# Issues and Strategies for Addressing Retiree Health and Pension Costs

## Public Sector vs. Private Sector Perspectives

Presentation to:

The California Public Employee Post-Employment Benefits Commission

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## Agenda:

- Public sector vs. private sector perspectives on retiree health and pension funding issues
- A best practice approach for examining the issues
- No recommendations on what is best solution for California

## Public and Private Sector Perspectives Are Similar At the Highest Levels:

- Both function in similar environments:
  - Accounting standards
    - Pension
    - OPEB
  - Federal environment
    - IRC
    - ERISA/Fiduciary
    - Workplace laws
  - Global economy
  - Capital markets

# Public and Private Sector Perspectives Are Similar At the Highest Levels:

- Both are concerned with:
  - Workforce management
    - Attraction, retention, transition to retirement
  - Cost efficiency
  - Enterprise risk management
    - Mission
    - Financial
    - Reputational

## Public and Private Sector Perspectives Are Similar At the Highest Levels:

- Both are ultimately concerned with allocation of limited resources against unlimited demand for those resources

# But, Public and Private Sector Perspectives Are Also Different

- Stakeholders and customers are different
  - e.g., Investors vs. taxpayers
- Basic missions and functions are different
  - Private interest vs. public interest
    - Producing and selling soft drinks is not the same as ensuring public safety and the general welfare!
- Governance structures are fundamentally different
- Improper to conclude that private sector solutions are always a good “fit” for public sector or even achievable and vice versa

# The For-Profit Private Sector Response To Pension and Retiree Health Benefits

- Massive decline in both DB pension plan and retiree health benefit coverage

- Shift to participant-managed 401(k) plans
  - Focus on wealth accumulation instead of retirement income

- Retiree health benefits reduced or eliminated

- Cost and risk shifting to employees

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# The For-Profit Private Sector Response

- Why?
- Federal tax policy
  - Minimum and maximum funding standards
    - PPA of 2006 is likely to accelerate this trend
  - Retiree health funding deduction limitations
- Fiduciary (ERISA)
- Securities
- FASB accounting standards
  - FASB Nos. 106 and 158
  - Pension and retiree health liabilities are hitting the bottom line and reducing stockholder equity
- Global competitive environment

# The For-Profit Private Sector Response

## Will the Pendulum Swing Back?

**Answer: Both Yes and No**

**More Risk Shifting for Retiree Health**

- Reduced eligibility
- Coverage reductions
- Increased cost sharing
- HSAs, MSAs

