

Issue Brief



EXPANDED USE OF DEFINED CONTRIBUTION PLANS BY STATES

Historical Provision of Retirement Benefits by States

Traditionally, many states provided retirement plan benefits to teachers and other workers through defined benefit plans.¹ The U.S. Bureau of Labor Statistics indicates that in 2010, 92% of full-time state and local government workers had access to a defined benefit plan.² In defined benefit plans, workers are usually provided with a monthly payment for life beginning at retirement based upon their average compensation and the number of years they worked. The employer consults with an actuary to determine how much money must be contributed each year in order to fund the promised benefits.

Many states have also given workers the ability to save their own money on a pre-tax basis through a voluntary defined contribution plan.³ The U.S. Bureau of Labor Statistics indicates that in 2010, 33% of full-time state and local government workers had access to a defined contribution plan.⁴ In defined contribution plans, workers have accounts to which contributions may be made by the employer and/or the employee. At retirement, the worker's account will be equal to the employer and employee contributions made over the years plus investment earnings reduced by any fees or investment losses.

Public education employers primarily use 403(b) plans as their defined contribution plan.⁵ 403(b) plans are similar to 401(k) plans. In 403(b) plans, employees can

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usually decide how much they are able to save and can change that amount as needed. Employers can also make contributions to 403(b) plans on behalf of their workers.

As discussed below, some states are considering using profit sharing plans as their defined contribution plan. In profit sharing plans, governmental workers cannot be given much flexibility in regard to how much they wish to save. If they choose to contribute, the amount elected must be a fixed percentage of their compensation that has been pre-determined by their employer. (This type of contribution is known as a “pick up” or “414(h)” contribution.) They are not allowed to contribute more or less than the pre-determined amount set forth in the plan. Employers can also make non-elective contributions to profit sharing plans.

Many States Are Considering Alternatives to Defined Benefit Plans

The Pew Center on the States reported in February 2010 that there was a significant gap between the retirement benefits promised by states and the amounts that had been put aside to fund those benefits.⁶ Their report indicated that some states were implementing reforms in 2008 - 2009 to address these concerns. Those reforms included: “1) keeping up with funding requirements; 2) reducing benefits or increasing the retirement age; 3) sharing the risk with employees; 4) increasing employee contributions; and 5) improving governance and investment oversight.”⁷

In a report issued later that year, the Pew Center on the States indicated that newly elected governors and legislators from both parties were proposing even more

¹ Barbara Bovbjerg, *Testimony on State and Local Government Pension Plans: Current Structure and Funded Status Before the Joint Economic Committee*, Gov't Accountability Office Report GAO-08-983-T (Jul. 2008), available at <http://www.gao.gov/products/GAO-08-983T>.

² U.S. Bureau of Labor Statistics, *Employee Benefits Survey* (Mar. 2010), available at http://www.bls.gov/ncs/ebs/benefits/2010/ownership_government.htm.

³ Bovbjerg, *supra*.

⁴ U.S. Bureau of Labor Statistics, *supra*.

⁵ Some states also make 457 plans available to teachers. These plans resemble 401(k) plans in that workers can decide how much they want to save and employers can make also contributions. However, fewer people participate in 457 plans and the assets held by 457 plans are considerably less than the assets held by 403(b) plans. See, e.g., Kristi Cook & Ellie Lowder, *The Source* 1-21 (3rd ed. 2011). See also, Investment Company Institute, *2011 Investment Company Fact Book*, available at http://www.iciactbook.org/fb_ch7.html (reflecting in Figure 7.21 that at the end of 2010, there were \$365 billion of 403(b) plan assets held in mutual funds and only \$75 billion of 457 plan assets held in mutual funds).

⁶ *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform*, Pew Center on the States (Feb. 2010), available at http://www.pewcenteronthestates.org/uploadedFiles/Trillion_Dollar_Gap_embargoed.pdf.

