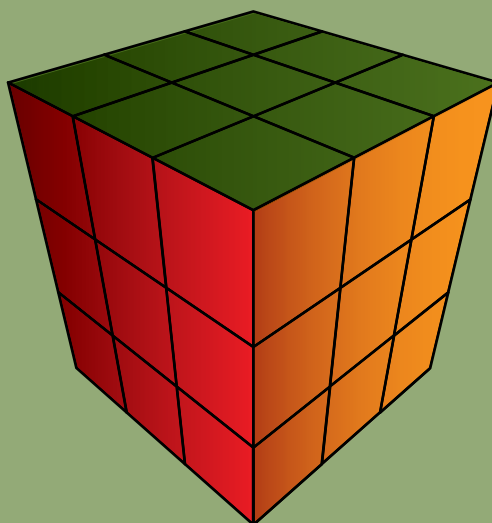


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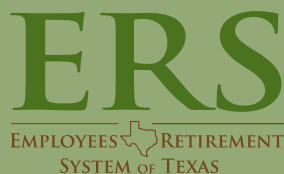


OF BENEFITS



RETIREMENT SUMMARY

NOVEMBER 9, 2011



Mission Statement

ERS enhances the lives of our participants through the delivery of quality benefits at a reasonable cost.

INTRODUCTION AND OVERVIEW

The U.S. employee benefit system is a shared responsibility among businesses, individuals, and the government. Employee benefits are a competitive incentive used by businesses to attract or retain qualified employees. Benefits also increase an employee's economic security and improve morale. Certain benefits, including Social Security, unemployment insurance, workers' compensation, and family and medical leave, are mandatory. General categories of benefits include retirement; health insurance; vacation, sick, and holiday pay; longevity pay; life and disability insurance; and education, among others.

Employer-sponsored retirement plans are just one tool for attracting and retaining the most qualified employees to meet the goals and business needs of an organization. They provide individual financial security through pensions, individual retirement accounts, disability benefits, and/or tax-free death benefits. Most states, including Texas, provide their employees with defined benefit pension plans that provide lifetime payments to retirees based on salary, years of service, and a funding formula. Such plans are protected and regulated by state and federal law, managed as trust funds, and overseen by boards of trustees.¹

This report is intended as a brief summary of the status of retirement plans operated by the Employees Retirement System of Texas (ERS). As policymakers consider modifications or revisions to improve these plans, an analysis of any impact from proposed changes to taxpayers, the employer (in this case, the State), state employees, retirees, and the overall state economy, should be included. Any examination of pension system modifications or alternative retirement plan options, such as converting to defined contribution plans (i.e. 401(k) and 457 plans) or hybrid plans (a combination of pensions and individual retirement accounts), should take a broad perspective.

Good public policy also includes the relative impact of retirement plan options on the State's workforce, especially in light of wage gaps between state employee wages and those among other public sector organizations and the private sector. A separate summary report details current difficulties faced by the State in recruiting and retaining qualified workers with the proper skills to deliver the services authorized and funded by the Texas Legislature. The importance of robust benefits to offset lower pay and higher turnover, especially among professional and technical staff, is also discussed in the report.

RETIREMENT PLAN OPTIONS

Defined Benefit Plans

Defined benefit plans provide workers with guaranteed lifetime payments that begin at retirement. Pension levels are usually based on years of service, earnings received near the end of one's career, and a funding formula or multiplier. Plan participants cannot collect benefits until reaching the plan's retirement age, which varies among employers. The key features of defined benefit plans include:²

- The enhanced ability of state and local governments to attract and retain qualified employees throughout their careers. This is especially important for occupations requiring special training and experience, such as public safety and education;
- A secure lifetime retirement benefit based on salary and service, thereby rewarding employees for long-term service;
- Pooled investment risks over the long term and reduced management fees, resulting in a lower cost per unit of benefit; and
- Disability and survivor benefits provided at a lower cost than third party providers.

Defined Contribution Plans

Defined contribution plans include 401(k) and 457 plans, among others, whereby employers and employees can both make tax-deferred contributions to a retirement account in the employee's name. The contribution amount can be set as a share of salary or

**State Employees
hired before 9/1/09 or who had
money on account with ERS
as of 8/31/2009**

**Highest average 36 months of salary
x
Service multiplier
(2.3% per year of service)
=
Monthly Standard Annuity**

State Employees hired on or after 9/1/09

**Highest average 48 months of salary
x
Service multiplier
(2.3% per year of service)
=
Monthly Standard Annuity**

**At an average salary
of \$3,000 per month, the monthly
standard annuity would be \$1,380
after 20 years of service**

¹United States Government Accounting Office, *State and Local Government Pension Plans: Current Structure and Funded Status*, Statement of Barbara D. Bovbjerg, Director Education, Workforce, and Income Security, Testimony Before the Joint Economic Committee, July 10, 2008. www.gao.gov/new.items/d08983t.pdf

²National Conference on Public Employee Retirement Systems, *The Evolution of Public Pension Plans: Past, Present and Future*, March 2008. www.ncpers.org/Files/evolution_of_public_pensions_2d.pdf

a given dollar amount. At retirement, workers receive the accumulated funds in their accounts, generally as a single lump sum. They also can use the account balance to purchase annuities in the marketplace. An employer may adopt a defined contribution plan to:³

- Supplement an existing defined benefit plan;
- Help employees achieve retirement income security;
- Avoid the long-term funding and liability commitments of a defined benefit plan; and
- Provide benefits for short-term workers.

