North Carolina
Future of Retirement
Study Commission

Areas for Recommendations from Meeting 7

Keep in mind that all of these questions are being answered for future hires only at this point.

<u>Focus on Preferred Design Types</u>

A1. Should the Commission limit consideration to the following three types of designs: DB Only, DB/DC Choice, and DB/DC Combination?

At the June meeting, these designs were the favorites with roughly equal numbers of votes and far more votes than the other alternatives.

<u>DB Design Details</u>

Starting with the current TSERS and LGERS design, consider the following questions. For these questions, assume that employee contributions will be adjusted up or down to keep the cost of the system to employers and value of the system to employees the same.

DB1. Do you wish to change the multiplier in order to achieve a different replacement rate for the career employee, however career employee is defined?

The current system replaces about 1.82% x 30 = 55% after 30 years of service and 1.82% x 40 = 73% after 40 years of service. The materials from the February meeting estimated that Social Security would replace about 37% of pay for the average single employee or employee married to a spouse with similar income. The Commission's median total replacement rate recommendation from that meeting was 80% to 84%.

DB2. Do you wish to index average final compensation for those who leave employment prior to reaching retirement eligibility?

For someone who works from age 25 to age 40, the current system does not offer an unreduced benefit until age 65. If this person receives 4% pay increases in their post-40 job, the current system will replace only 10% of their final salary at age 65. This is far less than the 28% replacement rate for someone who works the same 15 years, but at ages 50 to 65.

Here is an example of how indexing would change that. If the 40 year old earned $40,000 when he left the state and if the index we used averaged 3% per year, then his benefit would be roughly $40,000 x $1.03^{(65-40)}$ x 1.82% x 15 = $22,864. Based on the assumption above, his final pay would be $40,000 x $1.04^{(65-40)}$ = $106,633, so his replacement rate would be $22,864 / $106,633 = 21%.

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The index could be based on inflation, average increases in pay across the whole U.S., average increases in pay across NC state government, or investment returns. Both South Dakota and the Minnesota Teachers' Retirement Association index earnings used in the benefit calculation.

DB3. Do you wish to have a multiplier that varies with age and/or service prior to retirement eligibility?

Examples:
* 1.7% for each year worked under age 45. 2.0% for each year worked after age 45.
* 1.7% for the first 15 years of service. 2.0% for years after 15.
* 2.0% for the first 15 years of service. 1.7% for years after 15.
* 1.7% applied to all service if you leave with less than 30 years. 2.0% applied to all service if you leave with more than 30 years.

By tying the multiplier to age and/or service, we could increase benefits for people who work certain types of careers vs. others. The following table shows the variations:

Employee Career Type:	Works for 30 years	Works from age 25 to age 40 (15 years)	Works from age 50 to age 65 (15 years)
Multiplier that increases with age	Neutral	Decrease	Increase
Multiplier that increases with service	Increase	Decrease	Decrease
Multiplier that decreases with service	Decrease	Increase	Increase
Indexing Final Compensation	Decrease	Increase	Decrease

DB4. Do you wish to have the multiplier vary with salary?

For example, the TSERS formula in 1974 was (1.25% x average final compensation not in excess of $5,600 + 1.5% x average final compensation in excess of $5,600) x service.

The argument for a higher multiplier at higher salaries is that Social Security replaces a lower percentage of income for those at higher salaries and the employer pays no Social Security taxes on wages above some level ($106,800 in 2010).

The argument for a lower multiplier at higher salaries is that higher income employees can probably save for retirement on their own, without their employer's help.

If you believe these two arguments cancel out, you can keep the multiplier constant across pay levels.

DB5. Should the benefit be lower at the time of retirement and then have automatic (rather than ad-hoc) increases during the retirement years?

In the February meeting, 9 out of 10 Commission members who voted said that retirees should plan for increasing income needs during their retirement period. Probably the biggest reason this is not offered is because many employees/retirees underestimate the effects of inflation and prefer to get as large an initial benefit as possible. Based on current interest rates, the initial benefit at age 65 would need to be about 22% smaller for a 2.5% automatic COLA to be cost-neutral.

DB6. If you want automatic increases during retirement, should those increases be tied to a measure of inflation like CPI?

