Pension Plans: Alternatives for the Future

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Introduction

The history of the pension crisis in San Diego has necessarily reflected on past events that have led to present conditions. As the City of San Diego turns the corner by implementing crucial reforms, it is imperative that the City is prepared to provide competitive pension benefits to its future workforce. Mayor Jerry Sanders has committed to creating a pension plan for new employees as part of his FY 2007 Reforms (City of San Diego 2006). A pension plan for new employees must be both cost effective and provide the appropriate level of benefits to attract and retain valuable City employees.

The purpose of this report is to encourage meaningful discussion and eventual proposals regarding an innovative retirement plan that will allow the City to attract and retain high-quality employees while satisfying the City's present and future financial goals. The IBA has undertaken preliminary research to evaluate pension alternatives and their implications for the City's finances and future employees. This report will consider the potential benefits and drawbacks of the following pension plan proposals for employees and the City: a scaled back defined benefit plan; a defined contribution plan; and four formal models of hybrid pension plans. A glossary of terms is included in the penultimate section of this report to assist the reader in comparing the various pension plan models. In addition to an evaluation of pension plans for new employees, the IBA recommends a review of a plan transfer to CalPERS or the creation of a CalPERS plan for new employees. The City should use these proposals to evaluate how the City's pension plan can address the needs of the City's financial future and the next generation of City employees.

Pension Plan for New Employees

In an aging global landscape, governments and private companies alike are grappling with the dilemma of providing pensions to a large cohort of workers with extended life expectancies (Clark and Monk 2006, 8). This issue is not peculiar to the City of San Diego, but encompasses a global issue of escalating salience as a large number of experienced workers exit the labor force. At the crux of the pension issue is the promise explicit in traditional defined benefit pension plans of a guaranteed monthly benefit upon retirement (DOL 2006). In recent years the Pension Benefit Guaranty Corporation (PBGC), which insures private defined benefit pension plans, has been placed in a precarious financial situation due to the large number of defaults on plans in the private sector (Crane 2001, 124).[1] Public pension plans, although not insured by the PBGC, enjoy an implicit form of security due to a government's ability to tax the electorate (Peskin 2001, 197). Ultimately, however, the financial onus of *all* pensions rests on a body of taxpayers, since pension plans that do not ensure a sufficient level of retirement will require taxpayer subsidies in the form of welfare (Peskin 2001, 215).

There is a current, worldwide trend in both the public and private sector to replace traditional or "defined benefit" plans with "defined contribution" plans (Peskin 2001, 214). A defined contribution plan is a transferable, personal retirement account in which benefits are equivalent to an employee's individual account balance (EBRI 1996, 5). The account balance reflects employer contributions, employee contributions, or both, and investment returns (GAO 2000, 8). The retirement benefit is not guaranteed by the employer. In concert with this trend, employers are also implementing hybrid pension plans that combine aspects of defined contribution and defined benefit plans to temper the disadvantages of each (Albrecht et al. 2005, 1). Hybrid pension plans enjoy flexible plan design and can be tailored to an organization's needs.

Although organizations continue to explore alternatives to traditional defined benefit retirement plans, it is important to note that traditional plans can operate effectively if they are administered properly and the managing entity diligently contributes to the plan.[2] In fact, as Michael Peskin of the Pension Research Council points out, well-managed defined benefit plans can be more "economical" (Peskin 2001, 216). Peskin argues "from a national perspective, any system necessarily translates into a defined benefit system" (Peskin 2001, 215). In essence, if employers do not guarantee a retirement benefit to employees, the government, or more accurately, taxpayers, will bear the burden of providing welfare to retirees (ibid). In light of this social context, an employer should not approach alterations to a pension plan with the aim of expeditiously curing an ill-managed or under-funded system. Rather, an employer should look upon a pension plan as a responsibility, which must be carefully managed and properly insured to prevent the frivolous expenditure of public money.

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[1] The PBGC was established by the Employee Retirement Income Security Act of 1974 (ERISA).
[2] Examples of well-funded public sector pension systems in California include San Francisco, San Jose, CalPERS and CalSTRS (Schmidt 2005).

The proceeding section of this report will evaluate the following pension plan proposals for new employees: a scaled back defined benefit plan; a defined contribution plan; and four formal models of hybrid pension plans. The IBA recommends that the City Council and Mayor consider how a pension plan for new employees should be designed to reduce fiscal uncertainties and provide competitive pension benefits to attract and retain talented employees.

