



State Plan Sponsor of the Year: A Lesson in Funding

The West Virginia Teachers' Retirement System comes up with an unlikely solution to its financial problem: a return to a defined benefit plan.

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"We know that the only way to get to where we need to be is to be flexible," says Anne Werum Lambright, Executive Director of the West Virginia Consolidated Public Retirement Board, which oversees administration of eight public retirement plans. That attitude has come in especially handy with the troubled Teachers' Retirement System, which by 2003 had hit a funded ratio of just 18%.

Anne Lambright of the West Virginia Consolidated Public Retirement Board



"West Virginia faced an underfunding problem, particularly in the Teachers' Retirement System, that was far worse than any other statewide plan has faced," says Keith Brainard, Austin, Texas-based Research Director of the National Association of State Retirement Administrators (NASRA). "That is the lowest level for any public plan for a broad group of employees." (West Virginia's other pension plans—which include the Public Employees Retirement System, the Judges' Retirement System, the Deputy Sheriffs' Retirement System, Troopers Plan A, Troopers Plan B, and Emergency Medical Services Retirement System—have different funding setups and have not faced a similar crisis.)

To get finances back on track, the state changed course in the Teachers' Retirement System (TRS) plan design and funding approach, and it also has shifted the strategy of the West Virginia Investment Management Board, which oversees investments of the seven defined benefit (DB) plans as well as other state money.

Lambright attributes the flexibility to a smaller state's ability to build consensus quickly as well as to the private-sector experience of many of the state staffers involved. "Governor Joe Manchin brought in new people with private-sector experience to lead this pension-funding change, and he and they were able to get the legislature, the unions, the participants, and the taxpayers on board pretty quickly with responsibly funding the past promises and providing for the opportunity for the [defined contribution plan] members to participate in the defined benefit plan," she says.

By 2008, the funding level of the Teachers' Retirement System had risen to 51%. "Fifty percent does not look like a whole lot, but 50% is a big deal," Lambright says. "We are no longer the bottom of the pile."

DC to DB to DC—then back

The teachers' system started in 1941 as a defined contribution (DC) plan, before gradually morphing into a DB plan in the 1960s, as legislators took steps such as guaranteeing a

minimum benefit. However, while the plan design got converted to DB, the funding approach did not. "Unlike PERS, which got funded actuarially each year, they never got past, 'How much money do we need to pay benefits this year?'" says Harry Mandel, the Consolidated Public Retirement Board's actuary. The DB plan did not convert to actuarial funding until 1991.

DC to DB to DC—Then Back

Not surprisingly, that helped create a funding mess. "TRS operated essentially on a pay-as-you-go basis for most of the 20th century," Brainard says. "It caught up with them." In 1991, state lawmakers closed the teachers' DB plan to new participants. As of July 1, 1991, new hires went into a mandatory DC plan with a 7.5% employer-contribution rate. Legislators lowered the DC plan employee contribution to 4.5%, compared with 6% for the DB plan, and about 4,000 existing participants voluntarily switched into the new plan. "I have asked a variety of sources, and no one seems to know why they lowered the employee rate," Lambright says.

Craig Slaughter of the West Virginia
Investment Management Board



However, that approach did not help, either. "It was clear that the defined contribution plan had not saved the state money," Lambright says. The state analyzes costs by comparing the 7.5%-of-pay employer contribution rate under the teachers' DC plan with the teachers' DB plan "normal cost" rate as a percentage of pay.

Normal cost is the cost of paying benefits in a given year, she explains. All employee contributions go toward normal cost, plus a certain percentage of the employer contributions and what the state pays in the school-aid formula. The difference between the employer's and state's contribution and the normal cost is the amount of money that can go to reduce the unfunded liability that year, she says.

For DB plan members hired before the 1991 closure to new participants, the employers' current normal cost rate is slightly less than 3% of pay. Compared with the 7.5% of pay employers

contribute to the DC plan, that means realizing a savings of 4.5% of pay on current benefits—or a 60% reduction in current DB plan benefit costs compared with DC plan annual contribution costs.

"Closing off a pension plan does not in itself produce savings," Brainard says. "You do nothing to address the cost of the existing unfunded liabilities and, when you close a plan off to new hires, you shrink the pool of new workers that can pay off the unfunded liability."

In addition, participants' savings rates in the DC plan lagged way behind their peers in the DB plan, as the legislature found when it hired an outside actuary to review DC member accounts and project balances. The 19,851 DC plan members who had a balance on June 1, 2005, averaged \$33,944, and the 1,134 DC participants age 60 and older averaged just \$23,193 as a total balance.

In contrast, the average annual retirement benefit for a teacher retiring in the DB plan was \$29,777. That plan's current benefit formula is 2% of final average salary times years of employment, starting at age 60. "If you compare the 60-year-old teacher who has the

average balance of \$23,193 in his/her [defined contribution] retirement account to the 60-year-old teacher retiring from [the DB plan] who will receive more than that each and every year of his/her life, you can see the disparity that led to such dissatisfaction with the defined contribution system among the members and their unions," Lambright says.

