NORTH DAKOTA LEGISLATIVE COUNCIL

Minutes of the

EMPLOYEE BENEFITS PROGRAMS COMMITTEE

Monday, February 2, 1998
Harvest Room, State Capitol
Bismarck, North Dakota

Representative Francis J. Wald, Chairman, called the meeting to order at 9:00 a.m.

Members present: Representatives Francis J. Wald, James O. Coats, Glen Froseth, Allan Stenehjem; Senators Karen K. Krebsbach, Ed Kringstad, Elroy N. Lindaas, Carolyn Nelson

Member absent: Representative Leland Sabby

Others present: See Appendix A

It was moved by Representative Coats, seconded by Senator Nelson, and carried that the minutes of the November 20, 1997, meeting be approved as mailed.

RETIREMENT PORTABILITY STUDY

At the request of Chairman Wald, Mr. Dan LeRoy, Director, Central Personnel Division, Office of Management and Budget, addressed the committee. He distributed a copy of the retirement portability study prepared by the Public Employees Retirement System and the Office of Management and Budget. A copy of the report is on file in the Legislative Council office. He said the 1997 Legislative Assembly directed the Public Employees Retirement System and the Office of Management and Budget to undertake a pension portability study. He said the report focused on pension portability and how to balance the needs of long- and short-term employees within the defined benefit or defined contribution plan concepts. He said the Office of Management and Budget and the Public Employees Retirement System began work in June 1997 and the study consisted of three phases. He said phase 1 was a data collection and literature search, phase 2 an analysis, and phase 3 a final consideration and the report writing.

At the request of Chairman Wald, Ms. Deb Knudsen, Public Employees Retirement System, addressed the committee. She reviewed the history of the Public Employees Retirement System from 1965 to the present, reviewed the present benefit structure, and discussed other public pension plans. She said the Public Employees Retirement System plan began on July 1, 1966, as a money purchase plan. She said the general characteristic of a money purchase plan is that participating employer and employee costs are fixed, though individual benefits will vary. She said participating full-time employees were required to contribute four percent of their base salaries and the employer was required to contribute four percent of the employees' salaries up to a maximum of $300. She said these moneys were then distributed into three funds-- the employee contribution went into the employee fund, $3 of every $4 the employer contributed went into a vesting fund, and the remaining $1 went to the administrative expense and benefit fund. She said when an employee left state employment, that employee was entitled to receive 100 percent of the amount contributed from the employee's salary plus earnings on that amount. In addition, she said, the employee was entitled to receive up to 100 percent of the employer contribution in the vesting fund, plus a percentage of the interest thereon, if the employee retired at age 65 after any length of service, became permanently and totally disabled at any age, or died at any age. She said if the employee left state employment voluntarily or involuntarily other than for these reasons, the employee was entitled to the total employee contribution, the vested portion of the employer account, and earnings thereon. She said employees did not become fully vested until they accrued 20 years of service which was reduced to 15 years of service in 1975. In 1977, she said, the Legislative Assembly converted the money purchase plan to a defined benefit plan.

In response to a question from Representative Wald, Mr. Sparb Collins, Executive Director, Public Employees Retirement System, said the rationale for changing from a money purchase or defined contribution system in 1977 was because the investment climate at that time was not providing an adequate return and a number of state employees were seeing their equity accounts decline rather than increasing. Thus, he said, the

Legislative Assembly felt that the Public Employees Retirement System was not providing a secure retirement income for state employees.

In response to Mr. Collins' comments, Mr. John D. Olsrud, Director, Legislative Council, noted that many employees who retired during the late 1960s and early 1970s under the defined contribution or money purchase plan had contributed very little to the retirement system since it had been created late in their careers. As a result, he said, many of these employees had very low pension benefits and the Legislative Assembly converted the defined contribution plan to a defined benefit plan in order to provide these employees a secure increased benefit.

In response to a question from Representative Wald, Mr. Collins said that when the system was converted from a defined contribution plan to a defined benefit plan, a substantial unfunded liability was created to pay benefits for those retirees who retired soon after 1977 but who had not contributed a large amount of money to the fund. He said this unfunded liability has since been retired.

Mr. Collins said the Public Employees Retirement System also provides a number of economic benefits for the state. He said these benefits include the taxes paid by beneficiaries on their retirement income, the savings in FICA taxes to the state because the state "picks up" the employee contribution, the fact that the Public Employees Retirement System is a low-cost program funded by a diversified source of funds, and the Bank of North Dakota's "match loan program" which is funded by state retirement funds.