Scaled-back Defined Benefit Plan:

The Pension Reform Committee (PRC) suggested a scaled-back defined benefit plan for new employees within its recommendations. The PRC highlights the value of a defined benefit plan stating that it "believes… that the City would experience recruitment and retention difficulties in offering only a defined contribution plan in lieu of a defined benefit plan…" (City of San Diego 2004, 38). The PRC's recommendations provide the following parameters for a scaled back defined benefit plan:

- Increase normal retirement age by seven years;[3]
- Change the early retirement age to five years less than normal proposed retirement age ;[4]
- A 20% reduction to the accrual rate for the percentage of final base payroll used in calculating benefits;[5]
- Change final base payroll to calculation based on the average of an employee's three highest earning-years;[6]
- Final base payroll should exclude salary differentials (second shift differentials, bilingual differential, etc.) (City of San Diego 2004, 16-18).

One PRC recommendation was implemented in 2006 with the elimination of DROP and the purchase of service credit.

The immediate advantages of offering a scaled back defined benefit plan are twofold: (1) the City would retain a valuable recruitment tool since such plans are favored by employees; and (2) the City would enjoy a cost savings due to the reduction in benefits. The PRC gives annual estimates of savings that correspond to each recommendation (City of San Diego 2004a, 41). The PRC states, however, that "savings will be fully realized only when all employees under the existing benefit structure have retired" (City of San Diego 2004, 39).

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[3] Normal retirement age is currently 55 for General and Legislative members, and 50 for Safety members. This would change early retirement to age 62 for General and Legislative members, and age 57 for Safety members.

[4] Based on this proposal, early retirement age would be 57 for General and Legislative members and 52 for Safety members.

[5] Current accrual rate percentages are 2.5% for General members, 3% for Safety members, and 3.5% for Legislative members. Based on this proposal accrual rate percentages would be 2% for General members, 2.4% for Safety members, and 2.8% for Legislative members.

[6] Final base payroll is currently based on an employee's highest earning-year.

The explicit disadvantage of a scaled-back defined benefit plan is that it does not protect an employer from the funding volatility of actuarially determined contributions that may fluctuate due to market losses and gains. Nonetheless, the PRC opines that "…there is nothing inherently wrong with a defined benefit plan and that eliminating a defined benefit plan in favor of a defined contribution plan would not necessarily result in an improved situation" (City of San Diego 2004, 38). On this note, we will now turn to a discussion of the merits and disadvantages of a defined contribution plan.

Defined Contribution Plan:

A common alternative retirement option for new hires is a defined contribution plan. Defined contribution plans are portable, personal retirement accounts in which the final benefit is equivalent to the dollar amount in an individual's account upon retirement (EBRI 1996, 5). Both the employer and the employee can make contributions to the account, although requirements vary and employers are not required to contribute (Lowenstein 2005). The employee is responsible for making prudent investment decisions, as the employer does not administer investment choices (ibid). Ultimately the account balance is based on the sum of employee and/or employer contributions, and "investment earnings or losses minus administrative expenses" (GAO 2000, 8). These personal accounts can be transferred between employers as an employee transitions jobs (NCSL 2006). Defined contribution plans do not guarantee any benefit upon retirement (DOL 2006).

A major qualitative difference between defined benefit and defined contribution plans is the accrual rate, or "the rate at which plan participants must earn the right to a retirement benefit" (GAO 2000, 11). Most defined benefit plans calculate final retirement benefits using a formula referred to as "final average pay." This formula, commonly referred to as "back-loaded," utilizes employees' earnings in the years near to retirement to calculate benefits (GAO 2000, 23). The retirement benefit is equal to "a percentage of an employees' final years of pay multiplied by their length of service" (GAO 2000, 7). It is important to note that pay near retirement is likely to be the highest pay earned by an employee. Defined contribution retirement benefits are not directly related to employees' salaries at the end of their career; rather the benefit is equal only to the amount in the employee's personal retirement account (GAO 2000, 8).

