
**HOUSE COMMITTEE ON PENSIONS AND INVESTMENTS
TEXAS HOUSE OF REPRESENTATIVES
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**A REPORT TO THE
HOUSE OF REPRESENTATIVES
77TH TEXAS LEGISLATURE**

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DEFINED CONTRIBUTION / DEFINED BENEFIT

Background

In 1999, following the 76th Legislature, Regular Session, the Pensions and Investments Committee was charged with evaluating the pros and cons of defined contribution plans that do not guarantee members any specific level of benefits upon retirement. The charge stipulates that plans adopted in other jurisdictions should be considered and compared with Texas' state plans in regard to their ability to provide security to retirees, cost, and fairness to diverse employee groups.

A History of Public Pension Plans

Pension plans provide income to employees upon retirement. These benefits are offered as part of an overall compensation package designed to attract and retain qualified employees. Across the nation, all state government employees and nearly all local government employees are provided pension benefits. The first public pension plan started in New York City to cover the police force.¹³ In 1911, Massachusetts became the first state to develop a retirement program for its state employees, and by 1947, every state provided retirement benefits.¹⁴

According to the Department of Labor, over 90 percent of public-sector employees are currently covered by pension plans.¹⁵ The public employees covered under these plans are a diverse group with varied careers, income levels, and retirement needs. In designing a plan to best meet the needs of the individual and the state or local government, several objectives must be considered. These objectives provide a general framework for designing a plan. The pension plan should:

- Attract and retain a high-quality work force;
- Allow employees to depart from the work force financially secure and maintain the value of benefits throughout retirement;
- Provide benefits that are fiscally responsible and financially supportable;
- Fund benefits on an actuarially sound basis; and
- Invest assets prudently for the exclusive benefit of plan participants.¹⁶

Prior to the 1970s, public retirement systems were frequently financed on a pay-as-you-go basis. Since that time, a considerable focus has been placed on pre-funding benefits, and as a result, the vast majority of plans are actuarially sound.¹⁷

In addition to Social Security benefits, employers may provide retirement benefits under two basic structures: defined benefit plans and defined contribution plans. The purpose of the pension plan is a question that is critical in determining the best plan design. This question is central to the debate between the superiority of a defined benefit plan structure or a defined contribution plan structure.

Defined Benefit (DB) Plan

DB plans have been the standard form of retirement plans in the public sector since the 1940s.¹⁸ In a defined benefit plan, customarily, both the employee and the employer will contribute to the plan. Benefit levels, however, are independent of any given individual's contribution. The level of benefits an employee will receive at retirement is derived from a formula. This formula is based on years of

service, salary, and a multiplier factor. The basic formula typically looks like this:

$$(\text{years of service}) \times (\text{final average salary}) \times (\text{multiplier})$$

All states make use of this basic formula, but the definition of final average salary and the multiplier factor differs from plan to plan.

In DB plans, benefits are the contractual obligation of the employer, and as such, employers bear the risks of investment performance. In addition to the retirement benefits, DB plans frequently include disability benefits, early retirement incentives, and post-retirement cost-of-living adjustments.

Defined benefit plans require employees to “vest” before they are entitled to a benefit. Vesting occurs when an employee is entitled to receive a present or future pension benefit that is no longer contingent upon additional service to an employer. An employee must be a member of a plan for a set number of years before they are entitled to a benefit. Approximately 33 percent of statewide systems have a vesting requirement of ten years. Fifty percent have a vesting requirement of five years of credited service (including the Teacher Retirement System and the Employees Retirement System). Ten percent have three or four year vesting. The Arizona and Wisconsin consolidated retirement systems are the only two statewide plans to allow immediate vesting of benefits.¹⁹

Defined Contribution (DC) Plan

As the name suggests, in a defined contribution plan, the amount of contribution is defined, but the benefit amount is uncertain. With a DC plan, the employer contributes a specified percentage of salary into each employee’s individual account each year. Employees often contribute, as well. This individual account is credited with contributions and earnings and charged with investment losses and expenses. The benefit amount at retirement is the account balance. Under a DC plan, there is no guarantee of a certain benefit level, and the employee bears all of the investment risk. In addition, DC plans typically require the employee to bear the risk of pre-retirement death and disability.

At retirement, the benefit can be received as a lump sum, as equal payments over a specified number of years or can be used to purchase an annuity for a lifetime benefit.

Hybrid Plans

In addition to the traditional DB and DC plans, several states have developed hybrid plans that contain elements of both DB and DC plans. There are a variety of ways that states have modified DB plans to have some of the advantages of DC plans.

Comparison of Features

With the strong performance of the stock market in recent years, there has been increased interest in the movement from DB plans to DC plans in the public sector. It is important to assess the advantages and disadvantages of each type of plan to determine which best serves the needs of the State.

Risk

While there are many differences between the two plans, one of the primary differences is who bears the risk. Under a DB plan, benefit levels are set, but contribution levels needed to fund those benefits are not predictable over the long-term. Based on periodic evaluations, contribution rates are set at a level that is adequate to pay the promised benefits. Ultimately, in a DB plan, it is the employer who bears the risk. On the other hand, with a DC plan, the contribution levels are predictable, but the

benefit levels are not guaranteed. The individual employee makes the investment decisions and bears the risk.

Under a DB plan, benefits are funded over a period of time, usually between ten and thirty years. As a result, it is possible for a DB plan to have assets less than the present value of the benefits promised. In this situation, contribution levels must be increased. Therefore, it is the employer who bears the risk of investment performance.

The chart below summarizes who bears the risk from a variety of factors in the DB and DC plans.

FEATURES OF DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS

	<u>DEFINED BENEFIT</u>	<u>DEFINED CONTRIBUTION</u>
Inflation	Automatic or ad hoc adjustments can be provided to offset the impact of inflation on retirement income. However, without automatic adjustments, there is no guarantee that benefits will be protected from impact of inflation.	In a DC plan, the retiree generally bears the inflation risk. An employee's protection against inflation depends on investment earnings.
Employee Salary Changes	Salary increases affect both past and future benefits.	Salary changes affect only future contributions.
Investment Results	Investment performance affects funding, not benefits, directly. However, strong investment performance can lead to enhanced benefits in a DB plan.	The performance of investments will determine the employees retirement benefit.
Employee Risk	Future benefits are determined by a formula, and benefit levels are guaranteed.	No guarantee as to the level of benefits that will ultimately accrue.
Employer Risk	Regardless of investment performance, employer pays a set retirement amount. In a DB plan, employers bear the risk.	No risk for the employer, the employee bears the investment risk.

