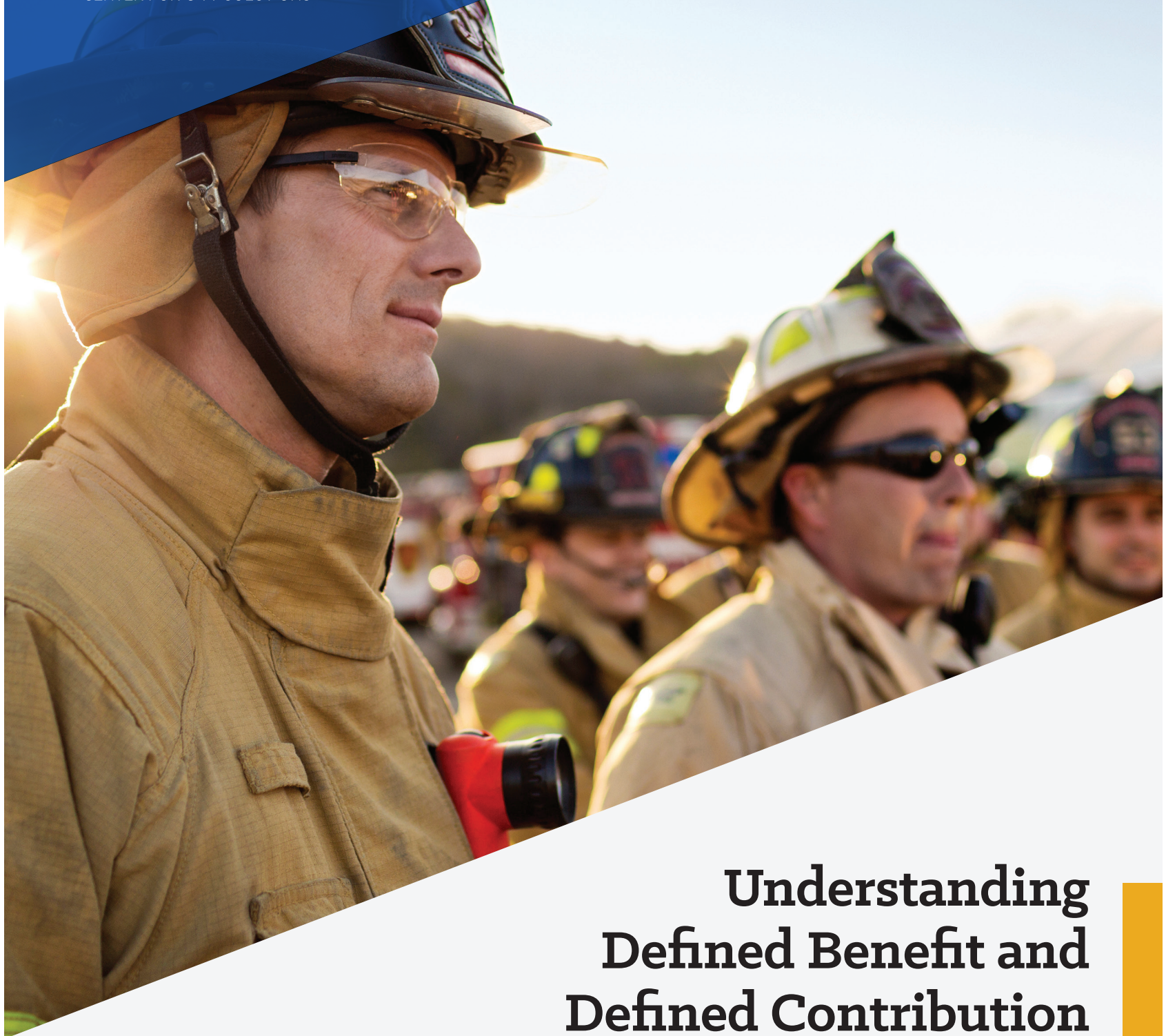




CENTER FOR CITY SOLUTIONS



# Understanding Defined Benefit and Defined Contribution Retirement Plans

**MUNICIPAL ACTION GUIDE**



CENTER FOR CITY SOLUTIONS

### **About the National League of Cities**

The National League of Cities (NLC) is the voice of America's cities, towns and villages, representing more than 200 million people. NLC works to strengthen local leadership, influence federal policy and drive innovative solutions.