⁷ *Id.* at 8. See also, *Roads to Reform: Changes to Public Sector Retirement Benefits Across States*, Pew Center on the States (Nov. 2010), available at http://www.pewcenteronthestates.org/uploadedFiles/wwwpewcenteronthestatesorg/Initiatives/States_Fiscal_Health_Project/Pensions_Web_Update_121710.pdf.

significant changes to their state retirement plans. The report stated, “These proposals range from drastic overhauls, such as switching from defined benefit to defined contribution plans, to more incremental changes such as increasing employee contribution rates, raising the retirement age and changing benefit calculations.”⁸

Several states are considering defined contribution plans as alternatives to their defined benefit plans. The National Conference of State Legislatures issued a report in April 2011 indicating, that at that point in time, there were proposals in at least six states to replace a defined benefit plan with a defined contribution plan.⁹ The report emphasizes the seriousness of these proposals and commented that:

“The proposals for shifts to defined contribution plans also are significant. This report mentions six because of the criterion for inclusion that such proposals originate with governors, legislative leaders or pension study commissions. Most states see such legislation filed and killed annually. These proposals come from sources that ensure them a hearing even if the proposals also are killed – the Virginia Senate Finance Committee rejected the governor’s proposal for an optional defined contribution retirement plan three times in 2011. In the fiscal and political climate of 2011, such proposals for fundamental change in state retirement policy may have a better chance of enactment than in other recent years. 2011 could prove to be an even more significant transition point in state retirement policy than 2010 was.”¹⁰

If states decide to replace their defined benefit plans with defined contribution plans for teachers, they will need to consider which type of defined contribution plan is appropriate.

Teachers Are Familiar with and Like the Convenience Provided by 403(b) Plans

Many states provide teachers with the ability to save for retirement through 403(b) plans. For example, in Kansas, all school districts provide their employees with the ability to contribute to 403(b) plans.¹¹ A recent survey reflects that approximately 50% of full-time Kansas public school employees currently participate in a 403(b) plan.¹²

Additionally, most teachers are familiar with 403(b) plans which have been around for over five decades.¹³

Teachers who work or have worked for schools that offer 403(b) plans are often familiar with the rules due to the plans’ broad eligibility provisions. Once a 403(b) plan is offered by an employer, all teachers are typically eligible to make contributions. This is required by tax code rules that mandate that if one employee is eligible to contribute to the plan, then all employees must be eligible, with limited exceptions. This is known as “universal availability rule.”

Workers like the fact that 403(b) plans allow them to keep their retirement savings in one place. A study by Fidelity reflected on the importance to investors that retirement savings be held in a single account.¹⁴ If retirement contributions were forced into a state-wide defined contribution plan, employees who had saved through 403(b) plans would be required to manage multiple retirement accounts.

403(b) Plans Provide Schools with Flexibility

403(b) plans provide schools with flexibility in terms of the level of involvement required by them. When 403(b) plans are sponsored by governmental entities, such as public schools, they are not subject to the Employee Retirement Income Security Act of 1974 (ERISA). As a result, public schools have some flexibility regarding their level of involvement in administering the plan.

Some schools have embraced the role of sponsoring a 403(b) plan, while others have adopted a more passive approach. For those employers who have taken a more passive approach, teachers frequently receive information from the service providers to the plan.

Service providers typically use one of three different business structures to educate employees about their 403(b) plan investment options: (1) independent representatives; (2) a dedicated workforce; and (3) online tools. Independent representatives and members of a dedicated workforce typically provide a hands-on approach to education. They may meet with teachers at their schools, or even at their homes, to discuss the importance of saving for retirement and their options under the plan. An independent representative is affiliated with, but not employed by, a financial services firm. Members of a dedicated workforce are employed by the financial services firm. Under the online method, employees are typically directed to a website where materials about the importance of saving and the plan’s investment options are available. Online options tend to be less expensive as a result of the types of services being provided to the individual.

Studies show that teachers want help with retirement planning, but have varied preferences about how they

⁸ Roads to Reform, *supra*.

⁹ Ron Snell, *State Pension Reform in 2010 and 2011*, National Conference of State Legislatures 3, available at http://www.ncsl.org/documents/fiscal/2010-2011PensionsReport_Apr2011.pdf. See also, Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz & Laura Quinby, *A Role for Defined Contribution Plans in the Private Sector*, Center for Retirement Research at Boston College (Apr. 2011), available at http://crr.bc.edu/briefs/a_role_for_defined_contribution_plans_in_the_public_sector.html.

¹⁰ *Id.*

¹¹ Kan. Stat. Ann. § 72-8603.

¹² An analysis of participants in 403(b) plans by a large Kansas service provider reflected that 21,777 out of 43,875 full-time employees participated in 403(b) plans sponsored by Kansas public school districts. This sampling represents approximately 65% of the public education employees in Kansas.

¹³ 403(b) plans were added to the Internal Revenue Code in 1958 and a number of public schools set up 403(b) programs prior to 1961. Kristi Cook & Ellie Lowder, *The Source* 1-2 (3rd ed. 2011).