	<u>DEFINED BENEFIT</u>	<u>DEFINED CONTRIBUTION</u>
Longevity	Benefit levels are guaranteed to be provided throughout a retiree's lifetime. Retirees are often given the option of also providing survivor benefits.	Benefits are limited to the account balance. Retirees must try to plan for enough benefits for an uncertain period of time. Whatever remains unspent at their death can be passed on to survivors.

Administrative Issues

There is much debate over which costs more, a DB plan or a DC plan. In the private sector, where cumbersome regulations burden DB plans, there is little doubt that the DB plan is more expensive to administer. From 1981 to 1996, the Hay Group tracked the relative administrative costs of DB and DC plans. In 1981, a very large DB plan cost \$245,000 a year to administer compared to a very large DC plan which cost \$270,000 a year to administer. By 1996, the DB cost had risen to \$717,00, and the DC costs were \$517,000.²⁰ The difference in cost trends in the private sector is due in part to Congress' effort to simplify DC plans for the private sector.

In the public sector, the major difference is who usually pays the costs in a DB or a DC plan. For the most part, the administrative costs of a DB plan are paid for by the performance of the fund. In a DC plan, there are administrative costs relating to education of membership and maintenance of individual accounts. Furthermore, transaction fees are normally charged to the individual. A Pension Welfare and Benefits Administrations report found that participants in 401(k) plans typically bear investment management fees that range from 75 to 90 percent of the total administrative fees and expenses that are borne by a plan.²¹

Portability

Proponents of DC plans claim that the nature of the workforce has changed. Employees no longer work for one employer throughout their career. The average employee will have at least seven different jobs over his or her lifetime. DC plans are fully portable which means that benefits from qualified public sector plans can be rolled into another qualified plan. As a result, some argue that DC plans are more suited for today's workforce.

Furthermore, proponents of DC plans assert that employees continue to earn benefits by earning investment income when they change jobs or leave employment altogether. Typically in a DB plan, if an employee terminates employment, they can withdraw their contribution with a modest interest rate, but they receive no employer contribution. If they leave their money in the plan, their retirement benefits are essentially frozen.²²

Proponents of DB plans claim that although DB benefits are not fully portable, there have been many improvements in the portability features of DB plans. Most DB plans have a service purchase provision. For example, in Texas, the Teacher Retirement System allows public school employees to purchase service time in out-of-state public schools. When plans do allow the purchase of service

credit, it is limited to selected types of service. This limitation allows employees the advantages of portability, but limits the costs to the plan. Generally, the purchase of service credit is limited to service with other public sector employers, such as the military.

In addition, a common means of transferring service among public sector employees is through reciprocity agreements. Typically, these agreements are among state and local government employers, within the same state, who agree to transfer service, funds, or both, for individuals that have worked for two or more employers participating in the agreement. This allows for portability among public employers.

Furthermore, W. Michael Carter, an actuary with Watson Wyatt, notes that the perception that employees in general are more mobile today than they have been in the past is an inaccurate assumption. According to recent studies conducted by Watson Wyatt, there has been very little change in average job tenure over the last 40 years. Their studies also find that termination rates have actually declined across all age and service groupings over the last 10 - 15 years.²³

Benefit Adequacy

Simply stated, DC plan advocates note that in a DC plan, there is no limit to the benefits an employee can accrue. Proponents of DB plans reply that there is also no guaranteed minimum benefit level under a DC plan.

Furthermore, DB plan proponents argue that the portability of DC plans does not necessarily guarantee retirement savings. DC plans have a pre-retirement distribution option which allows employees to cash in the plan, or borrow against it. E. Friend, president and chief executive officer of EFI Actuaries, referred to this option as “leakage from the house of retirement.”²⁴ United States Congressman Earl Pomeroy warns that this “leakage” may be leading to a national crisis because DC plans may provide inadequate income to retirees in the future. The issue of inadequate income for retirees is particularly relevant in the public sector. Inadequate retirement benefits will increase the demand for public assistance programs. As a result, ultimately the taxpayer will bear the liability of ensuring adequate retirement benefits in either a DB or DC plan.

Despite repeated warnings not to cash out retirement money unless it is absolutely necessary, a study by Hewitt Associates reveals that the majority of 401(k) participants, regardless of age, are choosing to take lump-sum payments when changing jobs instead of rolling the money into Individual Retirement Accounts or their new employer’s retirement plan. The company’s study reveals that for workers ages 20 - 59, 68 percent opt for cash payments when changing jobs. Only 26 percent roll their balances into IRAs and only 6 percent move their money into their new employers’ plans.²⁵

Furthermore, DC plans generally do not provide subsidized benefits, including disability, survivor benefits, etc. The average employee would need to take about 1 percent of pay (younger employees less and older employees more) to purchase death and disability benefits that are provided by a DB plan but not a DC plan.²⁶

Fund Performance

According to a recent study in the *Financial Analysts Journal*, three fund attributes determine the performance of the fund: fund size, proportion of assets passively managed, and the quality of the fund’s organizational design. An analysis of this study performed by Cost Effectiveness Measurement Inc.

determined that bigger is better in pension funds for two reasons: (1) economies of scale and lower unit operating costs; and (2) the ability to support a full-time professional management team dedicated to producing long-term results.²⁷ These factors would seem to indicate that DB plans would tend to yield higher returns than DC plans. In fact, aggregate returns are lower in DC plans because older DC participants are less able to tolerate risk.²⁸

DC plan proponents argue that in public pensions, investment decisions are often influenced by factors other than economics. For example, some investment decisions are made based on opposition to social issues -- this is referred to as social investing. Examples of social investing include the decision of some funds to divest investments from South Africa, or the more recent example of funds divesting assets from tobacco companies. In addition, some boards utilize “economically targeted investments” (ETIs). ETIs are usually selected in an attempt to bolster the local economy and are not selected based on investment returns. In fact, a 1983 study found that ETIs can cause a 2 percent reduction in returns.²⁹ One study estimates that non-economic investing cost public pension funds over \$28 billion in losses between 1985 - 1989.³⁰

Individual Control

In a DC plan, retirement funds for each worker are under his or her direct ownership and control. Proponents of DC plans claim that this allows workers to select investments that best meet their retirement needs instead of forcing them to participate in a “one-size fits all” plan. Furthermore, this direct control over their investments allows employees to reap the benefits of strong investment performance.