NLC's Center for City Solutions provides research and analysis on key topics and trends important to cities, creative solutions to improve the quality of life in communities, inspiration and ideas for local officials to use in tackling tough issues, and opportunities for city leaders to connect with peers, share experiences and learn about innovative approaches in cities.

### **About the Author**

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Report designed by Fred Hviid / New Wave Media



## About the Report

This Municipal Action Guide is a product of NLC’s Public Sector Retirement Initiative, a resource for elected officials to help them navigate the complexities of retirement and healthcare planning and funding for the municipal workforce. The Initiative is sponsored by ICMA-RC, an NLC Capstone Corporate Partner and non-profit independent financial services corporation focused on providing retirement plans and related services for over a million public sector participant accounts and approximately 9,000 retirement plans.

This guide is part of a series focused on strengthening the capacity of city leaders to ensure healthy public sector retirement outcomes.



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# Foreword

Over the next decade, the U.S. population will age significantly. As the number of older people surpasses the number of children in our country, we must face a harsh reality: Nearly a third of older Americans have nothing in retirement savings – no pension, no 401(k), no IRA account.

This means that after dedicating their lives for 30, 40 and in some cases 50 years to serving their communities or companies, millions of Americans will struggle to put food on their tables. Instead of being able to age with dignity, they could find themselves dependent on programs that have been on the brink of collapse for years, such as Social Security.

Financial instability impacts everything — housing, nutrition, quality of life, healthcare and even life expectancy. That is why solvent pensions are crucial to local governments and the employees who serve them.

Pensions ensure that the people who spend their lives serving our communities can retire comfortably, with the benefits they earned. They also enable local governments to attract the passionate, talented workers needed to make their cities thrive, including the very people who keep us safe, such as firefighters and police.

Many municipalities have little control over the types of pension plans they offer employees. However, they still have a role to play to ensure their workers are ready for a comfortable retirement. Cities can work with pension plan providers and human resources staff to educate and increase the financial literacy of their workers and to better understand employee contribution features, employee allocations, and distribution options for retirees.

That is why the National League of Cities is proud to release a new guide, “Understanding Defined Benefit and Defined Contribution Retirement Plans,” as a foundational resource on an increasingly important topic to an aging workforce.

Our communities are only as strong as the people who live and work in them. Let’s ensure that our workers have the support they need to keep our communities thriving.

Sincerely,



**Clarence E. Anthony**  
*CEO and Executive Director*  
National League of Cities

# Introduction

City governments, in their role as employers, are striving to attract talent that can support the critical work of serving communities. However, the wages of state and local government employees tend to be lower than for private sector employees with similar education and experience. So, how can municipal employers provide a more competitive alternative? One way is through employer-sponsored retirement benefits.

Retirement and savings coverage, usually provided by a defined benefit (DB) plan, has been an important characteristic of public sector employment. But since the Great Recession of 2008, several states have reformed their retirement systems. The high costs associated with DB plans have caused some employers to switch to alternative retirement plan options.<sup>1</sup> In fact, according to recent data from the Bureau of Labor Statistics (BLS), 17 percent of local government workers stopped receiving contributions from their employers to their DB retirement plans in 2017 (up from 12 percent in 2012). Instead, they were introduced to a new defined contribution (DC) plan alternative.

It is important for employers and employees alike to understand their pension plan options.<sup>2</sup> This research brief equips city leaders with an understanding of DB and DC pension plans, so that their local governments can better attract top talent. The brief analyzes recent U.S. Census Bureau and Bureau of Labor Statistics data and

provides an overview of retirement plan management and administration across the U.S. The brief also provides a series of questions that city leaders can consider to better understand their plans, the potential for changes, the impact of changes on employees and the competitiveness of the city in the labor market.