Hybrid Plans

Hybrid plans combine the features of defined benefit and defined contribution plans. The three most common hybrid options used by governmental entities are as follows:⁴

- A combined hybrid plan has two components – one of which is defined contribution, and the other defined benefit, but the two come together to form a single defined benefit at retirement. Many governmental plans have annuity savings accounts, which track the employees' contributions (and interest) and which at retirement are converted to annuities;
- The cash balance plan looks like a defined contribution plan because the value of the benefit is expressed during an employee's working life as an account. However, the benefit that is paid out is funded on an actuarial basis, based on the hybrid plan formula, and not on the amount in the member's account; and
- Separate mandatory defined benefit and defined contribution accounts whereby the defined benefit account has a lower funding formula for pension payments than those in traditional defined benefit plans. The defined contribution account provides a separate benefit at retirement based on the balance of the account.

Retirement Plans by Organization Sector

Nationally, there are approximately 20 million employees and 7.3 million retirees and survivors covered by public sector plans at the state and local levels, with annual pension payments of \$152.1 billion and an average monthly payment of \$1,736 per beneficiary.⁵ Most states, including Texas, have mandatory defined benefit plans and optional defined contribution plans.

The defined contribution plan, in contrast, is the dominant model for more than 90% of private sector employees who participate in retirement plans. Over the past 20 years, 401(k) plans have grown to be the most widespread private sector retirement plan in the United States and represents the largest number of participants and assets.⁶

The following table shows more defined benefit plans in the public sector (state and local) at 83%, compared to privately and publicly owned for-profit organizations (19% and 22% respectively). Although 83% of public sector organizations offer defined contribution programs to employees, the participation rate is only 21.6% due to the fact that most of these public sector plans are supplementary. And, it is relatively rare for public sector employers to match workers' contributions to these plans—only 12 states provide a match of any kind.⁷

Retirement Plan Options Available to Workers in Private and Public Sectors⁸

Plan Type	Overall	Government Sector	Privately Owned For-Profit	Nonprofit	Publicly Owned For-Profit
Defined Benefit	27%	83%	19%	35%	22%
Defined Contribution	92%	83%	90%	95%	98%
Hybrid	9%	11%	5%	13%	14%

Source: Society for Human Resource Management.

Texas state workers hired after January 1, 2008 are automatically enrolled in a 401(k) plan at 1% of salary. Workers may choose to opt out of the program.

RETIREMENT PLANS IN TEXAS

Defined Benefit Plans Administered by the State

In November 1946, Texas voters approved a constitutional amendment to create a state employee retirement fund, which was officially established by the Legislature in 1947. Another constitutional amendment resulted in ERS converting to a defined benefit plan in September 1958. The Texas Constitution requires that benefits are funded on an actuarially sound basis and that both the State and employees each contribute a minimum of 6% of payroll toward retirement.

³Employee Benefit Research Institute, *Fundamentals of Employee Benefit Programs* – 6th Edition (2009), Chapter 48. www.ebri.org/publications/books/?fa=fundamentals

⁴Government Finance Review, *Alternative Retirement Plan Designs* by Paul Zorn, April 2011. www.gabrielroeder.com/pdf/GFR_apr_11_hybrid_plans.pdf; and a presentation to the 37th NASRA Annual Conference (August 8, 2011) by Terry A.M. Mumford and Katrina M. Clingerman, Ice Miller LLP

⁵Employee Benefit Research Institute, *Fundamentals of Employee Benefit Programs* – 6th Edition (2009), Chapters 5 and 44. www.ebri.org/publications/books/?fa=fundamentals

⁶Employee Benefit Research Institute, Issue Brief: *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007*, by Jack VanDerhei, Sarah Holden, Luis Alonso, and Craig Copeland, December 2008, p. 5. www.ebri.org/pdf/briefspdf/EBRI_IB_08-20073.pdf

⁷United States Government Accounting Office, *State and Local Government Pension Plans: Current Structure and Funded Status*, Statement of Barbara D. Bovbjerg, Director Education, Workforce, and Income Security, Testimony Before the Joint Economic Committee, July 10, 2008: www.gao.gov/new.items/d08983t.pdf

⁸Society for Human Resource Management, *2010 Employee Benefits*, p. 58. www.shrm.org/Research/SurveyFindings/Articles/Documents/10-0280%20Employee%20Benefits%20Survey%20Report-FNL.pdf

