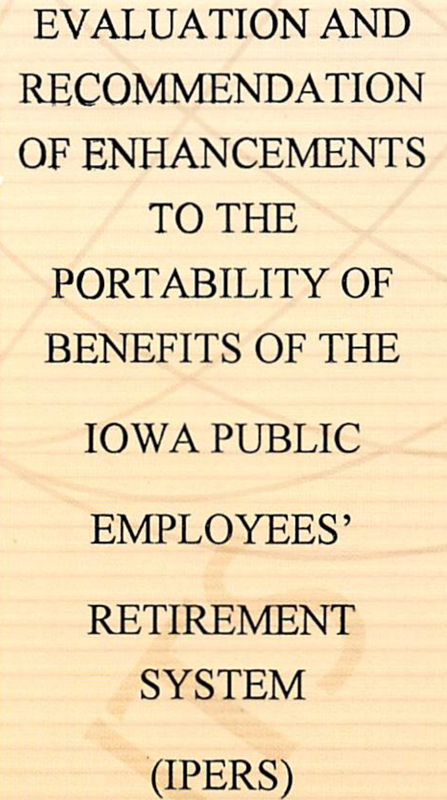

EVALUATION AND RECOMMENDATION OF ENHANCEMENTS TO THE PORTABILITY OF BENEFITS OF THE IOWA PUBLIC EMPLOYEES' RETIREMENT SYSTEM (IPERS)

June 15, 2001

SUBMITTED BY:

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A Mellon Consulting Company

EVALUATION AND RECOMMENDATION

OF ENHANCEMENTS TO THE PORTABILITY

OF BENEFITS OF THE

IOWA PUBLIC EMPLOYEES' RETIREMENT SYSTEM

(IPERS)

FINAL PROJECT REPORT

Submitted by
Buck Consultants, Inc.
June 15, 2001

BUCK
CONSULTANTS

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I. EXECUTIVE SUMMARY

A. OVERVIEW OF SCOPE OF PROJECT

The study has two primary areas of consideration:

First, recommendations for greater portability of benefits into IPERS;

Second, recommendations for greater portability of benefits out of IPERS.

Our recommendations are made with the objective of attracting and retaining employees while, at the same time, maintaining the integrity and financial soundness that characterize IPERS. In understanding the scope of the project, it is important to distinguish this study from our previous study submitted in 1997. The thrust of the 1997 study was to assist IPERS in developing a comprehensive master plan for the IPERS core benefit structure as a guide for action in the 21st century, providing "building block" recommendations to be considered by the General Assembly. As we stated in that Report:

> *By designing a master plan for a full IPERS core benefit structure - showing each of the benefit components that are in need of augmentation and strengthening - it is intended that this Report will be of material assistance to the General Assembly for the remainder of this decade and into the next century.*[1]

Several of these building block enhancements have been added to the IPERS defined benefit plan since 1997. These additions are documented in the IPERS 1999 Report to the Governor and General Assembly.[2] Following our benefit review in 1997, Buck was requested to submit a report on the issues involved in converting the IPERS defined benefit plan into a defined contribution plan.[3]

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[1] See Report and Recommendations on Enhancements to the Core Benefit Structure and Supplemental Plans and Features of the IPERS Defined Benefit Plan, May 21, 1997.
[2] Plan Design, Multi-Year Benefit Enhancements and Contribution Rates for IPERS, November 1999.
[3] Report and Recommendations on the Issues of Converting IPERS' Existing Defined Benefit Plan to a Defined Contribution Plan, August 19, 1997.

With this background in mind, we ask our readers to note that it is not within the confines of the present study to reassess the adequacy of the IPERS defined benefit plan generally, or to address key benefits issues affecting IPERS active and retired members and the public employers who participate in IPERS. Nor is this Report intended to recommend across-the-board "benefit enhancements." For example, the present Report is not intended to address the issue of post-retirement health care for Iowa's public employees. Rather, the Report presents several recommendations to increase portability into and out of IPERS and to attract and retain public employees. In the following pages we have summarized the key recommendations and ranked them in terms of relative importance, including a general assessment of their cost to IPERS, their contribution to portability into and out of IPERS and to attracting and retaining employees.

With respect to the cost of our recommendations, our cost estimates are general in nature. It is understood that the IPERS Actuary will prepare official fiscal notes on proposals before these proposals are taken to the General Assembly in September 2001. In developing recommendations to enhance portability into and out of IPERS and to attract and retain employees, we initially focused on recommendations that would not result in any additional cost to the employer, and would not increase the contribution rate, applicable for regular service members in IPERS, currently fixed by statute at 9.45% of payroll. However, in the course of our study we found it necessary to consider some changes that, by their very nature, would require additional employer contributions. In these instances, we have noted that these costs should be precisely established by the IPERS actuary. At the same time, based on our experience as actuaries, we are able to generally estimate the magnitude of these additional costs, and we have done so, describing them as ranging from minimal to substantial.

The "cost issue" must be emphasized in this Report in order that IPERS, its Constituent Group, the Governor, and the General Assembly can assess the relative financial impact of our recommendations on IPERS as a whole. To the extent that our recommendations result in additional costs, they would negatively affect other IPERS benefits, such as the dividend program for active and retired members. This negative impact could occur because of the fact that at the present time the "normal cost" of the IPERS plan has reached as high as it

can without resulting in an increase in the statutory contribution rate. Therefore, we underscore the following observation:

> ANY BENEFIT ENHANCEMENT REQUIRING AN ADDITIONAL CONTRIBUTION AT THIS TIME WILL RESULT IN AN INCREASE IN THE STATUTORY CONTRIBUTION RATE. TO THE EXTENT THAT COSTS ARE INCREASED BY ADDING BENEFIT ENHANCEMENTS, LESS MONEY WILL BE AVAILABLE IN THE FUTURE TO FUND COLAS FOR RETIREES AND TO PROVIDE SAAM CREDITS TO THE ACCOUNTS OF ACTIVE MEMBERS.

Accordingly, for cost reasons, as well as for policy reasons, we have prioritized our recommendations.

The present Report is comprised of two parts:

- The first part recommends arrangements to facilitate portability into and out of IPERS. In several instances, these arrangements would also help to attract and retain employees.

- The second part addresses the issue of whether the IPERS defined benefit plan should be "converted" into another type of retirement plan, either a hybrid plan or a defined contribution plan.

We make the following observations on the issue of converting IPERS to a defined contribution plan:

- Our research shows employees who remain in employment until they are eligible for early retirement generally are better off under the current IPERS defined benefit plan than under a defined contribution plan.

- Women do not fare as well under a defined contribution plan because of their higher longevity.

- Younger, shorter-term employees who do not stay in the IPERS plan until early retirement, but who separate from service after 5, 10 or 15 years of service with a vested benefit, generally are better off under a defined contribution plan. This is illustrated by our graphs in the Report showing how employees who leave employment early in their working careers tend to do better under defined contribution plans than under defined benefit plans, whereas employees who remain on the job until early or normal retirement age tend to do better under defined benefit plans.

- Shorter service employees who join the retirement system toward mid-career and remain on the job until early retirement age almost always do better under defined benefit plans.

- The adoption of a defined contribution plan as a replacement for the existing defined benefit plan places a burden of responsibility on individuals for their investments both during active worklife and in retirement.

- In assessing these patterns, we believe it is helpful if the reader keeps in mind the primary purpose of a retirement program: to provide adequate retirement income to career employees beginning at normal retirement age. Indeed, the IPERS defined benefit plan generally provides a career employee, one who works for 25 to 30 years and who retires at normal retirement age, with a benefit which, when added to primary Social Security, permits the employee to retire with total retirement income approximately equal to his or her pre-retirement take-home-pay. Viewed from this perspective, the IPERS defined benefit plan provides greater retirement security than a defined contribution plan having the same employer and employer contribution rate.

- Adding a defined contribution plan or a hybrid plan to the IPERS defined benefit plan would result in additional costs associated with setting up the new plan and in ongoing administration. The addition of a defined contribution plan could also result in increased costs to the IPERS defined benefit plan. As we pointed out in our 1997 Report:

> *Even if a defined contribution plan or hybrid plan is adopted, the current IPERS defined benefit plan will continue to operate well into the 21st century, providing benefits to current retirees and active members upon their retirement, providing them with benefits based on service accrued to date and perhaps benefits based on future service. (To the extent benefits would be based on future service, the plan would be "grandfathered".)*

- Depending on the extent of any "grandfathering," the current IPERS defined benefit plan would be continued as an ongoing operating program well into the future, for the next 50 to 75 years, albeit in the form of a "closed" plan. Moreover, in order to insure that a closed IPERS benefit plan remained "fully funded," additional employer (and employee) contributions would be required over these years. In our 1997 Report, we estimated that, depending upon the alternative plan selected, the costs of implementation steps could range from $400,000 to $2 million and could take two or more years to complete. We cautioned that these implementation costs were to be distinguished from the ultimate costs of conversion over time in funding a new plan and in maintaining an existing (frozen) defined benefit plan on a sound actuarial basis for many decades.

Based on our research showing the benefits provided at retirement age by the IPERS defined benefit plan, as well as taking into account the substantial additional costs associated with maintaining that plan and a defined contribution plan side by side, we recommend that IPERS retain its current defined benefit plan as the core retirement program both for current and future members and retirees.

Senate Bill 2411 sets forth the intent of the General Assembly in authorizing the current Study. It states that IPERS is charged with conducting a study to consider various proposals to provide persons covered under IPERS increased portability of pensions earned

prior to coverage under IPERS and of pension earned under IPERS. In particular, the General Assembly asks that the study address proposals for allowing employees to purchase additional service credit based on any public sector or private sector employment, as well as proposals for enhancing the ability of employees to transfer a greater portion of the value of their pensions earned under IPERS to other pension plans upon termination of employment. To these ends, our Report proposes that members be permitted to purchase additional service credit for prior employment as authorized by the Federal Internal Revenue Code. This will enhance portability into IPERS. With respect to portability "out of" IPERS, our report addresses the needs of terminated vested members, permitting them to rollover the full accrued value of their vested benefits into another tax-qualified retirement plan upon reaching early retirement age (age 55). We address the needs of those approaching retirement who want to continue working, but would like to "lock in" their retirement benefits earned to date and would like an incentive to continue work (called a DROP plan). We also address the needs of those in IPERS who have worked 30 or more years of service. Finally, we address the needs of retirees who return to work in the public sector and are also drawing pension benefits.

We have conducted the study keeping in mind the policy goals guiding the consideration of benefit enhancements as set forth in Chapter 97D of the Iowa Code, and developed by IPERS. We have also considered the best practices in other retirement systems.

In applying our software to alternative benefit designs, we have shown the benefits of IPERS members with different service and salaries and at different ages under alternative plans. It should be clear to the reader that there are fundamental differences between a defined benefit plan and a defined contribution plan, not only in providing retirement benefit security, but also in providing different benefit levels to employees depending upon their age and service. Our study shows that the IPERS defined benefit plan generally provides greater benefits and more retirement security to career IPERS members who remain in the System until early retirement age or later.

B. SUMMARY OF RECOMMENDATIONS

1. *Purchase of Service Credit as permitted under Section 415(n) of the Internal Revenue Code*

We recommend that the IPERS members be permitted to purchase credited service for employment in the public or private sector as permitted under the Federal Internal Revenue Code, Section 415(n). The member would be required to pay for the entire cost of the service credit as determined by the IPERS Actuary. Payments would be made by payroll deduction and on a pre-tax basis.

2. *Optional Benefits for Terminated Vested Members*

We recommend that IPERS provide greater portability and flexibility for members who separate with a vested benefit prior to early retirement age by permitting them to rollover the full accrued value of their vested benefits into another tax-qualified retirement plan upon reaching early retirement age (age 55).

3. *Lifting Current Earnings Limitations for Reemployed Retirees*

In order to encourage retired public employees to return to the work in the public sector after retirement, we recommend removing the current earnings limitations in effect for retirees who have not attained age 65.

4. *Increased Benefits for Members with 30 or more Years of Service*

We recommend that the current cap on benefits in IPERS that can be earned by long-service career public employees can be increased from 65% to 75% of Final Average Earnings. This will encourage long-service employees to remain in the work force if they are willing and able to do so for as much as another five years, thereby contributing to the goal of retaining valuable employees in the public sector work force.

5. *Establishment of a Voluntary Supplemental Savings Plan within IPERS*

Data gathered by IPERS show that approximately 20% to 30% of the membership do not have a deferred compensation plan available to them, whether a Section 457 deferred compensation plan or a Section 403(b) tax-deferred annuity plan. For this reason, we recommend that the current Section 457 deferred compensation plan be expanded to include all state and local employees. Alternatively, we recommend that IPERS provide a voluntary supplemental savings plan or plans to be made available to IPERS members who would not otherwise have the opportunity to make employee contributions on a pre-tax basis to such a plan. The precise design of such a plan as well as the investment options to be made available and the administrative features of the plan should be established by IPERS. IPERS has a highly skilled, professional investment staff that could evaluate the most appropriate investment options, whether provided by an external investment company, such as a mutual fund, or established on a customized basis in-house. The addition of an IPERS 457 and/or 403(b) plan would also provide an alternative for those members who would like to have investment options made available to them other than those provided by the plans in which they are currently eligible to participate.

6. *Adoption of a DROP*

A Deferred Retirement Option Plan (DROP) would permit active members of IPERS who are eligible to retire because of age and/or service to elect to "commence" their regular retirement benefit and to have the benefit "deposited" in a special account. During this period, they would continue to work and draw a salary from his/her employer. When a member who participates in a DROP ultimately retires, he or she would begin receiving the regular pension accrued to the date of DROP election as well as a lump sum equal to the amount of the pension benefit (plus interest) on deposit from the time the member elected to participate in the DROP until retirement. We recommend a DROP for IPERS. If properly designed and administered, we believe the DROP would help retain employees who might otherwise elect to retire and could positively contribute to portability out of IPERS. Alternatively, a partial lump sum option could be offered in lieu of a DROP.

7. ***Establishment of a Pension Equity Plan ("PEP") within IPERS for Employees and Officers of the Legislative and Executive Branches of State Government***

Many members of the General Assembly and officers in the Executive Branch of Government have a relatively short tenure of public service. They may be appointed by the Governor or elected by the voters, and they may not serve long enough to earn a vested benefit let alone reach early or normal retirement age. Iowa wants to attract the best people to serve in the Executive Branch and to sit in the General Assembly. These officials and the persons who work for them should be provided with retirement benefits commensurate with their service. For this reason, we propose the creation of a separate plan structure within IPERS, for members of the General Assembly and for appointees in the Executive Branch of government and their respective staffs who do not have civil service protection. IPERS should determine the precise requirements for membership in the plan and the benefit provisions in such a plan. There is ample precedent for separate plans within IPERS. Moreover, Judges have their own plans, as do public safety officers. We believe that a pension equity plan ("PEP") should be considered. The plan is discussed in the body of the Report.

C. Defined Contribution Plan and Hybrid Plan Alternatives

In Part V of the Report, we consider the pros and cons of alternative plans to replace the current IPERS defined benefit plan with a defined contribution plan or a hybrid plan.

Our graphs clearly show that IPERS members who have a career in public service and retire from IPERS at early or normal retirement age are generally better off under the IPERS defined benefit plan than they would be under a defined contribution or hybrid plan.

D. PRIORITIZATION OF RECOMMENDATIONS

Recommendation	Priority Ranking[1]	Cost Estimate[2]	Contribution to Portability	Contribution to Attracting/Retaining Employees	Work Plan/ Timetable	Commentary
1. Purchase of service credit as permitted under Section 415(n) of the Internal Revenue Code	#1	Member to pay full cost (as determined by Actuary) on a pre-tax, payroll deduction basis; will result in additional administrative costs to IPERS; could also result in increase in employer contribution rate over time depending upon plan experience; we have not seen evidence of employer subsidy for service credit purchase	Would contribute to portability into IPERS	Would contribute to attracting and retaining employees, if properly designed; it would be particularly attractive to mid-career hires (ages 35-45)	Determine additional staff/hours/administrative programs needed; 6 to 12 months lead time estimated	There is need for development of a specific program, including eligibility requirements, communications, administration
2. DROP: Recommend to General Assembly that they authorize IPERS to develop DROP and implement it	#1	Could be cost neutral depending upon design; if design incorporates a deposit equal to 100% of the pension otherwise payable would result in additional cost and corresponding increase in employer contribution rate	Would contribute to portability out of IPERS if upon retirement the member rolled DROP account into an IRA or another tax-qualified plan	The purpose of a DROP is to incent eligible employees not to retire for a period of time; therefore, the DROP would retain employees	Substantial work designing and costing of alternative DROPs would be required; a separate unit could be required to communicate and administer DROP; 1 year lead time estimated for implementation 7/1/02	Before a DROP can be adopted various alternative plan designs should be evaluated and costed on an actuarial basis; the review should also focus on the impact a DROP plan would have on meeting personnel and staffing needs

[1] #1 = highest to #10 - lowest.