## Types of Retirement Plans

According to the Employee Retirement Income Security Act, there are two types of pension plans:<sup>3</sup>

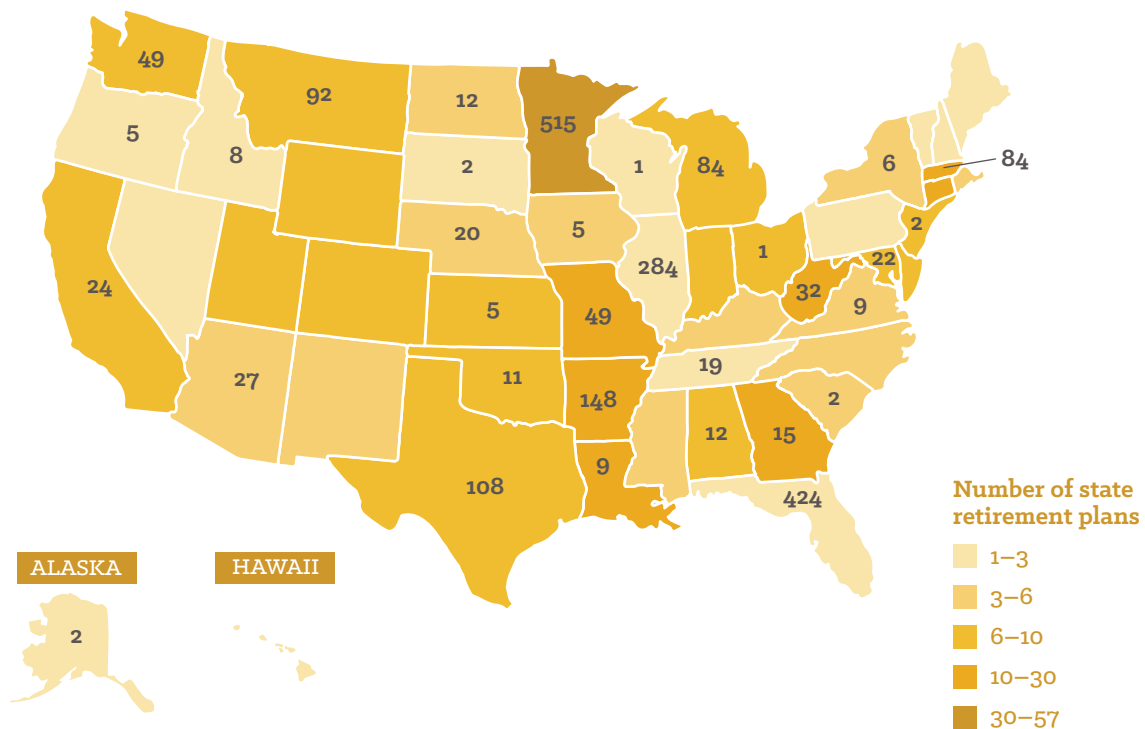
- Defined benefit (DB)
- Defined contribution (DC)

### Defined Benefit Pension Plans

A traditional DB plan is a retirement plan sponsored by an employer, where employee benefits are computed using a formula based on years of service and salary history.<sup>4</sup> A cash balance plan is a type of non-traditional DB plan where benefits are based on years worked, a specified contribution and a rate of interest on that contribution. Approximately 98 percent of local governments surveyed by

APPROXIMATELY 98 PERCENT  
OF LOCAL GOVERNMENTS  
SURVEYED BY THE BLS OFFER  
A DB PLAN, BUT 56 PERCENT OF  
THESE PLANS ARE NOT OPEN TO  
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Figure 1. Distribution of Pension Plans by State, County and Municipal Retirement Systems



Note. The text shown in the map corresponds with the number of municipally administered plans by state.  
Source: U.S. Census Bureau Annual Survey of Public Pensions

## Understanding Defined Benefit and Defined Contribution Retirement Plans

the BLS offer a DB plan, but 56 percent of these plans are not open to new employees as of 2016. The majority of these plans are administered by the state.<sup>5</sup>

Figure 1 shows the distribution of retirement systems by geographic unit. About half the states administer retirement systems at the county level. Three states manage and administer only a few retirement systems:

- Idaho
- Illinois
- Oregon

A few states administer many retirement systems:

- Arkansas
- Minnesota
- Mississippi
- Missouri

Although most municipalities with DB plans participate in their state retirement system, municipalities administered 3,702 DB pension plans of their own in 2017.<sup>6</sup> Some states, like Maine, Wyoming and Utah, do not administer any retirement systems at the municipal level. Others, including Minnesota, Illinois and Pennsylvania, administer many.