Employees Retirement System Plans

	State Employees	Elected Officials and District Attorneys	Certain law enforcement officers & custodial officers at DPS, TABC, TPWD, TYC, TDCJ & TBPP*	Total State Employees	Judges, justices and certain commissioners of court
Active Employees					
Contributing Members	103,103	335	39,052	142,490	539
Average Age	45	53	42	44	56
Average Years of Service	9.5	10.4	8.5	9.2	9.5
Average Annual Salary	\$42,104	\$63,048	\$37,979	\$41,022	\$127,560
Retirees					
All Annuitants	71,455	692	7,164	79,311	164
Average Annual Annuity	\$17,526	\$40,118	\$30,302**	\$18,372	\$58,640
Average Age	68	70	61	68	67
Average Years of Service @ Retirement	22.2	16.5	25.7	22.5	13.7
Non-Active/Non-Contributing Members					
Vested with at least 5 years of service				15,629	25
Non-vested with less than 5 years of service				66,096	105

Source: Employees Retirement System of Texas, provided to the House Committee on Pensions, Investments and Financial Services on February 22, 2011.

ERS acts as the administrative and investment body for elected state officials and state employees:

- Law Enforcement and Custodial Officers Supplemental Retirement Fund (LECOS) which provides supplemental benefits to state law enforcement and custodial officers,
- Judicial Retirement System Plan I, which was closed to new members in 1985, and,
- Judicial Retirement System Plan II which provides benefits to judges and justices of the Supreme Court, Court of Criminal Appeals, Court of Appeals, and District Courts.⁹

In 2010, ERS paid \$1.6 billion in annuity payments to 79,311 annuitants.

Although not administered by ERS, another large defined benefit plan is offered to employees in public, state-supported educational institutions in Texas. The Teacher Retirement System of Texas (TRS), created in 1937, is one of the largest retirement systems in the nation, providing service and disability retirement benefits and death benefits to 1.3 million active and retired state educators and their families. In 2010, TRS paid \$5.9 billion in service retirement benefits, \$141 million in disability benefits, and \$226 million in death and survivor benefits.¹⁰

Defined Contribution Plans Administered by ERS

ERS has administered the Texa\$aver Plan since 1991. Texa\$aver, a voluntary profit sharing plan, authorizes 457 and 401(k) contri-

butions under Internal Revenue Code guidelines. While the State does not match employee contributions, the Texas Legislature authorized automatic enrollment in the 401(k) beginning in 2008 for new employees at 1% of their eligible salary. These mandatory investments are placed in a Target Date investment option. These employees may opt out, increase their contribution, or change their investments at any time. Employees hired before 2008 may enroll in Texa\$aver at any time. Texa\$aver participants choose from 11 investment options, or a self-directed brokerage account.¹¹

Texa\$aver Assets and Deferral Amounts

	401(k)	457
Plan assets as of 8/31/10	\$1,249.5 million	\$334.5 million
Participant Balance		
• Median	\$784	\$3,662
• Average	\$12,431.13	\$17,952.07
Monthly Deferral		
• Median	\$26.86	\$100
• Average	\$147.17	\$385.87
Total eligible to participate	182,413	314,446
Participants with a balance	96,250	18,479
• Contributing	69,311 (72%)	11,649 (63%)
• Non-contributing	26,939 (28%)	6,830 (37%)

Source: Employees Retirement System of Texas (2010).

⁹Pension Review Board, *TexAverage Annual Annuity, Guide to Public Retirement Systems of Texas 2009*, Jan. 2009. www.ci.austin.tx.us/edims/document.cfm?id=144135

¹⁰The Teacher Retirement System of Texas, *A Great Value for All Texans*, Jan. 2011. www.trs.state.tx.us/about/documents/trs_value_brochure.pdf

¹¹Employees Retirement System of Texas, *FY2010 Annual Report*. www.ers.state.tx.us/news/reports/documents/ar_2010.pdf

Participation rates in Texa\$aver are as follows:

Texa\$aver Participation Rates by Age

Age Range	401(k)	457
20-30	22%	7%
30-40	20%	20%
40-50	25%	31%
50-60	23%	30%
60+	9%	12%

Source: Employees Retirement System of Texas (2010).

Hybrid Plans for Texas Cities, Counties, and Districts

The State does not currently administer hybrid plans on behalf of state employees. However, the Texas Municipal Retirement System (TMRS) and the Texas County and District Retirement System (TCDRS) operate cash balance hybrid plans on behalf of 843 participating cities and 619 participating county and district employers respectively.¹² Each employer (city, county, or district) has its own retirement plan design within the general framework provided by statute. Employers select available plan options according to their needs. While TMRS and TCERS have some differences, the following common provisions apply to both programs:

- The employee contribution rate varies based on employer selection (between 5% and 7% for TMRS, and between 4% and 7% for TCERS) - interest is credited on the employee's account annually;
- The employer contribution rate is also determined by each employer based on a percentage of the selected employee contribution rate (between 100% and 200% for TMRS, and between 100% and 250% for TCERS);
- Sixty percent of employers in the TMRS chose the 200% contributions rate, which is also the average rate for employers within TCERS; and
- At retirement, member contributions and credited interest are combined with the employer matching funds and a monthly retirement annuity is calculated (based on the option selected by the retiree).¹³

FUNDING STATUS OF ERS PENSION PLANS

ERS Defined Benefit Plans are Pre-Funded

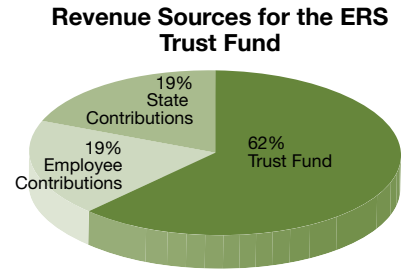
Unlike government programs funded out of general revenue, the ERS defined benefit plans are funded in advance through employer and employee contributions during the employees' working years.