DB plan proponents note that under a DC plan, individual control is limited to those options offered by the plan sponsor. In addition, they argue that the shifting of investment risk from the employer to the employee is a significant, but often overlooked issue. Recent investment experience has been favorable, but that may not continue. Furthermore, in a DB plan, the employer is able to take a long-term view regarding investment performance, but an individual may not have that flexibility. In fact, many individuals are more conservative when they have control over their investments, which results in a lower rate of return.³¹ Numerous surveys indicate that individual, non-professional investors will under-perform the market by as much as 2 percent (200 basis points).³²

Simplicity

Benefits accrued under a DC plan are easy to understand. The simplicity of the DC benefit structure is often cited as a factor for its superiority to a DB plan. DB plans use complex formulas to determine benefits. It is impossible to determine the total benefit which will be received under a DB plan because the formula is based on factors that cannot be predicted, such as longevity.

Costs are also easier to predict under a DC plan. Employer’s contributions are limited to a fixed percentage of salary under a DC plan. In a DB plan, assumptions are made about retirement patterns, market performance, etc., to determine the contribution amount. Ultimately, however, the employer must guarantee a certain benefit level.

Recruitment / Retention

DC plan advocates claim that the flexibility and portability of a DC plan makes working for the government more attractive to younger professional workers who do not expect to work in the public

sector for their entire career.

DB plan proponents counter this claim by noting that younger employees tend to worry less about long-term security and retirement, and as a result, retirement benefits may not be an effective recruiting tool. In addition, they note that the DB plan design encourages retention of employees. Furthermore, they note that the DB plan design is attractive to mid-career employees. Numerous studies have shown that mid-career and older workers (those over age 45) understand the value of DB plans, and in many cases, it is these experienced employees that the public employer will be trying to recruit.³³

Gender Equity

Proponents of DC plans argue that some of the greatest beneficiaries of defined contribution plans are women. They note that women benefit from shorter vesting schedules, the absence of benefit formulae, and the portability of DC retirement benefits.³⁴ In general, women are more likely to have interrupted work histories because of family responsibilities. As a result, DC plan advocates claim that women who take time off to raise a family are penalized because defined benefits are frozen when they leave the system. On the other hand, under a DC plan, a woman who takes time off to raise a family continues to accrue investment returns on her plan. Furthermore, they note that women are often the “victims” of DB plan formulas because these formulas are calculated using their final salary (usually an average of the three highest years salary). Since women’s salaries are lower, on average, than men’s salaries, their benefits are also lower.

In contrast, many people believe that a DB plan can provide women with higher benefits. Women who work part-time while raising a family actually accrue greater benefits under a DB plan, proponents of this retirement structure note. While calculating retirement benefits under the formula, years of service does not differentiate between part-time and full-time service. Therefore, women may have more flexibility and greater retirement benefits under a DB plan. In addition, proponents of the DB plan structure note that while women’s salaries tend to be lower than men’s salaries, either retirement structure will then result in lower benefits. If women have lower salaries than men under a DC plan structure, their contributions will be less, and as a result, their overall retirement savings will be lower.

Retirement Plans in Texas

Employees Retirement System

State employees in Texas participate in the Employees Retirement System (ERS). ERS currently manages a \$19 billion trust fund. The ERS fund is the 29th largest public pension fund and the 49th largest pension fund in the nation. There are 154,183 active members and 43,860 retirees participating in ERS. The fund has no unfunded liabilities.

ERS administers a separate fund and retirement plan for law enforcement officers and custodial officers for the State’s prisons and jails. Two separate plans cover the state judges (one plan is being phased out and replaced by another). The largest fund covers all other state employees. The details of that plan are outlined below.

The employee contributes six percent of wages which goes into an individual account and earns five percent simple interest. The State contributes six percent of the salary of each state employee to help with the overall financing of retirement benefits. These combined contributions are invested, and the contributions plus the investment returns fund retirement, death and disability benefits.

State employees are eligible to retire at the age of 60 with 5 years of state service, or when their years of service combined with their age equals 80 -- often referred to as the "Rule of 80." For example, an individual would be eligible to retire at the age of 50 with 30 years of credited service.

Monthly retirement benefits are based on the formula:

$$2.25\% \times \text{years of service} \times \text{final average salary}$$

The final average salary is the average of the thirty-six highest monthly salaries.

EXAMPLE: For a retiree who is 50 years and 8 months old, with 29 years and 4 months of service credit, and a final average salary of \$2,800

Calculation of the standard annuity

Final average salary	\$2800.00
Percentage value of creditable service (Based on 29 years and 4 months of credit)	x 66%
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At retirement, employees may select the standard annuity described above, or they may select from one of the five survivor options. If one of the survivor options is selected, the retirement benefit is actuarially reduced accordingly. In addition, employees have the option of selecting a Partial Lump Sum Option which allows new retirees to request from one to 36 months of their standard annuity as a lump sum payment at retirement. If this option is selected, their monthly annuity payments are reduced so that there is no actuarial impact.

In addition to retirement benefits, employees receive disability benefits for an on-the-job injury with no age or service requirements. Other disability benefits are payable only to employees with at least ten years of state service. Disability benefits are calculated by multiplying 2.25 percent times the years of service with the actual salary at time of the disability. A minimum benefit of 35 percent of that salary is provided.

Employees who separate from state service prior to obtaining retirement eligibility can leave their money with ERS as a non-contributing member. They can begin to draw an annuity if they have at least five years of service and reach the age of 60, or when their age plus years of service equals 80. They can also withdraw their contribution. If the contribution is withdrawn, the ERS membership and service credit is canceled. If an individual returns to state service after withdrawing his or her contribution, they do have the option to buy back service credit.

Employees can also participate in a deferred compensation (457 and 401(k)) plan. Participation in these plans is optional and there is no employer contribution. Over 62,000 state employees participate in either the 457 or 401(k) plan.

