

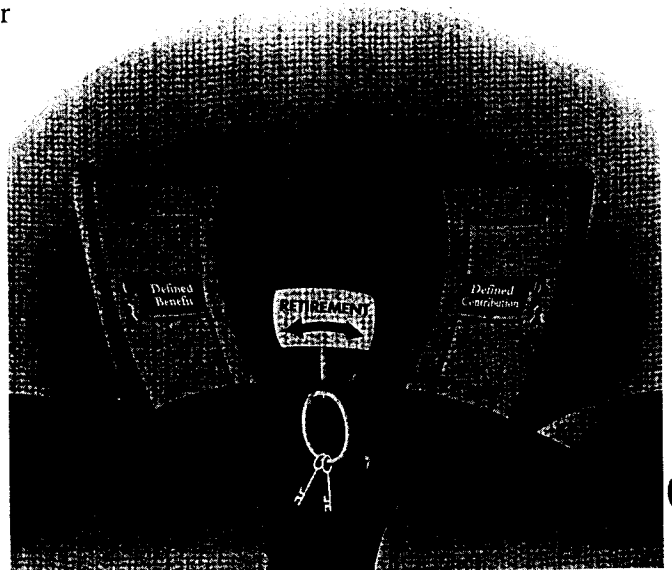
Defined Contribution Plans

Can Be Win-Win Solutions for the Public Sector

Joseph J. Jankowski, Jr.

In trying to balance the often-divergent interests of taxpayers, employees, and employers, today's state and local government executives are showing increased interest in the defined contribution retirement plan as an alternative to the traditional defined benefit plan. In several major ways, this type of plan offers significant advantages to both employers and employees.

These plans offer participants more control over their investments and greater flexibility to accommodate today's mobile lifestyles. At the same time, they provide the employer with better funding and budgeting predictability, as well as opportunities for cost control. Employers should fully consider the merits of both defined benefit and defined contribution plans as they review their retirement benefits, for each type of plan has distinct characteristics and benefits, depending on the demographics of the employees enrolled in the plan.



What Is the Difference Between a Defined Benefit and a Defined Contribution Plan?

While the primary goal of both defined benefit and defined contribution plans is to provide employees with income replacement at retirement, the two types of plans take different approaches. In a defined benefit plan, the employee receives the promise of benefit payments determined by a prespecified formula that usually multiplies the number of years of service \times the employee's salary in his or her final years of employment, \times a percentage "factor." While the benefit formula is known in advance for the employee, the actual lifetime cost to the employer is not known ahead of time but is actuarially estimated on a continuing basis. The final benefit is usually paid in the form of an annuity.

By contrast, a defined contribution plan does not specify the retirement benefit to be received by the employee. Rather, it builds a monetary balance by specifying a contribution (usually a percentage of compensation), which is deposited regularly into an individual account for each participant. The benefit to the employee is determined by the final account balance, which depends upon the level of contribution and the investment earnings in the account.

Where Do Defined Contribution Plans Excel?

In general, defined contribution plans work best where workers are relatively young and have a high degree of career mobility, as illustrated in the two accompanying graphs.

In the base case (see Figure 1), two retirees continue to work in the same job until retirement. The final benefits of defined benefit and defined contribution plans are roughly equivalent after 30 years with the same employer. Assumptions include a defined contribution rate of 7 percent, investment earnings of 7.5 percent, a 15-year life expectancy at age

Defined contribution plans work best

where workers are relatively young and have a high degree of career mobility.

65, a final salary of \$25,000, and a defined benefit plan constructed to provide 30 percent of final pay.