[2] Cost neutral means no actuarial cost that would increase employer contribution rate (does not include administrative costs). In each case, a fiscal note would be required from the IPERS Actuary to determine if a proposal would result in an increase in the employer contribution rate.

Recommendation	Priority Ranking[1]	Cost Estimate[2]	Contribution to Portability	Contribution to Attracting/Retaining Employees	Work Plan/ Timetable	Commentary
3. Optional lump sum value to employees who terminate with vested benefits on or after date of adoption; this amount is not eligible for immediate distribution, but is held in an IPERS investment fund with individual accounts (to be held until early retirement age or some other age to be determined)	#2	Actuary to determine present value of each individual reserve; will result in additional administrative costs to IPERS in the benefit and investment departments; could also result in an increase in employer contribution rate over time depending upon plan experience	Would contribute to portability if members are permitted to rollover accounts out of IPERS at early retirement age	Would contribute to attracting employees since it is progressive benefit; this would be an attractive feature for younger hires	This program could require the establishment of a defined contribution component unit with IPERS, with individual accounts, periodic statements, etc., as well as a new investment unit to direct the investment of the funds; one year lead time estimated for implementation 7/1/02	Design issues must be addressed such as whether members could self-direct investments and whether members could rollover accounts out of IPERS, e.g., upon reaching early retirement age

Recommendation	Priority Ranking[1]	Cost Estimate[2]	Contribution to Portability	Contribution to Attracting/Retaining Employees	Work Plan/ Timetable	Commentary
4. Increased service fraction for members with 30 to 40 years of service (2% x FAS for years between 30 and 35 and 1% for years between 35 and 40)	#2	This would result in an additional cost to the employer and an increase in the employer contribution rate; to the extent that the program defers retirements, the cost of the new benefit would be somewhat offset by savings due to favorable actuarial experience as retirees draw benefits for fewer years	Would not contribute to portability	Could contribute to retaining employees with 30 or more years of service	Communications to membership required; no additional administrative work required; 3 month lead time	We rank this #3 instead of #1 pending actuarial fiscal note and impact on existing dividend programs (COLAD, FED, SAAM); we also note this benefit would only affect a small number of members and should be considered in light of DROP alternatives
5. Removal of earnings limitations on reemployment of retired public employees in covered employment	#3	Cost neutral; Actuary to determine whether this enhancement would result in an additional cost sufficient to require an increase in the employer contribution rate	Would not contribute to portability	Would not contribute to retaining employees, but could encourage retirees to return to public service	Additional staff time may be needed; 6 months lead time estimated	Less than 2% of all retirees returned to covered employment and of that amount only 32 persons exceeded the $12,000 limits (1999); we agree with Chief Benefits Officer that the limits should be removed

Recommendation	Priority Ranking[1]	Cost Estimate[2]	Contribution to Portability	Contribution to Attracting/Retaining Employees	Work Plan/ Timetable	Commentary
6. Expand the current Section 457 Plan to include all state and local employees or alternatively establish a Section 457 savings plan within IPERS	#3	Cost neutral; Would result in additional administrative costs to IPERS	Would contribute to portability	Would contribute to attracting employees, at all ages	Additional staff time may be needed; 6 months lead time estimated	Would provide an option for all IPERS members to contribute to a supplemental tax-deferred arrangement
7. Establish a PEP for Officers and Employees of the Legislative and Executive branches	#4	This would apply to a small group of employees and so would not result in a large additional cost to the employer or a significant increase in the contribution rate	Would contribute to portability	Would contribute to attracting employees, at all ages	Additional staff time needed; 1 year lead time estimated for implementation	Would fill public personnel need to attract highly qualified public servants

II. IPERS IN PERSPECTIVE

A. Restatement and commentary on IPERS goals as set forth in Code Section 97D

In this Report, we are recommending benefit enhancements which are consistent with the guiding principles adopted by IPERS, namely, to foster benefit equity and fiscal soundness and, in doing so, to strengthen the IPERS defined benefit plan so that it will materially contribute to attracting and retaining public employees. In doing so, we have been mindful of the framework for consideration of benefit enhancements as set forth in Iowa Code Chapter 97D:

1. **The general assembly declares that legislative proposals for changes in specific public retirement systems should be considered within the context of all public retirement systems within the state, with emphasis on equity and equality among the systems. The following list of guiding goals shall apply to the consideration of proposed changes:**

   a. **Select those benefit enhancement options, which most successfully deliver the greatest good to the greatest number of employees.**

   b. **Choose those options, which best correct existing inequities between and among the various retirement groups in the state.**

   c. **Determine those options, which most ably serve the twin objectives of attracting and retaining quality employees.**

   d. **Avoid enacting further incentives toward earlier retirement with full benefits.**

   e. **Avoid further splintering of benefits by disproportionate enhancements of benefits for one group beyond those available to another.**

B. IPERS GOALS AS RESTATED AND AUGMENTED BY IPERS

IPERS submits to the Governor and General Assembly periodic reports with respect to plan design, benefit enhancements, and contribution rates. The November, 1999 Report contains a review of legislative enhancements enacted between 1987 and 1998, and in doing so shows the evolution of IPERS from "...a very uncompetitive position twelve years ago to the upper tier today when compared to other statewide public employee retirement systems around the country."[1]

The 1999 Report highlights significant improvements for active members, members nearing retirement, and members in retirement. For active members, the Chief Benefits Officer notes that the General Assembly enacted legislation "...providing greater flexibility for service credit portability into IPERS by allowing buying of service earned elsewhere as a public employee and buy-back for previously refunded IPERS' service."[2] In the current Study, we also recommend expanded opportunities for the purchase of service credit.

The 1999 Report notes that active members have been afforded "...greater flexibility for service credit portability out of IPERS by granting terminating vested members a portion of their employer contributions."[3] The current Study also addresses the need for greater flexibility for portability for terminated vested members.

In the Report to the Pension Subcommittee of the Senate and the House State Government Committees, December, 2000, the Chief Benefits Officer again addressed the General Assembly on current plan design changes in IPERS since 1998, including a provision for the purchase of service credit for public school teaching in Canada and service in the U.S. Peace Corps.

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[1] See To the Governor and General Assembly: A Report Regarding, and Recommendations For, Plan Design, Multi-Year Benefit Enhancements and Contribution Rates for The Iowa Public Employees' Retirement System, submitted by Greg Cusack, Chief Benefits Officer, IPERS, November 1999, pp. 16 ff.

[2] Ibid., p. 16.

[3] Ibid.

In doing so, he noted that IPERS adopted the following guiding principles for use in assessing benefit enhancements:

> As stewards of a public fund, we must balance our obligation to provide a generous retirement system...with the need to be sensitive to public perceptions of the cost/benefit ratio of benefits received by IPERS' members.
>
> Insofar as it is possible, those members who receive the value of benefit enhancements should pay their proportionate share.
>
> Inter-generational equity must be preserved and protected: our benefit program must be designed with all of our members in mind. A well-designed pension system must also heed the special needs which the few sometimes have of the many: the disabled, those who have taken time from the work force to raise children (truly an accrued value to the larger society), or retirees struggling near the poverty line.
>
> Neither retirees nor actives should receive disproportionate value.
>
> We must weigh benefit proposals according to not only how they would affect our total membership today, but also as to how well they will serve us tomorrow.4

It is against this background of goals and initiatives, that IPERS announced the current Study to the General Assembly. In doing so, the Chief Benefits Officer added:

> Knowing that you continue to have an interest in examining as well ways in which these plans, plus a review of hybrid vehicles, can be used to improve IPERS' over-all design, a scrutiny of these plans, plus a review of hybrid vehicles incorporating features of defined contribution plans, is also part of our charge to this consultant.[5]

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[4] To the Pension Subcommittee of the Senate and House State Government Committees: An Update on Current Plan Design of, including Current Research Efforts for, the Iowa Public Employees' Retirement System, submitted by Greg Cusack, Chief Benefits Officer, IPERS, December 2000, pp. 6-7.

[5] Ibid., p. 8.

C. CONSIDERATION OF DEMOGRAPHIC PROFILE OF THE IPERS MEMBERSHIP AND SIGNIFICANT DEMOGRAPHIC TRENDS

In November 2000, the Chief Benefits Officer prepared a report analyzing the membership demographics of IPERS. The observations and analysis in this Report provide a critical backdrop to the present Study. Among other findings relevant to our recommendations on increasing portability into and out of IPERS and further strengthening the IPERS defined benefit plan are the following:

- Retired lives are increasing at a faster rate than active lives to the extent that the IPERS retiree population will double in 12 years;
- Less than 2% of all retirees are currently reemployed;
- The number of inactive vested members continues to be a significant portion of the IPERS membership (10%); the number of inactive nonvested members is approximately 20% of the total membership;
- In the aggregate, women have fewer years of credited service at retirement than men;
- 68% of the IPERS workforce is age 40 or over;
- 50% of those eligible to retire between ages 55 and 65 are teachers.[6]

All of the above demographic findings point to the need for an IPERS defined benefit plan that "attracts," "retains" and "welcomes home" retired public employees, as well as separated vested members. We believe that the current IPERS plan does this and is competitive with the best public employee retirement systems across the country. However, we also believe that the IPERS program can be strengthened, along the lines discussed in this Report, both to attract and retain employees.

The demographic data suggests the following observations relevant to the present Study:

1. *Growing number of retirees:*

   The number of IPERS retirees will double over the next 12 to 15 years, growing from 65,000 today to 130,000. Retired lives are increasing at a faster rate than active lives. 68% of the work force is age 40 or over. 50% of those now eligible to retire between ages 55 and 65 are teachers. How can Iowa tap this badly needed workforce? How can it retain these valued public servants? Would the addition of a "DROP" encourage those otherwise planning to retire to defer their retirement for several years? Would employees with 30 to 35 years of service postpone retirement if they were credited with 2% a year, instead of 1%?

2. *Small percentage of reemployed retirees:*

   The percentage of IPERS retirees who are reemployed in their public employment is less than 2%. How can IPERS be restructured to make it more attractive for retirees who are willing and able to retain to the public sector work force? Should IPERS continue to penalize reemployed retirees for returning to work by limiting the wages they can earn while receiving a pension?

3. *Women have fewer years of credited service at retirement:*

   Females comprise 58% of the IPERS membership. At the same time, women have fewer years of credited service than the men in IPERS. The Chief Benefits Officer suggests that this is due to the fact that "women historically have borne the greater burden of child rearing, including taking time off from their careers." This has resulted in women having fewer years of credited service at the time of retirement than men. How can we attract women to become public employees and how can we retain them to stay on the job until retirement age? Would the ability to purchase year of credited service for private sector employment encourage them to stay in public employment?

[6] A Review of Membership Demographics for the Iowa Public Employees' Retirement System, Fiscal Year Ending June 30, 2000, prepared by Greg Cusack, Chief Benefits Officer, IPERS.

III. APPROACHES TO ATTRACT AND RETAIN EMPLOYEES: ENHANCEMENTS TO THE CURRENT IPERS PLAN

A. PURCHASE OF SERVICE CREDIT AS PERMITTED UNDER SECTION 415(N) OF THE INTERNAL REVENUE CODE

Senate Bill 2411 charges IPERS to consider, as part of this study, proposals to allow members to purchase additional service credit based on prior public or private sector employment that is not purchasable under the current statute. As shown in Appendix 1, many statewide public employee retirement systems, including IPERS, permit members in certain situations to purchase service credit for a limited number of years of employment. Section 97B.73 of the Iowa Code permits certain members to purchase prior service credit under IPERS. However, in some instances these provisions are more restrictive than those permitted by federal law (see Appendix 2). If IPERS permitted its members to purchase up to five years of "nonqualified" service credit for any employment (public or private sector) and unlimited "qualified" service credit, this would enhance portability and would also attract and retain employees. Individuals considering a public sector career, whether in teaching or state or municipal government service, would favorably view joining a retirement system that would offer them the ability to purchase up to five years of service credit for their prior "nonqualified" employment and even more for their prior "qualified" employment. Current members who are not able to purchase prior service credited under the current statute would be encouraged to remain in public service if they knew their pension could include this additional service credit.

The average IPERS retiree currently retires with 21 years of service credit. Depending on the percentage of members who utilize the existing credited service purchase provision, providing five years of additional service credit could raise the average years of service for IPERS to as much as 26 years (and even more if "qualified" service credit, which is not subject to the five year limitation, is taken into account). The resulting benefit, equal to 52% of final average salary, when added to Primary Social Security, could provide total retirement income equal to about 82% of final average salary for a typical retiree at age 65.

Under Section 415(n) of the Internal Revenue Code, the purchase of permissive, "non-qualified" service credit by a participant under a defined benefit governmental plan that can be "picked up" by the employer (on a pre-tax basis) is limited to five years, while the purchase of permissive "qualified" service credit is not subject to this five year limitation. What we are referring to as "qualified" service includes both service with a governmental entity as well as service with certain educational institutions which provide elementary or secondary education, provided that the recognition of such service would not cause a participant to receive a retirement benefit for the same service under more than one plan. Service with a governmental entity as well as service with these educational institutions that would cause a participant to receive a retirement benefit under more than one plan is known as "nonqualified service." It should be noted that "nonqualified" service credit may only be purchased by a participant who has at least five years of participation in the plan. The limitation is not applicable to the purchase of "qualified" service credit. We propose that if IPERS adopts this concept, it recommend to the General Assembly that the service credit be authorized to include any employment, both "qualified" and "nonqualified," permitted by Internal Revenue Service rules and regulations. Appendix 2 contains an analysis of IRS requirements. As explained above, we recommend that the service credit be purchasable by IPERS members on a pre-tax basis through periodic payroll deductions.

In the course of the study, we reviewed the portability provisions between IPERS, the Municipal Fire and Police Retirement System of Iowa (MFPRSI) and the Police Officers' Retirement and Accident and Disability System (POR) (see Appendix 7). The Iowa Code does not provide for portability from IPERS to these systems. The Code does provide for portability between MFPRSI and POR. We recommend that IPERS poll its membership to identify any barriers that prevent them from obtaining credited service earned in other Iowa retirement systems. With our recommendation for increased service credit purchases, as permitted by IRC 415(n), we believe that IPERS members should have virtually full portability for service earned elsewhere in Iowa.

B. OPTIONAL BENEFITS FOR TERMINATED VESTED MEMBERS

In Buck's Report on Enhancements to the Core Benefit Structure, May 21, 1997, we recommended that a terminated vested member be permitted to "roll over" the actuarial present value of his or her vested benefit into another tax-qualified retirement plan or IRA. In doing so, we stated:

> *If a member made the rollover election prior to termination, a member could request the IPERS actuary to calculate the value of the actuarial reserve established to fund future benefit payments (without the indexation feature). If the member did not make this election, his or her terminated vested benefit would be indexed ...and would be payable at normal retirement age without reduction or at early retirement age with reductions as provided in the IPERS plan.*[7]

As we stated in 1997, by providing a vested benefit with a portability option, IPERS would contribute to making public service in Iowa more attractive to young and mid-career employees.[8]

In the present Report we recommend that a terminated vested member be permitted to elect to have the full accrued present value of his or her vested benefit transferred within IPERS to an individual account, to be credited with interest at a fixed or variable rate, payable in a lump sum at early retirement age. At that time the member could elect to "rollover" the account to another tax-qualified plan or IRA. IPERS and its Investment Unit would need to further develop the plan design and the asset allocation for such a fund, including the question of whether or not a member would have any discretion as to the particular investments within his or her account.