These contributions generate revenue for the long-term funding of retirement benefits. The \$23.6 billion trust fund is comprised mostly of income generated from long-term investments; the remainder is from employee and employer contributions.

The ERS defined benefit plans are funded in advance through employer and employee contributions.

Over the last 20 years, the State has contributed \$5.8 billion toward state employees' retirement, while ERS paid \$16.5 billion in retirement benefits over the same period.

The Board of Trustees is responsible for setting policies and investment strategies with the advice and expertise of an independent Investment Advisory Committee. Day-to-day investment decisions are made by ERS' professional investment team.¹⁴



Source: Employees Retirement System of Texas for years 1991 to 2010.

Funding Shortfalls and Long-Term Liabilities

A defined benefit plan with a 100% funding level has an equal balance between assets and liabilities, with sufficient investment earnings and contributions to equal the benefits being earned (contributions + investment earnings = benefits + expenses). However, due largely to poor investment returns in recent years, and especially the market decline of 2008-09, the aggregate funding level of public pension plans nationally dropped to 75.7% in 2010.

Although funding ratios have declined, the median state pension fund will be able to pay benefits until 2030—even after poor investment returns during the economic downturn. This is due to the defined benefit feature of long-term funding which, like a home mortgage, is designed to slowly be funded over 25 years or more. Over the long term, public pension funds have met or exceeded their investment return assumptions of 7.5% to 8.5%

¹²TMRS was established in 1948 and is authorized by the TMRS Act (Texas Government Code, Title 8, Subtitle G); TCERS was established in 1967 and is authorized by Texas Government Code, Title 8, Subtitle F.

¹³Texas Municipal Retirement System Website. www.tmr.org/about_tmr.php; Texas County & District Retirement System Website. www.tcdrs.org/AboutUs/Pages/AboutUs.aspx; National Conference on Public Employee Retirement Systems, *The Evolution of Public Pension Plans: Past, Present and Future*, March 2008. www.ncpers.org/Files/evolution_of_public_pensions_2d.pdf; and overview materials provided by TCERS.

¹⁴Employees Retirement System, *Overview of ERS Programs, Presentation to the House Committee on Pensions, Investments and Financial Services*, February 22, 2011.

(8% in Texas). Because of this, the use of point-in-time measures, particularly at the low-point of the market recovery, is not, by itself, a viable justification for making major policy revisions.¹⁵

In 2010, the funding level of ERS plans was 83.2%, which reflects an unfunded liability of \$4.78 billion. This means that the projected assets of the fund (using an 8% average investment return over the next 31 years) plus State and employee contributions, can pay for 83.2% of projected benefits plus all related expenses. The following table summarizes the current financial status of ERS defined benefit plans:¹⁶

Summary Results of Fiscal Year 2010 Actuarial Valuations

	ERS (in billions)	LECOSRF (in millions)	JRS II (in millions)
Actuarial Value of Assets	\$23.6	\$802.9	\$264.5
Actuarial Value of Liabilities	\$28.4	\$966.6	\$281.8
Unfunded Liability	\$4.8	\$163.7	\$17.2
Funded Ratio	83.2%	83.1%	93.9%
Normal Cost Contribution Rate (cost of benefits being earned)	12.3%	2.1%	20.2%
Actuarial Sound Contribution Rate (needed to cover normal costs and unfunded liability)	17.1%	2.7%	21.7%

Source: Employees Retirement System of Texas (2010).

The National Institute on Retirement Security (NIRS) identified key features that are critical to a plans' ability to remain affordable and sustainable over the long term. The first criterion cited is ensuring that contributions pay the full amount of the annual required contribution in reference to a 30-year funding period.¹⁷

The State of Texas, as employer, has not paid the amount needed to pay normal costs (cost of benefits being earned) in six of the past 10 years. State budget cuts enacted by the 82nd Texas Legislature (2011) lowered the state contribution rate to 6% from 6.95%, effective September 1, 2011 (this rate will increase to 6.5% on September 1, 2012). Due to this reduction, state contributions will not cover normal costs as of September 1, 2011. Employees continue to contribute 6.5% of payroll to the state pension plan.