Teacher Retirement System

The Teacher Retirement System was created by constitutional amendment in 1937 to provide

retirement benefits for public education employees, including employees of institutions of higher education. TRS currently has 919,000 active member annuitants and manages an \$80 billion trust fund. It is the eighth largest defined benefit plan in the nation. The plan's benefit liabilities are actuarially fully funded.³⁵

The employee contributes 6.4 percent of wages which goes into an individual account and earns five percent simple interest. The State contributes six percent of the salary of each state employee to help with the overall financing of retirement benefits. The State's contribution goes into a separate account. These combined contributions are invested, and the contributions plus the investment returns fund retirement, death and disability benefits.

TRS participants are eligible to retire at the age of 65 with 5 years of state service, or when their years of service combined with their age equals 80 -- often referred to as the "Rule of 80." TRS participants can select early retirement at age 55 with 5 years of service with benefits actuarially reduced.

Monthly retirement benefits are based on the formula:

EXAMPLE: For a retiree who is 55 years old, with 30 years of service credit, and a final average salary of \$36,000	
The member's standard annuity would be calculated as follows:	
Final average salary	\$36000.00
Percentage value of creditable service (Based on 30 years of credit)	x 66%
Standard annual annuity =	\$23,760.00

$$2.2\% \times \text{years of service} \times \text{final average salary}$$

The final average salary is the average of the highest three annual salaries.

TRS retirees can choose various options for survivor benefits with a reduction in their monthly benefit. Furthermore, a \$10,000 lump sum payment is available to the survivor of a retiree. A surviving spouse can instead select a \$2,500 cash payment plus \$200 per month for the remainder of his or her life starting at the age of 65.

TRS members also have two different lump sum payment options to choose from: the Partial Lump Sum Option and the Deferred Retirement Option Program. Both of these programs allow members to take a reduced monthly annuity in exchange for a lump sum payment. These programs allow members to create an estate within the DB structure.

For TRS members who become permanently disabled, TRS provides disability retirement benefits when a worker cannot continue his or her current duties. TRS members with ten years of credited service at the time of their disability receive the same benefits as for retirement, with a minimum monthly

payment of \$150. For TRS members with less than ten years of service, the worker will receive \$150 per month for the number of months they contributed to the TRS system.

After five years of contributions into the TRS pension plan, an employee is vested. If an employee leaves public school employment and withdraws his or her contribution, then they will receive his or her own contribution plus five percent interest. A TRS member with over five years of service can leave his or her funds in the plan until they reach retirement eligibility and then they can begin to draw benefits. If an employee chooses to withdraw his or her contribution, the TRS membership and service credit is canceled. If an individual returns to employment with a public school after withdrawing his or her contribution, the service credit can be purchased.

There is no statewide optional deferred compensation program for school personnel. However, many school district personnel are offered these optional plans at the local level.

Texas Municipal Retirement System

The Texas Municipal Retirement System (TMRS), established in 1948, provides benefits to the member city employees. Currently, 738 municipalities participate in the plan, and TMRS manages \$7.66 billion in assets. TMRS receives no state funding, but is administered in accordance with the Texas Constitution and Texas Government Code, Title 8, Subtitle G. TMRS administers each plan individually; each city is separate, both actuarially and in terms of funding. However, all of TMRS' assets are pooled for investment purposes.

This TMRS plan is a hybrid of a DB and DC plan known as a cash balance plan. Members contribute a certain fixed percentage of pay, which is matched by the city employer. TMRS invests the funds and grants interest to the members' accounts. A guaranteed retirement benefit is calculated from this account, the city's matching funds and other credits. The retirement annuity for the member is the actuarial equivalent of the sum of the member's own monthly contributions plus interest and an equal or greater multiple sum out of the employer's accumulation account plus interest. Under this type of plan, assets are invested by the retirement system, not the individual.

Each city can choose from a variety of plan options. In fact, there are over 2,300 possible combinations of these choices for municipalities. Options include death and disability benefits, CPI increases, DROPs, etc. Basically, the employee of a TMRS city contributes 5 percent, 6 percent or 7 percent of his or her salary to TMRS. The city matches that amount either 1 to 1, 1 ½ to 1, or 2 to 1. TMRS pays interest on the employee's account and the city's matching funds annually.

In most TMRS cities, a member can retire with at least 10 years of service at age 60. Furthermore, most cities elect to allow members to retire at any age if they have 20 or 25 years of service. Typically, vesting occurs when the member has 10 years of service credit. If members leave employment and choose to withdraw their member contributions and interest, they will not receive the city's matching fund.

The retirement benefit is calculated based on:

- total member contributions made, plus earned interest;
- the sums the city has agreed to pay (matching contributions and other credits granted) on the member's retirement;

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- the member's remaining life expectancy at retirement;
 - the future interest rate on the annuity amount, as set by law; and
 - which of the seven TMRS benefit payment plans the member selects.

Texas County and District Retirement System

The Texas County and District Retirement System (TCDRS), is TMRS' counterpart serving counties and districts around the state. TCDRS is composed of 500 individual and separate county and district retirement plans. TCDRS administers the plans on behalf of each county and district. Like TMRS, TCDRS receives no state funds, but is governed by the Texas Constitution and state statute.

Under federal tax laws, TCDRS is considered to be a DB plan, however, like TMRS, the benefit structure is not that of a traditional final average salary defined benefit plan such as ERS or TRS. The TCDRS benefit structure is commonly referred to as a cash balance plan or money purchase arrangement where the amount of a member's individual benefit is determined by the value of the member's personal contributions and interest earnings, as well as the value of the employer financed credits.