In response to a question from Representative Wald, Mr. Collins said the State Investment Board would not be able to use state pension funds under a defined contribution system because of the term required to make a loan and the uncertain commitment of funds in a defined contribution system where funds would be entering and leaving the fund continuously. Also, he noted, under a defined benefit system the investment allocation is determined by the Public Employees Retirement System Board and the State Investment Board while under a defined contribution system the investments would be controlled by the owner of the account.

At the request of Chairman Wald, Mr. Roderick B. Crane, Vice President, The Segal Company, Denver, Colorado, addressed the committee. He reviewed design activities in other states that have recently considered the defined benefit versus defined contribution issues. In 1991, he said, the West Virginia Legislature closed its teachers' defined benefit plan to new hires and created a defined contribution plan in response to severe underfunding of the defined benefit plan. He said the defined contribution option provided funding certainty based on a percentage of payroll. In 1995, he said, the Washington State Legislature created a third retirement plan for members of the defined benefit teachers' retirement system to enhance pension benefits without raising costs. He said the Washington Legislature's Joint Committee on Pension Policy is currently exploring, with union officials, the possibility of establishing a similar hybrid plan for general state employees. In 1995, he said, the Colorado Public Employees Association, in which local government participation is voluntary, created a hybrid plan in order to better attract and retain employees and to meet local government's demand for a defined contribution option. In 1997, he said, Michigan enacted a law to create a defined contribution plan for new employees of the State Employees Retirement System and the Public School Employees Retirement System. He said all State Employees Retirement System employees hired after March 31, 1997, will automatically become members of the defined contribution plan. He said all Public School Employees Retirement System employees hired after July 1, 1997, will have a choice of participating in either the existing defined benefit plan or the new defined contribution plan. However, he noted, Michigan has revoked the authorization to convert the Public School Employees Retirement System to a defined contribution system. Concerning local governments in Michigan, he said, the Municipal Employees Retirement System of Michigan has offered a defined contribution option plan to its participating governments. In Texas, he said, the Texas Municipal Employee Retirement System maintains a cash balance plan, and legislation has been enacted requiring the Illinois State University Retirement System to establish a new portable retirement benefit program separate from its existing defined benefit plan.

In response to a question from Representative Wald, Mr. Crane said in those states that have converted from a defined benefit plan to a defined contribution plan, employees usually have the option of remaining in the defined benefit plan or converting to the defined contribution plan. However, he said, one legal ramification is that the defined benefit plan must still be able to meet the accrued liabilities of those employees who remain in the defined benefit plan. In response to a further question from Representative Wald, Mr. Crane said there is no set or specific age at which an employee must remain in a defined benefit plan in those states that have converted to a defined contribution plan. However, he said, usually longer tenured employees who have larger account balances tend to remain in the defined benefit plan while younger employees convert to the defined contribution plan.

In conclusion concerning design activities in other states, Mr. Crane said, Nevada, Idaho, the Illinois Municipal Retirees System, the Missouri Teachers System, and Vermont are also studying defined benefit pension plan and defined contribution pension plan issues.

Concerning the states that have initiated efforts to supplement their defined benefit plans with a defined contribution plan, Mr. Crane said, Missouri has implemented a supplemental retirement plan for its employees. He said the mechanism used in Missouri is the state's Section 457 deferred compensation plan. He said this mechanism is an incentive in the form of employer matching to encourage employees to participate in the state's deferred compensation plan. He said Missouri is a state that has done this and because of the success in Missouri, Oklahoma and New York are also reviewing this type of incentive.

At the request of Chairman Wald, Mr. Collins addressed the committee. He reviewed the prevalence of defined benefit and defined contribution plans and noted that there has been a decrease in the number of defined benefit plans while the number of defined contribution plans have increased since 1985.