Under defined contribution plans employer contributions usually reflect a percentage of employee pay (Summers 2006). Contributions are therefore predictable, allowing for "greater stability and accountability" for the employer, as costs are known beforehand and do not fluctuate much annually (ibid). This stands in stark relief to the volatility of required contributions under defined benefit plans that are actuarially determined and may vary due to market fluctuations.[7] Predictability "eliminates the risk of unfunded

[7] In the 1990's, pension plan trustees throughout the U.S. took advantage of high asset values and returns by taking "contribution holidays." These high asset values enabled benefit increases for employees and cost-of-living adjustments for retirees. When the stock market bubble burst in 2001, assets fell and liabilities skyrocketed (Clark and Monk 2006, 7 and 11).

liabilities and thus guarantees full funding of the system" (ibid). Yet predictability does not necessarily result in any cost savings to the employer. Some benefit may be realized from improving the predictability of contributions and thus "smoothing employer costs," but assurance of cost savings can only be realized to the extent annual employer contributions are reduced (Moulds 2005, 7). Furthermore, this savings may not be realized for a number of years (ibid). In the City's case, there would also be administrative costs associated with the administration of two plans until all members in the current defined benefit plan retire.

The major drawback of defined contribution plans for employees is that they do not guarantee a retirement benefit or offer any assurance that the money in the individual retirement account will be sufficient for retirement (Lowenstein 2005). It is often incumbent upon the employee to decide what percentage of their paycheck will be allocated to the account (ibid). Critics of defined contribution plans have argued that they do not ensure that employees will exercise good judgment when deciding what level of contribution to deposit into the plan (ibid). The administration of a defined contribution plan, therefore, raises concerns of employee security and satisfaction. To avoid employee dissatisfaction the employer could bear the cost burden of administering individual accounts with multiple investment options. Due to the inherent structure of defined contribution plans, it may be prudent for an employer to ensure proper management of personal employee accounts through various rules (ibid). Investment education and counseling may mitigate employee dissatisfaction and the risk of insufficient retirement.

The often-touted advantages of portability and investment choice in defined contribution plans do not guarantee employee satisfaction. Recently, West Virginia teachers voted to drop their defined contribution accounts to return to a defined benefit plan (NCPERS 2006). In 1990 the state legislature eliminated the defined benefit plan for new teachers to save money (ibid). Yet the state did not save money and teachers were dissatisfied with the defined contribution plan because it failed to provide them with adequate retirement income (ibid). Less effective recruitment of new teachers and loss of experienced teachers raised alarm. As a result, the state abolished the defined contribution plan for new hires in 1995 (ibid). This example is provided to elucidate the issue of recruitment and retention as well as cost savings when management is entertaining a possible transition from a defined benefit to a defined contribution pension plan.

Current employees may be at a disadvantage if an employer transitions from a defined benefit to a defined contribution plan for new hires. The contractual rights of vested members in the defined benefit plan are inviolable, but will nonetheless be affected by the closing of the defined benefit plan. New employees will no longer make contributions into the defined benefit plan, and the employer will not contribute to the plan on behalf of new employees (Moulds 2005). This could result in reduced earnings as fewer dollars are infused into the system and investment strategies must be modified, while withdrawals continue (ibid).

For these reasons, many scholars and union leaders have opined that a defined contribution plan is not an equivalent substitute for a defined benefit plan. Although defined contribution plans are common in the private sector, the City must also acknowledge that, as a public entity, such a switch could be problematic in terms of recruitment and retention. The City of San Diego must remain competitive with surrounding municipalities offering defined benefit plans.

Comparison of Defined Benefit vs. Defined Contribution Plan Attributes		
Characteristic	**Defined Benefit**	**Defined Contribution**
Guaranteed Benefit	yes	no
Predictable Cost	no	yes
Portability	no	yes
Required Employer Contributions	yes	no
Individual Accounts	no	yes
Calculation of Benefits	Final average pay; highest annual pay	account balance

Hybrid Pension Plans:

Hybrid pension plans usually include a defined contribution personal account, although a defined benefit styled formula is used to calculate minimum and/or maximum annuity benefits at retirement (Albrecht et al. 2005, 1). Hybrid plans can be designed to reduce or stabilize employer contributions, but do not always result in lower employer contributions as this is dependent upon plan design. Nevertheless, the hallmark of hybrid pension plans is their flexible plan design, in which both employer and employee needs can be addressed (EBRI 1996, 3).