### ***Cities Administering Their Own DB Plans***

Figure 2 shows how the number of municipal pension plans has changed over time. In 2012, there were 3,209 DB plans. Interestingly, municipalities in the following states do not receive any contributions from other levels of government:

- New Jersey
- Ohio
- South Dakota
- Wisconsin

We notice that while there were no municipal plans in Montana in 2012 — a few plans started appearing in 2014 — there are now 92 (all for fire department relief associations). According to the Montana League of Cities

and Towns, a change in the law made it more financially viable for cities to create their own pension plans.<sup>7</sup>

On the flip side, while there were 549 plans in Illinois in 2012, now there are only 284. In Illinois, most municipal plans represent police or fire. Of the plans that disbanded by 2017, approximately 62 percent of the plans represented police, and the rest represented fire. Based on the data, county governments began taking over the administration of police and fire plans from municipalities over time. In 2012, counties administered only two plans, whereas in 2017, counties administered 262 plans.

## Defined Contribution Plans

DC plans can be offered as the primary retirement plan or as a supplemental retirement plan. In 2017, approximately 27 percent of local governments surveyed by the BLS had access to DB and DC retirement plans, while five percent of local governments had access to only a DC plan. Additionally, 57 percent had access to retirement savings plans with no employer contributions (i.e., usually a 457(b)).

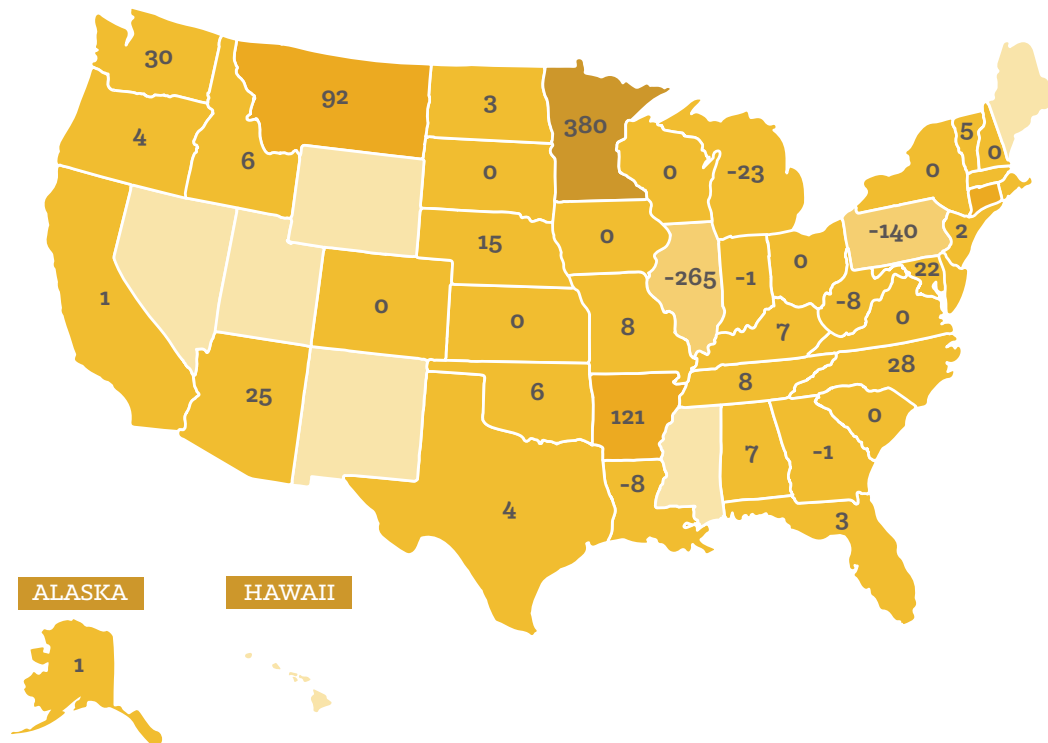
### ***Primary Retirement Plan***

Under a DC plan, the future retirement benefit is based upon how much the participant, and employer where applicable, contributed and the earnings made on those contributions. A DC plan places the investment risk/reward completely on the employee and is typically a tax-deferred retirement plan, like a 401(a), in which a certain amount or percent of money is set aside by the employee and/or employer.