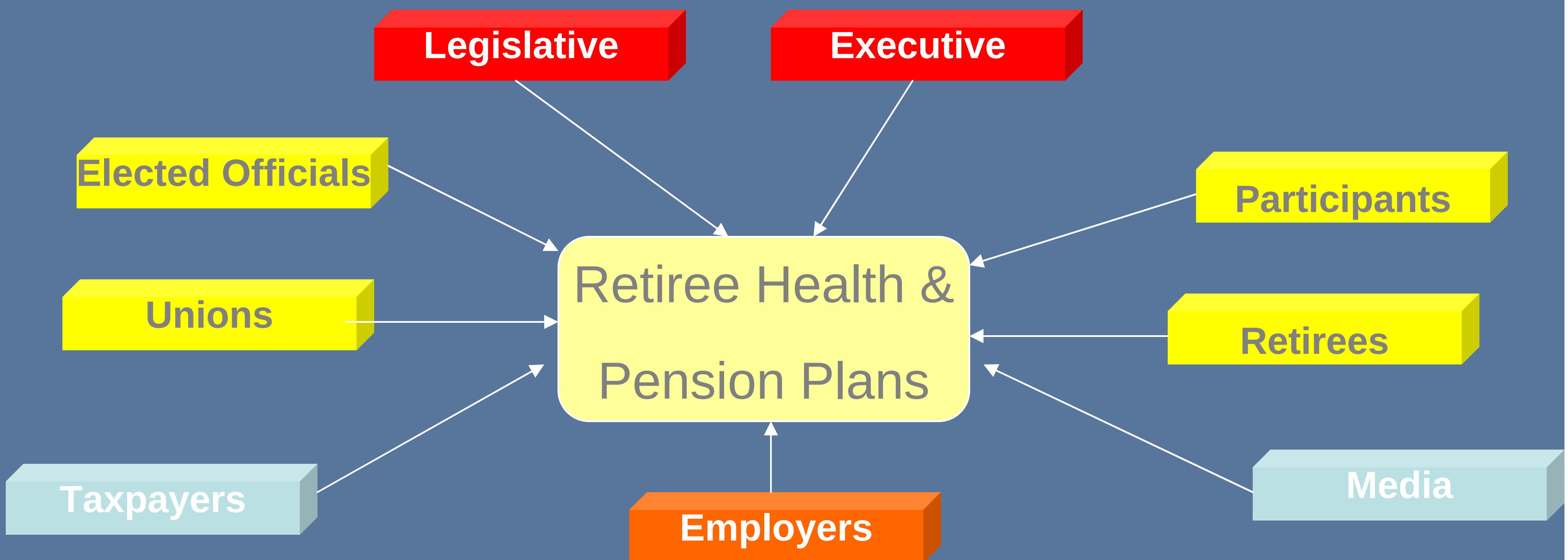

**Managing Risk**

- Hybrid plans
- Lifecycle target date funds
- Managed accounts
- Longevity risk annuities
- Inflation indexed products
- Investment advice

# The Public Sector

- Finances will drive the discussion
- DB pension funding levels are improving but required contributions still causing some pain
- Unfunded retiree health liabilities are daunting

# Public Sector Solutions Require a Strategy for Multiple Stakeholders



# <u>Odysseus's Choice Faces Public Policymakers</u>: The Scylla and Charbydis of Retiree Health and Pension Obligations

# Tough Choices: Options For Dealing with Retiree Health and Pension Funding Issues

- Increase funding
  - Employers, employees, general fund
    - Higher taxes?
  - Take more investment risk - will increase future funding volatility
- Refinance
  - Pension/Retiree Health Obligation Bonds
    - Interest arbitrage play – can win or lose depending on future economic conditions
    - Creates real debt for issuer
  - Defer costs to future years (and future taxpayers) - Longer amortization periods
- Decrease benefits
  - Close off the existing benefit level for new employees, creating a new tier with lower benefits
  - Reduce benefits for existing employees' future service
    - <u>Major legal restrictions exist</u>

# Going Forward: Assess the Current State

1. Inventory all retiree benefit plans
   - Primary or “core” retirement plans
   - Supplemental (voluntary/elective) plans
   - Retiree health plans
2. Assess true funded status of all retiree health and pension plans and promises
   - Basic yardsticks
     - Ratio of assets to liabilities
     - Actual contributions vs. actuarial required contributions
     - Ratio of UAL to covered compensation
   - Test actuarial assumptions and methods for reasonableness: investment return and inflation, particularly medical inflation

# Going Forward: Assess the Current State

3. Assess long-term affordability

- Taking into account other budget priorities, are these amounts affordable?

4. Assess short-term volatility

- Can we handle the potential volatility of the contribution rates?
  - Conduct stress tests on funding rates
  - Probability studies (stochastic modeling) to determine the likelihood that short-term market losses or long-term medical inflation may cause funding levels to rise to an unacceptable level

# Choosing The Right Course:
# Risk Management Principles Can Help

**Step 1**
Desired
Retiree Benefits
Policy

- Retirement Income
- Retiree health
- Disability
- Survivor benefits
- Workforce attraction and retention
- Social safety net

**Step 2**
Financial Risk
Management
Filters

- Investment and Funding Rate Risk
- Inflation and longevity risk
- Mortality and Disability Risk
- Termination Risk
- Annuitization Rate Risk
- Other Risks