Actions Taken to Keep Texas Plans Sustainable

According to the National Association of State Retirement

Administrators (NASRA), Texas is at the forefront of state retirement systems due to effective management of liabilities, reasonable benefit levels and affordable costs. The Texas Constitution requires consistent contributions by both the State and employees (6% each), and state law prohibits salary spiking and other practices that have damaged the long-term sustainability of pension programs in other states. As a result, the State's pension plans are better funded than those in most other states – with a funded ratio of 83.2% compared to the median average of 75.7% for state pension programs overall.¹⁸

ERS pension plans have several key provisions that have enabled them to remain relatively strong compared to other states:

- Multiplier increases (that determine a retiree's pension based on years of service and salary) must be actuarially valued and properly funded before adoption;
- Texas law prohibits pension increases or benefit improvements unless the fund is and will remain actuarially sound. Many other states have automatic cost of living increases regardless of funding levels, ERS, however, has not increased pensions since 2002;
- The definition of compensation used in the calculation of retirement benefits is narrowly defined in Texas law. It specifically excludes overtime pay and one-time merit bonuses. This prevents salary "spiking" prevalent in other states (inappropriately increasing salary to artificially increase pension levels);
- ERS is more than meeting its long-term investment goals with a 30-year return rate of 8.6%. The current assumption for long-term investment returns is 8% - a rate that is consistent with most state pension plans;
- ERS is required by statute to examine its economic actuarial assumptions at least every five years, and its board adjusts the assumptions as necessary;
- ERS reviews capital market assumptions annually and conducts asset/liability studies at least every five years; and
- ERS reports and educates legislators on the indirect impact to the retirement plan of certain employment policy decisions such as retirement incentives, furloughs, and layoffs. To comply with Texas law, ERS prepares an actuarial impact analysis on all legislative proposals that would impact the ERS plan.

Due to concerns about the viability of retirement plan benefits and funding, dating back to the 2001 recession, and to demographic changes and state fiscal conditions, most states have enacted

¹⁵National Conference on Public Employee Retirement Systems and Cobalt Community Research, *2011 NCPERS Public Fund Study, Preliminary Results, April 2011*. www.ncpers.org/Files/2011_06_ncpers_public_fund_study.pdf; National Association of State Retirement Administrators, *Public Fund Survey Summary of Findings for FY 2009*, prepared by Keith Brainard Research Director, November 2010, pp. 1-2; NASRA/NCTR Issue Brief: *Strong Investment Gains and Legislative Changes Speeding Public Pension Recovery*, April 2011. www.publicfundsurvey.org/publicfundsurvey/pdfs/Summary%20of%20Findings%20FY09.pdf; and House of Representatives Hearing, Testimony of Keith Brainard, February 14, 2011. <http://judiciary.house.gov/hearings/pdf/Brainard02142011.pdf>

¹⁶Employees Retirement System of Texas, *FY2010 Annual Report*. www.ers.state.tx.us/news/reports/documents/ar_2010.pdf

¹⁷National Institute on Retirement Security, *Lessons from Well-Funded Public Pensions: An Analysis of Six Plans that Weathered the Financial Storm*, by Jun Peng, Ph.D. and Ilana Boivie, June 2011. By Jun Peng, Ph.D., and Ilana Boivie www.nirsonline.org/storage/nirs/documents/Lessons%20Learned/final_june_29_report_lessonsfromwellfundedpublicpensions1.pdf

¹⁸National Association of State Retirement Administrators, Research Director, "Memo to Porter Wilson," Chief of Staff for Senator Duncan, February 18, 2011.

legislation to improve the financial condition of their pension plans. In 2011 alone (through June) 25 states enacted significant changes in public pension plans. Texas implemented significant changes in 2009, through passage of House Bill 2559 by the 81st Texas Legislature, which includes the following provisions:

- Increased state employees' monthly contributions by 0.5% (to 6.5% of salary);
 - Senate Bill 1 added an additional 0.5% to the State's contribution for a total of 6.95% (subsequently reduced to 6% for fiscal year 2012 and 6.5% for fiscal year 2013 by the 82nd Texas Legislature);
- Law enforcement and custodial officers began to contribute 0.5% to the supplemental retirement fund (they are also members of the ERS fund);
- A new tier of benefits was designed for employees hired after August 31, 2009 to reduce long-term liabilities. This included annuity reductions for retirees under the age of 60 and using a 48-month average, rather than 36 month, for annuity calculations;
- Employees retiring after May 30, 2009 must wait 90 days before returning to state employment; and
- State agencies that hire retirees who retired after September 1, 2009 must pay the ERS fund a surcharge equal to the state contribution.

RETIREMENT SECURITY

From the start, Social Security benefits were intended to replace a portion of employment income. Rather than being a retiree's sole source of income, Social Security was meant to augment personal savings and employer-provided pensions.¹⁹ The build-up of retirement assets is a complex process that varies with earnings, family changes, job changes, health status, individual choices, and fluctuations in housing and stock prices, among other factors. Employer trends toward freezing or closing defined plans, especially in the private sector, put increased responsibility on workers for ensuring their own retirement security.²⁰

The overwhelming majority of Americans are anxious about their retirement prospects. According to a report by the National Institute on Retirement Security, 34% of Americans consider a secure retirement as simply surviving or living comfortably, while only 11% expect retirement to include leisure, travel, restaurants, and/

or hobbies. Almost three-fourths of Americans believe that stock market volatility will make it impossible to predict the size of their retirement nest egg.²¹

Generally speaking, a pension provided by a defined benefit plan will provide greater retirement security than an individual account from a defined contribution plan. A pension provides lifetime payments, while defined contribution accounts could be too small if the participant did not contribute regularly, or invest wisely. The balance can also be exhausted before the retiree dies.