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[7] Report and Recommendations on Enhancements to The Core Benefit Structure and Supplemental Plans and Features of the IPERS Defined Benefit Plan, May 21, 1997, Buck Consultants, pg. 45.

[8] We also made this recommendation in our 1997 Report.

C. Removal of Current Earnings Limitations for Reemployed Retirees

In our 1995 Report to IPERS, we recommended that the statutory restrictions on earnings be removed for retired members of IPERS who have not attained age 65 and who have returned to public employment. [9]

Under current law, IPERS retirees who have not attained age 65 are permitted to be reemployed in covered public sector employment and continue to receive their IPERS retirement allowance until their wages exceed $14,000 in any calendar year. At that point, their pensions are reduced $.50 for each $1.00 of their wages above the $14,000 limitation. Reemployed retirees who have attained age 65 are not subject to earnings limitations or restrictions in reemployment under current Iowa law.

We believe that removing earnings limitations, or at least making the current limitations less restrictive, would materially contribute to IPERS' twin objectives of attracting and retaining public employees. IPERS reports that in 1999 only 2% of all retirees (4,985) were reemployed in public service. Retirees who might otherwise be unwilling to return to work in the public sector, might be more willing to do so if their pensions were not cutback because of such employment.

In IPERS' 1999 Report to the Governor and General Assembly, the Chief Benefits Officer made the following observations about these restrictions:

> *As there is a 'lag' in the reporting of wages (inevitable in a system that tracks contributions by a quarter of a year of service basis rather than daily or monthly), we frequently end up "billing" members for the amount of overpayment after the fact.*

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[9] See Report on the Benefit Enhancement Study for Iowa Public Employee' Retirement System, Buck Consultants, September 11, 1995, pp.74-75. In this Report we recommended a two-tiered approach: that retirees under age 65 whose earnings exceeded the statutory amount ($7440 at that time) be permitted to apply to the Department of Personnel to receive permission to be reemployed for a two-year period in covered service, provided that the retiree's prospective employer certified that the job could not be readily otherwise filed and that the job required the particular skills and experience of the retired IPERS member. If the Department of Personnel so certified, the retiree could be reemployed in such covered service and continue to receive his or her full retirement allowance.

Administering this provision consumes a lot of IPERS' time, relative to the small population involved. So far, this calendar year only, 32 persons out of 4,985 have exceeded $12,000.[10]

We agree with the Chief Benefits Officer that encouraging the reemployment of skilled former employees, including public school teachers, administrators, and other specialists, will likely become an increasingly attractive option for IPERS' covered employers in the near future. For this reason, we join with him in recommending again that reemployment be made, in his words "...as attractive as possible."

In his November, 1999 Report to the Governor and General Assembly, the Chief Benefits Officer recommended that the ceiling be completely lifted or at least raised from $12,000 to $25,000.[11] We support these recommendations as an alternative to completely removing all restrictions. We second the Chief Benefits Officers' cautionary note that eliminating the ceiling could be negatively construed. For this reason, if some ceiling is maintained, we suggest that the Department of Personnel be empowered to approve reemployment without a diminution of a retiree's pension in cases where the retiree's earnings are expected to exceed $25,000 per year. In such cases, if the Department of Personnel certifies that such reemployment is in the best interests of the state, municipality, or school district, the retiree's earnings would not be subject to any limitations.

[10] Report to the Governor and General Assembly, November 1999, op.cit., p. 59.
[11] Ibid., p. 59.

D. Increased Benefits for Members with 30 or More Years of Service

In reviewing the IPERS benefit structure, we have noted that the IPERS Plan limits benefits to 65% of Final Average Earnings after 35 years of service. The benefit formula is 2% for each year of service up to 30 years, but in order not to exceed the 65% cap, benefits for each year of service in excess of 30, but not greater than 35 years, are credited at the rate of 1% for each year of such service. Employees with 35 or more years of service do not earn any additional benefits under the IPERS, except that any increases in their salary during such years are included in the computation of their "Final Average Earnings," thereby resulting in a somewhat larger benefit.

IPERS has, heretofore, adopted the 65% cap because, when a benefit of this level is added to Primary Social Security benefits, a total benefit ranging from approximately 85% to 90% of final average earnings is provided to the average employee.[12] We suggest that the cap be raised from 65% to 75%. This would allow an increase in the service fraction used to credit service between 30 and 35 years from 1% to 2%, with the remaining 5 years (service between 35 and 40 years) to be credited at the rate of 1% of final average salary. When added to Primary Social Security under this formula, the benefits of the very long-term career retirees with 35 to 40 years of service would generally range from 95% (for the higher paid) to 100% (for the average wage earner) of final average salary. However, if one takes into account the cost of providing a joint-and-survivor option, the total benefit for most retirees would not exceed 100%. In evaluating this proposal, one must also take into account that the IPERS retirement benefit is financed both by employee as well as the employer and that career employees with service over 30 years should be treated in an equitable manner.

[12] See To the Governor and General Assembly: A Report Regarding, and Recommendation for, Plan Design, Multi-Year Benefit Enhancements and Contribution Rates for the Iowa Public Employees' Retirement System, November 1999, Greg Cusack, Chief Benefits Officer, IPERS, p.15. Mr. Cusack notes: "...some years ago IPERS proposed that we target as a benefit design goal that combined benefits from IPERS and Social Security would range from at least 70% but not to exceed 100% of a member's pre-retirement income. For career employees with 30 years of service, IPERS' payout of 60%...plus Social Security provide them with a retirement income of 70% to 95% of their pre-retirement income." Mr. Cusack also noted: that because of the formula used by Social Security, the total replacement ratio will be lower for the higher paid employees.

The net effect of this change would be to encourage Iowa's public employees who have reached 30 years of service and who are able and willing to remain on the job. Under the current scheme it may be difficult to retain employees who see no reason to stay in public employment once they have hit the 65% cap and, accordingly, are no longer accruing service credit under the IPERS defined benefit plan. We believe this benefit enhancement would result in a relatively small additional employer cost, and we would like to make this recommendation contingent on a report from the IPERS Actuary estimating the additional cost of the benefit. Appendix 2 contains a list of 100 comparable public employee retirement systems. 34 systems have a cap on benefits. Only three systems provide a lower service fraction for later years of service. IPERS appears to be the only system that provides no service credit for years after 35.

E. ESTABLISHMENT OF A VOLUNTARY SAVINGS PLAN WITHIN IPERS

As we noted in our 1997 Report, IPERS members who are State employees are currently eligible to participate in a non-qualified deferred compensation program under Section 457 of the Internal Revenue Code (Section 457 Plan). Many school districts also provide savings plans for their employees under Section 403(b) of the Internal Revenue Code. About 20% to 30% of non-statewide employees are not eligible to participate in any tax-deferred plan. We recommend that the current Section 457 Deferred Compensation Plan be expanded to include all state and local employees. Alternatively, we recommend that IPERS establish a voluntary 457 Plan to provide an umbrella of retirement protection for public employees not otherwise covered by such a plan. The recent changes in the federal pension law, signed into law on June 7, 2001, will make these plans even more attractive to IPERS members (see Appendix 8).

F. Establishment of a Pension Equity Plan (PEP) for Officers and Employees of the Legislative and Executive Branches of Government

This section addresses the application of an alternative plan design for present and future members of IPERS who are or will become officers and employees of the Executive and Legislative branches of the government of Iowa. Since many of the officers and employees in the Executive and Legislative branches have a relatively short tenure, the IPERS Plan does not provide meaningful benefits for these employees.

One alternative would be to provide a defined contribution plan. This would satisfy the issues of portability and meaningful benefits for employees with short tenure. This would require a separate plan structure with individual accounts and separate plan administration.

We believe a better solution would be a separate hybrid plan formula within the IPERS Plan. This could be either a cash balance plan formula or pension equity plan (PEP) formula. Each would satisfy the issues of portability and meaningful benefits for short service employees, while still maintaining the advantages of a defined benefit plan. Either hybrid formula would offer lump sums. Although the formulas under cash balance and PEP plans are significantly different, they can be designed to provide approximately the same level of benefits. Of the two hybrid alternatives, we believe the PEP formula is more suitable for several reasons. They are as follows:

- ***Ease of understanding and appreciation:***
  The PEP Plan formula defines the benefit as a lump sum payable as a percentage of average pay at termination or retirement and is therefore easier for the individual to estimate the amount of benefit he or she would receive. As an example, assume a PEP Plan with 10% credits for each year of service. This would provide a lump sum of 50% of final average pay at termination after five years. This is easier to understand and estimate then the amount of benefit under a cash balance plan with the accumulation of allocations and interest credits each year.

- ***Ease of administration:***

  Benefit calculations and administration are easier under PEP plans for the same reason that they are easier for an individual to understand and approximate the amount of benefits. Cash balance plans require significant record keeping needed to prepare benefit calculations.

- ***PEP Plans favor "Fast Track Employees":***

  As shown and discussed in the previous section, PEP plans provide better benefits for employees experiencing pay increases that are above average. This is because PEP plans are based on final average pay, in contrast to cash balance plans that are based on career pay. Therefore, the PEP Plan may be more suitable for this group of employees.

- ***Fixed Interest Credit Under Cash Balance Plan:***

  The cash balance plan closely resembles a defined contribution plan; however, the fixed interest credit under a cash balance plan does not allow the employee to benefit from above average investment performance. This can lead to dissatisfaction under a cash balance plan, particularly by more knowledgeable and higher level employees.

The graphs that follow show a PEP plan in comparison to the present IPERS Plan. We are illustrating two alternative PEP Plans: a flat 15% credit and alternatively a 10% credit.

There are several other issues to consider:

- Amount of credit per year of service, i.e., some percentage between 10% and 15% depending on cost considerations as weighed against attractiveness of benefit;
- The introduction of a PEP alternative will lead to higher costs;
- Additional administration;
- IPERS may need to consider offering the larger of the PEP formula or the current IPERS formula, particularly for individuals entering at later ages and who stay until age 55 or older.

IV. ADOPTION OF A DEFERRED RETIREMENT OPTION PLAN (DROP)

This section will present an analysis of the impact of a Deferred Retirement Option Plan (DROP) on the IPERS. DROPs have been offered for a number of years. In essence, under DROPs eligible active members elect to freeze their regular retirement benefit and to have that benefit "deposited" in a special account while they continue to work and draw a salary from a participating employer. DROPs were first popular under police and fire pension plans. More recently, general employee retirement systems have adopted DROPs, including plans in several states.

In the following pages we will provide some general design issues regarding DROPs, including advantages and disadvantages for both members and employers. Suggested DROP alternatives will be presented followed by some illustrations of the impact participation has on members. Finally, we will present a discussion of a partial lump sum option at retirement, a simpler alternative to a DROP.

A. General Operation of a DROP

The general operation of a DROP is outlined below:

Upon becoming eligible for normal retirement, a retirement system member satisfying DROP eligibility conditions is permitted to either:

- Retire; or
- Continue working and retire at a future date with a pension based on credited service and final average salary (FAS) at date of termination of employment; or
- Elect to participate in the DROP and retire at a future date with a pension based on FAS and service at date of election to participate in the DROP.

Participation in the DROP is generally subject to the following conditions:

- Satisfaction of eligibility conditions such as normal retirement eligibility.
- The amount of the member's pension is determined as of the date of DROP participation, based on credited service, FAS and retirement plan benefit provisions on that date.
- A DROP account is established in the name of the member. The account is credited with a percentage of the frozen monthly pension payments during the member's continued period of employment. The percentage may be 100% or some lower percentage selected so that DROP can be offered by the plan sponsor on a cost-neutral basis.
- The DROP account established for a given member is credited with payments for up to a maximum number of years after the date of election to participate in the DROP. Payments beyond the maximum DROP period, but prior to termination of employment, are forfeited.
- During the period of employment following election of DROP participation, the member does not contribute to the retirement system.
- Interest is generally credited to the member's DROP account at a fixed rate.

Upon termination of employment the frozen monthly pension begins and the member can typically elect one of the following alternatives for the DROP account:

- Lump sum distribution of the account balance, paying the appropriate taxes.
- Roll the account balance into an eligible plan such as an IRA.
- Convert the account balance to a monthly benefit to enhance the regular pension payments.
- Leave the account balance in the retirement system and draw down a portion either monthly or less frequently, depending on personal financial needs and DROP distribution rules.

B. Other Issues for Consideration

While the basic structure appears straightforward, there are many variations in plan design and a number of issues to consider before such a plan is adopted.

1. DROP Entry

- Eligibility - most DROPs require that participants be eligible for normal retirement. In addition, some limit the time period, after first becoming eligible, during which a participant can elect the DROP, e.g., 12 months. The extent to which DROP eligibility is limited will depend in part upon the retention goals the DROP is trying to meet.

- Benefit - the benefit is calculated at the beginning of DROP participation as though the member had retired on that date. If the DROP is to be cost neutral, it may be necessary to credit less than the full benefit to the DROP account. In addition, the treatment of accrued sick and vacation time will have to be decided.

- Period - a maximum DROP participation period will have to be selected. Three to five years are fairly common.

2. DROP Participation

- Interest Credits - the amount of interest, if any, to be credited to DROP participants' accounts will have to be determined. Cost neutrality may require a rate below the actuarially assumed rate. There are quite a number of choices, and the final decision will need to be made in conjunction with the percentage of full benefit to be credited to DROP accounts.

- Member/Employer Contributions - if the purpose of the DROP is to retain valuable employees, member contributions should be discontinued during DROP participation. Since the DROP is a personal decision, the same argument does not apply to employer contributions. That decision will likely come down to the issue of cost neutrality.

3. DROP Termination

- Death or Disability - if the participant becomes disabled or dies during the DROP period, DROP participation will cease. Although the account balance could be forfeited upon death, the savings are probably not large enough to justify the negative employee reaction this would generate. It is recommended that the account balance be paid to the DROP beneficiary, and that benefit payments continue in accordance with the optional form of benefit elected at the beginning of the DROP.

- Electing Out - It is recommended that the election be irrevocable. Allowing changes after DROP participation begins will lead to adverse selection. In addition, one of the purposes of the DROP is better planning for employee replacement.

- Distribution Options - as noted above, the available options include lump sum, rollover, annuity conversion, and leaving the balance in the System for additional interest credit. We recommend the lump sum and rollover options. We do not recommend annuity conversion or leaving the balance in IPERS because these two options would result in additional administrative expense not justified by the benefits.

- Continued Employment - some DROPs permit participants to continue to work at the end of the DROP period, while others require an actual separation from service. Any decision in this regard should be coupled with a review of the current return to work provisions, and both should be designed to address the retention problems the state is experiencing.

In addition to the design issues noted above, administrative considerations will have to be addressed. These include:

- Communications with members
- Development of administrative forms
- Maintenance of DROP accounts
- Lump sum payment processing

C. Advantages and Disadvantages

1. What are the benefits to members from a DROP?

- A DROP provides a means of providing for a partial lump sum distribution of a portion of a member's interest in a retirement fund.

- During the period of employment following election of DROP participation, the earnings of a member may be flat or even decrease (due to fewer hours worked, for example). As a result, final average salary for members nearing retirement may not increase significantly although they continue to work. In such situations, DROP participation may enhance the member's overall benefit value.

2. What are the disadvantages to members from a DROP?

In essence, an eligible member who elects to participate in a DROP is agreeing to forego future benefit accruals while continuing to work. In doing so, these are some of the issues the member needs to consider:

- By electing to forego future benefit accruals, the member may also be forfeiting future cost-of-living adjustments if the DROP lump sum is elected, thereby heartening the effects of inflation on post-retirement income.

- The member's earnings may actually increase substantially during the DROP period. For the member who has elected DROP, such pay increases will not be reflected in the actual benefit at retirement.

- If the DROP percentage is less than 100% to preserve cost neutrality (see discussion above), members may feel that they are being penalized for participating.

- By electing the DROP lump sum, the member's future pension payments will represent a lower percent of final average salary (i.e., they will produce a lower income replacement ratio).

3. Are there any benefits to plan sponsors?

- A well-designed program may provide a means to offer additional benefit choices at little or no cost.
- A DROP may induce valuable long service employees to delay their retirement.
- By having a maximum participation period, employers may be better able to plan for the replacement of long service employees.

