<u>The Overall Impact of the Self-Managed Plan</u>

Arthur H. Tepfer, A.S.A. , M.A.A.A

This is not intended to be a "soapbox" article—but, hopefully, a general critical discussion of what I feel is a potentially dangerous choice facing many new members of the Downstate Police funds—the so-called replacement "self-managed plan".

Interesting name—"self-managed". What is the current plan: professionally managed? unprofessionally managed? or maybe simply not managed at all!! Reading the new Section 109.3(a) discussing the "purpose" doesn't help. It simply states that the self-managed plan shall "offer participating employees the opportunity to accumulate assets for retirement through a combination of employee and employer contributions that may be invested in mutual funds, collective investment funds or other investment products…" So what have the Pension funds and Trustees been doing all these years, if not accumulating assets for retirement through a combination of employee and employer contributions that may be invested in mutual funds,…? But, enough of the rhetoric—this is a defined contribution option as compared to the existing defined benefit plan.

Let's make sure that we are all on the same page. After everything is sorted out, the fundamental differences between a defined contribution plan and a defined benefit plan come down to two issues—guarantees and investment risk. The current defined benefit program guarantees the amount of retirement income that each officer will receive upon retirement, disability, death and termination. Two officers with the same employment history will receive the same benefit—end of story. The investment risk to provide this guarantee is borne 100% by the municipality—end of story. In the defined contribution "self-managed plan" the only guarantee is that the officer will contribute 10% of his pay. Two officers with the same employment history will almost certainly <u>not</u> receive the same benefit (in fact there even is a possibility, although very small, that they will not receive any benefit at all) and the investment risk is borne 100% by the officer—end of story.

Just for the record—I am not opposed to defined contribution plans. In fact, over half of my consulting practice consists of the administration of defined contribution plans. What I am opposed to is poorly designed plans of *any* type, and I must tell you that, in my opinion, this "self-managed plan" is one of the worst designed programs for public safety personnel that I have seen in over thirty years of practice. This hastily thrown together tack-on legislation to a bill which provides needed defined benefit improvements (not to mention comparability to the firefighters) is a dangerous precedent and undermines the entire legislative process regarding benefit changes. Oops—I just got on the soapbox!

Let's get back to the facts. The current defined benefit program provides a guaranteed retirement benefit at age 50 and completion of 20 years of service equal to 50% of final salary. For an officer making $50,000—that's $25,000 a year for life, increasing 3% every year (more or less) and continuing for the life of the spouse. So how much money is needed at age 50 to provide this guaranteed benefit with all the bells and whistles? Your friendly actuaries will tell you that the amount needed depends upon the assumptions made regarding future investment earnings and life expectancies and other estimates, but all of them should agree that the answer is about $430,000. Over 30 years, at 7% interest and assuming salaries increase 5½% annually [state actuary assumptions]—the initial amount per year needed to accumulate to $430,000 is only about $2,500 or 10% of a $25,000 initial salary. [Of course as salaries increase, then the contribution amounts increase as well—but this is already taken into account in the calculations]. What a deal—sign me up! If I'm putting my 10% in and the municipality is putting another 10% in then I should have twice as much pension money available at age 50 than under the current program and, therefore, twice the benefit. This seems like a "no-brainer". Unfortunately, as we all have learned, the numbers don't always tell the full story. Suppose, that you only earn 5% on your money. Your total accumulation drops over 25%. At 3½% overall, you've lost over half your account. And, as you well know, the timing also makes quite a difference. The stock market has this tendency to go up *and* down. If you happen to retire on a downswing, you may never recover. So what is the defined benefit guarantee really worth? This is a crucial individual question.

Suppose you can get by the investment risk problem. Is the defined contribution plan still the better deal? Not if you die. Stated succinctly in bill Section 3.113.1(e) "no survivor benefits are payable to a participant in the self-managed plan"–end of story. This is poor design at its best!! No individual who puts his life on the line every day of his career can afford *this* risk.

So why was this section even offered to the legislators? Because it is cheaper for the municipalities. The total cost of the program from their side is 10% of payroll and that is substantially less than what they are paying for the defined benefit program. The defined benefit program, on average, is costing the municipalities almost 20% of payroll. The original defined benefit plan (the one back in the old days, without the automatic increases and the spousal coverages) was originally designed to be a two-to-one ratio of municipal contributions to participant contributions. Through the years, because of investment returns and the improvements in benefits, municipalities have been able to reduce the ratio slightly and in some cases, municipalities don't even make a contribution. But the fundamental design still is around two-to-one. Look at a new fund which enters the Downstate program and you will see the contributions in the two-to-one ratio. From the municipality side it *is* a "no-brainer" as they understand how much getting rid of the guaranteed benefits and uncertain cost is really worth. Oops—let me get back off the soapbox again!

Back to the poor design. The self-managed plan will only be offered to new participants who have six months to make an ***irrevocable election*** to participate. Are you kidding? Irrevocable—to a twenty-something rookie who probably has never even seen an IRA! If this is such a good deal why not offer it to everyone at any time. The answer should be obvious.

I could go on, but I want to direct your attention to some of the other not-so-apparent problems associated with this type of program and maybe even cause the municipalities to ask a few more questions before touting the merits of this self-managed plan. First, you should note, that as Trustees you are still responsible as fiduciaries for all of the assets in the pension fund. The current bill makes no provision for establishing a separate investment trust nor for relieving any Trustees of their fiduciary responsibility. In the private sector, where this type of individual account program has become more commonplace, Trustees are still responsible for the overall investment decisions made by the individual participants and, despite the bill's disclaimer that the person who is a fiduciary shall not be liable for any loss resulting from the investment direction, ERISA still holds the Trustees liable under the prudent man standards. Trustees may be able to mitigate their fiduciary responsibilities through a series of comprehensive actions which include investment education and communication, but they can never relieve themselves entirely of their overall fiduciary obligations. Let the litigation begin.

Lastly, consider the effects on the existing defined benefit program if newly hired, younger officers choose to "opt out". If fewer participants enter the program, then the average age of the group will begin to rise but, more importantly, fewer dollars will be coming into the program. The existing pensioners will have a smaller support group and more money will be going out with less coming in as compared to the current structure. We call this the effects of anti-selection. Funds will begin to be less well funded, and since there is a mandate that all funds be 100% funded by 2033, municipalities, as the balancing entity, will need to increase their contribution levels in order to maintain the current system. Since the current system is larger and contains older participants, the increases may become more substantial than the offset savings realized by the contributions to the less expensive self-managed plan.

Defined contribution plans can be fine, but poorly designed plans of any type are dangerous. Police officers deserve better than thrown-together legislation calling for an overhaul of a 37 year-old system. To me the choice is easy. But I lived through the stock market during the 80's and I watched my portfolio drop in the first quarter of this year. I'm fond of guarantees. Besides I try never to enter a dark building without my gun drawn and my backup in place. Damn that soapbox!