NORTH DAKOTA PUBLIC EMPLOYEE'S RETIREMENT SYSTEM (NDPERS)

TRANSITION COSTS AND BEST PRACTICES IN PENSION DESIGN

Prepared by:

Pension Integrity Project at Reason Foundation

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reason FOUNDATION

Policy Objectives

- **Keeping Promises:** Ensure the ability to pay 100% of the benefits earned and accrued by active workers and retirees
- **Retirement Security:** Provide retirement security for all current and future employees
- **Predictability:** Stabilize contribution rates for the long-term
- **Risk Reduction:** Reduce pension system exposure to financial risk and market volatility
- **Affordability:** Reduce long-term costs for employers/taxpayers and employees
- **Attractive Benefits:** Ensure the ability to recruit 21st Century employees
- **Good Governance:** Adopt best practices for board organization, investment management, and financial reporting

REASON FOUNDATION NDPERS MODELING TOOL

NDPERS Modeling

- The Pension Integrity Project is in the final stages of developing an interactive NDPERS actuarial modeling tool to allow policymakers and stakeholders to test and customize the plan designs you choose.

- The interactive actuarial modeling tool will also allow you to conduct stress testing around the current or alternative NDPERS retirement plan designs.

- We will deliver this tool to the committee subsequent to this meeting, via email.

EXAMINING "TRANSITION COSTS"

Pension Reform and "Transition Costs"

- To mitigate the risks that have led to major underfunding in traditional defined benefit pension plans, many government employers have shifted new employees over to new and lower-risk retirement plan designs:
  - Risk-managed defined benefit (DB) pensions,
  - Defined contribution (DC) retirement plan,
  - Hybrid DB+DC plans, or
  - Cash balance plans.

- A common but misguided objection to such policy reforms—particularly DC plans—is the idea of a so-called "transition cost".

- While taking different forms, this generally involves a mistaken belief that setting up new employees with a new retirement plan will require substantial money upfront to pay down unfunded liabilities in the legacy pension plan.

Transition Costs: Myths vs. Reality

- The supposed sources of transition costs are based not in law or practice, but rather actuarial preference:

1. **Amortization Policy**: When considering prospective plan design changes, actuaries may recommend that it would be prudent to accelerate the paydown of unfunded pension liabilities to mitigate risk, and potentially also level out annual contributions into equal annual installments instead of a percent-of-payroll based figure, like today.

   - There is no legal requirement at the federal or state level, nor any government accounting standard, mandating that pension contribution rates increase when adopting pension reform in order to accelerate unfunded liability payoff.

   - However, paying off pension debt faster is a good policy ***no matter what***. We believe that it is prudent to pay down existing unfunded liabilities as fast and level as possible—***regardless of whether or not you adopt a new plan design***.

   - Using an accelerated amortization method is likely to result in increased contribution rates towards the unfunded liability for the first few years, but such a change would also mean ***paying much less in the long run*** due to avoided interest costs.

   - Long-term costs are always the proper anchor for determining prudent pension policy, new plan design or not.

Transition Cost: Myths vs. Reality (cont'd)

2. **Discount Rate/Investment Return Assumption**: Another policy consulting actuaries often raise in pension reform discussion is a preference to change the discount rate/assumed rate of return when closing a defined benefit pension plan in order to make it less vulnerable to underperforming investments in the future.

   - In turn actuaries claim this would require increasing the contributions into the plan today to account for less expected investment returns decades in the future when assets are winding down.
   - Even if you closed the pension tomorrow, you would be paying out liabilities for at least 50-80 more years, and thus immediate changes to investment policy or portfolio are not necessary and can be adjusted over time.
   - Like amortization, North Dakota should consider adopting a lower discount rate for NDPERS whether new employees are shifted to a new retirement plan or not.
   - US public pension systems in states like California, New York State, Michigan and others are now adopting discount rates well below 7%, and so should NDPERS.
   - While lowering the discount rate might be fiscally prudent, there is no legal or financial requirement to do so if changing to a new retirement design.

