

Converting a Defined Benefit Program to Defined Contribution

CASE STUDY

Newport Beach Retiree Medical Plan



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Public Employee Post-Retirement Benefits Commission

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What We'll Cover

- **Introduction/Overview**
- **Old Program**
- **New Program**
- **Transition Plan/Process**
- **Outside Support**
- **Tools Used**
 - **Cost Projections/Comparisons (City)**
 - **Benefit Projections/Comparisons (Employees)**
- **Conclusion**



Catalyst

Employees Wanted Increased Benefit

(Rising Medical Costs)

City Wanted New Structure

(Limit Future Unfunded Liability)



Overview of What Happened

- **Converted Defined Benefit Program to Defined Contribution Program**
- **Done Through Meet & Confer Process**
- **Complex—Apples to Oranges—Communication and Explanation Effort was Critical**
- **Favorable to City**
 - **Permanently Capped Unfunded Liability**
 - **More Efficient Use of Resources**
- **Favorable to Employees**
 - **Enhanced Program**
 - **More Flexibility**

Key Provisions of Old Program

- **Benefit: Up to \$400 Month**
- **Cost Share: (Retiree 25%; Active Employees 25%; City 50%) (City plus Active Contribution=\$400 maximum)**
- **Usable Only for City Medical Insurance**
- **7 Years Employment to Vest**
- **Must Retire From City to Participate**

Problems With Old Program

Employees:

- **\$400 Month Maximum**
- **No Flexibility**
- **Had to Work at Least 7 Years and Retire From City to Receive any Benefit**
- **No Tax Advantage for Funds “Paid In”**
- **A Large Percentage of Those Who “Paid In” Along the Way Got Nothing**

City:

- **Unfunded Liability**
- **Pressure from Labor to Increase Benefit**
(Understandable, but potential cost liability was big concern)
- **Inherently Unfair Program**
(Inefficient use of funds; prefer not to perpetuate)

New Program: “Integral Part Trust”

- **Set Up Under IRC Section 115**
- **Defined Contribution Plan**
- **Each Employee Has Individual “Account”**
- **Funds in Account *Belong* to Employee**
- **City Health Insurance Available but Not Required**

New Program (continued)

- **Contributions (Deposits): 3 sources**
 - A. Employee: 1% of Salary
 - B. City: \$1.50 per month for each Year of Service+Year of Age (after 5 years employment)
 - C. Leave settlement proceeds for some Associations
- **Contributions are pre-tax--*mandatory and uniform* for all employees within a bargaining unit. No individual options.**

New Program (continued)

Example: An employee is 32 years old and has worked for the City for 8 years. Salary is \$7000 per month.

$$\begin{array}{rcl} 1\% \text{ of Salary:} & = & \$ 70 \\ \$1.50 \times (32+8) & = & \underline{\quad 60} \\ \text{Monthly Deposit} & & \$130 \end{array}$$

- One element varies with salary, the other does not.
- Age/longevity element goes up by \$3 each year.
- Changes negotiable on a go-forward basis, but must be mandatory and uniform for all in Bargaining Unit.

New Program (continued)

- Investments:

Directed by employee within parameters provided (similar to deferred compensation).

- Withdrawals:

For Medical and related purposes (as authorized by IRS) after leaving City employment. Non-Taxable.

- Authorized Participants:

Retiree and spouse/legal dependent. Funds remaining in account (if any) after death of authorized participants are “reverted to the plan.” IRS rule. Cannot be passed to heirs as of this time.

Transition Plan

- Existing Retirees

No change. Remain with old program.

- New (prospective) Employees

Mandatory enrollment in new program. Old program not available.

- Current Employees

- Age+years of service totaling 49 or less (45 for public safety); must convert to new program.
- Age+years of service totaling 50 or more (46 for public safety); given option of fully converting to new program or participating in a “hybrid” program with elements of both.

Special provisions for current employees to compensate for prior payments to retirees on old program.

Transition Plan (continued)

“Hybrid” Program Details

- **Temporary—One time option for relatively older current employees**
- **Participate in new program, but retain \$400 per month provision of old program (not enough time left to accumulate funds in new program)**
 - **Do not receive City contribution of \$1.50 per month for years of service+years of age (Part “B”)**
 - **Must “pay in” \$100 per month during remainder of time on active duty to help fund the \$400 per month after retirement.**

Mandatory conversion threshold probably not necessary. Few of those in the group that was not given the option would have preferred the hybrid plan.

Outside Support

- **Attorney** (Shana Saichek)
- **Actuary** (John Bartel)
- **Trustee / Account Custodian / Investment Services** (ING)
- **Claims Administrator** (ARC)
- **Trustee Custodian / Annuity Provider** (for remnants of old plan)