In the March meeting, staff showed how inflation risk protection can currently be achieved at no cost once you are already planning for a benefit that increases at the anticipated inflation rate. If the employers do not wish to bear the resulting inflation risk, they can ask the State to invest the assets related to those retirees in the proper mix of U.S. Treasury Inflation Protected Securities (TIPS).

DB7. Should we set a minimum age at which someone can retire with 30 years of service?

Currently, employees can retire with unreduced benefits after 30 years of service, regardless of age. With work during high school and sick leave conversion, we have seen retirements as early as age 44. The minimum age could be something like 50, 55, or 60. Note that the employee would not be required to keep working for the State until that age. He could quit, work somewhere else until the minimum age, and then quit his new job (or not) and start collecting his benefit from the State.

In meeting 2, the Commission was asked for a target age at which employees should plan to leave the workforce and the Commission was roughly divided between ages 55-60, 60-65, and 65-70.

Several employers and Commission members expressed concerns about retaining employees once they have 30 years of service. This change would obviously help retain those employees.

Many other states have been raising unreduced retirement ages in recent years, including AZ, IL, KY, MS, NV, NY, RI, TX, UT, VT, and VA. We are not aware of any state that has decreased the unreduced retirement age in recent years.

DB8. Should we change the age at which someone can retire unreduced with less than 30 years of service?

Currently, employees who do not have 30 years of service can receive unreduced retirement benefits at age 60 if they have 25 years of service or at age 65 if they have 5 years of service. For law enforcement officers, the age is 55 with 5 years of service.

DB9. Should we make the employee contribution rate variable?

The employee contribution rate is currently fixed in statute at 6% of pay. If investment returns or other experience are good, as they were during most of the past decade, then the employee contribution remains constant and the employer contribution can be reduced to well below 6%. However, if experience is bad, as it was during 2008, then the employer contribution increases to compensate.

If the employee contribution were variable, then investment and other risks would be shared between the employee and employer. A common arrangement is to set each contribution to a fixed percent of the total, for example 50%. If the total contribution can decrease from 12% to 8%, then the employee and employer contributions would both decrease from 6% to 4%. If the total contribution needs to increase from 12% to 16%, then the employee and employer contributions would both increase from 6% to 8%.

DB10. Should we have benefits depend on investment experience?
This could either be done on an ad-hoc basis when the need arose, as in South Dakota, or be based on a specific formula. For example, the benefit formula could be 1.82% x Service x Average Final Compensation x Investment Result Multiplier. The Investment Result Multiplier (IRM) would compare the returns during your career to the target return (currently 7.25%). If the returns were higher than 7.25%, the IRM would be greater than 1.0. If the returns were lower than 7.25%, the IRM would be less than 1.0. Once you retired, your benefit would be fixed in this example.

DB11. Should we adjust the vesting requirement up or down and/or change what a non-vested employee receives?

Currently, employees vest in a benefit after 5 years of service. If they leave prior to 5 years of service, they can take a refund of their contributions without interest. The 5 years could be raised or lowered depending on how you want to reward short-service employees and what incentives you want to create to get them to stay. You could also refund some portion of employer contributions.

DB12. Do you want to forbid refunds of employee contributions?

The current design requires very little effort or expertise from the employee. About the only way that a career employee can end up without a benefit is by withdrawing his or her contributions. We do have rare cases where someone withdraws his contributions even when he has 30 years of service. Withdrawals with 5 to 20 years of service are more common.

DB13. Do you want to lengthen the period over which final compensation is averaged?

The current formula uses a four year average. In the April meeting, local governments expressed concerns about employees switching jobs in the last four years of their careers in order to get a higher benefit. Recent articles in the press have highlighted some examples of employees

increasing pay in the final four years. It has also been a big concern in other states, although those other states usually have final averaging periods shorter than our four years.