4. What about negatives for plan sponsors?

- Plan administration is significantly more complex and costly. This is because the DROP requires election forms, maintenance of individual accounts, and other administrative tasks at the end of the DROP period.
- If 100% of the accrued benefit is deposited in the DROP, there will be additional costs. If an amount, such as 75% of the pension is the DROP payment, the benefit will be closer to cost neutral.
- It is difficult to design a truly cost-neutral plan that is popular. This is partly true because members have the opportunity to select against the system. That is, the members that expect to come out ahead financially are most likely to participate.
- If employer contributions are not collected on behalf of DROP participants, the employer rate applied to non-DROP salaries may have to increase in order to provide the same contribution income to the plan.

D. DROP DESIGN FOR IPERS

This section will outline a possible DROP design that can be added to the current IPERS structure. It must be kept in mind that the final DROP (assuming one is implemented) should be designed to meet clearly defined goals, such as cost neutrality, employee retention, partial lump sums for retiring members, succession planning, etc. Otherwise, the DROP may have unintended consequences.

Recommend DROP Provisions for IPERS

Eligibility: An IPERS member may become a DROP participant upon attaining normal retirement (age 55 with at least rule of 88 or age 62 with 20 years of service).

Election of DROP: A member satisfying DROP eligibility conditions is permitted to either:

1. Retire, or
2. Continue working and retire at a future date with a pension based on credited service and final average salary (FAS) at date of termination of employment, or
3. Elect to participate in the DROP and retire at a date up to three or alternatively five years in the future with a pension based on service and FAS at the date of election to participate in the DROP.

DROP Credits: The account of a participating member is credited with:

1. the pension payments the member would have been paid if the member had retired on the date of the DROP election, and
2. Interest on the outstanding balance at 5% per annum.

DROP Period: Three years (alternatively five years is also shown). If a DROP participant does not terminate employment within the three-year (five-year) time period, the DROP account balance is forfeited.[13]

[13] We are mindful that IPERS wants to attract and retain employees. We would discuss the DROP period with IPERS in light of these objectives and consider alternative DROP periods, such as five years.

DROP Payout:	Upon actual termination of employment, the frozen monthly pension begins, and the member can elect one of the following alternatives for the DROP account balance: 1. Receive a lump sum distribution, or 2. Roll the account balance into an eligible plan such as an IRA.
Contributions:	Member contributions cease during DROP participation. Employer contributions on behalf of the member continue until actual termination.

E. DROP ILLUSTRATIONS

The Exhibits on the following pages provide illustrations of the impact of a DROP under several design alternatives.

Exhibit 1 shows an illustration of a three-year DROP for an employee age 58 with 30 years of service. In this case, the employee is eligible for normal retirement under the Rule of 88, so the only additional benefits earned are on account of pay increases and an additional 1% accrual rate for each year of service over 30 years. We have assumed 4% pay increases. (If pay increases are less then 4%, the DROP is even more attractive and conversely if they are higher it is less attractive)

If the employee elected to participate in the DROP, the accrued pension of $18,000 (60% of $30,000) would be deposited into an account that is credited with 5% interest (a higher interest crediting rate would be more beneficial under the DROP but would increase costs). At the end of the three-year DROP period, the employee would have accumulated $58,164. The equivalent life annuity of the lump sum is $5,611 per annum. The comparison is shown in the box labeled "Benefit at Age 61." If the participant did not elect the DROP, at 61 he would have been entitled to an annual pension of $21,231. By electing the DROP, the participant would be eligible for a life annuity of $18,000 starting at age 61, plus a lump sum of $58,164, or a life annuity of $23,611 ($18,000 plus the $5,611 DROP annuity). Electing the DROP increases the annual pension by over 11%.

Exhibit 2 shows the same individual under a three-year DROP program, except that in this example only 75% of the accrued pension is deposited into the DROP account. In this scenario, the employee would accumulate $43,623 in the DROP account, or a supplemental life annuity of $4,208. Therefore, the comparison would be between an annual pension of $21,231 without DROP and $22,208 ($18,000 plus the $4,208 DROP annuity). This is a 5% increase in the annual pension.

Exhibits 3 and 4 are for the same individual under a Five-Year Drop Plan with a deposit of 100% and alternatively 75% of the accrued pension at the beginning of the DROP program. The comparison is shown between the benefits payable at 63 with or without the DROP election. The percentage increase in pension is 19% under the 100% deposit alternative, and 8.5% under the 75% deposit alternative.

The percentage increase in pension is dependent on the age and service characteristics of the employee electing the DROP. We have also prepared calculations for several other sample employees. We are showing one at age 62 with 20 years of service, another at age 60 with 35 years of service, and a protection occupation member age 55 with 22 years of service. The attached Exhibit 5 labeled "Summary of Examples" shows how each of these employees would fare under a three and five-year DROP program assuming 100% of the accrued pension is deposited in a DROP account. Exhibit 6 shows the same individuals assuming 75% of the accrued pension deposited into a DROP account.

As you can see, the employee age 60 with 35 years of service would benefit most from the DROP election because this employee would only earn additional benefits related to an increase in Final Average Salary. The employee age 58 and the 55 year old protection member also benefit well by the DROP election because the lower accrual rate of benefits for employees after 30 years under the IPERS Plan (22 years for members of the protection group). The 60-year-old with 20 years of service benefits the least under the DROP because by participating in the DROP he is forgoing additional accruals under the IPERS Plan at the rate of 2% for each year of service.

There are many design issues that need to be explored in designing a DROP. If cost neutrality were a goal, then depositing less then 100% of the accrued pension would be necessary. Another significant issue to consider is the maximum length of the DROP program. A short period, for example, three years may not be that attractive to the members, but would prevent some employees from deferring retirement for too long a period. These and other design issues, such as the interest-crediting rate, need to be given further examination after assessing cost constraints as well as personnel objectives.

Exhibit 1
Three Year DROP Plan
100% of Accrued Benefit Deposited into DROP Account

Assumptions			
Service at DROP	30	Annual Pay Inc.	4%
Age at DROP	58	DROP Interest Credit	5%
Final Average Salary	$ 30,000	DROP Participation	3

			Development of DROP Account					Accrued
Age (BOY)	Service (BOY)	FAS	Balance (BOY)	Additions	Interest Credit	Balance (EOY)	DROP Annuity	Pension No DROP
58	30	$ 30,000	$ -	$ 18,000	$ 450	$ 18,450		$ 18,000
59	31	31,200	18,450	18,000	1,373	37,823		19,032
60	32	32,400	37,823	18,000	2,341	58,164		20,088
61	33	33,700	58,164	-	-	-	5,611	21,231

	Benefit at Age 61	
	Life Annuity	Lump Sum
Without DROP	$ 21,231	n/a
With DROP		
- no Lump sum	$ 23,611	n/a
- Lump sum	$ 18,000	$ 58,164

Exhibit 2
Three Year DROP Plan
75% of Accrued Benefit Deposited into DROP Account

Assumptions			
Service at DROP	30	Annual Pay Inc.	4%
Age at DROP	58	DROP Interest Credit	5%
Final Average Salary	$ 30,000	DROP Participation	3

Age (BOY)	Service (BOY)	FAS	Development of DROP Account: Balance (BOY)	Additions	Interest Credit	Balance (EOY)	DROP Annuity	Accrued Pension No DROP
58	30	$ 30,000	$ -	$ 13,500	$ 338	$ 13,838		$ 18,000
59	31	31,200	13,838	13,500	1,029	28,367		19,032
60	32	32,400	28,367	13,500	1,756	43,623		20,088
61	33	33,700	43,623	-	-	-	4,208	21,231

	Benefit at Age 61: Life Annuity	Lump Sum
Without DROP	$ 21,231	n/a
With DROP		
- no Lump sum	$ 22,208	n/a
- Lump sum	$ 18,000	$ 43,623

Exhibit 3
Five Year DROP Plan
100% of Accrued Benefit Deposited into DROP Account

Assumptions			
Service at DROP	30	Annual Pay Inc.	4%
Age at DROP	58	DROP Interest Credit	5%
Final Average Salary	$ 30,000	DROP Participation	5

Age (BOY)	Service (BOY)	FAS	Development of DROP Account: Balance (BOY)	Additions	Interest Credit	Balance (EOY)	DROP Annuity	Accrued Pension No DROP
58	30	$ 30,000	$ -	$ 18,000	$ 450	$ 18,450		$ 18,000
59	31	31,200	18,450	18,000	1,373	37,823		19,032
60	32	32,400	37,823	18,000	2,341	58,164		20,088
61	33	33,700	58,164	18,000	3,358	79,522		21,231
62	34	35,000	79,522	18,000	4,426	101,948		22,400
63	35	36,400	101,948				10,209	23,660

	Benefit at Age 63: Life Annuity	Lump Sum
Without DROP	$ 23,660	n/a
With DROP		
- no Lump sum	$ 28,209	n/a
- Lump sum	$ 18,000	$ 101,948

Exhibit 4

Five Year DROP Plan

75% of Accrued Benefit Deposited into DROP Account

Assumptions			
Service at DROP	30	Annual Pay Inc.	4%
Age at DROP	58	DROP Interest Credit	5%
Final Average Salary	$ 30,000	DROP Participation	5

Age (BOY)	Service (BOY)	FAS	Development of DROP Account					Accrued Pension No DROP
			Balance (BOY)	Additions	Interest Credit	Balance (EOY)	DROP Annuity	
58	30	$ 30,000	$ -	$ 13,500	$ 338	$ 13,838		$ 18,000
59	31	31,200	13,838	13,500	1,029	28,367		19,032
60	32	32,400	28,367	13,500	1,756	43,623		20,088
61	33	33,700	43,623	13,500	2,519	59,642		21,231
62	34	35,000	59,642	13,500	3,320	76,462		22,400
63	35	36,400	76,462				7,657	23,660

	Benefit at Age 63	
	Life Annuity	Lump Sum
Without DROP	$ 23,660	n/a
With DROP		
- no Lump sum	$ 25,657	n/a
- Lump sum	$ 18,000	$ 76,462

Exhibit 5
Summary of DROP Examples
100% of Accrued Benefit Deposit into DROP Account

Age/Svc at DROP:			Benefits after Three Year DROP Period			Benefits after Five Year DROP Period		
Election	after 3yrs	after 5yrs	w/o DROP	w/ DROP	% Inc	w/o DROP	w/ DROP	% Inc
58/30	61/33	63/35	$ 21,231	$ 23,611	11.2%	$ 23,660	$ 28,209	19.2%
62/20	65/23	67/25	$ 15,502	$ 16,049	3.5%	$ 18,200	$ 19,433	6.8%
60/35	63/38	65/40	$ 21,905	$ 25,810	17.8%	$ 25,480	$ 31,032	21.8%
55/22 *	58/25	60/27	$ 21,231	$ 23,346	10.0%	$ 22,932	$ 27,669	20.7%

* Protection occupation member

Exhibit 6
Summary of DROP Examples
75% of Accrued Benefit Deposit into DROP Account

Age/Svc at DROP:			Benefits after Three Year DROP Period			Benefits after Five Year DROP Period		
Election	after 3yrs	after 5yrs	w/o DROP	w/ DROP	% Inc	w/o DROP	w/ DROP	% Inc
58/30	61/33	63/35	$ 21,231	$ 22,208	4.6%	$ 23,660	$ 25,657	8.4%
62/20	65/23	67/25	$ 15,502	$ 15,036	-3.0%	$ 18,200	$ 17,575	-3.4%
60/35	63/38	65/40	$ 21,905	$ 24,233	10.6%	$ 25,480	$ 28,149	10.5%
55/22 *	58/25	60/27	$ 21,231	$ 22,010	3.7%	$ 22,932	$ 25,251	10.1%

* Protection occupation member

F. PARTIAL LUMP SUM OPTION

If the driving force behind a DROP is to provide an opportunity for members to receive a portion of their benefit value at retirement in a lump sum, the addition of a partial lump sum option to the current list of optional benefit forms should be considered. When compared to a DROP, it is easier to administer, less restrictive on members, and more easily constructed so as to be cost neutral to the employers.

This option simply permits retiring members to elect to receive a portion of their benefits in a lump sum. Typically, the amount that is eligible for lump sum payments are the member's accumulated contributions with interest, but other amounts can be permitted. The amount paid out in a lump sum is converted to an actuarially equivalent monthly annuity, and the maximum retirement allowance is then reduced by that amount.

As an example, recall the illustrations shown in Exhibit 1. The individual in those examples would receive a lifetime annuity of $21,231 without DROP participation. If a partial lump sum option were available, that member might elect to receive a lump sum of $58,164, which would reduce his/her annuity by $5,611 to $15,620.

This approach is easier to administer because it eliminates the need for creating, tracking and converting DROP account balances. It is less restrictive on members because no choices need to be made until individuals are ready for retirement.

Finally, it is a more closely cost neutral approach because the conversion factors are on an actuarial equivalent basis. There will still likely be some anti-selection as those with perceived short life expectancies will more likely choose the lump sum option, but this risk is no greater than exists with the current optional benefit forms offered.

If the DROP is being used as a tool to keep people employed, the partial lump sum option can be restricted to those retiring with a certain service history, say 30 years. While this will not entice those with much shorter service to continue working, it will capture those employees with the most experience. The partial lump sum option can provide some of the benefits of a DROP with much less complexity.

V. APPROACHES TO ATTRACT AND RETAIN EMPLOYEES: ADOPTION OF A NEW PLAN DESIGN FOR IPERS

A. OVERVIEW OF ALTERNATIVE PLAN ANALYSIS

In the pages that follow, we will be discussing the pros and cons of converting the IPERS defined benefit plan into a defined contribution plan or a hybrid (defined benefit plan). Using our Designer Software, we will illustrate the benefits provided by three alternative plans, a defined contribution plan, a cash balance plan and a pension equity plan, comparing benefits payable to typical employees (at different hire, ages, and salaries). Although our program does not include employer cost calculations with respect to alternative plans, we will comment on any additional employer costs associated with the adoption of a new plan design for IPERS.

Based on our detailed analysis that follows, we have concluded (as we did in our 1997 Report to IPERS on the same subject) that instead of converting to a new contribution plan or adopting a hybrid plan, IPERS should continue to strengthen its defined benefit plan along the lines recommended in our May, 1997 Report to IPERS and as recommended in this Report.

B. COVERAGE OPTIONS: CURRENT MEMBERS AND/OR NEW MEMBERS

In proposing and enacting alternative retirement plans in the public sector, in most instances the threshold question facing policy-makers is "to whom should the new changes apply?"

There are several possible responses.

- If the changes are intended to apply to current members, should the changes apply only to future service or to past service?

- Are the changes intended to apply both to current members, perhaps on a future service basis only, and to new members as they are hired (sometimes referred to as "new borns")?

- Are the changes intended to apply to "new borns," thereby creating a "tiered" system of benefits under which employees are covered by different tiers of benefits, depending upon their date of hire?

In public retirement systems such as those of New York City and State, newly hired employees covered by a new tier of benefits are often provided with less generous benefits than employees covered by the earlier tiers. The question of coverage, in these instances, is governed not only by considerations of equity among employees, but also by legal considerations. In New York for example, public employee pension benefits accrued to date are protected by state constitutions. About a dozen states have constitutions prohibiting diminishment or impairment of pension benefits.

Normally, when an employer adopts a new pension plan, one of several things may occur with respect to coverage, among them:

- The accrued benefits of current members are "frozen;" current members are transitioned into the new plan with respect to their future service; new members are enrolled in the new plan from the inception of their careers;

- Current members are permitted to remain in the old plan, continue to accrue service credit and retire; the old plan is "closed" to new entrants from the inception of the new plan;

- The new plan covers only those hired on or after a certain date;

- Current members are transitioned into the new plan for all service, but their benefits under the old plan are "grandfathered" so that they are eligible at retirement to receive the greater of the old or new plan benefits.

As noted above in the public sector, either because of state constitutional law, case law, or statutory law, benefits are often protected from diminishment or impairment. Lesser benefits can only be provided on the basis of future service and for new hires. However, in most instances, benefits of current members would be protected from any diminution or impairment resulting from the adoption of a new pension plan.