The following factors determine the amount of TCDRS member benefit payment amounts:

- Total dollars of retirement credit the member has accumulated at retirement, where retirement credits consist of the amount of the member's personal account balance (the sum of the member's personal contributions and interest earnings) + an amount of employer financed credits that is always at least equal to the sum of the member's personal account balance, but is usually greater, depending on the election of each employer. For example, the average ratio of employer financed credits to the individual's personal account balance is 1.5, meaning that, on average, TCDRS plans provide employer financed credits equal to 150 percent of the individual member's personal account balance. Since individual members generally contribute 7 percent of pay to the plan, the end result is that members are accumulating retirement credits on an annual basis equal to 17 ½ percent of pay and those credits are increased each year by an annual interest allocation (currently 7 percent).
- The anticipated duration of benefit payment (actuarially determined based on the member's age at retirement and other underlying guarantees, e.g., period certain guarantee, survivor beneficiary lifetime guarantee).
- An annuity interest rate assumption of 7 percent (the reserves of retired members are guaranteed a 7 percent annual interest rate throughout the payment period and this guarantee is incorporated in the determination of the member's benefit payment and enhances that payment).
- Benefit payments can be periodically increased through post-retirement cost of living adjustments, if such adjustments are authorized and funded by the sponsoring county or district.³⁶

Optional Retirement Program

In Texas, higher education faculty, librarians, and certain administrators and professionals can choose between participating in the TRS retirement system, a DB plan, or the Optional Retirement System

(ORP), a DC plan. Eligible employees have 90 days from their first date of eligibility to make a one-time irrevocable election of ORP in lieu of TRS.

The Legislature established ORP in 1967 to provide a more portable retirement option for higher education employees whose careers routinely involve interstate mobility. Because of the mobility involved in the academic profession, many colleges and universities across the country offer ORP-type plans. The Texas Legislature authorized the creation of the ORP so that Texas could use the ORP as a recruitment tool to attract the highest quality individuals to Texas.

ORP was established by the Legislature as a de-centralized plan. Texas Government Code, Chapter 830, authorizes each governing board to administer its own ORP. As a result, institutions may make arrangements for ORP products to be offered to their employees by any insurance or investment company qualified to do business in the state. Most institutions offer a range of ten to twenty vendors. In total, there are over 100 companies authorized by all higher education institutions. Ten of these companies receive contributions from 75 percent of all participants and 20 companies receive contributions from 90 percent of the participants.

The Texas Higher Education Coordinating Board is charged with ORP responsibilities in three areas: eligibility, uniformity and reporting. The Higher Education Coordinating Board collects and reports data on participation in the ORP, but it does not track individual performance of ORP accounts. Therefore, it is difficult to compare the performance of the ORP to the DB plans in existence in the State. From time to time, the Committee has heard pleas from higher education employees who have requested the opportunity to switch from ORP to TRS after the 90 day period of initial employment has passed. In fact, in 1979, the Legislature authorized a one year window for individuals who had switched from TRS into ORP, to return to the TRS system.

Combining Service Credits

In Texas, service credits may be combined if a member participates in two or more of the following retirement systems: Employees Retirement System, Judicial Retirement System of Texas Plan One and Plan Two, Teacher Retirement System of Texas, Texas Municipal Retirement System, Texas County and District Retirement System, or the City of Austin Retirement System. When your age and combined service credits satisfy the retirement eligibility requirements of any one of the systems, you may receive a retirement benefit. You will receive monthly annuities based upon the annuity criteria of the respective systems. For example, an employee is 60 years of age and has four years service credit with the ERS and four years service credit with another statewide retirement system. Both systems allow members to retire at age 60 with at least five years service credit. Because combined service meets eligibility requirements for both systems, the employee may receive a monthly annuity from ERS based on four years of service and a monthly annuity from the other system based on four years of service.³⁷

Experience of Other States

In the private sector, there has been a significant decrease in the number of DB plans over the last ten years and a large increase in the number of DC plans. This increase in popularity of DC plans is often cited by proponents of DC plans in the public sector as evidence that public retirement systems are behind the times. That is not entirely the case when you look beyond the numbers. Virtually all of the decrease in the number of DB plans has occurred among small and medium size employers (employers

with less than 1,000 employees). Large employers, for the most part, have continued their DB plans and added DC plans. The decline in DB plans among small employers can be explained by the expense of complying with the complex and burdensome regulations of the Internal Revenue Service, the Department of Labor, and the Pension Benefit Guaranty Corporation. The public sector is exempt from most of these regulations.

As a result, the trends in the public sector are different. Currently, the majority of the retirement plans in the public sector are defined benefit plans. Among the approximately 100 large statewide plans, three are DC plans: Nebraska Public Employees Retirement System, the West Virginia Teachers Retirement System, and the Michigan State Employees Defined Contribution Plan³⁸. As of 1998, 94 percent of all public sector assets were invested in DB plans.³⁹ Despite the preponderance of DB plans, many public sector plans also have a DC option. A March 1999 report from the General Accounting Office (GAO) notes that all states have a defined contribution component, but at that time, only nine states contributed to the plan. Thirty-five states had retirement programs that included a DB component, a DC component with no employer contribution, and Social Security.⁴⁰

The GAO report also notes that all states have in some way changed the design of their retirement programs since their establishment. Many of the changes have been in response to changes in federal regulations. Other changes have been enacted to enhance benefits for employees.

As of March 1999, of the 48 state retirement programs with a DB component, officials representing 21 states indicated that they had considered dropping their DB component in favor of a DC plan. Reducing government costs, enhancing portability, and/or lobbying by special interest groups were among the reasons cited for considering such a change. The most common reasons cited for not making a change to a DC plan were: studies indicated there was no need to change; further study was needed; state's labor unions opposed the change; and/or there was a lack of interest or support.⁴¹

While few legislatures have abandoned DB plans in favor of DC plans, many legislatures have increased employee options through reductions in vesting requirements, improved benefits for employees who leave before vesting or reaching retirement age, and employer contributions to DC plans.⁴² In addition, nine systems allow a limited class of state employees to select between a DB and DC plan. This selection is usually limited to agency heads, elected officials, legislative staff or others who typically have a short tenure.

Nebraska

Nebraska presents an interesting case study in the DB/DC debate. While other states have recently adopted DC plans, Nebraska adopted one over thirty years ago. In the mid-sixties, the Nebraska Legislature authorized two statewide defined contribution plans: one for state government employees and another for county government employees. Prior to the creation of these plans, there was no employer-sponsored retirement plan for those employees. In previous decades, Nebraska had created DB plans for school employees, state judges and state patrol employees. In choosing a DC plan over a DB plan, the historical record reflects that the Legislature was concerned about unfunded liabilities in the existing DB plans.

Initially, investment options available were limited to a simple interest insurance product marketed through a major insurance company and an annuity product. In the 1980s, Nebraska expanded its investment options, increased the state/county contributions and continued the annuity program. Today

it offers members eleven investment options, daily valuation of accounts, Internet access to account information, and a comprehensive education program. Upon retirement or termination, members have the option to take an annuity, a systematic withdrawal of contributions, or a lump sum of the entire account.