Figure 3 shows the two main types of DC plans that local government workers surveyed by the BLS participated in. In a



**Figure 2. Change in Number of DB Pension Plans Administered by Municipalities from 2012-2017**

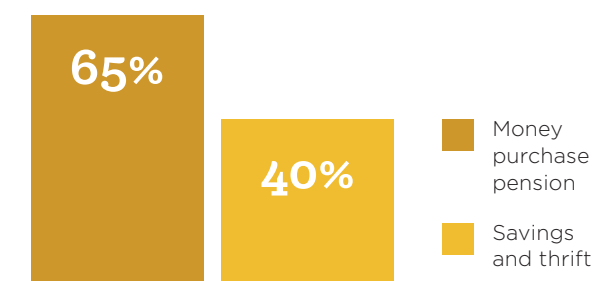


Source: U.S. Census Bureau Annual Survey of Public Pensions

money purchase pension plan, employers make fixed contributions, typically calculated as a percent of employee earnings, and allocate them to individual employee accounts each year. In a savings and thrift plan, employees may contribute a predetermined portion of earnings (usually pretax) — all or part of which the employer matches — to an individual account.

According to the BLS, in 2017 approximately 33 percent of local government workers had access to DC plans, while only 15 percent participated.<sup>8</sup> Five years ago, in 2012, 27 percent of local government workers had access, while only 12 percent participated.<sup>9</sup>

**Figure 3. Local Government Participation in DC Plans by Type of Plan, 2016**



Source: Bureau of Labor Statistics National Compensation Survey

### ***Supplemental Retirement Plan***

According to the BLS, approximately 25 percent of local governments do not offer social security benefits to their employees. And for the rest that do, social security benefits may not be enough to sustain an individual through retirement. Therefore, many employers offer supplemental retirement benefits, in addition to a traditional DB plan, primary DC plan or a hybrid plan with DB and DC components. Employers do not typically contribute to these supplemental retirement plans.

## How to Measure the Health of Your DB and DC Plans

Approximately 88 percent of local government members belong to a statewide pension system.<sup>10</sup> Additionally, nearly 60 percent of cities and other local governments are required to make pension contributions to the state system. Many cities feel as though any change — from increasing employee contributions and reducing benefits to increasing the retirement age — tends to happen in a vacuum at the state level without any input from the cities.

Increasing tensions between state and local governments have added to the financial burden for many cities, particularly in Illinois, New York and California. Mayors representing small and mid-sized cities tend to worry the most about how the failure of

the state pension system has pushed the cities to increase contributions from their own general fund. For example, Pasadena, California is expected to increase its pension contributions from 7.5 percent to 13.9 percent of the city's General Fund budget by 2021, due to an underperformance in California Public Employees' Retirement System (CalPERS) investments.

Meanwhile, particularly since the Great Recession of 2008, most state and local governments have introduced reforms to their retirement plans, furthering the uncertainty among employees, especially young ones, over how to save for their future. This looks different in cities and states across the country:

**Virginia:** All new hires after January 1, 2014 are automatically enrolled in a hybrid plan, which includes a DB component, for which the Virginia Retirement System manages the investments and related risk, and a DC component, for which the employee manages the investments.

**New Mexico:** Employees hired after 2010 enter a Tier 2 plan and are eligible for retirement after 30 years of service, contrary to workers hired before 2010, of whom police and fire could retire after 20 years of service and government employees could retire after 25 years. And in Florida, as of January 2018, all new employees will default into an investment plan — which is a DC plan — if they do not opt out of it and choose the DB pension plan within nine months. Lastly, in Alabama, employees hired after 2013 are required to provide 30 years of service as opposed to 25 in order to be eligible for retirement.