**Risk Managed Design**

Guaranteed Benefits
- DB
- Annuities

Nonguaranteed Benefits
- DC
- Variable annuities

Hybrid designs

Vesting/Portability/Cashability

Ancillary benefits

# The Filters: Financial Risk Areas in Retirement

- Filter A: Investment and Funding Rate Risk
  - Investment risk – the risk that investment returns will be less than necessary to provide the desired benefit levels.
  - Funding rate risk - the risk that plan investment or benefits experience is worse than expected requiring higher contributions to properly pay for the promised or desired benefits
- Filter B: Longevity and Inflation Risk
  - Longevity risk – the risk that the participant will live longer than expected
  - Inflation risk – the risk that inflation will decrease the value of the earned benefit
- Filter C: Mortality and Disability Risk
  - Mortality risk - the risk that the participant will die before expected
  - Disability risk – the risk that the participant will become disabled before becoming eligible for regular retirement benefit

# The Filters: Financial Risk Areas in Retirement

- Filter D: Termination Risk
  - The risk that the participant will end employment before vesting and forfeit accrued benefits
- Filter E: Other Risks
  - Annuitization rate risk - the risk for DC plans that the cost of annuitization at retirement is higher than anticipated
  - Workforce efficiency and retention risk – The risk that employees cannot afford to retire and become “retired on the job”
  - Social safety net risk – the risk that employees may retire at a lower standard of living and welfare programs experience higher costs that cannot be spread and funded over time like pension benefits
  - Intergenerational cost transfer risk – the risk that current costs become so high that they are passed on to future generations in terms of higher costs, lower service levels, or lower benefits for future employees

# Is An Integrated Strategy Possible?

- Ideal: Retiree health and pension benefits and funding policy should be integrated
  - Retiree financial security is based on adequate and secure retirement income and retiree health care
- Integration of retirement health and pension benefits and funding policy allows increased:
  - Cost efficiency
  - Tax efficiency
  - Benefit and compensation equity
  - Workforce attraction and retention effectiveness
  - Taxpayer equity

# Ideal: An Integrated Strategy

## But It  Will Not Be Easy

- Current benefit promises may limit flexibility and require separate strategies
  - Pension DB promises for existing employees may not be reduced
  - Pension cost savings, if any, may only be realized over the long-run
  - However, retiree health promises may not have the same level of protection
- Separate strategies may be necessary for:
  - New hire strategies vs. existing employees
  - But financing of both remains inextricably linked

# Concept: Integrated Retirement and Retiree Health Designs

**Allocate Employer and Employee Contributions**

**Core Retirement Plan**

**Voluntary Savings Plan**
[401(k), 403(b), 457]

**Retiree Medical Benefit**

**Integrated Administrative Platform**

**Coordinated Member Services**
- Website
- Call Center
- Benefits Statements
- Communications
- Education

**Investments**
- DC
- DB
  - Lifecycle
  - Core mutual funds
  - Brokerage window
  - Annuities
- Investment Advice

**Administration**
- Recordkeeping
- Distributions
- Claims Payments
- Fiduciary Support

# QUESTIONS?

# Appendix

# Issues When Considering Replacing DB with DC Plans

- First, remember that DC plans are not a funding panacea
  - The legacy DB costs will continue for some time
  - Benefit adequacy and security objectives still require meaningful and substantial funding for DC benefits
- Second, moving to DC has <u>no impact</u> on the legacy costs of the DB plan

# Issues When Considering Replacing DB with DC Plans

- Third, DC plans can meet retirement objectives without undue employer or participant risk, if designed properly
  - Core DC Plans should focus on providing retirement income and security
  - <u>Contrast</u>: Traditional corporate 401(k) or supplemental 457(b) or 403(b) plans focus on wealth accumulation only
- Fourth, DC plans may not fit all employee classes:
  - e.g., public safety