¹⁴ *Fidelity® Study Finds Many Investors Lack Understanding of Options for Assets in Old Workplace Savings Plans*, Fidelity.com (May 17, 2011), available at <http://www.fidelity.com/inside-fidelity/individual-investing/lack-of-understanding-of-options-for-assets>.

receive information about their retirement plans. A study by the TIAA-CREF Institute showed that 60% of all near-retirement higher education employees had consulted with a financial professional within the past two years regarding retirement.¹⁵ The study indicated that 89% of these workers discussed investment allocations with their advisor and 60% of them discussed their savings rate.¹⁶ However, a survey by Charles Schwab showed significant variety in how workers wanted retirement plan information delivered. The survey showed that 51% of retirement plan participants preferred one-on-one consultation, while 23% preferred an online tool that provided personalized investment selection and allocation recommendations.¹⁷ Similarly, a survey from the Profit Sharing/401(k) Council of America (PSCA) showed that the most common education approaches in 403(b) plans included on-site one-on-one meetings, which were used by 63% of respondents for participant education.¹⁸ As a result of these varied preferences, it is important that teachers be given the opportunity to choose the method that is right for them.

Making 403(b) Plans Even Better

Today, 403(b) plans offer significant advantages to teachers who want to save for their retirement. However, 403(b) providers can make these plans even better by reducing expenses and helping teachers to make informed choices with regard to investment products.

Teachers should be given the information they need to make an investment decision. They should have the freedom to work with the advisor that they trust and be able to choose the investment option that best suits their needs. For example, some participants do not need very much assistance and prefer a very low-cost option. However, other employees want someone to help them understand how much to save, how their plan works and what investment options are available. They want to work closely with an advisor on a one-to-one basis and are willing to pay for that level of service. The right advisors can help teachers be informed consumers who can select the investments that are best suited to their unique needs. In order to ensure that they have the tools to do so, teachers must be able to easily compare the services being offered to them and the costs associated with those services. There should be transparent disclosure of investment fees and all other expenses so that workers can clearly understand what they are paying for and what they are getting in return.

Some school districts may decide to hire a single third party administrator (TPA) to gain efficiencies and lower administrative costs. However, in order to allow teachers to have the choice to select the right provider for them, it is important that the TPA be independent.

Additionally, although a state-wide 403(b) program could select certain “core” investment providers that must be offered, each school district should be allowed to select additional investment providers they think are appropriate for their workforce. Allowing school districts to select providers would promote competition between investment providers to the benefit of teachers. The state program’s independent TPA could administer these additional options. Any administrative fee or disclosure requirements would be the same as for the state-selected investment providers.

In order to protect teacher choice, any state-wide 403(b) program should not inhibit the ability of school districts to negotiate the terms and conditions of their arrangements with investment advisors. Additionally, state-wide 403(b) programs should not favor investment providers selected by the state. Teachers in different school districts are unique and should be provided with a wide array of retirement savings options to suit their needs.

This approach is already being used in Florida by the IBC Model Plan.¹⁹ Florida’s four major education associations formed the IBC to help Florida K-12 employers reduce costs and satisfy the tax code’s requirements for 403(b) accounts.²⁰

States that decide to replace defined benefit plans with defined contribution plans should consider the benefits of 403(b) plans, which are familiar to teachers, permit teachers to keep their retirement savings in a single account, allow participants the opportunity to obtain the level of help they want and need, and provide public schools with the flexibility they need. When implementing state-wide 403(b) plans, states should not attempt to rein in administrative costs in a way that will deny participants the ability to choose the provider that best meets their needs. Teachers deserve the ability to make informed decisions about their investment providers and select the options that are right for them.

¹⁵ Paul J. Yakoboski, *The Use and Impact of Advice Among Near-Retirees*, TIAA-CREF Institute Trends and Issues 3 (Feb. 2010), available at http://www.tiaa-crefinstitute.org/articles/ti_nearretirees0210.html.

¹⁶ *Id.*

¹⁷ *The New Rules of Engagement for 401(k) Success*, Charles Schwab 18 (Sep. 2010), available at http://aboutschwab.com/images/uploads/schwab_engagement_study_slides.pdf (surveying over 1,000 participants in 401(k) plans).

¹⁸ *Id.*

¹⁹ Information about the IBC Model Plan is available at <http://www.themodelplan.com>.

²⁰ The Model Plan FAQ, available at <http://www.themodelplan.com/faq1.html#faq1>.