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DEPARTMENT OF ADMINISTRATION

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Defined Contribution Retirement (DCR) Plan
PERS Tier IV/ TRS Tier III
Is the DCR plan a hiring and retention impediment?
3/17/2008

History/Background

In 2004, actuarial valuations for both the public employees' retirement system (PERS) and the teachers' retirement system (TRS) showed that the employer normal cost rates would rise dramatically (PERS from 6.77% in 2004 - 24.91% and TRS from 14.44% in 2004 to 35.57% in 2005). In addition to rising contribution levels, investment returns at this time were volatile and medical costs were rising. PERS and TRS employers contacted their respective boards (Public Employees Retirement Board – PERB and the Teachers Retirement Board -TRB) and legislators regarding these increasing costs. The PERB and TRB formed a subcommittee to explore cost containment alternatives.

The Division of Retirement and Benefits (Division) conducted a survey to determine what benefit elements were most important to employers. Specifically, the system objectives targeted by employers included:

- System should provide medical benefits to retirees;
- Members should bear a greater share of the cost of medical benefits;
- Members should have to retire directly from the system to be eligible for medical benefits;
- Benefits should favor the longer-service member;
- Employer contributions should be predictable and stable;
- Investment risk should not be borne solely by employers;
- Healthcare inflation risk should not be borne solely by employers;
- Non-medical benefits must be sufficient to satisfy minimum requirements for employers who do not participate in Social Security;
- Benefit changes must take the form of new "tiers"; and
- Annual cost of benefits should not exceed the current System's normal cost rates.

The Division and its actuary recommended the PERB and TRB address employer concerns by creating new tiers. However, the boards rejected the notion of moving from a defined benefit (DB) to a defined contribution retirement (DCR) plan and recommended using cost containment measures in the existing retiree plans. In March 2005 Senate Bill (SB) 141 was introduced by the Senate Finance Committee which proposed new tiers in the form of DCR plans for both PERS and TRS.

The new DCR plans (PERS Tier IV and TRS Tier III) address and meet the goals and objectives initially set by employers of the system as articulated through the Division's survey. The objective of employer-participants was not to establish a new plan with employer rates that were less than the DB normal cost rates, but rather to establish a plan that produced **predictable** and **affordable** costs while shifting investment risk to employees. This met employer's objective of keeping the annual cost of benefits at the same level as the current system's normal cost rates while eliminating the accrual of future unfunded liabilities.

Investment, mortality and health care cost risks are borne by the employer in a DB plan. These risks cause volatility over the short-term in determining the annual cost that will sufficiently meet the long-term benefit obligation, due in large part to the significant risk associated with DB health care plan design. The employer contribution rates in the DCR plan are not subject to this short-term volatility due to the design of the DCR health plan and because members bear more of the risk. As a result, employer DCR contribution rates are stable and not subject to volatility.

Current Situation

SB 141 became law in 2005 and new retirement plans were implemented beginning July 1, 2006. These new DCR plans replaced DB retirement plans for new employees of both PERS and TRS. DCR plan participants and their employers make tax-qualified contributions toward retirement income based on a percent of salary.

Some have questioned whether the new plans are attractive to potential employees and whether the plans have an impact on recruitment and retention of State employees. Critics say employees desire security (a monthly retirement check) above flexibility and portability of individually managed accounts, but these features are not mutually exclusive. How exactly will these differences play out? It is simply too soon to tell.

Challenges

The new DCR plans are not well understood by the general public. For example, a retiree was quoted recently in the Juneau Empire (October 19) saying a benefit of the DB plans was "the longer you worked and the more you made, the better your retirement benefits." But, the same is true for the new DCR plans.

DCR Plan Benefits
Like the DB tiers, the DCR plans provide employees the benefit of tax deferral, employer contributions, and health benefits above and beyond Medicare during retirement. The DCR plans permit flexible payment schedules rather than inflexible monthly amounts like the older tier plans. Retirees and their survivors can take money out of the account during retirement based on individual needs, which often change over time, while remaining funds can continue to grow, tax-deferred.

Portability is another new feature of the DCR plans. Contributions can easily follow the employee to the next job and more contributions can be added to meet future retirement needs, without tax problems. DB plan contributions cannot easily move outside the PERS/TRS systems to other employer sponsored plans.