**Memphis, Tennessee:** As of July 1, 2016, employees with less than 7.5 years of service and new employees are placed in a hybrid

**Figure 4. The Relationships of Cities as Employers and Retirement Plan Sponsors**



plan with a DB component called a market-based cash balance plan and a DC component in the form of a 401(a) plan. These reforms are the result of pressure from the state to control pension costs, even though the city administers its own pension system.

While many local leaders may feel helpless about what they can effectively do to address their pension funding gaps, one thing they can do is identify partners (see Figure 4) who can help them understand

basic pension plan features, how pensions can help recruit and retain talent, and how financial literacy can be improved to educate employees on the nuances of the overall compensation package.

While many cities with DB plans participate in their state retirement system, they can still learn a lot from pension plan providers to better understand employee contribution features, monitor employee allocations and recognize distribution options for retirees



## Understanding Defined Benefit and Defined Contribution Retirement Plans

(see Table 1). For example, understanding participation trends around general plan usage, as well as during periods of hiring and wage freezes, can help city officials plan for future periods of economic uncertainty, when employee contributions tend to flatten and competing necessities such as food, shelter and clothing.

An understanding of how contribution levels are set can also help city officials better plan for future retirements. Some plans allow contributions to be made on an ad hoc, dollar-value basis, while other plans require contributions to be a percentage of pay as part of an automatic enrollment feature. In addition to understanding those plan features, it is a good idea to monitor aggregate participant allocations by age to ensure young and old employees are investing their monies in a manner that will set them up for retirement success. This type of oversight will also signal to your employees that you are there to answer their nagging questions, and ultimately, to support them in accumulating enough savings to retire.

But while accumulating savings is important, how employees receive that money during retirement is just as important. Running out of money in retirement is a major concern for many American workers. The phenomenon is dubbed longevity risk because of the potential danger of exhausting one's assets before death. But many retirees are unclear of the options available to them. City officials can quell those concerns by understanding whether their plan provider offers their retirees the option of a lump-sum or annuitized distribution. For example, the South Dakota Retirement System permits retiring participants to annuitize all or some of their supplemental retirement savings,

converting non-DB assets into a lifetime stream of income.

Amid the uncertainties in long-term employer-provided benefits and compensation, there is a growing need for public sector employers to offer education programs to increase financial literacy and help workers understand and prepare for their financial futures. This is particularly true for younger workers, who will need to bear greater individual responsibility. Still, according to one study, only 26 percent of human resources directors report that their local governments offer a financial literacy program to employees.<sup>11</sup>

Ideally, financial literacy programs offered by employers should be comprehensive, covering not just retirement planning and the benefits offered, but also everyday budgeting and money management, financial planning for lifestyle changes, student debt/college savings and the financial impacts of health care. Local officials should work with their human resources staff to examine whether their existing education programs are enough to help their employees understand the value of their plans and whether they can be improved to increase employee plan participation and contributions.

**Table 1. How Cities Can Work with Pension Staff and Employees to Ensure Plan Health**

<b>DB, DC, or Both</b>	<b>Plan sponsor responsibility</b>	<b>Resource</b>	<b>What cities can do</b>
Both	Measure contributions	Plan Provider	Examine the average level of contributions by different age segments of the employee population, as well as contributions during hiring and wage freezes and periods of economic stress.
Both	Evaluate investment funds	Plan Provider	Understand and evaluate which funds are available to your employees (e.g., target date funds) and how they are constructed. Properly disclose this information to your employees to help them select the funds that best meet their needs.
Both	Measure fees	Plan Provider	Work with your plan provider to periodically review total fees paid by your employees and the revenue retained by the provider.
Both	Understand distribution options	Plan Provider	Work with your plan provider to understand the distribution options available to your employees. Ensure these choices are communicated to your employees and periodically monitor the distribution choices of your retirees.
Both	Understand contribution features	Plan Provider	Understand how contribution levels are set. Also understand any potential limitations placed by your state with respect to automatic enrollment and escalation programs.
DC	Monitor employee allocations	Plan Provider	Monitor aggregate participant allocations by age. If those allocations are too aggressive or conservative, work with your plan provider to understand why and devise a solution.
DC	Measure participation	Plan Provider	First determine whether all employees have access to a DB plan only, or if new employees, for example, also have access to a DC plan or only have access to a DC plan.
Both	Examine education programs	Human Resources Department	Examine your existing education programs and work with your human resources staff to improve programs and increase employee plan participation and contributions.
DB	Benefit Levels	Human Resources Department	Examine participant vesting levels and benefit levels by hire date.
DB	Actuarial Services and Plan Funding	Human Resources Department	Understand contribution levels and excess taxes for failure to meet minimum contribution levels (as well as excess funding).