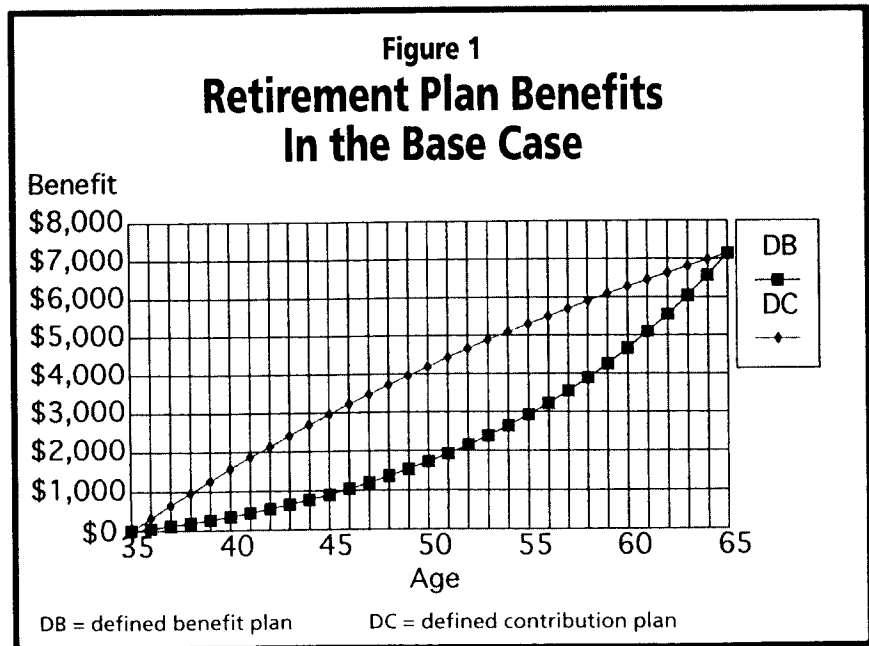
However, if both retirees were to separate from service and begin to receive benefits after 15 years, at age 50 (early retirement case, Figure 2), the defined contribution plan would provide approximately double the benefit of the defined benefit plan. Of course this analysis is not intended to show that one plan is better than the other but to illustrate how these plans work under different circumstances and assumptions concerning years of service. (Data for the graphs were developed by the Alexander & Alexander Consulting Group, Inc., of

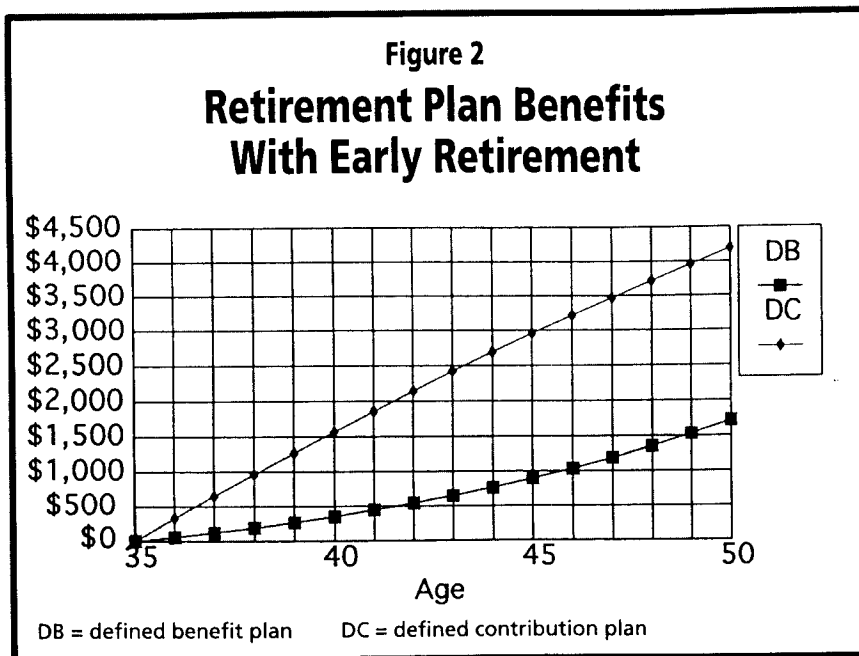
Baltimore, Maryland.)

Following are specific areas in which defined contribution plans can provide value.

Budget predictability is usually one of the big advantages of defined contribution plans and a chief concern of employers who have defined benefit plans. Many local governments are subject to severe budget cutbacks or legislation that limits tax increases. In this belt-tightening environment, the uncertain funding liabilities and relatively high administrative costs of defined benefit plans can be problems. With defined contribution plans, there is no need for actuarial consultants, and there are no unfunded liabilities and fewer budgeting uncertainties because most expenses are known in advance.

Portability is another area in which defined contribution plans offer an advantage, this time to the employee. As mentioned, an increasingly mobile workforce has created a mismatch between the old pension model and the work patterns of today's employees. In the past, workers tended to have long periods of service with one employer, which resulted in





high payouts from a defined benefit plan. But with such a plan, benefits do not grow after a separation from service. Consequently, today's mobile employees face a serious loss of benefits due to the structure of defined benefit plan vesting and accrual provisions.

Defined contribution plans provide a chance for employees to minimize this loss of retirement benefits by letting assets remain invested, grow in the employee's account, or be transferred to an IRA or other tax-qualified retirement plan after the employee separates from service.

Flexibility in financial and retirement planning is another benefit of defined contribution plans. For example, it is common for employees to have access to retirement assets via a loan option, if necessary, during employment and to enjoy a wide array of payout options when it comes time to retire. Properly structured defined contribution plans, such as 401(a) money purchase plans, usually offer more of these choices to employees than do defined benefit plans. In the latter type of plan, the choices are generally limited to such annuity-payment arrangements as single life, joint

and survivor, or period certain.