Bottom Line on Transition Costs

How to fund existing NDPERS unfunded liabilities is a distinct policy matter on its own terms that should not constrain responsible, prospective pension reform:

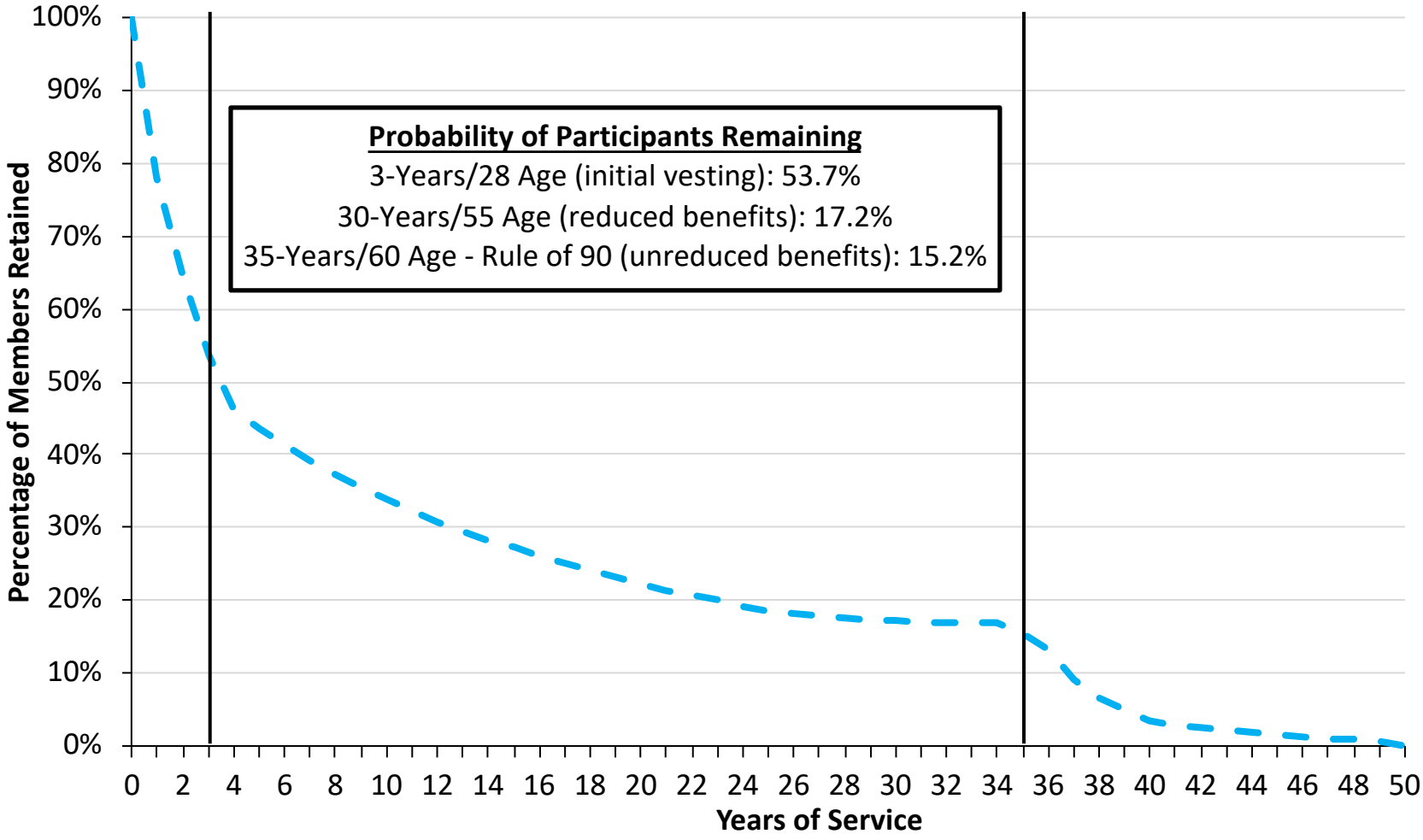
- Other states — such as Oklahoma, Arizona, and Utah — have faced the same concerns and found ways to design around any contribution rate increase that was unaffordable in the given climate.
- The question of transition costs is entirely a political, not an accounting or actuarial, question. It is up to legislators and state departments to determine how they want to pay down unfunded liabilities.
- Legacy unfunded pension liabilities cost what they cost, reform or not. Reform does not make your current pensions more expensive since those are formula-driven benefits.
- Public pensions are not Ponzi schemes, and by design, pension contributions under a prudent funding policy are not affected by whether or not there are new entrants every year.
- **The key is to ensure that after reform, legacy unfunded liabilities are paid down at the same or faster rate than they are today**.