No Realistic Chance

Why did balances lag so far behind? Lower contribution rates, for one. Plus, many DC participants chose conservative investments. A lot gravitated to a fixed annuity that paid 8.5% one year, but then dropped to its contract floor of 4.5% in 1992. Differences in age and other demographics did not play a major role in the lower account balances, Lambright says. "The workforce is slightly older—less than one year older—than similar state teachers' plan participants, but nothing else is unique or different. In general, they are very conservative, but that is true for other states' teachers' retirement system participants, too."

Harry Mandel of the West Virginia Consolidated Public Retirement Board



By 2005, it became clear that many of the DC participants had no realistic chance to retire successfully. So, in 2005, lawmakers moved to close the DC plan and transfer members' assets to the DB plan, if 50% of DC participants voting favored it. Some DC members who did not want to transfer filed suit and, in January 2008, the West Virginia Supreme Court of Appeals declined to review a lower-court decision that the legislature violated participants' rights by requiring a transfer. So, in a March 2008 special session, legislators regrouped and gave DC plan members the option to transfer July 1, 2008.

The 22,000 DC plan participants had to make a choice quickly, within about six weeks. Some knew immediately what they wanted to do, but many others needed help. So, many Retirement Board staffers fanned out throughout the state, training school principals on how to do participant-education sessions and, in some cases, actually doing the sessions. The Board also had 20 staffers manning special phone lines to answer questions. "It was very intense," Lambright says of the condensed education effort. "It was like a war. I felt like a general directing the troops."

Ultimately, almost 80% of those eligible to transfer chose to do it. "There have been many more young people than we expected," Lambright says. "We thought they would want the portability of a defined contribution plan, but they want the security of a defined benefit plan, and they do not want to think about the investments. They want predictability." Great-West Retirement Services still serves as recordkeeper for the approximately 4,000 active DC accounts, and the Retirement Board serves as its own recordkeeper for the state's DB plans.

Until June 30 of this year, participants who transferred into the DB plan also have the option to make up for not making the same contributions by purchasing benefits credits. Since DC plan members only contributed 75% of what DB members contributed (4.5% versus 6%), Lambright says, the basic service transfer was set at 75%. Those who want to purchase the remaining 25% service credit pay a cost based on the 1.5% of pay not contributed, plus 4% interest.

The state sees a savings from going back to the DB plan. For employees hired July 1, 2005, and after (who automatically went into the DB plan), as well as existing participants who opted to transfer into the DB plan, the employers' normal cost rate for the DB plan is about 3.78% (9.78% minus the 6% employee contributions), Lambright says—or half the 7.5% DC plan contribution rate. For fiscal 2008, new DB plan members hired July 1, 2005, through June 30, 2008, generated a \$6.8 million savings, she says. Lambright adds that this savings

will grow as new hires all enter the DB plan. The 14,000-plus transfers from the DC to DB plans will generate about a 3.78%-of-pay savings each year through retirement.

A Shift Into Alternative Investments

Not that the 457 program has been shunted aside. Deputy Treasurer John Fisher said the 457 plan got transferred to his office from the Retirement Board as of July 2006. With Treasurer John Perdue also running the West Virginia 529 plan and overseeing a variety of financial education efforts, Fisher said the feeling was his office could better focus on and provide good customer service to 457 plan participants. "We feel like it was a good fit," Fisher said. "We wanted to increase the exposure of the plan and promote it aggressively." Among the changes, both effective July 1, 2007: auto-enrollment for new state hires, and participants saving at least \$10 a pay period for a fiscal year are eligible for a \$100 a year "match" for four years.

The pension funds' overseers also hope that a shift into alternative investments will improve the funded status by lowering volatility and boosting investment returns. In spring 2007, state legislators—who only agreed to change the state constitution to allow the West Virginia Investment Management Board to invest in equities in 1998—approved its move into hedge funds, real estate, and private equity.

The DB plans' current allocation stands at 25% domestic equity, 25% international equity, 20% fixed income, 10% private equity, 10% real estate, and 10% hedge funds. Prior to that, it had been 40% domestic equity, 40% fixed income, and 20% international equity. The current targets took effect in November 2007, so there are no plans now to change them, says Craig Slaughter, the Investment Board's Executive Director.

That alternative-investment target exceeds the average public fund's allocation, Brainard says.

"Deviating from others is a strategy for us," Slaughter says. The portfolio currently uses a return assumption of 7.5%. Fourth-quarter 2008 saw a negative 12.9% approximate return for Teachers' Retirement System investments.

The state also took steps to make the plans' funding process more disciplined. The 2005 legislation established more-realistic actuarially required contribution rates. For the 2009 fiscal year ending June 30, employers—including county school districts as well as colleges and universities—will have contributed \$323.3 million toward TRS. That compares with \$337.2 million in fiscal 2007 and \$348.5 million in fiscal 2008.

The legislation set a deadline for each pension plan to reach full funding; TRS has until 2034, based on a 40-year amortization schedule established in 1994. Given the progress made so far, Lambright says, that date looks realistic. It also stipulated that the teachers' DB plan cannot increase future benefits for active employees until the plan reaches full funding.

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