The City should consider hybrid plans to address the retirement needs of incoming young, mobile employees. Hybrid plans offer features absent in pure defined contribution and defined benefit plans that may attract and retain these employees. Hybrid plans may also offer the City a better financial plan for the future. The proceeding discussion will evaluate four models of hybrid pension plans: Cash Balance; Pension Equity; Floor-Offset; and Target Benefit. In particular, our discussion will explore the advantages and disadvantages of plan design for both employee and employer. We will also compare these hybrid models to traditional defined benefit and defined contribution retirement plan models.

- **Cash Balance**

Cash balance hybrid pension plans are categorized as defined benefit plans with defined contribution characteristics (EBRI 1996, 7). Similar to a defined benefit plan, cash balance plans guarantee a future benefit utilizing a specific formula (ibid). The employer must administer the plan and make prudent investment decisions (ibid). Analogous to defined contribution plans, benefits are expressed in portable, individual accounts as a lump sum (EBRI 1996, 8).

In a typical cash balance plan, an employee's account is credited each year with an employer-provided "cash balance credit," such as five percent of an employee's compensation, and an "interest credit," either at a fixed or variable rate that is linked to an index (EBRI 1996, 8). Unlike defined contribution accounts, cash balance accounts are hypothetical accounts that serve only as "record-keeping devices" that are simply used to communicate to the participant the present value of their accrued benefits (EBRI 1996, 8). Individual accounts are not credited with actual investment gains or losses, and plan assets are actually unallocated within the trust (GAO 2000, 11 and EBRI 1996, 9). At normal retirement age, this individual account balance will be equal to the accrued benefit of the employee in lump sum dollars (GAO 2000, 21). Individual accounts have been seen as an advantage of the cash balance plan because employees find the account statement easier to understand than a projection of their plan benefits at retirement (ibid).

An employer's actual annual contributions are placed in a pension trust fund on behalf of all employees (GAO 2000, 11). Contributions are calculated "based on complex federal rules designed to ensure the trust has sufficient assets to pay expected benefits" (ibid). The final benefit is dispensed as a lump sum amount equivalent to an employee's vested account balance when the employee reaches normal retirement age or terminates employment (EBRI 1996, 10 and GAO 2000, 21). An employee may also elect to receive their benefit in the form of an annuity that is actuarially equivalent to the account balance (EBRI 1996, 10).

Cash balance plans benefit employees through their portability, steady rate of accrual, and personal account format akin to a defined contribution account. The employer also bears the risk of investment and provides contributions, which are guaranteed (EBRI 1996, 9). Younger, mobile workers find cash balance plans attractive, since the plans can be rolled over into another employer's plan due to lump sum distributions (Boehner 2004b). Younger workers may also accrue higher pension benefits earlier in their careers (GAO 2000, 17). Unlike a defined benefit plan in which benefits accrue slowly the first twenty years and rapidly the following ten, employees under a cash balance plan accrue benefits at a faster rate early in their career and slower rate at the end of their career (EBRI 1996, 8). This "front-loaded" accrual pattern occurs because the annual accrued benefit includes all the hypothetical interest the cash balance credit would earn until normal age retirement as specified in the plan (GAO 2000, 22). A younger employee will have an accrued annual benefit that reflects many more years of interest simply because they have a larger number of years until retirement (GAO 2000, 23). The plan's appeal to younger workers allows employers to use cash balance plans as a recruitment

tool. The House Education and Workforce Committee claims that "cash balance plans are also better suited to Americans' work patterns" in which employees are increasingly mobile (Boehner 2004b).

An employer may benefit from the more predictable and flexible costs of cash balance plans. According to a survey conducted by the Employee Benefit Research Institute (EBRI) in March of 1996, some respondents reported a cost savings when switching to a cash balance plan, but others stated the switch was cost-neutral (EBRI 1996, 28). One respondent noted that the plan was "more costly, although costs were also more predictable and less likely to need expensive updating" (ibid). Employer contributions still retain some volatility since investment gains and losses affect employer contributions similar to a defined benefit plan (EBRI 1996, 9). The EBRI noted that an employer can achieve cost control objectives by severing benefits from salary inflation (EBRI 1996, 7).

Cash balance plans might be more costly and difficult to administer than defined benefit plans due to the record keeping aspect of individual accounts (EBRI 1997). On the other hand, England's Department for Work and Pensions states that administrative costs should be less costly than defined contribution plans because investments are not directly allocated to employees (DWP 2005, 17). A public employer may have higher administrative costs for many years to maintain both the defined benefit plan for retirees and vested employees along with the cash balance plan (EBRI 1997).