Protection of pension benefits, once accrued is not exclusive to the public sector. Under the Employees' Retirement Income Security Act (ERISA) current members are protected against cutbacks based on service credit accrued to date.

In considering various alternative plan designs for IPERS, whether a defined contribution plan or a hybrid plan, the issue of coverage must be addressed. As we did in our 1997 Report to IPERS, we note again that should IPERS adopt a new pension plan, the current IPERS defined benefit plan would, nevertheless, be continued for the foreseeable future, albeit as a "closed plan." We would anticipate that current members would continue to accrue retirement benefits under the IPERS defined benefit plan until retirement-- 10, 20 or 30 or more years from now-- and that a new plan, for example, a hybrid cash balance plan, would apply to new members and perhaps to current members, only if they voluntarily elected coverage and their benefits accrued to date were guaranteed.

C. DEFINED CONTRIBUTION PLANS

We have been requested to model an alternative defined contribution plan to replace IPERS' defined benefit plan. In response, we have modeled an alternative defined contribution plan equal to 9.45% of pay for each year and compared it to the IPERS' defined benefit plan (represents the statutory rate of 9.45%, inclusive of an employee contribution rate of 3.7%).

We are assuming the employee contribution is 3.7% towards the total contribution of 9.45%. We are assuming a 7.5% investment return for the defined contribution plans. In the graphs that follow this section, we have illustrated the different effects of the plans. Three line graphs are shown for employees hired at ages 25, 35, and 45. We are using pay at hire of $25,000. The graphs show the percentage of final year's salary replaced by each of the three plans. The pay level does not have an impact on the comparisons between the Plans. We are assuming pay increases of 4% per annum. Two bar graphs are shown which illustrate the impact of certain variables – salary increases and investment returns.

Graph 1: Employee hired at age 25

The first graph shows the example of an age 25 hire. The red line shows the current IPERS Plan. The orange line shows the IPERS Plan if the 65% Final Average Salary cap is increased to 75%. The line "spikes" at the ages the individual becomes eligible for early and normal retirement benefits. The 9.45% DC Plan is depicted by the green line. The DC Plan shows a "smooth" accrual pattern with higher benefits for terminations prior to early retirement age then under the IPERS Plan. The IPERS Plan provides larger benefits at ages 55 through 60.

Graph 2: Employee hired at age 35

The second graph shows an age 35 hire with the IPERS Plan providing larger benefits at ages 54 and older. The mid career hire covered under a DC Plan has a shorter time frame over which to build a significant account through the accumulation of contributions and earnings. The only possible way in which the mid or late career hire can achieve parity when compared to the IPERS Plan at retirement ages is through achieving a significantly higher investment return than 7.5%. This can only be realized by incurring significant risk and is discussed further below.

Graph 3: Employee hired at age 45

The third graph shows an age 45 hire with the IPERS Plan. The IPERS Plan provides a significantly greater benefit at ages 50 and older.

Graph 4: Impact of Salary Increases

The fourth graph is a bar graph showing the sensitivity of the salary increase and the effect on the comparison of IPERS to the DC Plans. This shows a comparison for a 35-year-old hire retiring at age 62, at alternative salary increase rates. In all cases, the IPERS Plan provides the same replacement of income, regardless of the pay increases experienced during an employee's career. The DC Plan, however, provides a lower replacement of income for the "fast track employee" and a higher replacement for the "slow track employee." This is because the benefit under the IPERS Plan is based on the final three years of salary in contrast to the DC Plans that are based on career salaries.

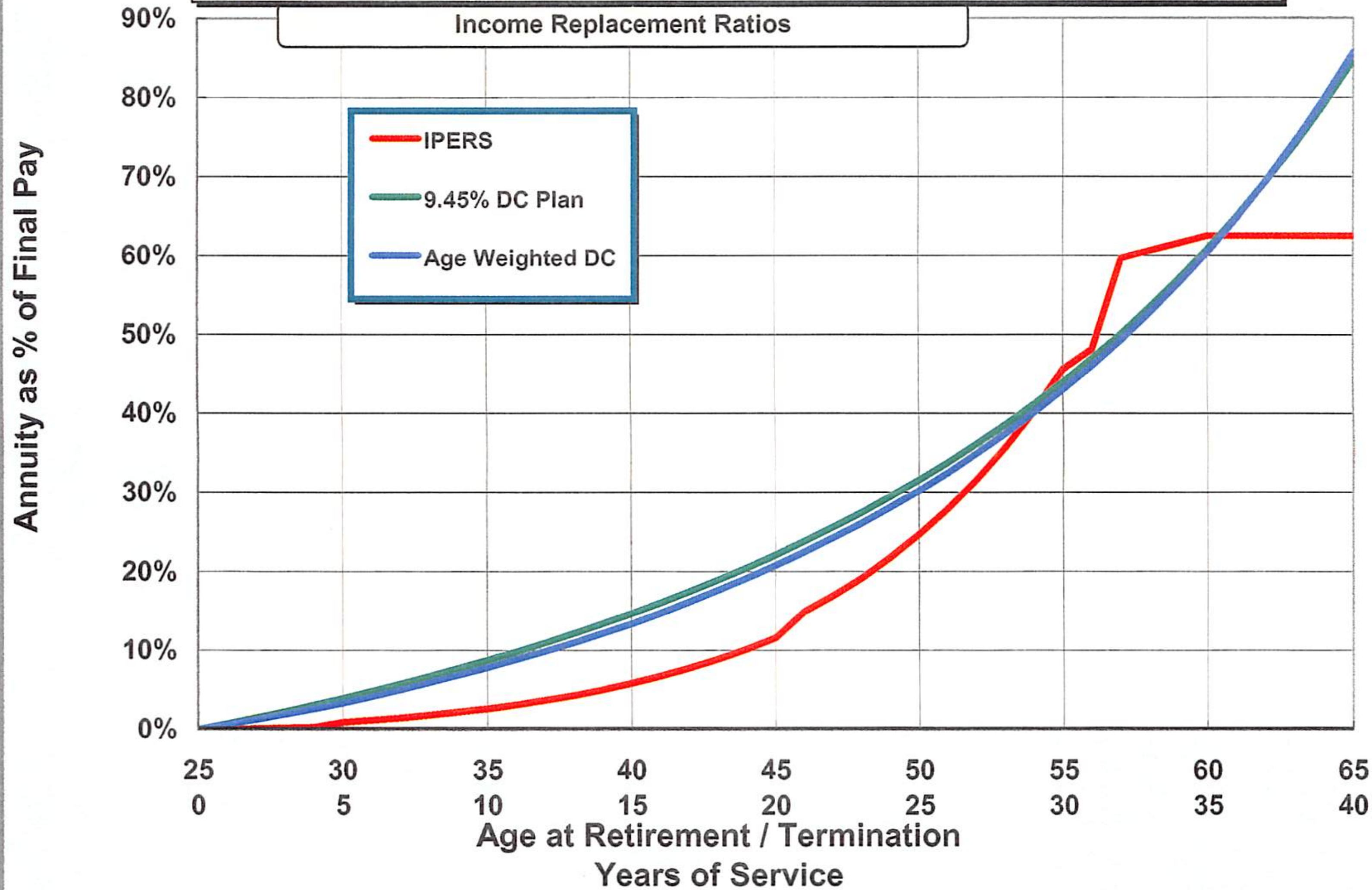
Graph 5: Impact of Investment Returns

The fifth graph is another bar graph which shows the impact of alternative investment returns for the same individual hired at age 35 and retiring at age 62. As is the case in the previous graph, the IPERS Plan is independent of the investment return achieved. However, the investment return has a dramatic impact on the benefits under the DC Plan alternatives. This highlights the risk/reward issue with regard to DC plans.

The 9.45% DC Plan alternative has been designed to be cost neutral since it is currently at the same level as the combined employer and employee contribution requirements as the present IPERS Plan.

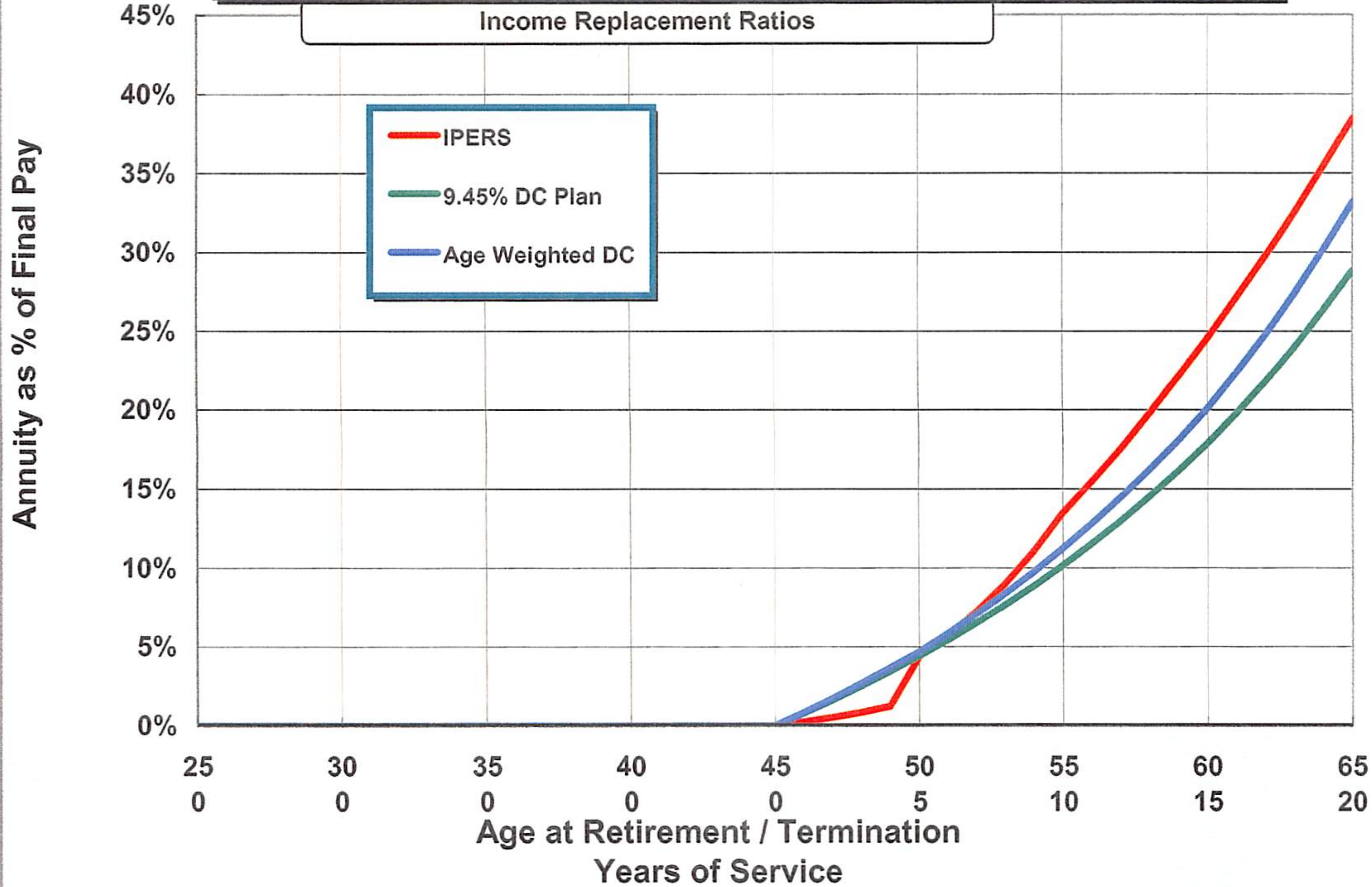
There is one additional point we would like to make with regard to the IPERS Plan. In all comparisons, we have not mentioned the COLAs feature of the IPERS Plan. Although there is no commitment to provide COLAs to future retirees, IPERS has from time to time provided these adjustments and has established a fund to provide these for existing retirees. This has not been reflected in the graphs.

The additional value of a COLA is significant. To illustrate, assume that a 2% COLA is given each year. An employee retiring at age 55 who receives a 2% COLA each year would receive total benefits over his lifetime, which is nearly 24% higher than a pension without COLA. The corresponding figure for an employee retiring at age 65 is 19%. Another way of viewing the value of the COLA is an employee covered under a defined contribution plan and retiring at age 55 would need to accumulate a balance which is 24% higher in order to provide a 2% COLA. In practice, retirees do not receive a 2% COLA each year; however, the actual amount they receive may be somewhat greater or less than 2% per year.