Multiple Pre-Tax Plans
Many DB and DCR employees, regardless of retirement tier, have the opportunity to tailor their retirement nest egg through two other pre-tax plans. For State and several other public employers, the Supplemental Annuity Plan (SBS-AP) is a mandatory 6.13% of wages and a matching employer contribution instead of contributing to Social Security.

Deferred Compensation plans permit employees to voluntarily save some of their income each pay period. Like the new DCR plans, both SBS-AP and the Deferred Compensation plans are participant /employee directed and allow individuals to choose from a variety of investment options.

Recruitment
On December 31, 2005, the vacancy rate for the Executive Branch (excluding the Governor's Office) was 15% and on December 31, 2006 was 9%. This rate is calculated as of a certain date and does not reflect the entire year. The fact that it was 6% lower six months after implementation of the DCR plans does not support contentions that the DCR plans have had a negative impact on recruitment.

Other variables affect vacancy rates, like failure to remove deleted positions timely. When this happens, it actually increases the vacancy rate, which could have been the case in 2005. Regardless, the fact remains that more jobs were filled on December 31, 2006 than on December 31, 2005.

For Market Based Pay purposes, the Division of Personnel reviewed recruitment data for calendar years 2005 and 2006. The data showed greater recruitment trouble in 2006 compared to 2005. However, the data doesn't tell us why individuals do not apply in the first place.

For those that do apply but turn down job offers, managers report they are unable to offer a competitive salary. Managers have not reported that applicants are turning down offers due to the DCR plan.

The Division of Retirement and Benefits reports keen interest in the DCR plan when new employees attend retirement plan training. At a recent training for the North Slope School District, several new teachers expressed preference for the portability of the DCR plan.

DCR participants (new employees) are also bringing retirement funds with them. DCR plan funds total over $25 million to date – which reflects nearly one million dollars of conversions and roll-ins.

Retention
Some assert that DCR plans hurt employee retention. Today, there is no data to support this idea. There is a significant incentive for DCR participants to remain in system-covered service. DCR plan participants must retire from a system-covered position in order to receive retirement health benefits.

In contrast, older tier DB plan participants, once vested, can separate from system service and still receive a pension and health benefits at retirement age – whether or not they retire from a PERS/TRS covered position.

In the future, exit interviews will be the most effective method to answer whether the DCR plan is a factor in retention.

<u>Comparison between DCR and DB plans</u>

Defined contribution retirement (DCR) plans have:

- **Portability – VERY PORTABLE**
  Employees can take their funds with them or continue managing them through the State; and new employees can roll-in investments from other sources.
- **Investment Earning – INDIVIDUAL EMPLOYEE BENEFITS**
  Distributions accrue to the individual and can increase during periods of investment growth and/or capital appreciation and can be used for any number of unexpected purchases or expenses. The plan includes investment advice services that are tailored to the individual employees desired level of help from guidance-only to full managed account services.

- **Distributions – FLEXIBLE TO FIT LIFE'S CHANGES**
  Employees can design and periodically change their distributions to meet the unique needs of their retirement plan.
- **Inheritability – SURVIVORS BENEFITS**
  Survivors may inherit the entire undistributed balance of the retirement accounts.
- **Health Plan – MODERN – BEST PRACTICES**
  New plan includes preventive care and member-controlled HRA accounts which provide flexibility in a changing health care environment. Member directed health care spending produces better outcomes for informed consumer-members.

Defined benefit (DB) plans have:

- **Portability – LIMITED PORTABILITY**
  Employees can remove funds, but forfeit post-retirement health care benefits when they do so. Employees can re-enter the system prior to retirement by repaying the refunded amount(s) plus interest prior to June 30, 2010.
- **Investment Earnings – PLAN OR EMPLOYER BENEFIT**
  Market up-sides accrue to the plan or accrue as credits to future employer contributions rather than to the individual.
- **Distributions – NOT FLEXIBLE**
  Set monthly amounts throughout retirement.
- **Inheritability – REDUCED**
  Reduced survivor inheritance is available to survivors.
- **Health Plan – OLD FASHIONED – OUTDATED PRACTICES**
  The old plan is nearly impossible to change without significant additional costs and potential legal challenges due to case law which causes barriers to the latest and best available health care practices.