In a letter to the Pensions and Investments Committee, Anna Sullivan, Director of the Nebraska Public Employees Retirement System, identifies some of the advantages and disadvantages of the DC plan based on Nebraska's experiences.

Advantages

- portability for all employees;
- greater benefits for short-term employees;
- no unfunded liabilities for employer;
- investment risk borne by members, not employer; and
- multiple options at retirement.

Disadvantages

- communication and educational challenges for a diverse workforce, especially in the area of investment and retirement decisions;
- smaller benefits at retirement due to conservative investment selection or risk of retiring during a market correction;
- investment risk borne solely by members;
- high cost of bundled investment products, which lowers overall investment return for members;
- heavy marketing to members upon retirement by financial firms wanting the member to roll a lump sum to them for their investment; and
- lack of cost-of-living adjustment options after retirement.

Sullivan sums up Nebraska's experience by stating, "Our experience with the defined contribution plans has been mixed. We have had over 35 years to 'test' this experiment and find generally that our defined contribution plan members retire with lower benefits than their defined benefit plan counterparts."

She notes that the administrative costs of a DC plan are high. In Nebraska, they spend more in investment management fees, record-keeping fees, educational programs and material with the defined contribution plans than with the defined benefit plans. In 1999, Nebraska's plan expenses for their defined contribution plans were approximately 30 basis points (BP) versus 15 BP for their defined benefit plans.

Nebraska commissioned a study to review the benefit adequacy of the Nebraska Retirement System. In 1994, Buck Consultants completed a study which measured the purchasing power of estimated lifetime income as a percentage of final salary. They looked exclusively at employees who worked a thirty year career with the state, and found that all of these employees would have a higher percentage of purchasing power based on their final salary under their DB plan.⁴³ In addition, a December 1998

study showed that pension plan participants fared better than their DC counterparts in Nebraska. The study found that ten years after retirement, a retiree with 30 years of service who had an average annual salary of \$30,000 receives about \$11,230 each year from a DC plan. A DB plan participant with similar pay and service credit receives \$16,797 each year.⁴⁴

Minnesota

Another state which had a mixed experience with a defined contribution plan is Minnesota. Between 1969 and 1972, public school employees in Minnesota were given the option of a DC plan instead of the DB plan. Approximately 15,000 employees selected the DC option. For many of these individuals, the financial benefit was not as great as expected. In 1978, dissatisfied DC plan participants complained to the Legislature, and as a result, they were converted back to the DB plan in a two step process. This experiment cost the state about \$120 million.⁴⁵

Florida

In 2000, the Florida Legislature passed legislation to restructure the Florida Retirement System as a plan with two basic programs - a defined benefit plan and defined contribution plan. The FRS has 600,000 members and \$101 billion in assets, and is the fourth largest public pension plan in the country. Unlike other States that have passed legislation creating a DC retirement plan, Florida gives existing employees the option of moving their assets from the DB plan to the DC plan. The Florida Legislature established an employer-funded optional DC plan, the "Public Employee Optional Retirement Program," and restructured the existing DB plan to be optional.

Prior to the adoption of the legislation, the Florida Legislature commissioned a study of employees to measure their overall satisfaction with current retirement benefits and to determine employee interest in alternatives to the defined benefit plan. The survey found that when presented with two plan descriptions (DB and DC), respondents were split on their preference. However, the importance rating of desired features in a plan indicated a tilt toward a DB plan preference. Most respondents were interested in having a choice between two retirement plans. The most important features of a retirement plan as identified by respondents was a monthly guaranteed lifetime benefit and portability of benefits. Respondents also indicated that the DB plan benefits motivated most respondents to continue working for the state.⁴⁶

Under the plan adopted by the Florida Legislature, existing employees will be given 90 days to transfer to a DC plan. New employees will have 180 days to decide between the DB and DC options. After the regular enrollment period, each employee will have one chance to move from one plan to another. Some questioned the feasibility of allowing employees the opportunity to move from one plan to another. The director of the Florida Division of Retirement noted that this provision could create a strain on taxpayers if people who did not do well with their DC investments returned to the DB plan just before their retirement.⁴⁷

An FRS member who elects to transfer to the defined contribution program could either keep the service credit earned under the DB program and remain eligible for a future lifetime benefit, or move the value of his or her service credit to the DC account.

Participants in the DC plan will vest in employer contributions paid into his/her account after one year of creditable service. Benefits will accrue in individual, participant directed accounts. The bill expresses

an intent to establish disability coverage for employees who select the DC plan.

Employees do not have to contribute in either the DB or DC plan. In the DC plan, the contribution rate is equal to the contribution rate for the DB plan minus the cost of administration and disability coverage.

Participants in the DC plan vest in one year. If a current employee already has over one year of service credit and selects the DC plan, he or she will be immediately vested. In addition, the Florida Legislature reduced the vesting period for participants in the DB plan from ten years to six.

Florida expects to provide employees who select the DC option with between five and eight mutual funds from which to choose investments. The State Board of Administration, the entity which manages the current DB plan, will select the investment options and decide whether to bundle services. The legislation also allows for an unbundled approach or more than one bundled or semi-bundled provider. It also allows for investment education for plan participants.

One unanswered question that remains regarding Florida's new legislation is what will happen if employees opt out of the DB plan, leaving no new money flowing into the DB plan to pay for current obligations. If the influx of new members into the DB plan is substantially reduced, and there is no reduction in the benefit payout of the DB plan, a significant imbalance between the contribution inflow and the benefit outflow will result.⁴⁸ In this scenario, will taxpayers get stuck with the massive transition liability?⁴⁹

Montana

In 1999, Montana authorized an optional defined contribution plan for Montana Public Employees Retirement Systems (PERS) members to be effective by July 1, 2002. Membership in PERS is comprised of approximately 28,000 state, university, county, municipal and school district employees other than teachers. When the DC plan was authorized, the existing DB plan had future benefit obligations which exceeded assets on hand by about \$200 million.⁵⁰

All current and future Montana PERS members will be eligible to select the DC plan or the existing DB plan. The DB plan will continue to operate and be open to new enrollees. Current members will have one year after the effective date to select the DC plan. New employees will be enrolled in the DB plan by default, and they will have one year from their date of employment to opt for the DC plan.