In 2002, the Nebraska Legislature established a cash balance plan for new state and county employees and gave existing defined contribution plan participants the option to switch (NASRA 2006). The transition was initiated in response to concerns that employees were not accumulating enough for retirement through the defined contribution plan (ibid). Other plan sponsors that have implemented cash balance plans include Bank of America, the first to implement such a plan in 1985; Bell Atlantic; BellSouth Corporation; Chemical Bank; and Catholic Health Corporation (EBRI 1996, 6)

In summary, the most salient differences between a traditional defined benefit plan and a cash balance plan are the cash balance plan's portability, lump sum disbursement option, individual account model and front-loaded accrual pattern. Some evidence shows that a cash balance plan might also improve predictability and control over costs.

- **Pension Equity**

Like the cash balance plan, the pension equity plan is categorized as a defined benefit plan with defined contribution characteristics. In 1993 popular attention was drawn to this pension scheme after RJR Nabisco implemented a pension equity plan with the objective of hiring and retaining mid-career employees in the context of a mobile workforce (EBRI 1996, 14). Pension equity plans are suited for such an objective as they combine the portability of a defined contribution plan with the security of a defined benefit plan (ibid).

Like a defined benefit plan, the typical pension equity plan credits an employee a percentage to be applied to the final average earnings for each year worked (EBRI 1996, 14-15). As an employee accumulates years of service, the percentage to be applied to final earnings increases (EBRI 1996, 15). Benefits are equal to final average earnings multiplied by the sum of the percentages earned over the course of an employee's career (ibid). Some employers require that employees receive their benefit in the form of an annuity, although benefits are generally defined in terms of a lump sum value. An employee can usually choose to receive their benefit as an annuity or a lump sum payment (ibid).

The primary difference between a pension equity plan and a cash balance plan is the accrual pattern used to calculate benefits (EBRI 1996, 14). Pension equity plans use a "final average earnings" formula defined "as an annual average of the highest earnings over a specific number of years" (Green 2003). For instance, pension equity plans calculate benefits based on an employee's average salary over his/her three highest earning years, which are typically the last years of employment. Benefits are, therefore, accrued primarily in the final years of employment since benefits are calculated based on years of service and final average salary (GAO 2000, 23). In this way, benefits are better protected against inflation because they "reflect the economic conditions at retirement rather than conditions when the benefit was earned" (EBRI 1996, 16). Pension equity plan benefits, however, build up more steadily over the course of an employee's career than traditional defined benefit or defined contribution plans (EBRI, 1996, 15-16). [8]

Employers can benefit from the employee-oriented advantages of a pension equity plan by using the plan as a recruitment tool to attract and retain new, experienced employees (ibid). In addition, pension equity plans do not express benefits in terms of individual accounts, which may reduce administrative costs when compared to defined contribution or cash balance pension plans. Yet the calculation of benefits, based on final average earnings, can result in decreased control over costs when compared to cash balance plans. Benefits are based on earnings at the end of an employee's career, which are typically higher than those earned over a lifetime (EBRI 1996, 16).

To date, pension equity plans have been used primarily in the private sector. Ameritech Corporation, Scientific-Atlanta, and Dow Chemical have pension equity plans (EBRI 1996, 14). When compared to traditional defined benefit plans, the most significant aspects of the pension equity model are portability, lump sum disbursement, and a steadier build-up of benefits throughout an employee's career. We have not seen evidence that pension equity plans will necessarily reduce costs or improve contribution predictability.

[8] Defined benefit plans provide less build-up in value early in an employee's career, while defined contribution plans provide less build-up as a percentage of compensation in later years.

- **Floor-offset**

A floor-offset plan is characterized by two separate, related pension plans; a defined benefit "floor" plan and a defined contribution "base" plan (EBRI 1996, 17). The defined benefit plan utilizes a standard formula to define a "minimum benefit level," taking into account age, service, and/or compensation (ibid). The employee receives the benefit equivalent to the defined contribution account if the defined contribution benefit is equal to or exceeds the minimum benefit set by the defined benefit floor plan (ibid). Yet if the defined contribution plan provides less than the minimum benefit level established by the defined benefit plan, the floor plan (the defined benefit portion) will make up the difference between the defined contribution benefit and the defined benefit minimum established level (ibid).