The period could be lengthened to a specific number or to the whole career. When the period is lengthened, it will usually decrease benefits because compensation typically rises over time, even for employees who are not spiking their pay. To offset this, we could either raise the multiplier or we could index the earnings. Here is an example:

Year	Pay	Indexed Pays (assume 3% index)
2011	$40,000	$40,000 * 1.03^9 = $52,191
2012	$42,000	$42,000 * 1.03^8 = $53,204
2013	$44,000	$54,114
2014	$46,000	$54,926
2015	$48,000	$55,645
2016	$50,000	$56,275
2017	$52,000	$56,822
2018	$54,000	$57,289
2019	$56,000	$57,680
2020	$58,000	$58,000
4 Year Average	$55,000	$57,448
10 Year Average	$49,000	$55,615

Let's suppose the employee has 30 years of service. The current formula would give a benefit of 1.82% x 30 x $55,000 = $30,030. If we used a higher multiplier with a 10-year average of actual pays, we might provide 2.043% x 30 x $49,000 = $30,032, roughly the same benefit for this particular person (but a much lower benefit for a pay spiker). Alternatively, we could use a slightly lower multiplier with indexed earnings, for example 1.80% x 30 x $55,615 = $30,032.

DB14. Do you want to limit the year-to-year increase in the salary used in the calculation?

For example, if the limit were 10% and the employer reported $50,000 one year and $100,000 the next, we would only use $50,000 x 1.1 = $55,000 for the second year salary in the benefit calculation. The next year, we would use no more than $55,000 x 1.1 = $60,500. The effect of this would be similar to the effect of lengthening the averaging period.

DB15. Do you wish to relax restrictions on returning to work for the state or local government while you are collecting a retirement benefit?

Federal tax law places some limits on how much we can relax our rules and the public often frowns on employees collecting a paycheck and a pension check at the same time, but we might be able to relax them some. This is particularly true for employees over age 62, for whom there is an

exemption in the federal law. The UNC system already takes advantage of this exemption in their phased retirement program which allows faculty who are over age 62 to begin collecting their TSERS benefit while working only half-time.

Relaxing the restrictions will encourage people to retire earlier, which will increase the cost of the system. This could be offset with a decrease in the multiplier or an increase in the employee contribution.

DB16. Do you wish to adopt a Deferred Retirement Option Plan (DROP)?

This would allow employees to keep working and essentially receive their retirement benefit at the same time, except that the retirement check would be deposited into something like a 401(k) account instead of being paid out to the employee. This avoids some of the problems with federal tax law, but may still be viewed negatively by the public. It also usually has a cost because employees are essentially receiving their benefit earlier. This cost can be reduced by not providing any investment earnings on the money in the 401(k)-like account or it can be offset by a decrease in the multiplier or an increase in the employee contribution.

DB17. Do you wish to have a higher multiplier for service after 30 years?

For service beyond 30 years, employees could earn benefits with a higher multiplier, for example 2.0%. This would encourage these employees to keep working and not collect their benefit yet. This obviously has a cost, which could be offset by lowering the multiplier for everyone else or increasing the employee contribution.

DB18. Do you recommend that State agencies and local employers simply raise salaries for those retirement-eligible employees they wish to keep?

This is obviously not a pension design feature, but if employers wish to retain certain employees who are eligible to retire, they could simply choose to pay them more. In the April meeting, the local governments indicated that they felt they could often address the problem with this tool. This allows employers to target the incentive only at those employees they most want to keep.

DC Design Details

The following questions are about the DC plan that would be offered in a DB/DC choice arrangement.

DC1. Should the employee contribution be required, automatic with opt-out provision, or voluntary?

As discussed in the May meeting readings, automatic contributions have been shown to help most employees better prepare for retirement, while still allowing employees who have financial expertise or hire a financial planner to choose the contribution that is right for them. Entirely

voluntary contributions (default contributions of 0%) tend to result in a low level of participation and low contribution rates.

In DB/DC Choice or DB/DC Combination arrangements, employee contributions to the DC plan are often mandatory to mirror the mandatory participation in the DB plan.

DC2. If the employee contribution is automatic, should it be set to a certain percent of pay or should it be targeted to achieve a certain replacement rate?

In the IBM 401(k) plan described in the June meeting, the contribution is set to a certain percent of pay. This approach keeps the automatic contribution steadier.

In the Automated DC Plan described in the June meeting, it is targeted to achieve a certain replacement rate. This approach makes it more likely that the contribution will be sufficient to achieve the employee's retirement goals.