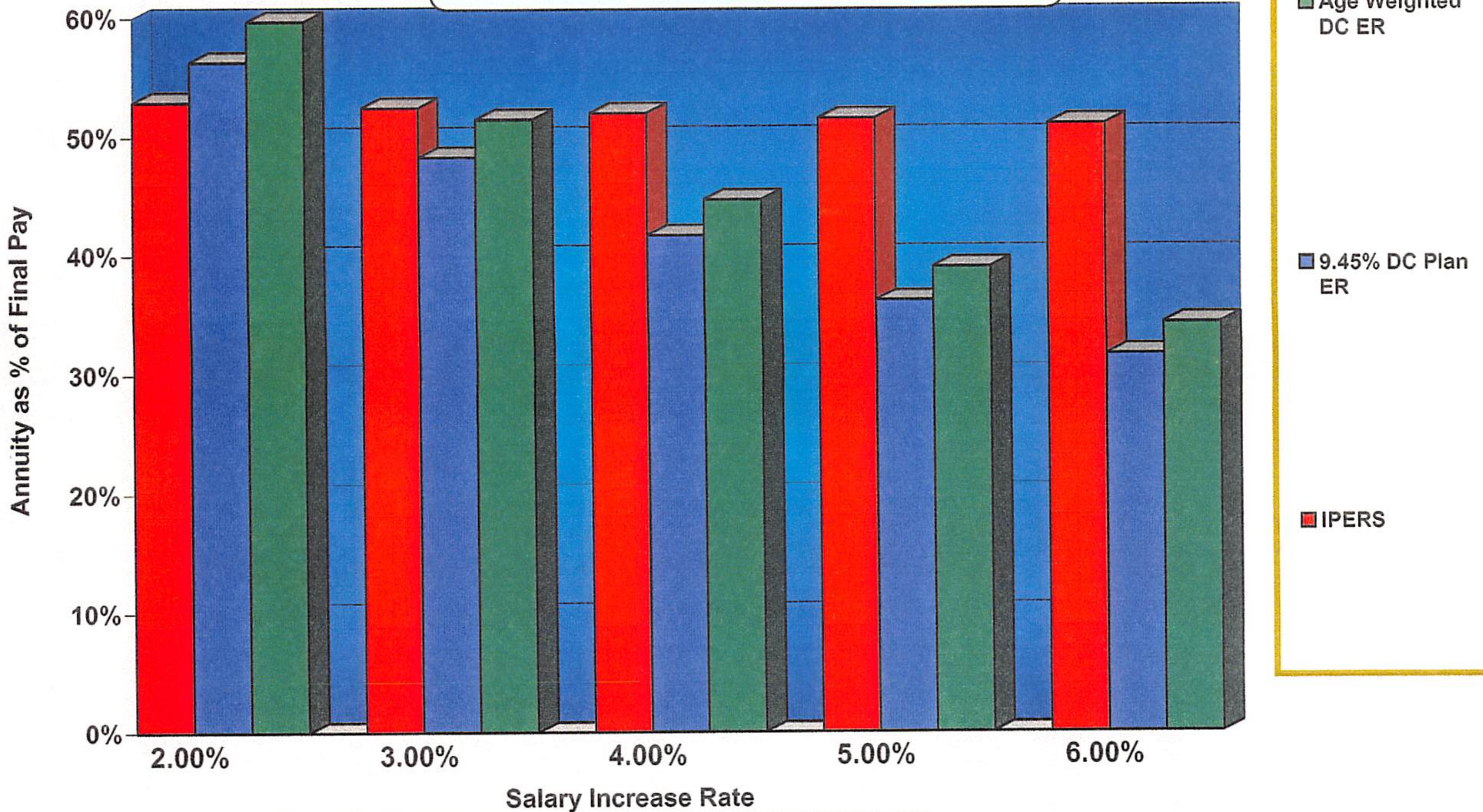


Age 25 Hire

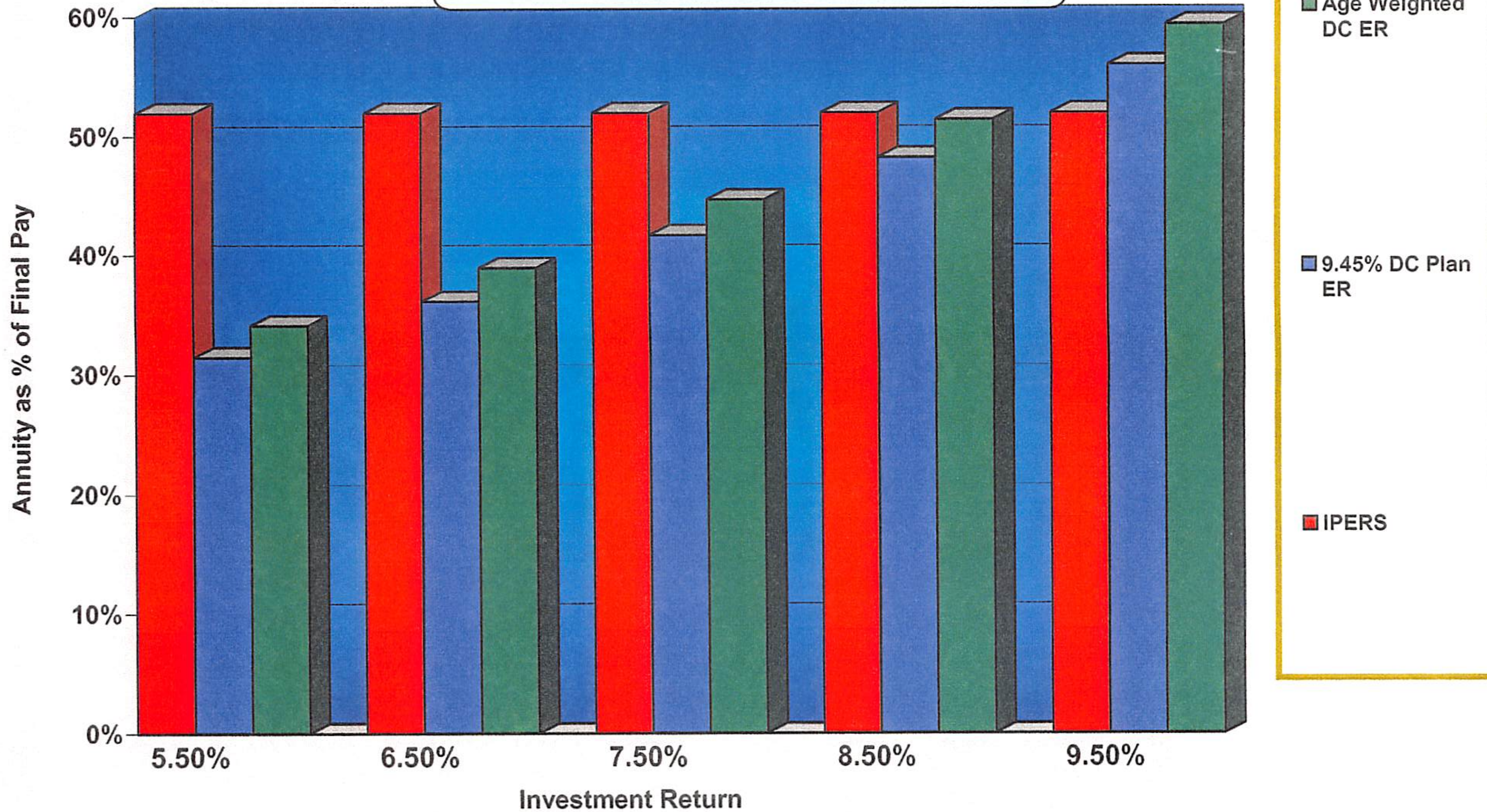
Age 35 Hire



Age 45 Hire



Age 62 Retirement - Alternative Salary Growth



Age 62 Retirement - Alternative Investment Returns

D. Cash Balance Plan

In our 1997 Report to IPERS, we discussed the pros and cons of IPERS adopting a cash balance plan. Since that time, cash balance plans have continued to attract attention, both in the private and public sectors. However, few, if any, have been adopted in the public sector, and certainly not by large statewide retirement systems such as IPERS. As explained below, there are many reasons for this. As requested, we have developed a cash balance plan design and have compared it to the benefits provided by the current IPERS defined benefit plan.

In our 1997 Report to IPERS, we discussed the general features of a cash balance plan.[14]

As we stated in our 1997 Report, during the past several years, some employers, almost exclusively in the corporate sector, have adopted new, innovative pension plans designed to be more attractive to employees than their existing defined benefit plans while reducing future benefit accruals and the cost of these accruals. These hybrid plans can also be designed to attract and retain young, mobile, employees. They often benefit shorter service employees. As we stated in our 1997 Report:

> Traditional defined benefit pension plans, like IPERS, that reward long-term employment, frequently are not attractive to younger employees. The value of benefits under these plans, in some instances, may be unappreciated by employees whose benefits will not materialize for 20 years or more. Responding to these issues, some employers, particularly in the corporate sector, are using hybrid pension plans...[15]

A cash balance pension plan is a hybrid defined benefit plan that looks more like a defined contribution plan. The most distinguishing feature of the cash balance pension plan is its use of a hypothetical account for each participant. Generally, the employer credits a certain amount to each account and also credits each account with interest earned. Although the employee's account looks like an account in a defined contribution plan, the employees are sheltered from investment losses.

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[14] Report and Recommendations on The Issues of Converting IPERS' Existing Defined Benefit Plan to a Defined Contribution Plan, submitted by Buck Consultants, Inc., August 19, 1997, pp. 21-25.

[15] ibid., p. 21.

The amount an employer contributes to a cash balance pension plan is actuarially determined the same as for a traditional DB plan. Based on certain assumptions regarding mortality, interest, turnover, and similar factors, an actuary determines how much the employer must contribute in order to provide sufficient funds to cover the benefits required by the plan.

Cash balance plans appeal to employees because they see their accounts growing and can easily understand the lump sum value shown. One advantage of the cash balance pension plan is that investment risks are borne by the employer. The employer is exclusively responsible for investment decisions; employees do not direct the investments of their individual accounts. A discussion of key features follows.

a. *Account Balance*

As the name indicates, a cash balance pension plan features an "account balance" for each participant. However, a cash balance pension plan should not be confused with a typical defined contribution plan in which actual individual accounts are maintained. Under a cash balance plan, there only are "hypothetical accounts," which exist as a communications device.

The funds are not segregated into individual accounts, but instead, as in a traditional defined benefit plan, all monies are available to provide benefits to all participants. However, participants in a cash balance plan are kept informed – usually on a quarterly basis – of the ever-increasing lump sum value of their accrued benefit. This is a dramatic means of making participants aware of the value of their pension benefits.

b. *Accrual rates*

A participant's cash balance typically is equal to an amount based on annual allocations, e.g., 5% of the year's compensation which also is credited with interest each year at a rate specified in the plan. Many plans used an interest rate tied to a published index, e.g., prime rate, one-year T-bill rate, or 30-year treasury rate.

The ultimate benefit is determined based on the total annual allocations plus the total interest credited to the participant. The allocation rates might be level over an employee's career or they might vary by age and/or length of service.

A higher accrual rate for longer service employees would help to compensate for the fact that a cash balance plan with a single rate is less favorable in terms of replacement ratios for longer service employees than for employees with less service.

c. *Funding*

Because a cash balance plan is a qualified defined benefit plan, it is subject to certain funding requirements. As with a traditional defined benefit pension plan, contributions must be actuarially determined taking into account expected fund earnings and forfeitures. Any of the approved actuarial funding methods may be used.

d. *Nondiscrimination Testing*

A cash balance plan must satisfy the IRS nondiscrimination requirements. Governmental plans are currently exempt from IRC Section 401(a)(4) testing. It is unclear at this time how or if these rules will be applied in the future. Legislation has been introduced in Congress to exempt governmental plans from these complex rules on a permanent basis.

A 9.45% cash balance plan was modeled and shown in comparison to the IPERS' defined benefit plan. The fixed rate of interest we assume for the cash balance plan is 6%.

In the cash balance plan we are again assuming the employee contribution is 3.7% towards the total allocation of 9.45%. Three line graphs are shown following this section for employees hired at ages 25, 35, and 45. We are using pay at hire of $25,000. The graphs show the percentage of final year's salary replaced by each of the three plans. A fourth graph illustrates the effects of varying salary increases and compares them to the IPERS Plan.

Graph 1: Employee hired at age 25

The first graph shows the example of an employee hired at age 25. The red line again depicts the IPERS Plan and the orange line depicts the increase in the cap from 65% to 75% of Final Average Salary. The blue line depicts the 9.45% cash balance plan. Similar to the DC plan, the cash balance plan shows a "smooth" accrual pattern with higher benefits for terminations prior to early retirement age than under the IPERS Plan. The IPERS Plan provides larger benefits at ages 52 through 64 and equal benefits at age 65.

Graph 2: Employee hired at age 35

The second graph shows an age 35 hire, with the IPERS Plan providing larger benefits at ages 52 and older. The only possible way in which the mid or late career hire can achieve parity when compared to the IPERS Plan is through providing significantly higher allocations to the cash balance plan, or if the Plan were to grant a higher interest credit.

Graph 3: Employee hired at age 45

The third graph shows an age 45 hire with the IPERS Plan. The IPERS Plan provides a significantly greater benefit at ages 50 and older.

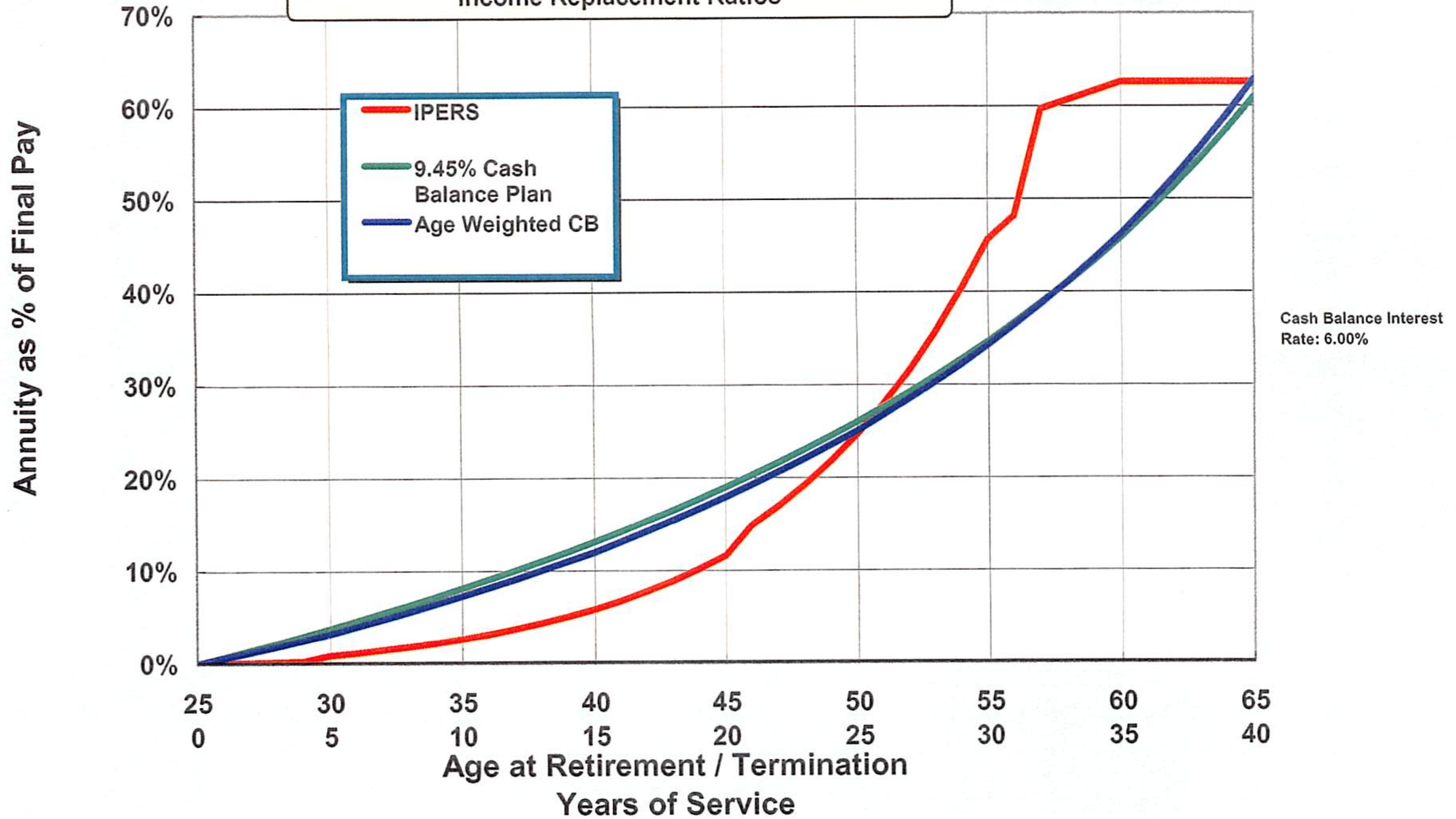
Graph 4: Impact of Salary Increases

The fourth graph is a bar graph showing the sensitivity of the salary increase and the effect on the comparison of IPERS to the cash balance plans. This shows a comparison for a 35-year-old hire retiring at age 62, at alternative salary increase rates. In all cases, the IPERS Plan provides the same replacement of income, regardless of the pay increases experienced during an employee's career. The cash balance plan, however, provides a lower replacement of income for the "fast track employee" and a higher replacement for the "slow track employee." This is because the benefit under the IPERS Plan is based on the final three years of salary, in contrast to the cash balance plans in which the benefit is based on career salaries.

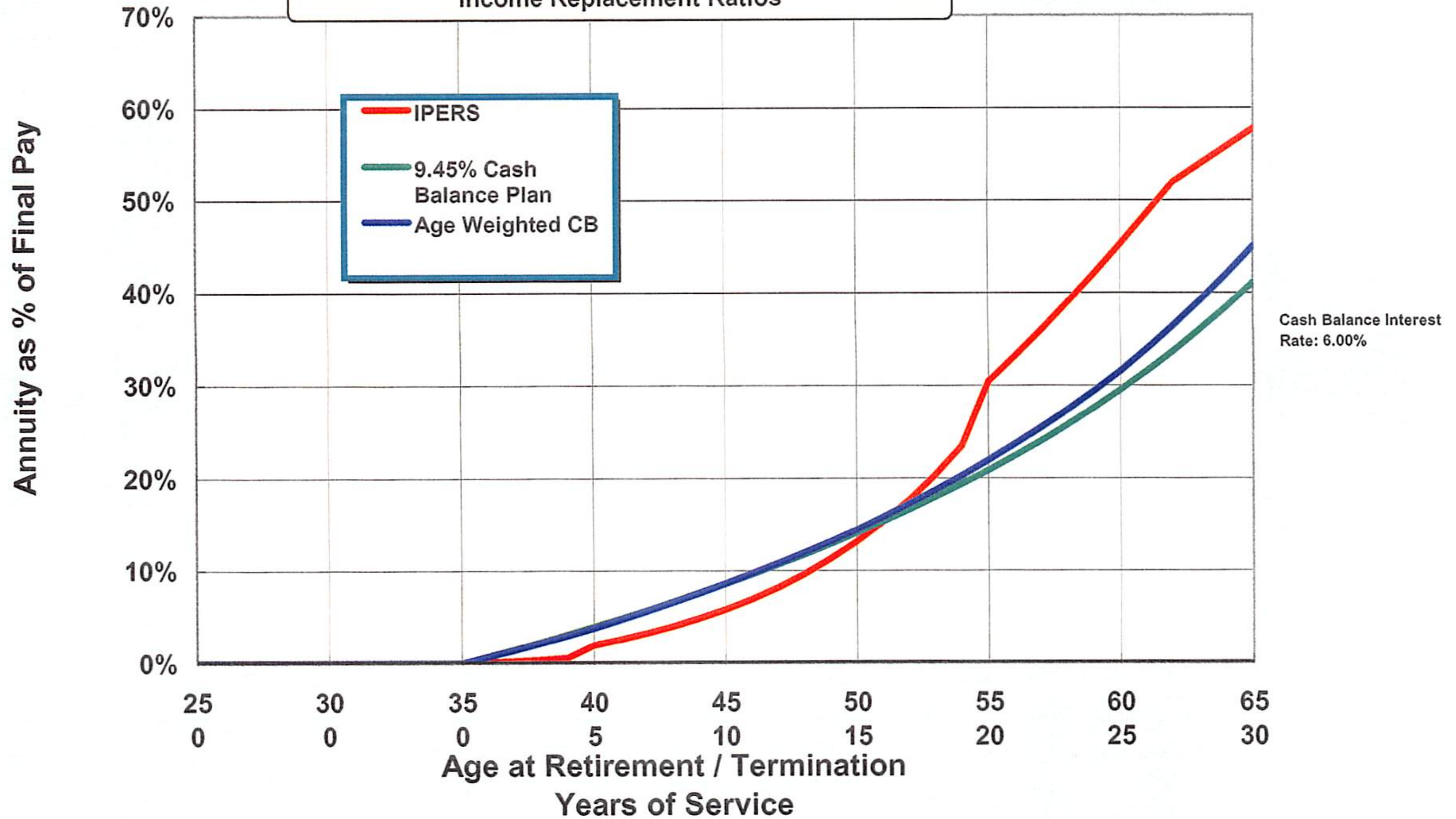
As regards to the comparisons in the previous section on DC plans, we have not taken into account the COLAs feature of the IPERS Plan. This is difficult to provide in a cash balance plan. As discussed in the previous section, if it were included in some form, the IPERS defined benefit plan would look even more favorable.