This structure provides employees with a guarantee that their retirement benefits will be equivalent to, at least, a traditional defined benefit plan (DOL 2002). The employee is protected from the insecurity of adverse investment returns, but stands to benefit from favorable investment returns (EBRI 1996, 18). The employer may additionally benefit from these advantages. The floor-offset plan provides a unique opportunity for employers seeking to "maximize income and security for career employees" while concurrently provide portability and "meaningful cash accumulation for younger, more mobile employees" (ibid). Therefore, a floor-offset plan can be viewed as a valuable recruitment tool to attract both young and experienced career employees.

Although it may be possible to realize a cost savings through the implementation of a floor-offset plan, cost is again dependent on annually determined contribution rates and the cost of administering the various components of the plan. The cost of the defined benefit portion of the plan is dependant upon the contribution levels and investment returns of the defined contribution plan (EBRI 1996, 18). Poor investment returns in the defined contribution plan could result in losses, which would increase requirements in the defined benefit floor plan to protect the promised benefits (EBRI 1996, 19). Plan administration might be more complex due to the various defined contribution and defined benefit components of the plan (EBRI 1996, 18).

The floor-offset plan is often used by private sector corporations in which a profit-sharing plan serves as the defined contribution component of the plan (EBRI 1996, 18). For instance, Intel's floor-offset plan comprises a profit-sharing defined contribution plan base plan and a defined benefit plan floor plan (Elswick 2003). The Profit Sharing Retirement Plan is a defined contribution plan to which a discretionary employer cash contribution is determined and allocated annually (Intel 2005, 9). The defined benefit floor component is designed to provide retirement income as "determined by a pension formula based on final average pay, Social Security covered compensation and length of service upon separation not to exceed 35 years" (Intel 2005, 9). Upon retirement, an actuarial calculation compares the value of an employee's Profit Sharing Retirement Plan (the defined contribution component) with a defined benefit pension formula (Elswick 2003). If the Profit Sharing Retirement Plan account balance does not provide the minimum level of retirement income as calculated by the defined benefit formula, the

defined benefit floor plan will make up the difference. This guarantees employees a minimum defined benefit retirement income (ibid).

In conclusion, the floor-offset plan provides portability, lump sum disbursement, and individual account balances. It also retains earlier value accumulation for the mobile worker through the defined contribution aspect, but offers maximum income for career employees through the defined benefit formula.

- **Target Benefit**

A target benefit plan is a defined contribution plan with defined benefit features (EBRI 1996, 22). The plan uses a defined benefit formula to set a target benefit for each participant at normal retirement age (ibid). Employer contributions are determined for each employee by an accepted actuarial cost method that is projected to result in the targeted benefit (EBRI 1996, 22). However, the employer does not guarantee the targeted benefit (ibid). The employer is not obligated to restore a retirement system account balance to the target level if plan assets do not yield the assumed rate of return (ibid). Therefore, actuarial gains and losses are ignored and do not impact the subsequent employer contributions (Matthews and Matthews 1991, 179). Similar to defined contribution plans, payable benefits are determined by account balances, which may exceed or fall below the targeted benefit (EBRI 1996, 22).

The defined contribution feature of an individual account can be seen as an advantage to an employee eager to monitor their retirement account (Matthews and Matthews 1991, 179). Yet actual benefits retain a level of unpredictability since final account balances can be higher or lower than the target (ibid). The plan does not guarantee the target benefit upon retirement and investment decisions are also borne by the employee as with traditional defined contribution plans.

Despite these contrasting benefits and drawbacks, target benefit plan design is flexible. Formulas can be based on years of service and/or various measures of compensation such as career average earnings, final average earnings or final year earnings (EBRI 1996, 23). As exemplified below, target benefit plans can incorporate design features from other hybrids such as floor-offset plans that provide a minimum guarantee.

The following describes the "Newport News Shipbuilding and Dry Dock Company Target Benefit Plan for Employees Covered by United Steelworkers of America, Local 8888." The employer establishes an account for each employee to which it makes all contributions (Newport 2006, 1-2). Contributions are determined by an independent actuary and made quarterly (Newport 2006, 8). The target benefit is determined by multiplying the number of years of pension credit an employee is expected to earn by the dollar multiplier in effect for that year (Newport 2006, 4). The actual benefit is equivalent to the actual value of the account. If the account is not sufficient to provide the frozen Minimum Benefit, the employee is entitled to receive the difference under the

Pension Plan (ibid). This portion of the plan resembles a floor offset arrangement. If superior investment performance results in an account balance greater than the Minimum Benefit, the employee is entitled to the total account balance (ibid). The company also bears the burden of administering the plan (Newport 2006, 8).

