amounts of the annual pre-Social Security ($37,318) and post-Social Security pensions ($25,656) as well as the Social Security benefit ($12,336) remain constant over time. The amounts remain constant because they are shown in current year dollars and OLO assumed that future cost of living adjustments will approximate the future rate of inflation, canceling each other out. For example, future cost of living adjustments will raise the Firefighter's annual pre-Social Security pension income above $37,318. However, the increases will be offset by inflation, keeping the value of future payments equal to $37,318 when measured in current year dollars.

Example (4): Child Welfare Case Worker (Grade 23). Non-public safety County Government employees hired since 1994 participate either in the Retirement Savings Plan (RSP) of the Guaranteed Retirement Income Plan (GRIP). RSP and GRIP participants do not receive an annual pension. Instead, the County Government and the employee both make annual contributions to a retirement account. Currently, the County Government annually contributes 8% of salary and the employee contributes 4% of salary to the employee's RSP or GRIP retirement account.

The current maximum salary for a Grade 23 County Government employee is $88,027. In this example, the Child Welfare Case Worker participated in the GRIP and received an annual guaranteed return of 7.25% for the entirety of his/her County employment.[10] Under current terms of the GRIP, the Child Welfare Case Worker would have accumulated a retirement account balance of more than $536,000 by the end of his/her 30 years of service.

In addition, the retiree would be eligible for a Social Security benefit of $17,076 per year beginning at age 62. The receipt of Social Security benefits does not alter the retirement benefit for employees in the RSP or GRIP.

Retirement Account Balance for Child Welfare Case Worker
Retiring at Maximum Salary in July 2011
(Current Year $)

Years of Service	30
Age at Retirement	54
Final Salary	$88,027
Social Security Benefit (age 62+)	$17,076
Retirement Account Balance	$536,132

A table summarizing the income from retirement benefits for the four positions appears on the following page. The assumptions used in the calculations are listed below the table. The table on the following page also includes a present value calculation of the retirement income for each of the four employee examples (see question #4 on page 13).

[10] Neither the RSP nor the GRIP existed 30 years ago. A Child Welfare Case Worker (or other non-public safety County Government employee) who retires in July 2011 after 30 years of service would receive a pension as a member of the Employees' Retirement System (ERS). The County closed the ERS to non-public safety and non-represented employees hired since 1994 and the majority of current non-public safety County Government employees participate in the RSP or GRIP.

The Child Welfare Case Worker example in this memo is a hypothetical case intended to illustrate the retirement benefit for an employee who retires after 30 years in the GRIP. A similar example for an RSP participant could be calculated based on assumptions of the market performance of the employee's investment selections.

Summary of Income from Retirement Benefits
Four Examples of Employees Retiring at Top of Salary Grade in July 2011

	Teacher (MA Degree)	Master Firefighter	Firefighter III	Child Welfare Case Worker
Years of Service	30	30	20	30
Age at Retirement	54	54	44	54
Final Salary	$96,966	$87,422	$74,272	$88,027
Annual Retirement Benefit (until age 62)	$47,009	$58,382	$37,318	$0
Pension	$47,009	$58,382	$37,318	--
Social Security	$0	$0	$0	$0
Annual Retirement Benefit (age 62 +)	$64,733	$57,166	$37,992	$17,076
Pension	$47,009	$40,138	$25,656	--
Social Security	$17,724	$17,028	$12,336	$17,076
Retirement Account Balance	--	--	--	$536,132
Present Value of Retirement Benefit				
excluding Social Security	$1,363,264	$1,291,709	$1,198,851	$536,132
including Social Security	$1,753,192	$1,666,325	$1,470,243	$911,804

Assumptions

- All dollar amounts represent current year dollars.
- Pension payments and retirement account withdrawals are subject to Federal and State income tax. All dollar amounts shown are pre-tax dollars.
- All employees worked full time, were hired into their positions at age 24, and retire on July 1, 2011 with no unused sick leave.
- All employees retired with a top of grade salary for the position (including longevity awards).
- The Social Security Administration's online "Social Security Quick Calculator" is the source for annual Social Security benefits.
- Social Security pension amounts assume that retirees do not take another paid job after leaving County service and will be eligible for benefits beginning at age 62.
- The Child Welfare Case Worker's retirement account balance assumes a starting salary of $25,000; an annual employer contribution of 8% of salary; an annual employee contribution of 4% of salary; and participation in the GRIP with an annual guaranteed return of 7.25%.
- Present value calculations assume that pension and Social Security cost of living adjustments equal the future rate of inflation.
- Present value calculations assume an average life expectancy of 84 years (the current average life expectancy assumption for ERS plan members).

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D. Retirement Plan Questions and Answers

This final section adopts a question and answer format to explain the major variations between/among the retirement benefits received by the four employee examples presented above.