DC3. Should the employer contribution be automatic or should it be a match that depends on the employee contribution?

The advantage of a match is that it encourages greater employee contribution levels. The advantage of an automatic contribution is that every employee gets the same employer contribution, regardless of how much the employee is able to contribute.

DC4. Should the employer contribution vary with age, service, pay level, or any other factor?

Most DC plans provide the same employer contribution rate for everyone. The advantages of varying rates with age, service, pay level or other factors have been described above under the DB Design Details section.

DC5. Which of the following best describes the amount of investment risk the employee should bear under the default investment option?

   A.   **No investment risk (invest entirely in safe assets, for example long-term TIPS).**
   B.   **Reduce investment risk to zero during career, so that all assets are safe at the time of retirement.**
   C.   **Reduce investment risk during career, but leave about 50% of assets in stocks at retirement. This is typical of current target-date funds.**

The advantage of A is safety. The advantage of C is better returns on average and therefore lower employee contributions to achieve the same replacement rate. B is somewhere between the two extremes.

DC6. Should the employers provide free financial advice?

As noted in the May meeting, financial advice can help employees make better retirement planning decisions, while still giving them the freedom to do what they think is best. The cost of this could be offset by reducing the employer contribution by an equivalent amount.

DC7. How many years of service should we require before an employee vests in the employer contributions?

As with DB vesting, this is a question of how well you want to treat short service employees and how much incentive you want to create for them to stick around.

<u>Choice Design Details</u>

Choice1. How many opportunities should the employee have to make the decision?
Five other systems, including the UNC ORP, offer only a single choice. Four other systems offer two opportunities. One other system (Ohio PERS) offers four opportunities. Note that opportunities to switch add cost because an employee could choose to be in the DC plan at younger ages when that is more valuable and then switch to the DB plan at older ages, when that plan is more valuable. This cost could be offset by reducing the multiplier and/or increasing the employee contribution in the DB plan.

Choice2. If the employee is given multiple choice opportunities, how will the transition work?

   A. **There is no transfer of value. The employee maintains accounts in both plans.**
   B. **The value of the benefit under the old plan is transferred to the new plan.**
   C. **The benefit will be based on a theoretical calculation as if the employee had always been in the new plan. This can be expensive if people in the DC plan switch to the DB plan after a big drop in asset values.**

Other states that offer multiple choices appear to be split between approach A and approach B. No one seems to use approach C.

Choice3. Should the DB and DC plan be of roughly equivalent value for the average employee?

Making them roughly equivalent is fairer, but increases anti-selection and makes the decision more difficult. Every other state that offers choice appears to try to make them roughly equivalent.

Choice4. What kind of guidance should employees receive in order to make their choice: handbooks, plan comparisons, workshops, help lines, modeling tools, benefit statements, one-on-one counseling?

Other states offer at least a handbook and many offer plan comparisons. Workshops, help lines, modeling tools, and benefit statements are offered by some states, but are obviously more expensive. No state appears to offer one-on-one in-person counseling.

Choice5. Which plan should be the default if the employee fails to submit an election form?

The DB plan is usually set as the default in other states.

Choice6. Would you make any changes to the DB plan you selected if it is part of a DB/DC choice offering?

Combination Design Details

Combo1. Should the mandatory DB and DC components provide roughly the same economic value to the average employee or should one component be weighted more heavily than the other?

Three of the other states that offer Combination plans set them at roughly the same value. In Indiana, the DB component is somewhat more valuable. In Ohio, the DC component is somewhat more valuable. This basically comes down to whether you want something that looks more like a DB plan, more like a DC plan, or exactly in the middle.

Combo2. Should the DB component be funded by employer contributions, employee contributions, or a mix?

The most common approach is to fund the DB component with employer contributions only. This keeps it simpler and allows the employer to prevent employees from withdrawing their contributions and giving up retirement benefits.

Combo3. Should the DC component be funded by employer contributions, employee contributions, or a mix?

The most common approach is to fund the DC component with employee contributions only. This keeps it simpler and allows the employee to feel more control over the money that they are contributing.

Combo4. Would you make any changes to the DB plan you selected if it is part of a DB/DC choice offering?