The following pages reflect the administrative and monetary differences among the various PERS and TRS tiers, as labeled:

PERS Tier Comparison Chart:

PERS Tiers	Tier I 1/1/61 - 6/30/86	Tier II Entered after 6/30/86	Tier III Entered after 6/30/96	Tier IV Entered after 6/30/2006
Employee Contribution Rates **(% of pay)**	Pre-tax employee contribution: 6.75% beginning 1/1/87—all others 7.5% beginning 1/1/87—police and fire 9.6% beginning 7/1/99—school district	Pre-tax employee contribution: 6.75% beginning 1/1/87—all others 7.5% beginning 1/1/87—police and fire 9.6% beginning 7/1/99—school district	Pre-tax employee contribution: 6.75% beginning 1/1/87—all others 7.5% beginning 1/1/87—police and fire 9.6% beginning 7/1/99—school district	Pre-tax employee contribution: 8% for all employees
Employer Contribution **(% of payroll)**	Determined by annual actuarial valuation.	Determined by annual actuarial valuation.	Determined by annual actuarial valuation.	5% - Retirement 1.75% - Health Plan – adjusted by actuarial valuation annually. **plus** Health Reimbursement Arrangement (HRA)- Flat dollar amount per employee based on 3% of all PERS/TRS employers' average annual employee compensation. .4% Disability – Police /Fire .3% Disability – All others
Vesting	Employees vest with 5 years of service.	Employees vest with 5 years of service.	Employees vest with 5 years of service.	100% vested in employee contributions immediately. % vested in employer contributions: 25% after 2 years of service, 50% after 3 years, 75% after 4 years 100% after 5 years.

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PERS Tier Comparison Chart (*Continued*):

PERS Tiers	Tier I 1/1/61 – 6/30/86	Tier II Entered after 6/30/86	Tier III Entered after 6/30/96	Tier IV Entered after 6/30/2006
Qualifications for Retirement	Normal retirement age is 55, with early retirement at age 50; ▪ police/fire members can retire at any age after 20 years of police/fire service; ▪ all other members can retire at any age after 30 years of membership service. Early retirement reduction will be 1/2% per month or 6% per year for every year less than the required normal retirement age.	Normal retirement age is 60, with early retirement at age 55; ▪ police/fire members can retire at any age after 20 years of police/fire service; ▪ all other members can retire at any age after 30 years of membership service. Early retirement reduction will be 1/2% per month or 6% per year for every year less than the required normal retirement age.	Normal retirement age is 60, with early retirement at age 55; ▪ police/fire members can retire at any age after 20 years of police/fire service; ▪ all other members can retire at any age after 30 years of membership service. Early retirement reduction will be 1/2% per month or 6% per year for every year less than the required normal retirement age.	None for investment account. Taxes and penalties may apply if withdrawn before age 59-1/2. See requirements for Retirement Medical Coverage.
Benefit Calculation Formula	Benefit formula: ▪ 2% for first 10 years and all years of service prior to July 1, 1986, ▪ 2.25% for the next 10 years, and ▪ 2.5% per year thereafter. Police/Fire - 2% X 10, 2.5% over 10. Benefit calculation is determined on the average of the **high three** consecutive years' salary.	Benefit formula: ▪ 2% for first 10 years of service, ▪ 2.25% for the next 10 years, and ▪ 2.5% per year thereafter. Police/Fire - 2% X 10, 2.5% over 10. Benefit calculation is determined on the average of the **high three** consecutive years' salary.	Benefit formula: ▪ 2% for first 10 years of service, ▪ 2.25% for the next 10 years, and ▪ 2.5% per year thereafter. Police/Fire - 2% X 10, 2.5% over 10. Benefit calculation is determined on the average of the **high five** consecutive years' salary. Benefit calculation for police and fire members is the average of the **high three** consecutive years regardless of tier (effective 2002).	DC account balance plus investment earnings. May be received in several different payment options. Payout options include lump-sum payments, rollovers to another qualified plan, or annuities. Annuities may be taken as a lifetime annuity, joint and survivor annuity, or for a period certain.

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Alaska Cost-of-living Increases (COLA)	An Alaska Cost-of-Living Allowance is payable to benefit recipients who remain domiciled in Alaska after retirement. The allowance is $50 or 10% of the base benefit, whichever is greater.	An Alaska Cost-of-Living Allowance is payable to benefit recipients 65 or older or disability benefit recipients regardless of age who remain domiciled in Alaska after retirement. The allowance is $50 or 10% of the base benefit, whichever is greater.	An Alaska Cost-of-Living Allowance is payable to benefit recipients 65 or older or disability benefit recipients regardless of age who remain domiciled in Alaska after retirement. The allowance is $50 or 10% of the base benefit, whichever is greater.	None provided.