In summary, a target benefit plan provides portability, lump sum disbursement and individual accounts. It also provides significant protection from contribution volatility since market returns are ignored; however this comes at the cost of less income security for employees than offered by traditional defined benefit plans.

Hybrid Plan Key Characteristics	**Cash Balance**	**Pension Equity**	**Floor Offset**	**Target Benefit**
Classification	defined benefit	defined benefit	defined benefit & defined contribution	defined contribution
Guaranteed Benefit (Employer Investment Risk)	yes	yes	yes	no
Contribution Volatility as Compared to Traditional Defined Benefit	slightly less	same	same	significantly less
Portability	yes	yes	yes	yes
Required Employer Contributions	yes	yes	yes	yes
Individual Accounts	yes	no	yes	yes
Benefit Accrual	career average	final average	flexible	flexible

The IBA recommends that the Mayor and City Council discuss all possible options when considering a pension plan for new employees. The ability of the City to attract and retain valuable employees will be partially informed by the perceived quality of the City's pension plan. The ideal plan will satisfy the expectations of the City's future workforce and the financial goals of the City.

Transfer to CalPERS

The City should further evaluate transferring the current Retirement System to the statewide system, California Public Employees' Retirement System (CalPERS). CalPERS, which includes state workers and 1,500 local agencies, is an example of a well-funded pension system. CalPERS website boasts the management of "pension and health benefits for more than 1.4 million California public employees, retirees, and their families" (CalPERS 2006). The retirement plan is a defined benefit plan providing "benefits based on a member's years of service, age, and highest compensation" (ibid). The immediate advantage of a transfer to CalPERS would be the preservation of a defined benefit plan, which can serve as an important recruitment and retention tool. A transfer might also be a popular option among the City's citizens, since administrative duties would be removed from local influence. Furthermore, the City should consider opening CalPERs membership to select employee groups such as new employees.

An open discussion must address the fact that a transfer to CalPERS may not save the City money, and may increase costs. A transfer to CalPERS may also entail unforeseen administrative hurdles that could result in additional costs to cover the act of a transfer. The Manager's Report identified several questions to be considered when assessing the viability of a potential transfer of the Retirement System to CalPERS:

> (1) Can the City join CalPERS without a vote of the public?; (2) Does the City Retirement System funding ratio need to be at a certain level prior to the transfer of the City's program to CalPERS?; (3) Since retirement is an individually vested right, is it up to each individual which retirement system they join? (City of San Diego 2005b, 21)

The City Attorney's legal opinion entitled "CalPERS Eligibility" states that the City can enter into a contract with CalPERS, absent a vote of the people or any action of the SDCERS Board, upon the affirmative vote of active members (City of San Diego 2005a, 2). The opinion further states that the City would need to "resolve the unfunded liability" and would have to "seek and obtain CalPERS approval to amortize the unfunded liability" (City of San Diego 2005a, 4-5). The extent of the City's unfunded liability may prevent the City from realizing any cost savings from the transfer (City of San Diego 2005a, 5). The City Attorney's memo states, however, that "contracting public entities can be placed in 'risk pools' by CalPERS," which are often advantageous because risk is spread out among comparable employers. This risk pool assessment thus reduces the employer contribution rate (ibid). Prior to the initiation of such a transfer, the City needs to decide which City employee groups would be contracted for membership. These groups could include all members consisting of active and retired employees, retirees, new hires or employees who are members of specific classifications such as fire or police (City of San Diego 2005a, 4). Individual members would not have a choice as to which retirement system they could join (City of San Diego 2005a, 3).

The City of Oakland provides one example of such a transfer to CalPERS. Oakland has three defined benefit retirement plans, two of which are closed plans that cover Police and Fire employees hired prior to July 1976 and Municipal Employees hired prior to September 1970. All other employees are covered by CalPERS (City of Oakland 2005). Oakland's transfer to CalPERS resulted in an increase in City contributions. In August 2000 the City of Oakland estimated that Measure "J," which would allow active members of the police and fire retirement system to transfer to CalPERS, might cost the City an additional $2.2 million per year. It was noted that member contributions would be a higher percentage of pay under CalPERS and that the City would subsidize this increase in contributions (City of Oakland 2000). Although this information is instructive, the City would have to conduct its own evaluation of the cost implications related to a transfer of the Retirement System to CalPERS.