Source: Saeli, John. "Measuring the Health of Your Defined Contribution Plan." Government Finance Review. Feb 2011.

# Conclusion

As more young workers enter the workforce, it is increasingly important for local government employers to ensure their retirement benefits are well understood. Through education and guidance, employers can help their employees enjoy more secure financial futures. To get started, ask yourself these questions:

1. What recent retirement-related reforms have occurred in my state?
2. What retirement plans does my city provide to my employees? How does this differ for government employees and police and fire employees?
3. How can I work with my plan provider to understand employee contribution features and allocations?
4. Do my employees understand the plan offerings? If not, how can I work with my human resources staff to better communicate this information?
5. Do the benefits my city provides allow me to recruit and retain the workforce my city needs?





## Endnotes

<sup>1</sup> “Retirement costs for defined benefit plans higher than for defined contribution plans,” Beyond the Numbers: Pay and Benefits (U.S. Bureau of Labor Statistics, December 2012), [www.bls.gov/opub/btn/volume-1/pdf/retirement-costs-for-defined-benefit-plans-higher-than-for-defined-contribution-plans.pdf](http://www.bls.gov/opub/btn/volume-1/pdf/retirement-costs-for-defined-benefit-plans-higher-than-for-defined-contribution-plans.pdf)

<sup>2</sup> Brainard, Keith and Alex Brown. “Spotlight on Significant Reforms to State Retirement Systems.” 2018. <https://www.nasra.org/reforms>

<sup>3</sup> The Employee Retirement Income Security Act of 1974 is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans. U.S. Department of Labor. Employee Retirement Income Security Act (ERISA). <https://www.dol.gov/general/topic/retirement/erisa>

<sup>4</sup> Bureau of Labor Statistics. National Compensation Survey. <https://www.bls.gov/ncs/home.htm>

<sup>5</sup> Urban Institute. “State and Local Government Pensions.” <https://www.urban.org/policy-centers/cross-center-initiatives/state-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions>

<sup>6</sup> Census Bureau. Annual Survey of Public Pensions. 2017. <https://www.census.gov/programs-surveys/aspp.html>

<sup>7</sup> Scurr, Sheri. “Research Memorandum.” Montana Legislative Services Division. August 2016. <https://leg.mt.gov/content/Committees/Interim/2015-2016/State-Administration-and-Veterans-Affairs/Meetings/Aug-2016/Fire%20Relief%20Assoc%20Research%20Memo.pdf>

<sup>8</sup> Retirement benefits: Access, participation, and take-up rates, State and local government workers, March 2017. <https://www.bls.gov/ncs/ebs/benefits/2017/ownership/govt/table02a.pdf>

<sup>9</sup> Retirement benefits: Access, participation, and take-up rates, State and local government workers, National Compensation Survey, March 2012. <https://www.bls.gov/ncs/ebs/benefits/2012/ebbl0050.pdf>

<sup>10</sup> Urban Institute. “State and Local Government Pensions.” 2014. <https://www.urban.org/policy-centers/cross-center-initiatives/state-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions>

<sup>11</sup> Liss-Levinson, Rivka and Joshua Franzel. “Financial Literacy Programs for Local Government Employees.” Center for State and Local Government Excellence. January 2019. <https://www.slge.org/assets/uploads/2019/01/financial-literacy.pdf>