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PERS Tier Comparison Chart (*Continued*):

PERS Tiers	Tier I 1/1/61 - 6/30/86	Tier II Entered after 6/30/86	Tier III Entered after 6/30/96	Tier IV Entered after 6/30/2006
Post Retirement Pension Adjustments (PRPA) (Inflation Protection)	PRPA increases granted on an ad hoc basis. PERS fund must be over 105% funded to permit ad hoc PRPA. If an ad hoc is not granted, Tier I employees must be age 60 or over or receiving benefits for 5 years to qualify for the automatic PRPA. The automatic PRPA passed in 1986 applied to all members regardless of hire date.	Automatic PRPA adjustments to disabled members, retirees 60 and over, and those who have received benefits for 5 years.	Automatic PRPA adjustments to disabled members, retirees 60 and over, and those who have received benefits for 5 years.	None provided.
Retirement Medical Coverage	Medical coverage is provided to all benefit recipients and their eligible dependents. The retiree medical plan premium is paid by the retirement system.	Medical coverage is provided to disabilitants, regardless of age and benefit recipients over age 60 and, ▪ Peace officer/fire members with 25 years of police/fire service, ▪ all other members with 30 years of membership service and their eligible dependents. The retirement system pays the retiree medical plan premium. Retirees under age 60 who are not retired with 30 years of service, or with 25 years of service for peace officer/fire, and survivors under age 60 must pay the full premium cost if they want coverage.	Same as Tier II. However, employees must accrue a minimum of 10 years of credited service* to have system-paid coverage at age 60. Employees with less than 10 years and their survivors must pay the full premiums as long as they wish to continue medical coverage.	Access to medical coverage at Medicare eligible age with 10 years of service or at any age with 25 years of service for peace officers and firefighters or with 30 years of service for all others. Must retire directly from the system. If not eligible for Medicare, must pay full premium. May use health reimbursement arrangement (HRA) account to pay premiums. Once the HRA is exhausted, member self- pays premiums. When eligible for Medicare, the percentage of premium paid by the retiree or surviving spouse is: ▪ 10-14 years of service - 30% ▪ 15-19 years - 25% ▪ 20-24 years - 20% ▪ 25-29 years - 15% ▪ 30 years or more – 10%

PERS Tier Comparison Chart (*Continued*):

PERS Tiers	Tier I 1/1/61 - 6/30/86	Tier II Entered after 6/30/86	Tier III Entered after 6/30/96	Tier IV Entered after 6/30/2006
Disability Benefits	Nonoccupational disability benefits available to vested members. Calculated as a normal retirement. Occupational disability provides 40% of the gross monthly compensation. Disabled member continues to accrue service credit until eligible for normal retirement. Different occupational disability formula available before 7/1/76.	Nonoccupational disability benefits available to vested members. Calculated as a normal retirement. Occupational disability provides 40% of the gross monthly compensation. Disabled member continues to accrue service credit until eligible for normal retirement.	Nonoccupational disability benefits available to vested members. Calculated as a normal retirement. Occupational disability provides 40% of the gross monthly compensation. Disabled member continues to accrue service credit until eligible for normal retirement.	Must be a total and presumably permanent disability whose cause is directly related to performance of duties of the job or an on the job injury. Benefit is 40% of salary, earns service while on occupational disability. Employer continues to make all required contributions as if the member were working, plus the member's required contributions to the DCR account, without deduction from the member's disability payment. Disability benefits cease when the member becomes eligible for normal retirement at Medicare eligible age and 10 years of service or at any age with 25 years of service for peace officers and firefighters or with 30 years of service for all others. Medical insurance is available to members receiving disability when member is eligible for a normal retirement.