At the request of Chairman Wald, Ms. Leslie Thompson, Enrolled Actuary, The Segal Company, Denver, Colorado, reviewed the program differences between defined benefit and defined contribution plans. She said under a defined benefit plan employees earn a fixed benefit based on a formula while under a defined contribution plan an employee's benefit is equal to that person's vested account balance at normal retirement. She noted that defined benefit plans can provide for postretirement increases while defined contribution plans usually do not. Concerning death benefits, she said, defined benefit plans can provide spouse benefits at death while defined contribution plans typically pay the employee's account balance to a designated beneficiary at the employee's death. Concerning disability benefits, she said, a defined benefit plan can offer disability retirement benefits while under a defined contribution pension plan the disability benefit would be the accumulated account balance at the time of the disability. Under defined benefit plans, she said, the risk of investment performance is on the employer while the risk of investment performance is on the employee in a defined contribution plan. In defined benefit plans, she said, employees have no investment direction while, although not required, defined contribution plans usually offer investment choices to employees. Concerning vesting of accruals, she said, under the North Dakota Public Employees Retirement System a member vests at five years and defined contribution plans may use the same vesting schedule as a defined benefit plan. Concerning unfunded liability, she said, a defined benefit plan can produce an unfunded liability while under a defined contribution plan, since the employee's benefit is based only on what is in the employee's account, no unfunded liability can exist. She said defined benefit plans can provide benefit increases while under a defined contribution plan benefits can increase only by increases in the account balance through increased employer or employee contributions or by an increased investment performance.

In response to a question from Representative Wald, Mr. Crane said if an employee were to mismanage or not optimize that employee's defined contribution plan and as a result the account balance was insufficient to provide an adequate retirement, any liability of the state would depend upon the fiduciary laws of that state. Also, he said, liability may hinge on how much disclosure of the risk was communicated to the employee; thus, he said, if risk is not well communicated to the employee the fiduciary liability may still flow back to the employer.

At the request of Chairman Wald, Mr. Collins addressed the committee. He discussed the issue of pension portability, which he defined as the ability of an employee to take that person's pension with him or her when the person leaves one employer and goes to another. He said portability issues include portability of benefits, portability of assets, and portability of service. He said these issues are important because they are essential in attracting and retaining a quality work force, addressing mobility issues in the work force, and ensuring adequate retirement income. He said if the Public Employees Retirement System defined benefit system was converted to a defined contribution system, the issues that would need to be addressed and resolved include the existing state investment structure, the Public Employees Retirement System benefit assessment, membership considerations, the retiree health credit program and other Public Employees Retirement System retirement programs, disability and surviving spouse benefits, the administrative and investment expenses of the Public Employees Retirement System, the rule of 85, ad hoc benefit adjustments for retirees, and legal considerations.

Mr. Collins next discussed the identification of concepts to increase the portability of the Public Employees Retirement System. He said the options identified in the report included reduced vesting, indexing of final salary, automatic vesting in the employer contribution, incentive vesting in the employer contribution, allowing rollovers into the plan, cooperative agreements, enhanced purchase provisions, allowing pretax purchase of service, and changing the early retirement reduction. Based upon an analysis of each option, he said, the study group decided to eliminate the indexing of salary because it was thought to be too expensive, the automatic vesting in employer contribution since it does not promote retirement security, cooperative agreements since they do not provide a comprehensive approach for all members, changing the early retirement reduction since it does little to address portability, and the purchase provisions because they would conflict with federal regulations for employees with less than five years of service from further consideration. Mr. Collins next reviewed the advantages and disadvantages of the selected portability options and concluded that the concepts identified for further study are reducing the vesting schedule to three years, providing an incentive matching of the employer contribution, including an additional rollover provision in the Public Employees Retirement System pension plan, and allowing for the pretax purchase of service credit. He said the Public Employees Retirement System Board will be submitting a bill draft incorporating these concepts to the committee by the April 1 deadline.

In response to a question from Representative Wald, Ms. Thompson said if The Segal Company were to advise the committee on converting the defined benefit pension plan to a defined contribution pension plan or hybrid plan, the first step would be to prepare an initial issues paper on defined benefit and defined contribution issues encompassing such items as portability. She said the anticipated cost of preparing the initial issues paper would be between $35,000 and $40,000. The next step, she said, would be to prepare a benefits analysis addressing the actuarial work, contractual rights, and cost analyses at an estimated cost of $50,000. In response to a further question from Representative Wald, Ms. Thompson said The Segal Company would provide an estimate of these costs for the committee.

Chairman Wald recognized Congressman Earl Pomeroy. Congressman Pomeroy distributed a copy of H.R.1656, the Secure Assets for Employees (SAFE) Plan Act of 1997 and a summary of the bill. The summary is attached as Appendix B and a copy of the bill is on file in the Legislative Council office. He said the aim of the bill is to allow small businesses to extend defined benefit type pension plans to their employees. He said many small business employers do not have such plans because of administrative burdens and the high cost of providing qualified retirement plans for their employees. He said one positive aspect of defined benefit plans is that they provide a steady income stream for life while a defined contribution plan, if not properly managed, may be exhausted prior to the end of the owner's life. He said this is especially true in North Dakota because of the large percentage of elderly and the long life span of North Dakotans. He said he has closely followed the debate across the country and, except for Michigan, many of the states that have examined the issue have retained their defined benefit plans. He said California rejected a conversion to a defined contribution plan and Vermont, Arizona, Kansas, and Iowa seem to be rejecting the conversion. In conclusion, he said, retaining the defined benefit plan, especially one that is fully funded and working well, is a better option than scrapping the plan and moving into a defined contribution plan with all of its insecurities.