Cost Estimation Worksheets

Full-time EE as of 11-29-05							←	→	←	→			
Title	Sex	Misc/Sa	Age+Sv	Age v. A\	Yrs Remai	Year	Estimated Expectancy	Projected Death	2008	2009	2010	2021	2064
COMMUNITY SERVICE	F	Misc	14	14	14	2019	21.09	2040					
ADMIN ASST TO POLI	F	Misc	15	15	15	2020	21.09	2041					
ASSISTANT, ADMINIS	F	Misc	16	16	16	2020	21.09	2041					
POLICE DISPATCHER	F	Misc	16	16	16	2021	21.09	2042				1	
POLICE DISPATCHER	F	Misc	16	16	16	2021	21.09	2042				1	
POLICE OFFICER	F	Safety	7	7	7	2011	30.62	2042					
LIBRARIAN I	F	Misc	16	16	16	2021	21.09	2042				1	
FIREFIGHTER	112 M	Safety	30	30	30	2034	29.73	2064					(1)
FIREFIGHTER	112 M	Safety	30	30	30	2035	29.73	2064					(1)
FIREFIGHTER	112 M	Safety	31	31	31	2036	29.73	2066					
POLICE RECRUIT	M	Misc	35	35	35	2040	25.94	2066					
MAINTENANCE WORK	M	Misc	37	37	37	2042	25.94	2068					
TOTAL NEW PARTICIPANTS									0	0	7		
TOTAL LOST PARTICIPANTS													(16)
TOTAL NET PARTICIPANTS									0	0	7		(16)
COST PER PARTICIPANT PER MONTH									400	400	400	400	
COST PER PARTICIPANT PER YEAR									4800	4,800	4,800	4,800	
BENEFITS BEING DRAWN PER YEAR									-	-	105,600	220,800	
									0	0	22	46	
ACTIVE PARTICIPANTS PER YEAR									326	326	304	-	
CONTRIBUTION PER ACTIVE PER MONTH									70	70	70	70	
CONTRIBUTION PER ACTIVE PER YEAR									840	840	840	840	
CONTRIBUTIONS PER YEAR									273,840	273,840	255,360	-	
Initial cost per month							400	Net City Cash Outflow	(273,840)	(273,840)	(149,760)	220,800	
Initial cost per month for Actives							70		35,737,560	sum			
Annual CPI Adjustment							0.00%		(\$1,025,433.20)	partial npv			
									\$4,409,792.66	partial npv			
Net Cost of Current Program (assumes all retirees at \$400 cap after their own 25% contrib.)									\$3,384,359.46	NPV			
Annual Payment if NPV is capitalized at 6% over 45 years									-218,970				
Annual Payment if NPV is capitalized at 6% over 30 years									-245,870				

Interactive Worksheet

Current employee at top step converting to the New Program										
Sworn safety employees must convert to the New Program if their age + years of service are 45 or less. Non-sworn employees must convert to the New Program if their age + years of service are 49 or less.								Current Monthly Salary		
								\$7,000.00		
COLA		2.75%						Percentage		
Part A Contribution		1%						1.00%		
Prior Svc Contribution		100.00	per month of prior service							
Prior Svc Months		120						Negotiated by Assoc.		
Part B Contribution		\$1.50	per age + years of service							
Year Hired		1999						Assumption		
Age At Hire Date		23								
Estimated Retirement Yr		2034						Varies by Individual		
Part C Contribution		300	Projected number of leave hours to be included at retirement.							
Hours worked per year		2080	<i>Firefighters Only. If you are assigned to a 56-hour work week, you need to change this number to 2912.</i>							
Hourly Salary at Retirement		86.32								
								Assumed		
		Misc EE	Level A Contributions		Level B Contributions		Total	Accumulated	Rate of	
Year	Year	Monthly Salary	Monthly	Annual	Monthly	Annual	Contributions	Total	Return	
1	2006	7,000.00	70.00	840.00	55.50	666.00	1,506.00	1,551.18	3%	
2	2007	7,192.50	71.93	863.10	58.50	702.00	1,565.10	3,240.93	4%	
↓ 3	2008	7,390.29	73.90	886.84	61.50	738.00	1,624.84	5,109.05	5%	
4	2009	7,593.53	75.94	911.22	64.50	774.00	1,685.22	7,201.93	6%	
↑ 27	2032	14,171.82	141.72	1,700.62	133.50	1,602.00	3,302.62	142,774.34	6%	
28	2033	14,561.55	145.62	1,747.39	136.50	1,638.00	3,385.39	154,929.30	6%	
29	2034	14,961.99	149.62	1,795.44	139.50	1,674.00	3,469.44	167,902.67	6%	
30	2035	15,373.44	153.73	1,844.81	142.50	1,710.00	3,554.81	181,744.93	6%	
		Add'l City Contribution at Retirement					12,000.00			
		Part C Contribution					25,895.75			
									\$400.00	
									205,798.42	
									\$1,233.87	
									Current Plan Benefit	
									Accumulated Total at Retirement	
									Amount Available per Month for 30 Years	

Conclusion

- Employees

- Guaranteed participation
- Flexibility
- Tax free money—both going in and coming out

- City

- Liability capped and limited
- Risk reduced
- More efficient use of funds
- Reality: No free lunch. A different way to address the cost. Essentially pre-funding much of the liability and insuring that it does not re-accumulate. Forces more of a “pay full labor cost as services are received” fiscal policy.

Conclusion (continued)

Adaptability Elsewhere?

- **Every City's situation different**
- **At least some aspects applicable**
- **Meet and Confer process helpful**
 - Dealt with issue as part of overall compensation
 - Problem solving approach, rather than focusing on employees as adversaries
 - Approved by strong margin by every Employee Association
 - Education/explanation effort was essential
- **Not strictly one-sided; many advantages for employees**

Questions?



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