RECAP OF APRIL 11TH AND 25TH MEETINGS

"Better Bang for the Buck 3.0"

- **NIRS study from January 2022**
  - Third round of this study, other two released in 2008 and 2014.
  - Highlighted by Milliman in previous presentations to the board.
  - Presents an incomplete perspective on the relative efficiency of a DB vs DC.
- **Key issues**
  - Is a DB plan more "efficient" with taxpayer dollars?
  - Does a DB plan manage risk better?
  - Do DC plans have more fees?
  - Are pension funds better investors than individuals?
  - Is a DC plan 50% more expensive than a DB for the same benefit?
  - Risk pooling vs Annuities
  - Portability

Probability of Members Remaining in NDPERS



Source: Pension Integrity Project analysis of NDPERS reports and CAFRs.
Illustration is based on *Main Plan* assumptions and a hypothetical analysis of an average member hired at the age of 25

Do NDPERS Retirement Plans Work for All Employees?

- **46%** of new NDPERS members leave before 3 years.
  - Benefited employees must work 3 years before their benefits become vested.
  - Members who leave the plan before then must forfeit contributions their employer made on their behalf.
  - Another 20% of new employees who are still working after 3 years will leave before 10 years of service.

- **17%** of all new paid members hired next year will still be working after 30 years (with age 55), long enough to qualify for a reduced benefits.
  - North Dakota ensures that all state employees have access to Social Security benefits.

Source: Pension Integrity Project analysis of NDPERS withdrawal and retirement rate assumptions. Estimated percentages are based on the expectations used by the plan actuaries; if actual experience is differing substantially from the assumptions then these forecasts would need to be adjusted accordingly.

Plan Design Discussions

- **DC**
  - Milliman said they would present on Michigan and West Virginia for background on DB to DC swap.
    - Important that Milliman also looks at Oklahoma, which has a fully funded pension after their transition.
    - While Michigan has had a long history of DC design improvement in their Public Employees plan, we built the Michigan Teacher choice-DC plan which is an exemplary model.
    - West Virginia suffered from a poor DC plan design along with a failure of policymakers to properly fund the legacy pension—both were avoidable through better design.
  - Committee asked to look at opening loan and hardship provision in current DC and 457 plans.
    - Just as you can't borrow against a pension, one should not be able to borrow against an account in a DC retirement plan intended to serve as a primary retirement vehicle.
    - "No borrowing against DC account balances" is a best practice in our policy paper: *Best Practices in the Design and Utilization of Public Sector Defined Contribution Plans*.
- **Cash Balance**
  - Milliman stated that a CB has the same sort of contribution volatility as a DB plan, but our actuarial modeling for the Texas' Employees Retirement System swap to a CB last year suggests less volatility.
  - Milliman also stated that the surge in private sector CB plans was a way to "mask a benefit reduction for employees because they can't compare apples to oranges like actuaries can."
    - Benefit levels and generosity are entirely policy decisions of the legislature, and not a function of the plan type.
    - As you saw from the retention charts, having a more portable option like a CB, DC, or hybrid would benefit a larger number of employees.

Plan Design Discussions

- **Variable Plan**
  - Unsure of where this plan design option came from.
  - Somewhat like South Dakota's pension design.
  - Milliman does offer their "Milliman Sustainable Income Plan".
    - This design may be an example, but to our knowledge no statewide public pension system has adopted it.
- **Critique of Milliman Score Card**
  - Milliman offers a scorecard showing how different plan designs match different goals, covering 9 metrics.
  - **All 9 considerations on their list can have a "checkmark" if the plan design is structured properly.**

Questions Around Narrowing Down Options?

- Defined Contribution
- DB+DC Hybrid
- Cash Balance
- Optimized Retirement Choice (DB or DC)

Questions?

Pension Integrity Project at Reason Foundation

Len Gilroy, Vice President

leonard.gilroy@reason.org

Ryan Frost, Senior Policy Analyst

ryan.frost@reason.org