At the request of Chairman Wald, committee counsel distributed a copy of the Uniform Management of Public Employees Retirement Systems Act and a brochure entitled *An Elected Officials Guide to Public Retirement Plans*. These items are on file in the Legislative Council office. He said the Act was drafted by the National Conference of Commissioners on Uniform State Laws and submitted by North Dakota's Uniform Laws Commissioners to the Legislative Council, which in turn assigned it to the Judiciary Committee for review. Upon review, he said, the Judiciary Committee determined that it affected the state's retirement programs and forwarded it to the Employee Benefits Programs Committee to prepare an actuarial report on the bill. He said once the committee receives the requested actuarial information and makes a recommendation, the bill will be returned to the interim Judiciary Committee for final determination on whether it should be submitted to the Legislative Council and introduced during the 1999 Legislative Assembly.

At the request of Chairman Wald, Mr. Crane reviewed the Uniform Management of Public

Employees Retirement Systems Act. A copy of the overheads used in his presentation is attached as Appendix C. He said the Act is the result of a comprehensive study undertaken by the National Conference of Commissioners on Uniform State Laws. He said he served on the advisory committee to the Act's drafting committee for the last two and one-half years and thus was privy to some of the thought processes that went into the drafting of the Act. He said the purpose of the Act is to establish uniform fiduciary responsibilities and standards of conduct for public sector retirement plans, protect participant benefits and plan assets, and to lessen the possibility of federal intervention. He said the management of Public Employees Retirement Systems Act ensures that pension assets are held in trust, ensures that trustees have exclusive authority over trust assets, establishes fiduciary duties and standards of conduct and liabilities, provides for significant reporting and disclosure to employers and participants, creates causes of action against trustees, and provides that benefits may not be assigned or alienated. He said the Act applies to public employee retirement plans except unfunded plans for higher compensated employees, severance plans, Social Security, Section 415 excess plans, IRAs, tax-sheltered annuities, and workers' compensation. He said the Act adopts the prudent person rule and a provision that trustees are personally liable for breaches of fiduciary duty. Finally, he said, the Act does not impose minimum funding requirements or address benefit design.

In response to a question from Senator Nelson, Mr. Crane said the Act would not have a significant impact or require significant changes on the part of the Public Employees Retirement System or the Teachers' Fund for Retirement.

At the request of Chairman Wald, Mr. Franklin J. Smith, Secretary/Treasurer, Bismarck Firefighters Relief Association, presented an overview of the Bismarck Firefighters Relief Association. A copy of the investment policy statement for the association and the association's November 1997 newsletter are on file in the Legislative Council office.

In response to a question from Representative Wald, Mr. Smith said the vesting period for the Bismarck Firefighters Relief Association plan is 10 years.

At the request of Chairman Wald, Ms. Thompson presented the January 1, 1996, actuarial valuation of the Bismarck Firefighters Relief Association. She said a biennial valuation is performed for the association. A copy of the valuation is attached as Appendix D.

At the request of Chairman Wald, Mr. Tom Schons, Secretary/Treasurer, Fargo Firefighters Relief Association, presented an overview of the Fargo Firefighters Relief Association plan. He said the plan is 108 percent funded, has 82 active members, and 63 retired members.

At the request of Chairman Wald, Mr. Crane presented the January 1, 1997, actuarial valuation of the Fargo Firefighters Relief Association plan. A copy of the valuation results is attached as Appendix E. Unlike Bismarck, he said, the Fargo plan has a vesting requirement of 20 years and a minimum retirement age of 55. He noted that a 20-year vesting or cliff vesting requirement is a very antiquated pension plan concept and the Fargo Firefighters Relief Association is considering plan design changes to liberalize this requirement and provide other enhanced pension benefits for its members.