1. Why does the Teacher's annual pension payment remain unchanged after age 62, while the two Firefighters' pensions from the County Government decrease at that age?

<u>**Social Security Integration:**</u> Since FY79, the County Government's pension plan has "integrated" with Social Security. Social Security integration means that an employer reduces a retiree's annual pension payment when the retiree becomes eligible for Social Security.[11] When a Firefighter becomes eligible for Social Security, the County Government's integrated plan reduces the annual pension payment to 68.75% of the initial annual pension amount.

Neither the State's pension plan nor the MCPS pension supplement integrates with Social Security for service after July 1, 1998. Therefore, for all service after that date, a Teacher's pension is not reduced when a retiree becomes eligible for Social Security.

2. If the Teacher's final salary is greater than the Master Firefighter's final salary, why does the Teacher receive a lower annual pension (up to age 62) than the Master Firefighter?

<u>**Pension Multipliers:**</u> As described earlier in this memo, a retiree's annual pension payment is based on both average final salary and a multiplier. The Master Firefighter who worked for 30 years earned a pension equal to 2.5% (the multiplier) of average final salary for the first 20 years of service plus 2.0% of average final salary for the next 10 years of service. The multipliers result in the Master Firefighter receiving a pension equal to 70% of final average salary after 30 years of service.

Teachers receive an annual pension equal to 1.28% of average final salary for each year of service before FY99 and 2.0% of average final salary for each year of service from FY99 on. A Teacher retiring this summer after 30 years of service would have a pension equal to 48.5% of average final salary. In future years, a Teacher retiring after 30 years of service will have worked additional post-FY99 years (with those years subject to the higher 2.0% multiplier), and so, will have a higher pension.

3. The Firefighter III retires with a final salary that is about 85% of the Master Firefighter's final salary. Why is the annual pension for the Firefighter III only equal to about 64% of the Master Firefighter's annual pension?

<u>**Years of Service:**</u> One of the primary factors that determines a retiree's final pension is years of service. In the examples shown in this memo, the Master Firefighter worked for 30 years while the Firefighter III worked for 20 years. Based on current Employee Retirement System plan provisions, a firefighter's annual pension equals 50% of average final salary after 20 years of service and rises to 70% of average final salary after 30 years of service. Working ten additional years results in the retiree receiving a higher annual pension.

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[11] For the examples in this memo, OLO assumed that the retirees would not take another paid job after leaving County service. As such, these retirees would become eligible for Social Security benefits beginning at age 62.

4. The Teacher and the Firefighters receive annual pension payments while the Child Welfare Case Worker leaves employment with a retirement account. Is there a way to compare these different types of retirement benefits?

Present Value Analysis: Pensions offer a stream of fixed payments from the time of retirement until the end of life; retirement accounts provide a cash balance that is available for withdrawal or re-investment during retirement.[12] The two plan types offer different benefits that make them difficult to compare.

Nonetheless, a present value analysis offers one means of comparison. Present value is a calculation of the current value of future cash payments. These calculations allow for a comparison of a current year cash amount (such as a retirement account balance) with a stream of future cash payments (such as pension benefits). Present value analysis also can be used to compare the relative value of different pension plans.

OLO calculated the present value of the Teacher, Master Firefighter, Firefighter III pension benefits shown as examples in this memo.[13] For this analysis, OLO assumed that retirees would receive benefits through age 84, the current average life expectancy for members of the County Government's Employees' Retirement System. For the Child Welfare Case Worker, the cash balance of his/her retirement account at retirement equals the present value of this benefit.

As shown in the table below, the present value of the retirement benefits (excluding Social Security benefits) for the four examples shown in this memo are:

Position	Type of Retirement Benefit	Years of Service	Present Value of Retirement Benefit
Teacher (MA)	Pension	30	$1,363,264
Master Firefighter	Pension	30	$1,291,709
Firefighter III	Pension	20	$1,198,851
Child Welfare Case Worker	Retirement Account	30	$536,132

5. Are retirement plan benefits and Social Security the sole source of income for retired County employees?

Post-Retirement Employment and Savings: The amount of income (other than retirement benefits and Social Security) available to retirees varies depending on the life and financial circumstances of the retiree. Depending on age, skill sets, and health, a person could take a new job after leaving County employment.

In addition, employees who are able and choose to set aside additional retirement savings during their working years have additional resources available to them during retirement. The County Government and MCPS provide employees the option of making additional pre-tax contributions (capped under federal law) annually to deferred compensation accounts.