Baby boomers are the first generation to rely heavily on their 401(k) plans to subsidize their retirements. About 60% of households nearing retirement age have 401 (k)-type accounts, which often represent the majority of their savings. The median 401(k) plan only held \$149,400, which would generate \$9,073 per year. Vanguard Group, one of the biggest providers of 401 (k) plans, has recommended an increase in combined employer and employee contributions to 12% to 15% (up from 9% to 12%) to help ensure that retirement security can be achieved for defined contribution participants.²²

Additionally, defined contribution participants are increasingly withdrawing or liquidating their accounts. In 2010, 6.9% of 401(k) account holders made a withdrawal, about 20% of which were for hardships. In addition to the taxes and penalties, early withdrawals mean the account balance has been immediately reduced and removed the ability of that money to work over time.²³

A defined benefit plan provides higher benefits for each dollar contributed by employers and employees. It is 35% less expensive to provide a given benefit amount in a defined benefit plan than it is in a defined contribution plan because:²⁴

- Most defined contribution investors (employees managing their own money) do not have the knowledge or appropriate assets to build an investment portfolio that maps to a combination of asset classes for their individual needs;
- Individuals do not have access to the volume pricing that institutions have; and
- Defined benefit plans are often able to invest more efficiently because the plan is freed from the need of an individual to invest more conservatively as he or she grows older.

¹⁹Employee Benefit Research Institute, *Fundamentals of Employee Benefit Programs – 6th Edition* (2009), Chapter 2. www.ebri.org/publications/books/?fa=fundamentals

²⁰American Academy of Actuaries, *A Balancing Act: Achieving Adequacy and Sustainability in Retirement Income Reform*, "What are the Trade-Offs – Defined Benefit vs. Defined Contribution Systems," by Ron Gebhardt, FSA, MAAA, Senior Pension Fellow, Presentation in Brussels, Belgium, March 4, 2004. www.actuary.org/pdf/pension/tradeoffs_030404.pdf

²¹National Institute on Retirement Security, *Pensions and Retirement Security 2011: A Roadmap for Policy Makers*, by Brian Perlman, Kelly Kenneally, and Ilana Boivie, March 2011. msnbcmedia.msn.com/CNBC/Sections/News_And_Analysis/_Story_Inserts/graphics/_PDF/retirement_final_report.pdf

²²Center for Retirement Research at Boston College, *Why Have Some States Introduced Defined Contribution Plans?*, by Alicia H. Munnell, Alex Golub-Sass, Kelly Haverstick, Mauricio Soto, and Gregory Wiles, January 2008. http://crr.bc.edu/images/stories/Briefs/slp_3b.pdf

²³San Antonio Express, "401(k) Hardship Withdrawals Require Serious Thought," by David Pitt, AP Personal Finance Writer, September 20, 2011. <http://newsok.com/401k-hardship-withdrawals-require-serious-thought/article/3606065>

²⁴Gabriel, Roeder, Smith & Company, GRS Research Memorandum, "List of Advantages and Disadvantages for DB and DC Plans," November 17, 2003. www.nasra.org/resources/GRS%20DB%20DC.pdf; and Investment Insights, p. 7, Waring and Siegel, p. 7, February 2007. www2.blackrock.com/webcore/litService/search/getDocument.seam?contentId=1111097820&Source=SEARCH&Venue=PUB_INS

Poverty rates are about six times lower among older households with a pension than those without. Pensions also reduce—and in some cases eliminate—the added risk of poverty and the need for public assistance faced especially by women and minority populations.²⁵ For a defined contribution plan to provide this level of security there is little room for employee error. This includes investing wisely, changing their asset allocation as they age; avoiding lengthy sabbaticals from work, investing consistently, not borrowing or withdrawing the assets, and withholding enough from their pay.²⁶

ISSUES TO CONSIDER

Overview

Retirement systems are complex and changes can have a major impact on an employee’s retirement security, unfunded liabilities, costs, and recruitment and retention of a viable State workforce. Careful consideration is needed to assess and evaluate the impact of proposed changes to the state, taxpayers, the State workforce, and retirees, and to ensure that any modifications do not result in higher costs or other unintended consequences.

Policymakers will need to deal with competing interests and philosophies for how best to provide retirement security for its

workforce at a cost that is consistent with employer and employee resources. Whether the State maintains its current retirement plans, modifies them, or explores new options, this broad-based perspective will ensure that choices are made to create the highest possible benefit for all affected parties.

Features to Consider Among Plan Options

Retirement plans, whether defined benefit, defined contribution, or hybrid, are intended to be an incentive for hiring and retaining employees, and a tool to help ensure retirement security for retirees. Each plan design has features that affect the employer, workforce, employees, and retirees differently. The following chart reflects features of these plans overall, and not of the specific plans through the State of Texas.