A cash balance plan which "allocated" 9.45% of each year's pay would be less expensive than a DC Plan with the same 9.45% "contribution." This is because under the cash balance plan, interest is credited at a lower rate than the IPERS trust is expected to earn (7.5%). Since a cash balance plan is a defined benefit plan, excess earnings are used to reduce contributions to the trust, not increase benefits for individuals. Since the current IPERS contribution rate is a combined 9.45%, the proposed cash balance plan should be less expensive than the IPERS Plan. Alternatively, a higher allocation under the cash balance plan, such as 11%, would provide benefits that are more comparable. However, there is no guarantee that even the 9.45% cash balance plan would be less expensive then the current IPERS Plan. This, of course, would be a function of the experience of the plan; most notable is the investment return earned by the trust. Also, since the cash balance plan provides better benefits to employees who do not stay until retirement, the cash balance plan could be more expensive if the majority of employees in the future do, in fact, terminate prior to retirement eligibility.

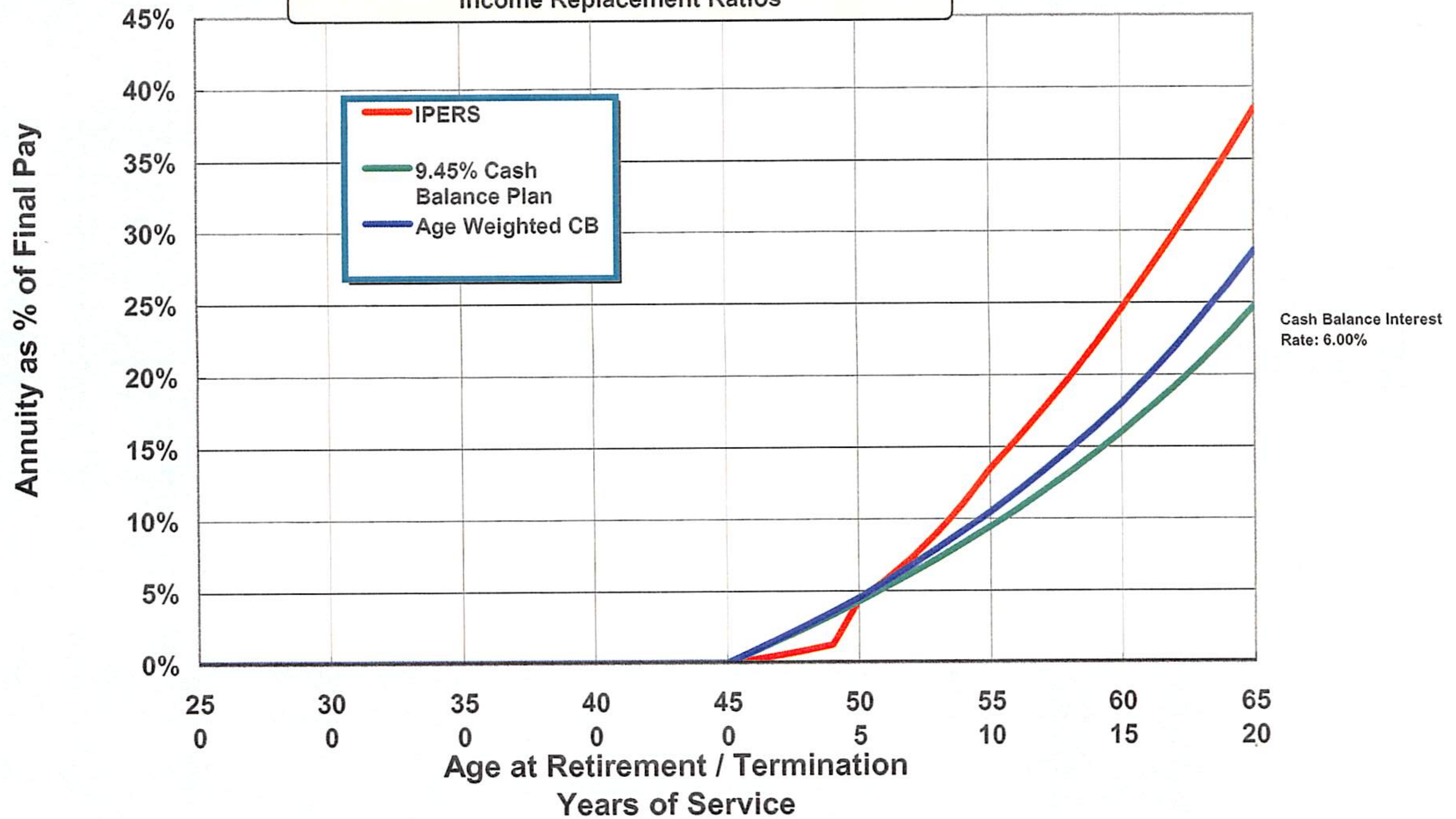
Our comments and illustrations assume the introduction of a cash balance plan for new hires only. Any transition for current IPERS members to a cash balance plan would involve significant analysis with regard to transition issues and grandfather provisions. Of course, any Plan design which involved providing the better of the two plans for all existing IPERS active members would produce higher costs. For these reasons, we have not modeled a "grandfathered" cash balance plan.



Age 25 Hire

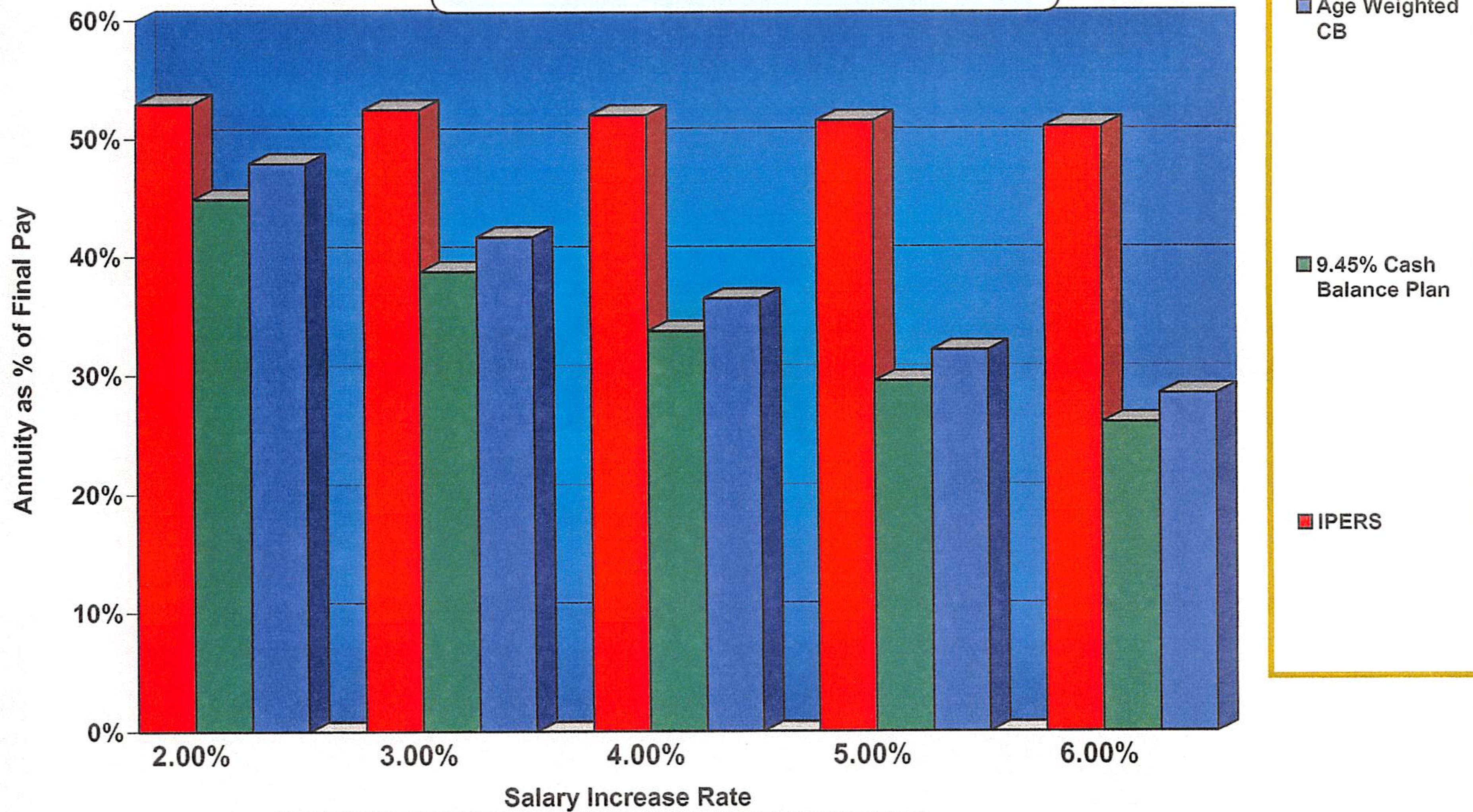


Age 35 Hire



Age 45 Hire

IPERS vs.Cash Balance Plan



Age at Termination: 62
Current Pay: $25,000, Current Age: 35, Service: 0

Age 62 Retirement - Alternative Salary Growth

E. Pension Equity Plan

In addition to modeling a defined contribution plan and cash balance plan as alternatives for the IPERS defined benefit plan, we have modeled the adoption of a Pension Equity Plan (PEP).

PEP is a defined benefit plan that states the amount payable at retirement as a single sum that is a multiple of pay. While payable as a lump sum, it must also be offered as an annuity for life. This type of plan is an attempt to combine the best features of the three most popular vehicles for providing retirement benefits:

- traditional final average pay pension plans,
- defined contribution plans, and
- cash balance plans.

a. Plan Design

The basic concept behind the PEP is that each year the employee is granted retirement credits. These credits are called retirement credits.

At retirement, death or vested termination, the employee's benefit can be paid as a lump sum, calculated as a percentage of final average salary based on the number of retirement credits earned, or as an annuity based on the value of the account.

For example, assume 4 credits are granted per year of credited service. If the employee works 20 years, the number of retirement bonus credits at retirement or termination would be 80 and the benefit would be 80% of the employee's final average salary.

b. Transition Credits

Any accrued benefit earned under a defined benefit plan prior to the effective date of the PEP can be preserved as transition credits. These transition credits are added to the regular retirement bonus credits in calculating the lump sum benefit.

c. *Extensions of the Basic Concept*

Plan sponsors can tailor the PEP structure more closely to their objectives by providing higher credits for older employees, integrating with Social Security covered compensation, reducing benefits on payment before retirement eligibility, and coordinating with other retirement benefits.

d. *Communications*

PEP is easy to communicate. For example, the plan sponsor can periodically report the employee's total credits earned. The employee can easily estimate the total benefit by multiplying his or her credits by his or her current "final average salary."

e. *Comparison to Defined Benefit and Defined Contribution Plans*

As compared with traditional defined benefit pension plans, PEP retains many of the positive aspects of the traditional plan, including the relationship of benefits to final average salary within the government-imposed limits. Importantly from an employee's perspective as compared with most cash balance programs, the benefits for the PEP are calculated based on average final compensation.

f. *Legal Requirements*

The requirements that apply to qualified governmental defined benefit plans apply to the PEP under IRC Section 401(a) and other applicable provisions of the Code.

A PEP plan with 15% credits was modeled and shown in comparison to the IPERS' defined benefit plan (including an employee contribution of 3.7%)

Accumulated credits are applied to Average Final Salary (3-Year) and paid as a lump sum. As is the case with a cash balance plan, PEP has to offer equivalent annuities as an option, but the benefit is communicated as a lump sum. There are no individual accounts as under a DC Plan or "hypothetical accounts" as in a cash balance plan.

In the first alternative, for example, an employee retiring at age 60 with 20 years of service and Final Average Salary of $30,000 would be entitled to a lump sum of 300% of $30,000 or $90,000. (20 years times 15% times $30,000).

Unlike cash balance plans, PEP Plans do not credit interest on a balance, but instead apply percentage credits to Final Average Salary. Since a PEP is a defined benefit plan, the individual is not at risk for investment return as he or she would be under a defined contribution plan. One advantage of a PEP is that benefits are based on Final Average Salary, in contrast with a cash balance or defined contribution plan that bases benefits on career pay. Therefore, a PEP, like the current IPERS plan provides inflation protection as well as providing protection for "fast track" employees. This is discussed further below.

In each alternative PEP, we are again assuming the employee contribution is 3.7% towards the total credit of 15%. Two line graphs are shown following this section for employees hired at ages 25, 35, and 45. We are using pay at hire of $25,000. The graphs show the percentage of final year's salary replaced by each of the three plans. A fourth graph illustrates the effects of varying salary increases and compares them to the IPERS Plan.

Graph 1: Employee hired at age 25

The first graph shows the example of an employee hired at age 25. The red line again depicts the IPERS Plan. The blue line depicts the 15% PEP. As is the case with a DC and cash balance plan, both PEP demonstrates the "smooth" accrual pattern of a PEP with higher benefits for terminations prior to early retirement age than under the IPERS Plan. The IPERS Plan provides larger benefits at ages 53 through 64 and equal benefits at age 65.

Graph 2: Employee hired at age 35

The second graph shows an age 35 hire with the IPERS Plan providing larger benefits at ages 54 and older.