# Core DC Plan: Best Practice Design

- Participation
  - Mandatory, automatic enrollment
- Contributions
  - 10 to 12% of pay minimum contribution rate
    - Higher for non-Social Security employers
    - At least ½ paid for by employer
    - Target ≅ 70 +% income replacement for career employees
  - Consider age or service based contribution schedules
    - Mimics DB benefit accrual patterns
  - Elective additional employee contributions to supplemental plan

# Core DC Plans: Best Practice Design

- <u>Investments</u>
  - Limit participant-directed investments
    - Consider employer-directed investments appropriate for core retirement plan
    - Consider <u>mandatory</u> life-cycle funds
  - Consider annuities to control risk
  - For participant-directed accounts, provide array of investments ranging from conservative to aggressive
    - Array should be consistent with retirement income objective
    - Use lifecycle funds as default
    - Limit # of funds to about 20 to reduce costs and complexity

# Core DC Plans: Best Practice Design

- Participant Investment Education and Advice
  - Integrated individual participant investment advice, retirement and financial planning services
  - Independent objective investment advice
  - Delivery should be one-on-one supplemented by call center and website

- Distributions
  - Mandatory full or partial annuitization at retirement
  - Limit lump-sum, loans and hardship distributions

# Core DC Plans: Best Practice Design

- <u>Ancillary Benefits</u>
  - Retiree health
  - Mandatory employer contribution to disability and preretirement death benefits, if not separately provided

- <u>Administration and Fees</u>
  - Single, consolidated administrative platform
    - One point of contact for participants and employer
  - Total administration costs should not exceed 40 bps
  - Total plan costs, with investment expenses, should not exceed 100 bps

# Options For Dealing with Retiree Health Funding Issues

- Reducing or eliminating eligibility for retiree health benefits
  - Increase age and service requirements
  - Cutting coverage for certain classes of employees or entirely
- Reducing insurance costs
  - Reduced benefits – higher co-pays, coinsurance, deductibles
  - Mandating managed care/Medicare Part B
  - Catastrophic coverage only

# Options For Dealing with Retiree Health Funding Issues

- Reducing employer premium cost sharing
  - Providing access only – retirees pay full cost
  - Increasing retiree contributions
  - Capping employer subsidy
- Disconnecting cost of insurance coverage from employer subsidy
  - e.g.,
    - $5 per month/year of service
    - $200 month

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# Options For Dealing with Retiree Health Funding Issues

- Moving to defined contribution approaches
  - Health Reimbursement Accounts (HRAs)
  - Health Savings Accounts (HSAs)
    - Coupled with High Deductible Health Plans
- Prefunding
  - Objective: Dedicated assets to offset GASB liability
  - Common funding vehicles
    - 501(c)(9) Voluntary Employee Beneficiary Association Trusts (VEBA)
    - 115 integral part trusts
    - 401(h) medical accounts (sub-account of qualified pension plan)

# Attributes of an Ideal Retiree Health Trust Funding Vehicle

- Allow nontaxable employer contributions
- Allow nontaxable employee contributions
- Allow tax exempt investment earnings on plan assets
- Provide non-taxable health benefits
- Assets should count as a GASB OPEB asset against retiree health obligations, if necessary
- Unused benefits are not forfeited
  - An issue for defined contribution designs

# Choosing the Best Trust Funding Vehicle

| Funding Vehicle | Pre-tax Employer Contributions | Pre-tax Employee Contributions | Tax-Exempt Earnings | Non-taxable Health Benefits | GASB Asset | Unused Benefits Not Forfeited |
|---|---|---|---|---|---|---|
| **401(h)** | Yes | Yes | Yes | Yes | Yes | Yes |
| **VEBA** | Yes | No* | Yes | Yes | Yes | No** |
| **115 Trust** | Yes | No* | Yes | Yes | Yes | No** |

*** Recent IRS Rulings**

**** Federal domestic partner legislation may affect this**

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