Addressing Unfunded Liabilities

ERS pension programs had a cumulative unfunded liability of \$4.78 billion at the end of fiscal 2010. While the funding level of 82.3% is well below full funding, it is far better than the 75.7% level for state pension programs overall. The Legislative Budget Board found that, while Texas must address its long-term funding issues to be actuarially sound, the ERS plans are not in the kind of fiscal crisis that other states are facing.²⁸

General Features of Three Pension Plan Options²⁷

Objective	Defined Benefit	Defined Contribution	Hybrid
Funding Certainty	Plan liabilities change based on actuarial experience (e.g. future salary increases, investment earnings, employer turnover).	Plan liabilities are fulfilled annually as contributions are made to employee accounts based on a fixed amount or percentage of payrolls.	Plan liabilities are reduced to the extent that pension or lump sum payments are tied to employee account balances rather than a set formula.
Predictable Contribution Costs	Annual contributions may vary from year to year, based on actuarial experience. Rates may be set by statute to increase predictability.	Annual employer contributions are more predictable because they are based on a set percentage of employee salaries.	While actuarial valuations play a role in the level of retiree benefit levels, they can be based on conditions at the time of retirement rather than a set formula when the employee was hired.
Retention, Recruitment and Portability	Effective for recruiting and retaining long-term employees. Employee contributions plus interest are portable, or vested members can draw a pension at the retirement age set by the plan.	Effective for recruiting short-term employees. Employer contributions are vested, whereby employee accounts include employer and employee contributions following vesting (usually 3 to 5 years).	Effectiveness will depend on mix of defined benefit and defined contribution features.
Expenses	Expenses include actuarial valuation and investment fees (including record-keeping and investment management). Unfunded liabilities are included in long-term expenses.	Some plan expenses may be lower. However, employee education costs may be higher.	Plan expenses will likely be higher and include the actuarial valuation, investment fees, and employee education costs.
Investment Risk	Investment risk is pooled among all members and assumed by the employer	The employee assumes investment risk and will likely pay higher investment fees.	Investment risk will be shared by the employer and employees.

Source: Employee Benefit Research Institute.

²⁵National Institute on Retirement Security, *The Pension Factor: Assessing the Role of Defined Benefit Plans in Reducing Elder Hardships*, by Frank Porell, Ph.D. and Beth Almeida, July 2009. www.imrf.org/press_room/research/2009/pension_factor/pension_factor_report.pdf

²⁶Pension Research Council Symposium Presentation, by Gary W. Anderson and Keith Brainard, April 26-27, 2004, p.7. www.nasra.org/resources/economic/AndersonBrainard.pdf

²⁷Employee Benefit Research Institute, *Fundamentals of Employee Benefit Programs – 6th Edition* (2009), Chapter 6. www.ebri.org/publications/books/?fa=fundamentals

²⁸Legislative Budget Board Staff, *Effectiveness and Efficiency Reports*, “Maintain the Pension Solvency of the Employees Retirement System and the Teacher Retirement System,” January 2011, p. 97-116. www.lbb.state.tx.us/Performance%20Reporting/TX_Govt_Effective_Efficiency_Report_82nd.pdf

Prescribed accounting standards make it hard for actuarial valuations to predict exact future benefit obligations. The financial obligations of plan sponsors continue long after the employee retires, while solid funding depends on a stable flow of contributions and a positive investment return (long-term) on these contributions. Effective policies and stable contributions are crucial to maintaining the long-term solvency of any defined benefit plan.

The difficult economic climate in recent years has created some concerns that underfunded public pension plans are a burden on taxpayers and could threaten the solvency of state governments. Some analysts report future unfunded liabilities at \$3 trillion or more, and that many state pension plans will “run dry” within the next 10 years, based on calculating future pension fund assets at lower investment-return rates than the standard 8% per year.²⁹

Others say that unfunded liabilities, while a concern, are more realistically calculated at roughly \$700 billion based on an 8% investment return, which has been exceeded during the past 30 years in Texas, despite two economic downturns in the past decade. Combined, state and local retirement systems hold in trust some \$2.8 trillion, equal to roughly 14 times the amount these funds paid out last year.³⁰

State law and recent changes to the ERS pension structure promise to improve the solvency of the pension program in the long term, though these changes will take time to bear fruit. While the historical return-on-investments for pension funds over the long term can reasonably be expected to make up for at least some of the short-term fluctuations experienced this decade,³¹ the State contribution level of 6% of payroll, combined with the employee contribution level of 6.5%, is not enough to cover normal costs and the unfunded liability, hence it is likely that unfunded liability costs will continue to increase.