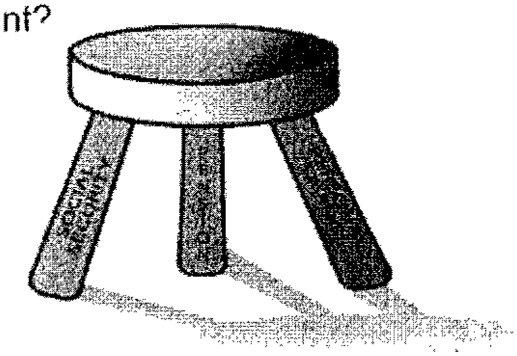
c. Steve Farber

[12] ERS and GRIP account withdrawals are subject to IRS penalties if made before the retiree reaches the age of 59½.

[13] Present value analyses commonly discounts future payments to account for inflation. The present value calculations in this memo do not discount future pension or Social Security payments because both of these benefits include annual cost of living adjustments. The present value calculations in this memo assume that pension and Social Security cost of living adjustments approximate the future rate of inflation.

Retirement Security

Why is Social Security's work on retirement issues important?



Retirement income used to fit the model of the three-legged stool—Social Security, a defined benefit pension from an employer, and a personal savings.

For better or worse, it is no longer that simple for a number of reasons:

- The increasing reliance on defined-contribution pension plans shifts financial risks from employers to employees.
- The increasing life spans and lower personal saving rates can lead to people outliving their personal retirement savings.
- Despite longer lives, most workers continue to take their Social Security benefits at age 62 even though that may permanently reduce the monthly benefit. A 2007 survey found that only 19 percent of workers can correctly identify the age at which they will be eligible for unreduced benefits from Social Security.

Building a financially secure retirement has become much more complicated, especially with falling contributions from employers and lower rates of personal saving. Everyone, from workers and employers to researchers and policymakers, is trying to figure out how to build retirement security in the 21st century.

Workers can educate themselves about how to plan for retirement and when to claim Social Security benefits. That is why Social Security has developed a special initiative to encourage saving by improving financial literacy and education.

For policymakers and researchers, Social Security is studying ways to develop retirement security that addresses 21st century challenges. Keeping Social Security sound for future generations is at the heart of work on trust fund solvency and in the research that we support through the Retirement Research Consortium.

U.S. News & World Report
usnews.com

4 Retirement Pillars Have Serious Cracks

By Philip Moeller
Posted January 31, 2011 11:31 AM ET

Something not-so-funny has happened to millions of Americans, including me, on the way to retirement. The rules have changed. This is hardly news, but much of the debate over retirement security is still shaped by the traditional view of retirement supports. That long-held view was that retirement was a three-legged stool, supported by an employer pension, private investments, and Social Security.

[See 10 Senior-Smart Community Ideas.]

One of the major legs of the stool—employer pensions—began weakening in the 1980s as employers began moving away from traditional, defined benefit pension plans to defined contribution plans. How's that working out for us? Not so good. As employees, we were not very responsible in taking advantage of these new contribution-based plans. As investors, we often sell low and buy high. Important reforms enacted in 2006 put badly needed improvements in place—just in time for the market crash of 2007 and 2008. Most 401(k) plans have since recovered a lot of ground, but not enough to reverse life-altering declines in nest eggs that weren't big enough even before the Wall Street collapse.

Private investments were never a real strong leg of the stool for most Americans. We didn't save enough and, of course, those assets got hammered during the Great Recession along with 401k(s) and IRAs.

Social Security has continued paying all of its benefits, and has assumed an importance in retirement income well beyond its initial role. Even here, however, a slowly widening funding shortfall has raised questions about Social Security's long-term viability. It needs a fix.

So much for the three-legged stool. Out with the old, as they say. Meet the four pillars of retirement. Four is more, and thus better than three, right? And pillars are more substantial and stronger than the legs of a stool, aren't they? Late last year, I interviewed a retirement policy expert who talked naturally about the four pillars. When I asked what they were, he seemed surprised. This is a well-known concept, he said, and has been in use for a long time.

[See Senior Safety Nets at Risk in 2011.]

Don't be embarrassed if you cannot name the four pillars. They have not exactly become the Mt. Rushmore icons of retirement security.

While doing some superficial research, I came across an outfit called the Geneva Association in Switzerland, which bills itself as the international think tank of the insurance industry. The association began a research effort into what it called the Four Pillars Program (or Programme, for Eurocentric readers). Here was its rationale:

"The Geneva Association launched its 'Four Pillars' Research Program with a view to identifying possible solutions to the issue of the future financing of pensions and, more generally, to organizing social security systems. Demographic trends—especially increased life expectancy—could be seen as positive if we were able to devise ways of enabling 'aging in good-health populations' to make a valid economic and social contribution to the functioning of our service economies over the decades to come."