A choice to remain in the DB plan or to transfer to the DC plan will be a one-time, irrevocable choice for the duration of the employment cycle. An individual who withdrew from either plan and was rehired into covered employment after a break in service of less than 24 months would have to rejoin the plan from which the member withdrew. A person with a break in service of more than 24 months will have the same plan choice as a newly hired employee.

The DC contribution rate will be 6.9 percent from employees and 4.53 percent from employers. (Current DB contributions are 6.9 percent from employees and employers). To offset the unfunded actuarial liability of the DB plan, employers who contribute to the DC plan will also pay into the DB at a rate of 2.37 percent of covered compensation. This amount may be adjusted up or down as required by the DB plan's performance.⁵¹

A key component of Montana's plan is the "plan choice rate." This ensures the DB plan's actuarial soundness and also protects the DC plan's funding from being tapped to pay the DB plan's future unfunded liabilities or increases in the normal costs of benefits in the DB plan not caused by members

opting out of the DB plan and into the DC plan. The plan choice rate is an actuarially determined and adjustable percentage of payroll that the employer continues to pay to the DB plan until past obligations are paid and normal cost changes stabilize.⁵²

For existing members who transfer from the DB plan to the DC plan, the amount of funds transferred will include past contributions; the employer contribution, less the amount required to offset the unfunded actuarial liability; and the interest compounded at 8 percent.

DC plan participants will be vested immediately in their own contributions, and over a five-year period, they gradually vest in the employer contributions, as well.

Current trustees of Montana PERS will also act as trustees for the DC plan. They are required to contract out administrative, educational and investment services. In addition, they are required to offer at least eight investment choices to DC members.

The Montana Legislature has not resolved the issue of providing health and disability insurance for DC plan members. Legislators are considering severing disability from pension plans altogether. In addition, they are currently studying the health insurance issue.⁵³

Michigan

A DC plan for state workers and public school employees was proposed by Michigan Governor John Engler and passed by the Michigan Legislature in 1996. The plan mandated that all new state employees and public school employees hired after a specified date would be enrolled in a newly created DC plan. (The plan for public school employees was repealed prior to enactment because of opposition from school employees). Existing employees were given the option of remaining in the DB plan or transferring membership to the DC plan. For those members who transfer from the DB plan, the actuarial present value of the member's accumulated benefit obligation plus accumulated contributions are transferred.

For participants in the DC plan, the state contributes 4 percent of the employee's salary into his or her DC account. The individual can contribute up to 3 percent of his or her salary and receive a state match. The state match is in addition to the 4 percent contribution. Individuals can contribute larger amounts, but receive no additional state match.

DC plan participants immediately vest in their personal contributions, and gradually vest in employer contributions. They are fully vested in employer contributions after four years of credited service. They become vested in health insurance after 10 years of credited service. Members of the DC plan direct their investments into categories of investment funds offered by the state treasurer, and they are responsible for all administrative costs.

Colorado

In 1995, the Colorado Public Employees Retirement Association (PERA) recommended changes to the General Assembly to improve the portability and flexibility of its retirement system. Changes were advocated, in part, because in Colorado, state employees are not covered by Social Security. As a result, the guaranteed lifetime benefit provided by a DB plan is important, but non-vested employees and employees who leave state employment early in their career also need retirement security.

The changes adopted by the General Assembly in 1995 maintained the DB structure, but added

increased portability for shorter term state employees. For example, changes included: the addition of an employer match to employee contributions withdrawn from PERA; a higher interest rate on member accounts than before; and the option of a lifetime benefit for nonvested members who leave PERA-covered employment but who leave their funds with the system. These revisions applied to all active and inactive members of PERA. The benefit improvements were applied retroactively.

In Colorado, employees contribute 8 percent of their monthly salary. The State of Colorado contributes 11.4 percent, 10.0 percent and 15.0 percent for state and school, municipal and judicial employees respectively. Of those amounts, 1.1 percent is used to fund the health care trust. Vesting in PERA occurs with five years of service. Under the new Colorado law, individuals who withdraw their contributions before vesting will receive interest calculated at 80 percent of the PERA actuarial investment assumption rate (currently a yield of 6.8 percent) plus a 25 percent matching employer contribution. Interest is calculated from the date of the contribution. If a member who is not vested leaves his or her contribution with PERA until they are 65, the match rate increases to 50 percent and the member may choose a lifetime benefit instead of a refund. This lifetime benefit is a money-purchase plan based on the member's contributions, interest and the 50 percent match. Cost of living adjustments and a health care subsidy are included with the lifetime benefit.⁵⁴

Vested members also receive enhanced benefit options under the new Colorado plan. Member's benefits are calculated in two different ways: as a money-purchase benefit and according to the defined benefit formula. The member receives the greater of the two benefits. At retirement, vested members who have left their contribution in PERA may choose to receive a lump-sum refund including the 50 percent employer match instead of the lifetime benefit. In addition, the plan offers death and disability benefits.

Deferred Compensation Plan Matches

Several states have recently passed legislation to match employee contributions in voluntary deferred compensation plans. In 1998, Oklahoma and Tennessee adopted legislation to match employee contributions in order to stimulate participation in the voluntary deferred compensation programs. In Oklahoma, participation has jumped from 20 percent of eligible employees to 78 percent. In Tennessee, participation has increased from 20 percent of eligible employees to 40 percent.⁵⁵ In 1999, Arizona, Colorado, Indiana, Maryland, South Carolina, and Virginia authorized some level of employer match to supplemental plans.⁵⁶

Targeted Defined Contribution Plans

A few states have created defined contribution plans for a narrow segment of the workforce, such as elected public officials, legislative staff, or agency heads. For example, in 1999, Arizona adopted an optional DC plan for exempt state employees and elected state officials who are subject to term limits. Louisiana created an optional DC plan for a small group of unclassified state employees which includes statewide elected officials and political appointees. Only about 100 positions are eligible for this DC plan. Participants and the state in the Louisiana DC plan will contribute the same amounts as they would have in the state DB plan.

Analysis of the Problem

The debate over which retirement structure is superior for public employees has become a politically

charged issue. Nevertheless, the issue before the Committee is which plan better meets the needs of the State and the employee?