Options for Modifications or Conversion to Other Plan Options

According to the Legislative Budget Board, benefits earned under a defined benefit plan are generally considered to be implicit contractual rights, depending on state law and constitutional provisions and federal requirements. Making benefit reductions for current retirees is usually not allowed. For active and inactive members who have not yet retired, some changes are permitted. It would be difficult to change any benefits earned to date, but it is possible to change the benefit accrual for future service and for new hires.³²

The Texas Public Policy Foundation (TPPF) recommends that the legislature freeze the current defined benefit plan to all new and unvested public sector employees and transfer them to a defined contribution plan coupled with a Health Savings Account.³³ The Texas Conservative Coalition Research Institute (TCCRI) recommends that Texas begin the transition to a defined contribution model by placing all employees earning over a specified annual income level into a defined contribution plan while retaining lower-earners in the existing defined benefit model.³⁴

A recent study concluded that closing pensions to new hires can have several serious, unintended consequences, including increasing administrative costs associated with running two plans, of foregoing or undermining economic efficiencies of traditional pension plans, accelerating pension costs for employees in the closed plan, worsening retirement insecurity, and potentially damaging employer recruitment and retention efforts.³⁵

Proposed legislation during the 82nd Texas Legislature (2011) would have established a defined contribution retirement plan for members of employee or elected class hired on or after September 1, 2012. By requiring members hired after this date to enter the defined contribution plan, it would close the defined benefit plan to new members. The actuarial analysis of the impact of this legislation assumed that all member and State contributions of new employees hired after September 1, 2012, would be directed to the new, mandatory defined contribution plan, while the closed defined benefit plan would be funded only by member and State contributions for employees hired prior to this date. The actuary concluded that, if passed, the legislation would require an increase in State and/or member contribution rates by a combined 7.9% (from 17.81% to 25.71%) to achieve full funding within 31 years.³⁶

Texans for Public Pension Reform suggests that conversion to a cash balance plan that defines the promised benefit in terms of a retiree’s account balance would be feasible, although it acknowledges that short-term costs associated with such a conversion would increase.³⁷

²⁹Josh Rau, “The Day of Reckoning for State Pension Plans, March 22, 2010. <http://kelloggfinance.wordpress.com/2010/03/22/the-day-of-reckoning-for-state-pension-plans/>

³⁰National Association of State Retirement Administrators, Keith Brainard, Research Director, Testimony before the House of Representatives, February 14, 2011. <http://judiciary.house.gov/hearings/pdf/Brainard02142011.pdf>

³¹U.S. Public Finance, Moody’s Investors Service, *Combining Debt and Pension Liabilities of U.S. States Enhances Comparability*, January 26, 2011. www.nasra.org/resources/Moodys1101.pdf

³²Legislative Budget Board Staff, *Effectiveness and Efficiency Reports*, “Maintain the Pension Solvency of the Employees Retirement System and the Teacher Retirement System,” January 2011, p. 97-116. www.lbb.state.tx.us/Performance%20Reporting/TX_Govt_Effective_Efficiency_Report_82nd.pdf

³³Arduin, Laffer, & Moore Econometrics, *A Study Prepared for the Texas Public Policy Foundation*, “Reforming Texas’ State and Local Pension Systems for the 21st Century. www.texaspolicy.com/pdf/2011-04-RR05-ReformingTexasStateLocalPensionSystems-laffer.pdf

³⁴Texas Conservative Coalition Research Institute, *Blueprint for a Balanced Budget: The Final Report of the 2009-2010 TCCRI State Budget Task Force*, January 2011. www.tcccri.org/TCCRI-StateBudgetTaskForceReport.pdf

CONCLUSIONS

The plans administered by ERS are in relatively good condition compared to other states and are able to pay benefits well into the future. However, persistent underfunding coupled with recent investment challenges have increased ERS' unfunded liability.

The Texas Legislature made proactive changes in 2009 to rein in the cost of benefits being earned and to lower early retirement rates. Some public policy groups believe more changes are necessary and want to see defined benefit plans for public employees retirement phased out and transitioned to defined contribution plans. Drastic changes, such as closing defined benefit plans to new or non-vested employees, have the immediate effect of increasing the unfunded actuarial liability and do not release the State from long-term obligations that will continue decades into the future.

There may be other viable retirement plan options that balance the State's needs to attract and maintain an efficient and skilled workforce, provide benefits equal to what the State and employees are willing to support, and provide state employees with reasonable financial security in retirement. It is clear that any action to modify ERS' current plans should consider both the short- and long-term effects on the state, its workforce, and the citizens that rely on their services.

ERS will be exploring these options, their costs and potential impact over the course of the interim and will report the findings to the Texas Legislature.

³⁵National Institute on Retirement Security, *Look Before You Leap: The Unintended Consequences of Pension Freezes*, Ilana Boivie and Beth Almeida, October 2008. www.imrf.org/press_room/research/2009/unintended_consequences_freeze/Pension_Freeze.pdf

³⁶Buck Consultants, Richard A. Mackesey and R. Ryan Falls, "Actuarial Impact of Establishing a Defined Contribution Retirement plan within the Employees Retirement System (House Bill 1974 by Sheets)," April 6, 2011.

³⁷Bay Area News, "Former Kemah Mayor Bill King Proposes Public Pension Overhaul," by Florian Martin, September 16, 2011. www.yourhoustonnews.com/bay_area/news/former-kemah-mayor-bill-king-proposes-public-pension-overhaul/article_a916ee6f-0227-5e06-9ff3-b8eb9a1b11f9.html



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