Additionally, defined benefit plans do not provide an opportunity to self-manage the assets or to take a loan. With a defined contribution plan, however, the following choices are usually available:

- Transfer of assets to an IRA.
- Transfer of assets to another employer's qualified plan.
- Annuitization of assets.
- A named beneficiary for payment of assets upon the death of the surviving spouse.
- Loan of assets at a favorable interest rate.

Potential Problems with Defined Contribution Plans

When might circumstances not favor the use of a defined contribution plan? If an employer identifies the current employee population as consisting primarily of older workers with long service records and low turnover, a transition to a defined contribution plan might not be the best alternative. Such employees would probably be better off staying in the defined benefit plan because the structure

of such plans tends to favor older employees with long tenure on the job.

Defined contribution plans give employees the chance to manage their own investments. This can work either for or against the employee, depending on his or her investment knowledge, discipline, and the performance of financial markets. Critics of defined contribution plans believe that most employees will not take the time and trouble to become educated about investment matters, and that their retirement assets will be at risk. Therefore, the installation of a proactive program of employee investment education becomes critical when local governments consider using a defined contribution plan.

The Best of Both Worlds

Is it possible for public sector plans to have both a defined benefit plan and a defined contribution plan at the same time? The answer is an unequivocal yes. Many public officials are showing great interest in defined benefit/defined contribution (DB/DC) combinations, which can provide the best of both plan types. These can be partial, complete, or new-employee-only programs, resulting in everything from the total transfer of all assets into a defined contribution plan to the maintenance of the defined benefit plan with a supplemental or alternative defined contribution plan.

Experience shows that all three types of programs can be undertaken with a high degree of success. The advantages and disadvantages of each type depend on the specifics of the existing plan, such as any unfunded liabilities, the goals of the employer, and the characteristics of the employee population.

Important Factors in DB/DC Transitions

Considerable planning and preparation must take place before a transition can be implemented. First, an initial period of information gathering is important to ensure that both the current and the

new plans will be appropriately structured to meet participant needs. Finding the right provider is also an important piece of the puzzle and can make the difference between a successful transition and one that falls short of the mark.

The provider must not only offer a wide range of high-quality investment options but also must be the standard bearer for employee education. Where a partial transition is being considered, the provider should be prepared to conduct individual counseling to assist employees in deciding whether or not they should switch. Some providers can even use state-of-the-art software to analyze which plan type will work better for a specific participant. Finally, ongoing communication about employer/employee objectives, and negotiation focused on selecting the plan that best meets the needs of everyone, should result in a smooth transition and an optimal result.

Obstacles to the Creation Of Defined Contribution Plans

With so much in favor of the DB/DC transition, why aren't more governments jumping on the bandwagon? Perhaps the biggest reason is that many state and local governments are not legislatively empowered to allow defined contribution plans and must first pass enabling legislation. On July 19, the Executive Board of ICMA passed a resolution endorsing model legislation developed by the ICMA Retirement Corporation (RC) that would help local governments do just that. Using the RC legislation as a model, local governments can pass their own laws permitting the voluntary creation of optional defined contribution retirement plans as alternatives or supplements for their employees.

Another reason why some local governments are going slow is that large, powerful public pension plans often carry with them a high degree of political influence. When viewed through this political filter, the concept of "breaking

up" a defined benefit plan by dispersing some of its assets into a defined contribution plan can have either a powerfully positive or a powerfully negative impact on perceptions of the plan. Yet another political consideration is that labor unions tend strongly to favor retaining the defined benefit plan structure and sometimes use plan benefits as a negotiating point in collective bargaining.

When it comes to their pension plans, both employers and employees are asking themselves the question, "How can we do this better?" In light of the financial and taxpayer pressures faced by states and localities and the increasing interest in retirement issues shown by employees, one thing is certain: The future will bring many changes to the public sector retirement system, and defined contribution plans will doubtless play a big part in those changes. **DM**

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ICMA Resource

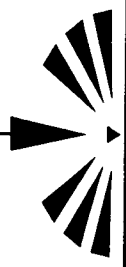
The ICMA Executive Board has endorsed model legislation developed by the ICMA Retirement Corporation to permit local-option defined contribution retirement plans. The October 1996 *MIS Report* "Defined Contribution Retirement Plans" presents an action plan for evaluating an employer's existing plan and converting from a defined benefit plan to a defined contribution plan. The report (item number 42124, \$14.95) includes a review of retirement program design, a method for evaluating plan benefits, and a conversion checklist.

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