The City Attorney's opinion additionally highlights the vesting requirements under CalPERS. Members are fully vested after five years under CalPERS (City of San Diego 2005a, 5). This stands in stark relief to the current SDCERS vesting requirements of ten years at age 62 or twenty years at age 55 (ibid). The City Attorney's opinion cautions that "the increased cost associated with an earlier vesting dictate must be considered by the City in potentially contracting for CalPERS membership" (City of San Diego 2005a, 5-6). The IBA concurs that the City must consider any financial burdens that the City might incur from a transfer of any portion of its existing or new membership to CalPERS.

The IBA suggests that the Mayor's office assess the viability of a transfer to CalPERS, taking into account the above hurdles that must be overcome to execute a transfer. This issue should be debated in concert with a discussion of a ballot measure to alter the SDCERS Board composition as discussed in the companion to this report, "Pension Plan: A Strategy for Action," as such a transfer would render the ballot measure moot. The creation of a CalPERS plan for new employees should also be considered in the stead of formulating a new pension plan.

Conclusion

All of the alternative pension plan designs and options discussed herein provide viable options that the City should entertain. A new pension plan must address the City's present and future financial goals and account for the changing demographics of a new workforce. The City should consider the mobile career patterns of a new generation, despite the trend of long tenures in the public sector. The issue of global aging and extended life expectancies will continue to affect the actuarial assumptions of the pension plan. A new pension plan that is designed to accommodate this changing workforce and the future financial needs of the City is therefore in order. The IBA recommends that the City evaluate, with the utmost scrutiny, a new pension plan that will position the City to recruit and retain a workforce that will lead the City into the future.

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Glossary

Accrual Rate	The rate at which pension benefits grow throughout employee service.
Accrued benefit	The amount of accumulated pension benefits of a pension plan member on the basis of years of service.
Annuity	A form of financial contract that guarantees a fixed or variable payment of income benefit for life or for a specified period of time.
Back-loaded	Characterizes a pension accrual formula that utilizes employees' earnings in the years near to retirement to calculate benefits. This accrual formula is used in pension equity and defined benefit plans.
Benefit	Payment made to a pension fund member after retirement.
Career Average Pension Plan	Pension plan that calculates retirement benefits on the number of years of participation and the average salary during the employee's entire career
Cash Balance	A defined benefit plan that defines benefits for each employee by reference to the amount of the employees hypothetical account balance.
Contribution	Payment made to a pension plan by an employee or employer.
Defined Contribution	A pension plan that is based on employer and/or employee contributions and the performance of the investments chosen. Investment returns (both gains and losses) are applied to the account.
Final Average Pension Plan	Pension plan that calculates benefits based on number of years of participation and the average salary in the workers final years. (Defined Benefit and Pension Equity)
Floor-offset Pension Plan	Pension plan characterized by a defined benefit "floor" plan that defines a minimum benefit and a defined contribution "base" plan. The employee receives the defined contribution "base" plan if it is equivalent to or exceeds the defined benefit "floor" plan.
Front-loaded	Characterizes a pension accrual formula in which employees accrue benefits more rapidly in the beginning of their career. This accrual formula is used in cash balance plans.
Hybrid Pension Plan	Pension Plan that combines features of defined contribution and defined benefit plans.

Lump Sum Payment	Form of pension payment in which the employee receives their pension benefit all at once.
Normal Retirement Age	Age at which the employee is eligible for pension benefits.
Pension Equity Pension Plan	Defined benefit pension plan that contains the portability features of a defined contribution plan.
Target Benefit Pension Plan	Defined contribution pension plan that uses a defined benefit formula to set a target benefit for each employee at normal age retirement.
Traditional Defined Benefit	Pension plan in which benefits are linked through a formula to an employee's earnings and length of employment.
Volatility	The rate and degree of which the price of an investment moves up and down over time. Also signifies the tendency of markets to go down periodically. In defined benefit plans employer contributions become volatile depending on market performance.

[9]

[9] Many of these definitions were derived from the Organisation for Economic Cooperation and Development (OECD). 2005. *Private Pensions: OECD Classification and Glossary*. www.oecd.org/dataoecd/5/4/2496718.pdf.

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