A traditional DB plan definitely rewards employees with longer service. It provides the greatest value to the employee who stays to retirement. As a result, the average age and average service credit in the typical public pension plan is consistently higher than in the typical private sector plan. Conversely, the DC plan typically favors the shorter service employee. The employee who works for a few years and leaves public employment will leave with a greater benefit under the DC structure.

The Committee's charge specifically states that Texas' current retirement programs should be compared to those in other jurisdictions and judged on three criteria: their ability to provide security to retirees, cost and fairness to diverse employee groups.

In terms of security, the DB benefit program provides retirees with the most stable retirement benefits. There is a valid argument that DB plans do little to help short-term workers save for retirement. However, statistics show that younger, short-term workers tend to cash in their 401(k) plans instead of saving for retirement. For the refunds of TRS member accounts issued in FY1999 and FY2000, only 18 percent to 19 percent of those withdrawing their retirement funds rolled them into another retirement vehicle. Therefore, a DC plan may not actually help younger workers save for retirement. Furthermore, the majority of states that have adopted DC plans have done so recently, so it is difficult to judge the impact on retirees, particularly because we are currently experiencing strong market performance. Nebraska, the one state that has had a DC plan in place for over 30 years admits that its results have been mixed and that retirees in its DB plan appear to be better off.

The issue of cost is more difficult to determine. Several states that have adopted DC plans did so because their DB plans were not fully funded or because they were concerned about uncertain funding obligations. Short-term costs for the State appear to be about the same with either plan design. In a DC plan, the administrative costs shift from investment costs to education costs. Recently, states such as Florida have offered employees the option of selecting between a DB and a DC plan. The long-term implications of this are unknown. When you allow employees the option to choose between two plans, they will select the plan that best meets their needs. While this ability to choose is beneficial to the employee, it increases the total cost for the entire system. For example, a young employee who does not plan to make a career with the state will select a DC plan. A mid-career employee who plans to work for fifteen to twenty additional years will select a DB plan. This adverse selection can drive up normal costs for the DB plan. In 1990, the State of Texas commissioned a study regarding the issue of DB vs. DC plans. At that time, normal costs for the ERS were around 11.861 percent. The consultant who completed the study noted that actual normal cost is less than six percent of payroll for younger members and over twenty percent of payroll for older members. If primarily younger workers select a DC plan, the average costs for the remaining members will increase.⁵⁷ The report concluded that financially it would not be possible to offer employees a choice between the two options.

The Committee was also charged with evaluating the fairness to diverse employee groups of each retirement structure. Clearly, the DB plan favors career employees and the DC plan favors the short-term employees. However, as demonstrated by Colorado's recent restructuring of its retirement system, some changes can be made within a DB structure to increase portability, and thereby enhance benefits for shorter term workers. In fact, Texas has already implemented some features which

enhance portability such as reciprocal agreements with other state and local retirement plans. Another issue that is important to note concerning fairness is that a DB plan allows the State flexibility in adjusting benefits. For example, if inflation is high and the buying power of retirees is eroding, the State can implement a cost of living adjustment. In addition, certain careers in the public sector typically have a shorter tenure such as law enforcement and firefighters. Having a DB structure, allows the State to subsidize early retirement for these types of employees. This is not possible under a DC plan. Furthermore, with a DB structure, the State can better influence retirement patterns. For example, when certain Texas public employees faced layoffs due to privatization, they were offered early retirement incentives. Again, these options would not be possible with a DC plan.

Recommendations

1. Maintain the current DB structure of the ERS and TRS retirement programs.

According to the General Accounting Office (GAO), there are three key sources of retirement income: Social Security, private pensions, and savings. In 1997, Americans saved only 3.9 percent of their disposable income.⁵⁸ This low-savings rate increases reliance on employer-sponsored pension plans. For the majority of Texas school personnel, this is particularly important because many of them do not participate in the Social Security program. Of the 1043 school districts in Texas, 21 provide Social Security coverage to all of their employees and 26 provide Social Security coverage to select employees.⁵⁹ As a result, the TRS pension plan provides them with a guaranteed income that would otherwise not exist.

Furthermore, the DB plan provides more retirement benefits for the dollar. In a DB plan, about 80 percent of the accrued dollars are spent on normal retirement benefits for career employees. By comparison, approximately one-half of the dollars collected for DC plans fund retirement benefits. The remainder funds loans, termination payments and early retirements.⁶⁰

In addition, the DB structure allows the state to accomplish various objectives with the retirement program. For example, the DB plan structure provides experienced, highly trained employees strong incentive to remain with their employer. As the State currently struggles to retain employees, a retirement system that rewards tenure and longevity better meets the needs of the State.

2. When fund performance exceeds liabilities, look for ways to enhance benefits for employees.

One of the criticisms of DB plans is that employees often do not reap the rewards of strong market performance. There are several benefit enhancements that have been implemented in Texas to share the rewards of the strong market performance. This past session, for example, the Legislature increased the TRS multiplier. The State should continue to look at ways to enhance benefits without jeopardizing the long-term ability of the fund to meet obligations. This next session, for example, the State should consider the feasibility of increasing the TRS multiplier. The State should also look at ways to increase portability and benefits for short-term employees. For example, the feasibility of increasing the interest rate payment on withdrawn contributions at ERS should be considered. These benefit enhancements should only be enacted if they do not jeopardize the ability of the State to meet obligations.

3. Encourage participation in ERS' optional deferred compensation plan.

Over the past year, ERS has made improvements in the optional 401(k) and 457 plans. Membership in these plans is high, particularly in light of the fact that there is no State contribution. Several states have implemented programs to augment their existing DB plans by providing a match to participants in the optional deferred compensation plans. Doing so preserves the security of the DB fund, but increases portability for short-term employees. This should only be considered in Texas if the match was provided in addition to the current DB plan funding.

4. Explore the need and cost of establishing a similar, optional deferred compensation plan at TRS.

The Committee received testimony that the 401(k) and 403(b) plans offered by the local school districts vary greatly in cost and performance. The need for a centralized, optional plan at TRS should be further explored. If it is determined that such a plan should be established, funding should not supplant existing funding of the TRS retirement system. In fact, the feasibility of making this plan self-supporting should be analyzed. If such a plan were established, providing an employer match, whether from school districts or the State, would greatly enhance participation. In addition, this structure would provide teachers the stability of a DB plan and the portability of a DC plan.

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