Retirement News Highlights

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Vermont highlights DB/DC split in public plans

Lawmakers override veto to nix addition of DC plan for teachers and state employees

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Vermont lawmakers unanimously passed legislation on May 6 to shore up the state's pension funds for teachers and state employees — and they did so over the objections of a governor looking to lift a page from the playbook of other states.

The standoff offers a window into a broader national debate surrounding the incorporation of defined contribution plans into public-sector retirement systems.

Just days earlier, Gov. Phil Scott had vetoed the legislation, miffed with lawmakers for ignoring his plea to give new employees the option of joining a DC plan instead of the state's two traditional defined benefit plans. Other states have taken similar approaches to try to address funding issues in their DB plans.

"It does not include enough structural change to solve the enormous unfunded liability problems the state faces," Mr. Scott complained in a letter to lawmakers, referring to the package of reforms to close the combined $3 billion funding gap in the $2.5 billion Vermont State Teachers' Retirement System and the $2.75 billion Vermont State Employees' Retirement System, both in Montpelier.

Lawmakers quickly overrode his veto, arguing the governor's recommendation was too last minute and lacked the actuarial analysis to support his suggested reform measure.

As states look to solve long-term funding shortfalls in their defined benefit plans, some are either offering new employees a DC plan as an alternative to a traditional pension or closing the plan to new hires altogether and giving them a defined contribution plan instead. To date, nine states offer a defined contribution plan as an alternative to a defined benefit plan, and three — Alaska, Michigan and Oklahoma — have taken the broader measure of offering a DC plan as the only option for new workers, said Aleena Oberthur, manager at The Pew Charitable Trusts in Washington.

Defined contribution supporters position DC alternatives to defined benefit plans as giving employees more choice, which they say is important given today's mobile workforce, as well as making state's future retirement costs more predictable. Those who support traditional defined benefit plans, however, see such measures as the first step in killing off public pension plans.

"I think the concern of a lot of the DB advocates is that this is a step toward getting rid of pensions over time," said Dan Doonan, executive director of the National Institute on Retirement Security in Washington.

Opening a defined contribution plan takes away future members of the traditional pension plan, which weakens its ratio of workers to retirees, thereby straining funding, Mr. Doonan said.

Pressure on DB funding

Vermont Treasurer Beth Pearce, a fierce defender of defined benefit plans, also sees the addition of defined contribution plans as aging the profile of existing DB plans. Fewer people coming into a DB plan means there are fewer people providing contributions to support a growing base of retirees.

"Your population is getting older and more likely to retire," she said, adding that the demographic dynamic puts added pressure on a DB plan's unfunded liabilities.

Ms. Pearce, who describes herself as "a little bit of an actuarial nerd," emphasized that the introduction of a DC option would increase costs and would not take care of the $3 billion unfunded liability of the two pension plans for state employees and teachers.

After delving into the state's data, Ms. Pearce estimates that if the DC plan now in place for exempt employees were implemented and applied to all employees, it would increase total DB and DC costs by an estimated $60 million in 10 years and continue growing each subsequent year. The increased costs would be substantial even if the defined contribution plan applied to just new employees, she said.

Ms. Pearce explained that DC plan costs are higher than the DB plans' so-called "normal costs" or those not related to the unfunded liability. "The contribution rate per participant for the existing defined contribution system exceeds the normal cost per participant in the defined benefit plan," Ms. Pearce said.

Ms. Pearce also points out that studies have consistently shown that DB plans are easier on state budgets than DC plans. For example, in a study released in January, the National Institute on Retirement Security found that the typical DB plan has a 49% cost advantage over a typical individually directed defined contribution plan, with four-fifths of the difference occurring post-retirement.

Derisk DB portfolios

While Mr. Scott called for structural reforms to "right the ship," experience has shown that when DB plans are closed, their unfunded liabilities often grow, according to industry experts. That's because fewer people are now contributing to the DB plan, triggering negative cash flows, said Gene Kalwarski, CEO and principal consulting actuary at Cheiron Inc. in McLean, Va.

"With less money coming into the DB plan, we now have to dip into investments to pay those benefits," he said, adding that if assets are liquidated during a market downturn, "you can't recoup."

One way to prevent the unfunded liability from growing after closing a DB plan is to derisk the portfolio by investing in assets that are less volatile, something that most public plans don't do, Mr. Kalwarski said.

"They continue to invest as though the plan is still open, and that's why the unfunded liabilities in most cases grow," he said.

For states that closed their pension plans to new employees and offered them defined contribution plans instead, the result has not been encouraging. West Virginia, for example, which closed its pension plan for teachers in 1991, wound up reopening the plan in 2005 after discovering that closing the DB plan didn't help the unfunded liability at all, said Craig Slaughter, Charleston-based CEO of the West Virginia Investment Management Board, which manages the assets of the state's DB plans for teachers and other state employees.

Even though the state developed a 40-year funding plan for the DB plan that ate up one-tenth of the state's general budget each year, it realized that the now $8.7 billion plan was shrinking because there were fewer people making contributions, he said.

"They discovered that it would have been actuarially more efficient for the DB plan to have remained opened and not do a DC plan," he said.

In addition to reopening the DB plan to new hires, West Virginia in 2008 allowed teachers in the DC plan to switch to the DB plan, an option taken by more than 78% of teachers, according to an August 2019 report by the National Institute on Retirement Security.

Alaska's funding

Alaska, too, saw its unfunded liabilities grow after closing its two statewide DB plans for teachers and public employees in 2005. As of June 30, 2021, their combined unfunded liability stood at $7.4 billion, up from $4.1 billion in 2005, according to The Public Plans Data, a public database maintained by the Center for Retirement Research at Boston College in partnership with MissionSquare Research Institute, the National Association of State Retirement Administrators, and the Government Finance Officers Association.

Alysia Jones, board liaison officer for the Alaska Retirement Management Board in Juneau, declined to discuss the impact the closing of its DB plans had on the state's unfunded liabilities.

In its 2019 report, however, the National Institute on National Security said Alaska's growing unfunded liability was exacerbated by the fact that it underpaid the actuarially determined employer contribution for many years in both the teachers' and public employees' DB plans. Still, a large one-time $3 billion infusion of the state's financial resources in 2014 was insufficient to prevent the unfunded liabilities of the two plans from growing, the report said.

The state, which NIRS' Mr. Doonan and other experts say is facing significant challenges recruiting teachers, state troopers and other state workers, is now considering legislation that would allow its teachers and public employees to choose between the state's defined benefit and defined contribution plans.

For its part, Vermont is looking to reduce its unfunded liabilities the traditional way by reducing benefits and increasing contributions. The state's recent pension reform legislation calls for teachers and state employees to boost their contributions gradually over a three- to five-year period and to accept more modest cost-of-living adjustments. The state, in turn, will make a one-time $200 million payment to the pension systems to pay down unfunded liabilities in fiscal year 2022, plus ongoing additional payments beginning in 2024 that ramp up to $15 million and remain at that level until the pension systems are 90% funded.

As Ms. Pearce sees it, defined benefit plans are better equipped to serve the state's public workers than defined contribution plans on multiple fronts, be it plan affordability and sustainability, recruiting and retention or retirement security.

Retirement plans should be attractive to employees and provide them with retirement security, while being sustainable as well as affordable to workers and taxpayers, she said.

"I believe that defined benefit plans fit the mold much better than defined contribution plans," she said.

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