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Not bad, and especially insightful, given that the program began in 1987! The three legs of the traditional stool were retained, although the pension component was shifting into defined contribution plans. The fourth pillar, the association said, was "the need for a flexible extension of work-life, mainly on a part-time basis, in order to supplement income from the three existing pillars for future years." So, the fourth pillar was continued employment. What may have seemed an optional solution in 1987 is, of course, a necessity in 2011.

More recently, in 2005, Prudential Financial unveiled a new framework. It was called the Four Pillars of U.S. Retirement. Again, the legs of that traditional stool were still there. Now, they were supplemented with a fourth pillar the company called "Retirement Choices." It was different than the Geneva Association's pillar. In fact, it sounded a lot like Prudential's product brochure:

"There are aspects of retirement planning that fall outside of 'saving.' Many Americans may choose to continue working in retirement, while others may consider the equity they've built in their homes as a potential retirement income source. In addition, protecting retirement income through annuities and long-term care insurance, and providing wealth transfer through life insurance, are other choices individuals should consider."

[See Social Security, Medicare a Bargain for Many.]

Others have weighed in with their own views of the Four Pillars. In 2007, AARP came up with a version that lumped pensions and retirement savings into a single pillar, picked up supplemental income as a third pillar, and added affordable healthcare as its fourth pillar. Given that healthcare is the largest uncontrollable expense faced by retirees, there is logic for viewing affordable care as a pillar of retirement security. Here were AARP's objectives in 2007:

"Social Security: We must protect this essential program from destructive changes that would undermine the goal of Social Security solvency. The public must be educated about their need for additional income because too many Americans are relying upon Social Security as their chief source of retirement income.

"Affordable Health Care: Health care is one of the most pressing issues facing American seniors today. Without affordable health care, a person's entire retirement security could be hanging in the balance—left vulnerable to an unplanned illness or other health concern.

"Pensions/Retirement Savings Plans: Too many Americans have suffered recently as an increasing number of businesses have dramatically scaled back retirees' pension and benefits plans—putting retirement security at risk for countless Americans.

"Supplemental Earnings: Many seniors can't afford to retire when they wish. More employment opportunities must be created for American seniors who want to work, and age discrimination should be kept out of the workplace."

So, perhaps the Four Pillars haven't quite settled into their new roles. Maybe your fourth pillar is having a roof over your head. Or that hoped-for inheritance from Uncle Sid. Works for me.

Twitter: @PhilMoeller

Why We're Not Wired for Successful Retirements
Senior Villages Take Root as Movement Matures

Montgomery County Office of Human Resources
Personnel Management Review
2010 Average Annual Salary by Grade (Full-Time Employees)

Grade	Category	Number of Employees	Average Annual Salary
Overall Weighted Average		**7,873**	**$70,424**
A1	Police Management	133	$98,460
A2		32	$116,167
A3		21	$135,961
B1	Fire Management	100	$88,382
B2		139	$108,553
B3		24	$123,606
B4		13	$134,447
B6		3	$152,308
C1	Corrections and Rehabilitation Management	20	$92,726
C2		3	$103,377
C3		7	$40,538
C4		65	$50,176
C5		161	$60,361
C6		43	$80,379
D1	Deputy Sheriff Management	29	$96,755
D2		11	$97,409
D3		4	$117,642
D4		0	--
F1	Firefighter/Rescuer	1	$41,613
F2		254	$50,493
F3		372	$64,120
F4		206	$81,618
G2	Deputy Sheriff	3	$45,170
G3		20	$50,990
G4		70	$68,812
H3	Physician	0	--
H4		1	$191,682
J3	Psychiatrist	2	$173,732
J4		1	$172,494
M1	Management Leadership Service	20	$146,679
M2		103	$127,736
M3		226	$107,093

Montgomery County Office of Human Resources
Personnel Management Review
2010 Average Annual Salary by Grade (Full-Time Employees)
(Continued)

Grade	Category	Number of Employees	Average Annual Salary
P1	Police	33	$47,383
P2		37	$49,881
P3		133	$55,580
P4		708	$76,138
P5		64	$88,318
5	General Government	4	$37,534
7		6	$38,834
8		23	$38,997
9		28	$36,690
10		39	$36,586
11		18	$44,563
12		36	$45,770
13		263	$47,818
14		187	$44,180
15		782	$46,213
16		438	$54,684
17		179	$54,856
18		469	$61,041
19		121	$64,522
20		254	$65,404
21		331	$69,566
22		132	$72,243
23		509	$77,161
24		345	$82,105
25		352	$89,629
26		88	$93,738
27		46	$96,509
28		123	$105,075
29		2	$106,765
31		1	$127,511
32		32	$120,307
34		2	$119,754
40		1	$136,372

Source: Montgomery County Office of Human Resources, Personnel Management Review, April 2011