At the request of Chairman Wald, Mr. Rod A. Backman, Director, Office of Management and Budget, addressed the committee. He said he had recently attended a conference on public sector defined benefit pension plans and defined contribution pension plans. He also distributed an information sheet concerning Social Security, a copy of which is attached as Appendix F. He noted that the uncertainty of the Social Security system is leading many employers to convert their defined benefit pension plans to defined contribution pension plans. He said defined contribution plans provide more affordability and immediate vesting in an era when many employees do not work for one employer long enough to vest in any one retirement system and the labor force is more mobile. He noted that one study has shown that 58 percent of California public employees do not vest in the California Public Employees Retirement System. Concerning the North Dakota Public Employees Retirement System, he said, even excluding employees who leave with two years or fewer of service, 46 percent of employees leaving the state cash out and thus forfeit the employer contribution. He said even more than half of employees with over 10 years of service cash out and thus forfeit the employer contribution.

At the request of Chairman Wald, Representative Tom D. Freier addressed the committee. He said he is a registered representative of Sunwest Securities. He discussed defined benefit pension plans and defined contribution pension plans as well as Social Security issues. He distributed a publication from the American Legislative Exchange Council entitled *Pension Liberation - A Proactive Solution for the Nation's Public Pension Systems*. He also distributed information on a public pension privatization summit, a policy perspective published by the Cascade Policy Institute entitled *Should Your State Opt Out of Social Security*, an article entitled *Remodeling Social Security Five Key Concepts*, considerations and perceived criticisms of defined benefit versus defined contribution pension plans, and an outline prepared by Representative Matt Brainerd of Montana concerning establishing a study of changes in the Montana Public Employees Retirement System. Copies of these materials are on file in the Legislative Council office. He said problems with the federal Social Security system are the reason many states are reexamining their state defined benefit pension plans. He noted that many employers in the private sector have moved away from defined benefit pension plans and have instituted defined contribution plans. However, he noted, the majority of public sector employers still have defined benefit pension plans. He said defined benefit pensions are skewed toward older employees while younger employees who would like to change employers forfeit the employer contribution. Also, he said, employees should have the freedom to manage their own pension accounts based upon their own goals and objectives. He said the committee should place itself in the position of a state employee and make decisions upon which plan would be best for state employees. He noted that although a defined contribution plan shifts the investment risk to the individual it also shifts the investment opportunity to the individual. Other reasons, he said, to shift to a defined contribution plan in addition to investment return are that it gives a member personal control and a fair benefit.

In response to a question from Representative Coats, Representative Freier said he is confident that state employees can properly manage their defined contribution accounts and enhance their retirement benefits through active management.

At the request of Chairman Wald, Dr. Tom Robinson, Professor of Mathematics (retired), University of North Dakota, Grand Forks, addressed the committee. He discussed the conversion of teaching employees of the higher education system from the Teachers' Fund for Retirement to TIAA-CREF. A copy of CREF stock account annuity unit values used in his presentation is attached as Appendix G. He also distributed a chart summarizing the 1979-80 college elections including information on teacher contributions and state appropriations when the transfer was made. A copy of this schedule is attached as Appendix H.

At the request of Chairman Wald, committee counsel reviewed a memorandum entitled *Employee Benefits Programs Committee - Committee Recommendations and Payment for Actuarial Services*, a 1995 survey of state and provincial police and Highway Patrol agencies, and the 1977 report of the Legislative Council's interim State and Federal Government Committee. Copies of these items are on file in the Legislative Council office.

PUBLIC EMPLOYEE HEALTH INSURANCE BENEFITS STUDY

At the request of Chairman Wald, Mr. Collins addressed the committee. He presented an outline of a proposed health plan presentation, a copy of which is attached as Appendix I. He said if the committee approved of the overview, he would arrange for representatives of Blue Cross Blue Shield of North Dakota to make a presentation to the committee based on the outline. He said Blue Cross Blue Shield representatives would address each of the items and the presentation would take approximately two hours.

At the request of Chairman Wald, Mr. Weldee Baetsch, Association of Former Public Employees, addressed the committee. He said the association supports the review of defined benefit pension plan and defined contribution pension plan issues.

In response to a question from Representative Wald, Mr. Baetsch said the Association of Former Public Employees would not be averse to studying pension plan issues to see if enhancements could not be made in the North Dakota retirement plans.

At the request of Chairman Wald, Ms. Chris Runge, Executive Director, North Dakota Public Employees Association, addressed the committee. She said the Public Employees Association participated in the Office of Management and Budget and Public Employees Retirement System study but cautioned that the committee should go slow in studying defined contribution pension plan issues.

No further business appearing, Chairman Wald adjourned the meeting at 3:45 p.m.

Jeffrey N. Nelson
Counsel

John D. Olsrud
Director

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