Kansas Coalition of Public Retirees

Defined Benefit (DB)vs Defined Contribution (DC) Retirement Programs

The purpose of this memorandum is to revisit the need to keep a Defined Benefit type of retirement system which is found in Tier I and II in the KPERS retirement system. Information about Tier III is available on the KCPR Website, www.ksretirees.org. The positives of a Defined Benefit retirement system are listed below. Conversion ideas of switching to a Defined Contribution (DC) type of retirement plan first surfaced during the KPERS Commission of 2011 and then again in 2015. During the 2021 Kansas Legislation system, the idea again surfaced in the House and on the floor of the Senate. This has led KCPR to address the topic once again.

Important Pension Positives of DB:
Sherry Chan, the chief actuary of New York City, states the following in an op-ed in *Crain's New York Business entitled, "Public Pensions Help the Whole City, Not Just Retirees."*:

1. All citizens benefit from public pensions, not just the retirees.
2. While public pensions may carry debt, they also create revenue.
3. Unfortunately, pension costs, funding levels and their liabilities seem to be the only matters highlighted. In her op-ed, she points out what she calls the "right reasons" to care about public pensions:
   A. Pension Money stays home and gets recycled.
   B. Public Pensions are predictable contributors to the economy.
   C. Pension Costs and Economic Benefits are both shared by all.
   D. **Pensions are important in small communities during economic troubled times as they provide basic economic stability.**
4. A Defined Benefit (DB) retirement plan contains a formula to calculate the benefit so a potential retiree knows exactly what their benefit will be.

With the Defined Contribution (DC), 401k type programs as follows often occurs:

1. DC programs are often subject to higher fees because lower service fees are not available because of the small amount of money held in individual accounts.
   A. Investment cost in a DB pension program average .7%.
   B. Investment cost in a DC investment program can run as high as 2.0%.
2. DC programs most often require the employee to make investment decisions on their own.
3. DC programs eliminate the traditional 3-legged stool concept because of the removal of the pension's contribution.

The Latest NIRS Study on DB (Defined Benefit) vs. DC (Defined Contribution) Retirement Plans
January 2022
The following material is from the latest National Institute on Retirement Security (nirsonline.org). This information… "follows two previous analyses conducted in 2008 and 2014 comparing DB plans and DC accounts, and it includes two new elements not included in the previous studies: 1) the impact of the current low interest rate environment; and 2) how saving mid-career rather than early career reduces total retirement savings."

"A contribution of 16.5 % of salary to a retirement fund is necessary to accumulate the amount of money one needs to retire." (These figures are calculated on a female with a final average salary of $60,000.00 and 30 years of work.)

"NIRS (National Institute of Retirement Security) calculates that a 16.5% contribution of salary investment is needed to fund a DB while it takes 32.2% to fund the same amount for retirement with DC.

A principal reason for this is that the perimeters of the investment change once a person retires, so a bigger contribution is required to accomplish the same result. In times of low returns, the cost for DB is 21.2% investment, while DC rises to 44.4%."

The study indicates that the *accumulation phase* of retirement fund between the two approaches, DB vs. DC, especially with improved DC plans such as 'target dated funds' tend to be even. "In fact, the analysis reveals that four-fifth of the *DC plans inefficiency appears post retirement.*" A DC retirement plan contains the following concerns:

1. 'Leakage' is the term often used to describe taking out loans against retirement assets as well as early withdrawals. In most plans, these options are *not* available in DB plans.
2. According to NIRS:
   A. An individual does not know how long they will live. The result of this is that 25% of retirees will either outlive their money or must reduce the withdrawal amount. Those who do not outlive their funds, will not be able to use all their funds, for their retirement, because of not knowing how long they will need their retirement income.
   B. With a DC program, there is an 'efficiency gap.' This term relates to reduced investment levels at retirement and the need to alter the investment risk the retiree is choosing.
   C. There is also no 'behavioral drag' with a DB pension plan.
      a. Retirees often lose the advice and education provided by DC plan sponsors and their employer simply because they obviously are not present at work anymore because they have retired.
      b. Without this advice, they are open to making poor choices with their investments.
      c. When money is professionally managed, these two concerns go away.
3. "DB Pension plans retain their cost advantage as a means of providing retirement benefits to workers." Reasons are:
   A. Longevity risk pooling.
   B. Long term portfolio diversification.
   C. Professional money management throughout accumulation and retirement.
   D. Investment returns are higher because investment costs are less because of the large amount of moneys invested by a retirement system.
4. Advantages DB offers to the retiree and beneficiary:
   A. The retirement benefit remains constant no matter how long they live.
   B. After beginning retirement, with a DC plan the former employee cannot afford to continue to invest at the rate they did while working.
   C. They also must consider their investment risk once they retire. With a DB pension system these decisions are made by professional money managers.
   D. "This study also assumes that the retiree, using a DC plan for retirement, will take their retirement at just the right pace and amount, not too fast, not too slow, not too much, just the right amount!"

<u>Additional Comments by the Author:</u>
The income of the average KPERS State and KPERS School employee is $46,153.00. A contribution of 16.5% would not be financially feasible without contribution on the part of state government. Since approximately 80% of the retirees and their beneficiaries reside in the state, if their retirement income runs out, their care still rests on state government. Therefore, retirement with initial cost as well as benefit production is necessary.

Definitions and Acknowledgements:

a. DB (Defined Benefit) Pension plans, like KPERS define what an employee will receive at retirement calculated by a formula. The rate of benefit calculated and is constant until death.

b. DC (Defined Contribution) Pension plans are synonymous with 401K investments.

c. *The information in this summary is the result of information gathered from NIRS Studies, AARP information, NRTA (National Retired Teachers Association), sources noted above and numerous financial testimonies and years of personal research by Ernie Claudel.*

Updated February 2022.