TRS Tier Comparison Chart:

TRS Tier	Tier I 7/1/1955 – 6/30/90	Tier II Entered after 6/30/90	Tier III Entered after 6/30/06
Employee Contribution Rates (% of pay)	Pre-tax employee contribution: 8.65% beginning 1/1/91	Pre-tax employee contribution: 8.65% beginning 1/1/91	Pre-tax employee contribution: 8%
Employer Contribution (% of payroll)	Single rate for all TRS employers determined by annual actuarial valuation.	Single rate for all TRS employers determined by annual actuarial valuation.	7% - DCR account 1.75% Health Plan - determined by annual actuarial valuation after FY07. plus Heath Reimbursement Arrangement (HRA) - Flat dollar amount per employee based on 3% of all PERS/TRS employers' average annual employee compensation.
Vesting	Members vest with 8 years of service.	Members vest with 8 years of service.	100% vested in employee contributions from inception. Vested in employer contributions based on the following schedule: ▪ 25% after 2 years of service ▪ 50% after 3 years ▪ 75% after 4 years and 100% after five years.
Qualifications for Retirement	Normal retirement age is 55, with early retirement at age 50; teachers can retire at any age after 20 years of membership service.	Normal retirement age is 60, with early retirement at age 55; teachers can retire at any age after 20 years of membership service.	None for investment account. Taxes and penalties may apply if withdrawn before age 59 1/2. See requirements for Retirement Medical Coverage.
Benefit Calculation Formula	Benefit formula is 2% for the first 20 years and all years of service prior to July 1, 1990, 2.5% thereafter. Benefit calculation is determined on the average of the high three contract salaries.	Benefit formula is 2% for the first 20 years, 2.5% thereafter. Benefit calculation is determined on the average of the high three contract salaries.	DC account balance plus investment earnings. May be received in several different payment options. Payout options include lump sum payments, rollovers to another qualified plan, or annuities. Annuities may be taken as a lifetime annuity, joint and survivor annuity, or for a period certain.
Alaska Cost-of-living Increases (COLA)	An Alaska Cost-of-Living Allowance is payable to benefit recipients who remain domiciled in Alaska after retirement. The allowance is 10% of the base benefit.	An Alaska Cost-of-Living Allowance is payable to benefit recipients 65 or older or disability benefit recipients regardless of age who remain domiciled in Alaska after retirement. The allowance is 10% of the base benefit.	None provided.

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TRS Tier Comparison Chart *(Continued)*:

TRS Tier	Tier I 7/1/1955 – 6/30/90	Tier II Entered after 6/30/90	Tier III Entered after 6/30/06
Post Retirement Pension Adjustments (PRPA) *Inflation protection*	PRPA increases granted on an ad hoc basis. TRS fund must be over 105% funded to permit ad hoc PRPA. If an ad hoc is not granted, Tier I employees must be age 60 or over or receiving benefits for 8 years to qualify for the automatic PRPA. The automatic PRPA passed in 1990 applied to all members regardless of hire date.	Automatic PRPA adjustments to disabled members, retirees 60 and over, and those who have received benefits for 8 years.	None provided.
Retirement Medical Coverage	Medical coverage is provided to all benefit recipients and their eligible dependents. The retiree medical plan premium is paid by the retirement system.	The retirement system pays the retiree medical plan premium for all disabilitants regardless of age, for retirees and survivors over age 60, and for retirees with at least 25 years of membership service. This coverage includes eligible dependents. Retirees and survivors under age 60, with less than 25 years of membership service must pay the full premium cost if they want coverage.	Access to medical coverage at Medicare eligible age with 10 years of service or at any age with 30 years of service. Must retire directly from the system. If not eligible for Medicare, must pay full premium. May use health reimbursement arrangement (HRA) account to pay premiums. Once the HRA is exhausted, member self- pays premiums. When eligible for Medicare, the percentage of premium paid by the retiree or surviving spouse is: 10-14 years of service - 30% 15-19 years - 25% 20-24 years - 20% 25-29 years - 15% 30 years or more - 10%
Disability Benefits	Disability benefits are available to disabled members with at least 5 years of membership service. Benefits are 50% of base salary, plus 10% for each eligible dependent child up to a maximum of 4 children.	Disability benefits are available to disabled members with at least 5 years of membership service. Benefits are 50% of base salary, plus 10% for each eligible dependent child up to a maximum of 4 children.	Must be a total and presumably permanent disability whose cause is directly related to performance of duties of the job or an on the job injury. Benefit is 40% of salary, earns service while on occupational disability. Employer continues to make all required contributions as if the member were working, plus the member's required contributions to the DC account, without deduction from the member's disability payment. Disability benefits cease when the member becomes eligible for normal retirement at Medicare eligible age and 10 years of service or at any age with 30 years of service. No medical insurance until eligible for normal retirement.

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