Graph 3: Employee hired at age 45

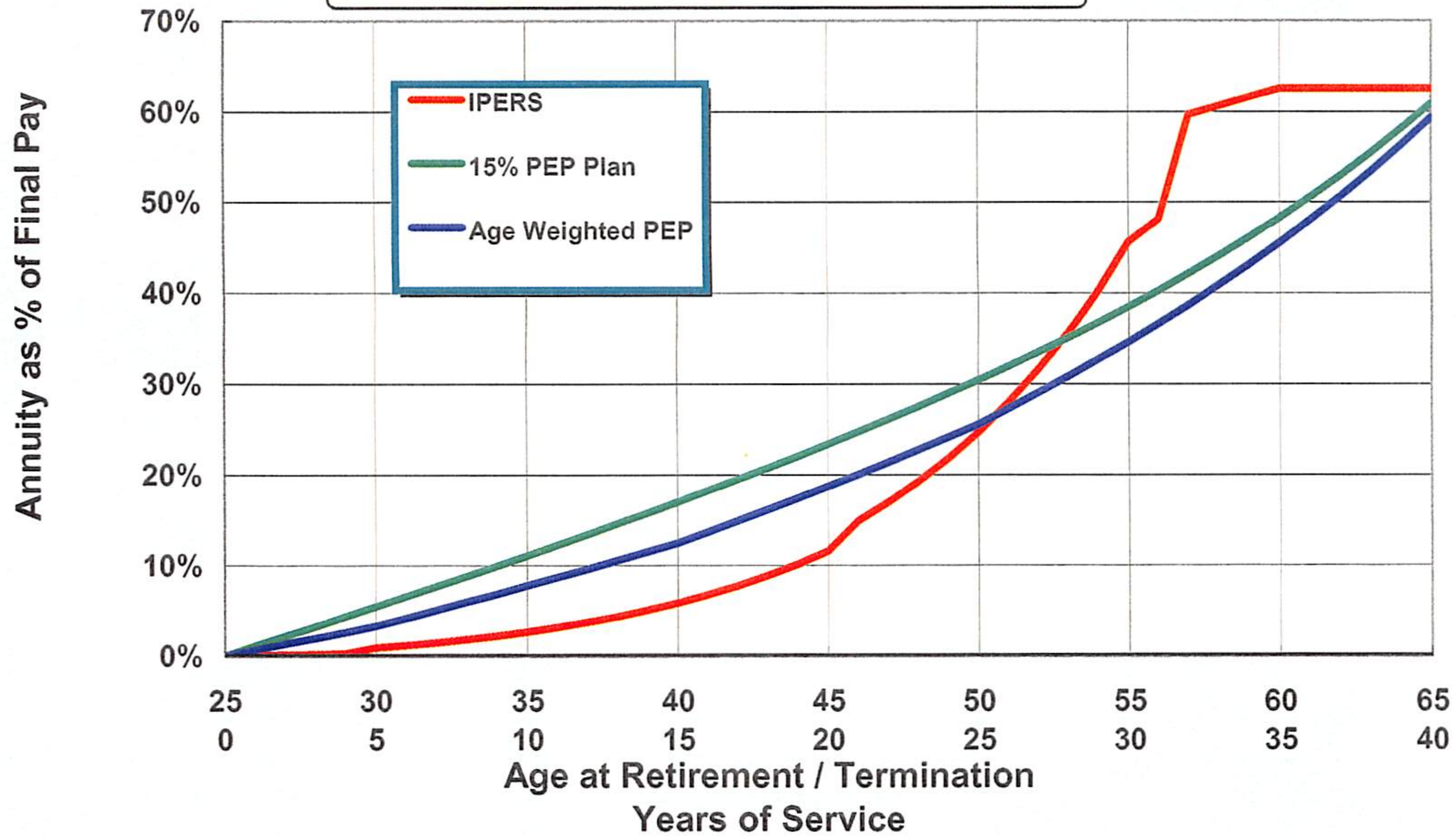
The third graph shows an age 45 hire with the IPERS Plan providing larger benefits at ages 58 and older. The only way to match the benefits under the IPERS Plan at later ages would be to provide a higher credit schedule. This will increase the cost of the PEP alternative.

Graph 4: Impact of Salary Increases

The fourth graph is a bar graph showing the sensitivity of the salary increases and the effect on the comparison of IPERS to the PEP. This shows a comparison for a 35-year-old hire retiring at age 62, at alternative salary increase rates. In all cases, the IPERS Plan provides the same replacement of income, regardless of the pay increases experienced during an employee's career. The PEP also provides the same replacement of income for the "fast track employee" as for the "slow track employee." This is because both plans base benefits on the final three years of salary. As we saw in the cash balance plan and the defined contribution plan, the "slow track" employee fares better under each of these alternative plans whereas the "fast track" employee fairs poorly. The question to consider is which employees to reward.

As in the comparisons for the cash balance plans and defined contribution plans, we have not reflected the COLA in the above analysis. As is the case with defined contribution plans and cash balance plans, a COLA is not generally provided under a PEP Plan.

IPERS vs. Pension Equity Plan

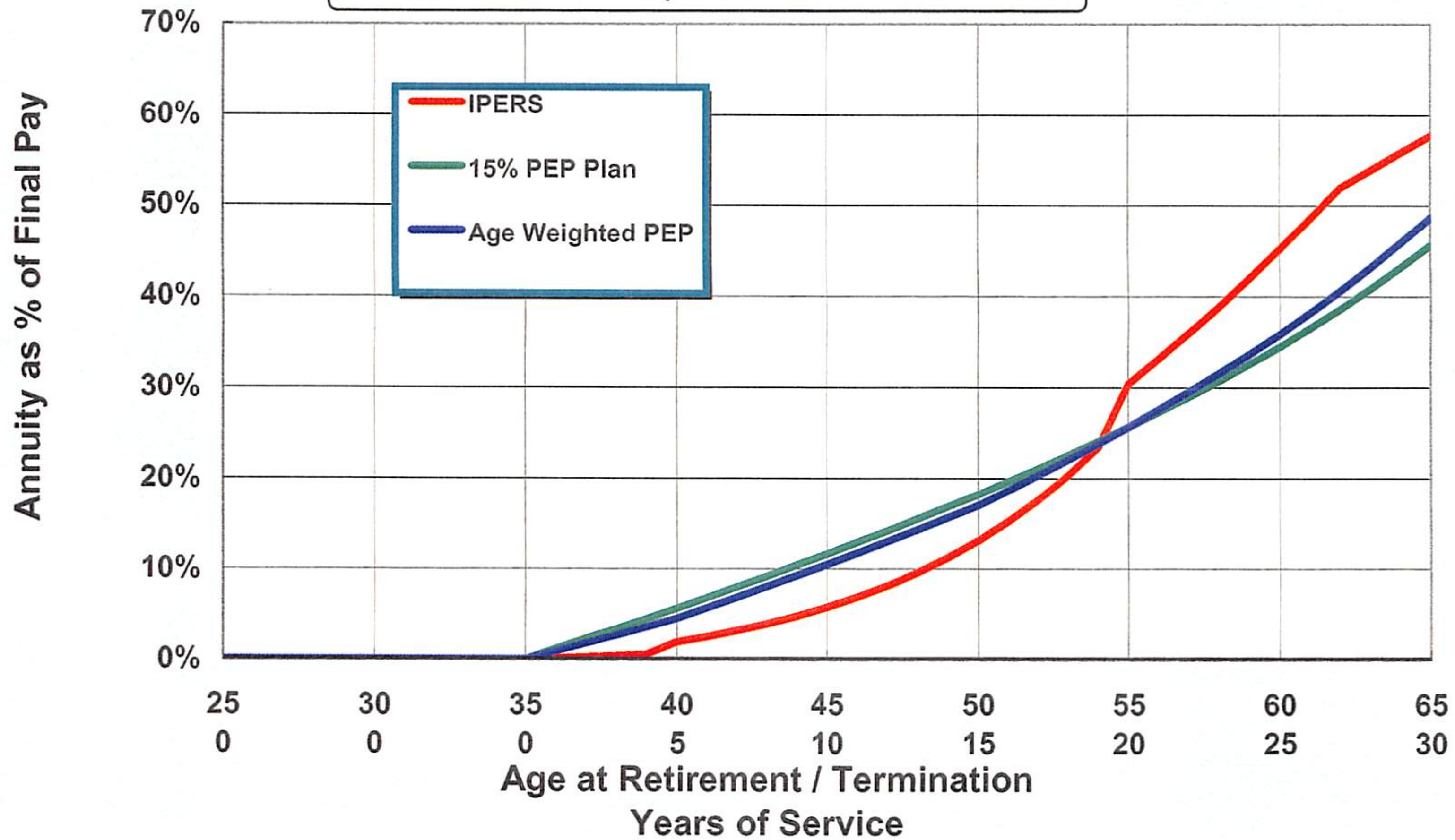


Age 25 Hire

IPERS vs. Pension Equity Plan

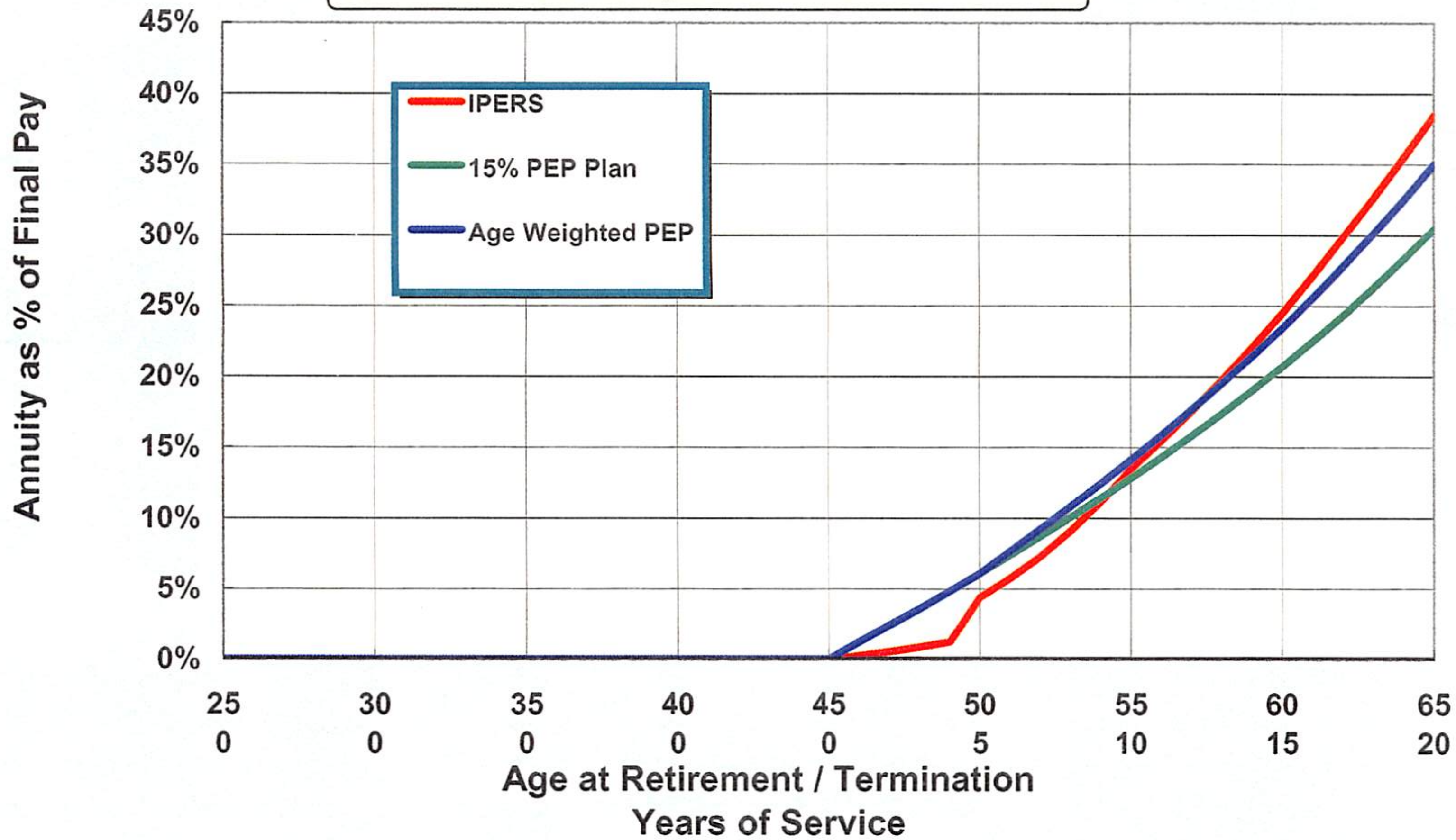
Current Pay : $25,000, Salary Increase Rate: 4.00%

Current Age: 35, Past Service: 0



Age 35 Hire

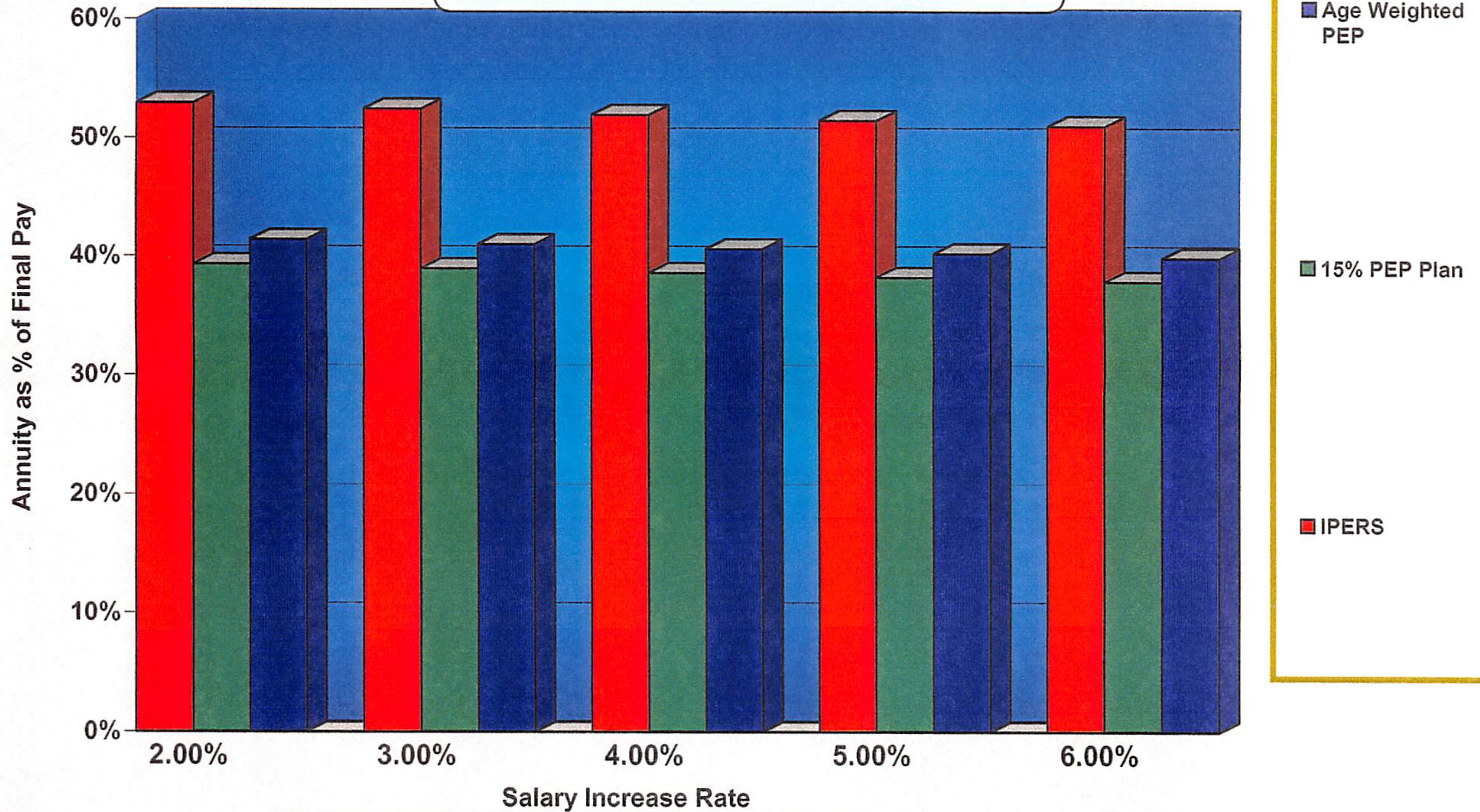
IPERS vs. Pension Equity Plan



Age 45 Hire

IPERS vs. Pension Equity Plan

Income Replacement Ratios



Age at Termination: 62
Current Pay: $25,000, Current Age: 35, Service: 0

Age 62 Retirement - Alternative Salary Growth

APPENDIX 1

Credited Service Provisions in Other Systems[1]

Name of Retirement System	Provision
Alaska TRS	Can purchase up to 10 years of out-of-state teaching service; such service coupled with military service purchased cannot exceed 10 years.
Arizona ASRS	Any period with another public employer; no limitation on years purchased; and provided that no benefit will be received from another system for such service.
California STRS	Creditable service prior to becoming an STRS member, including part-time or substitute teaching service.
Colorado PERA	One year of service may be purchased for each year of full-time, non-covered public employment, including out-of-state service; provided the member has one year of earned service credit with PERS at the time of such purchase if the service is with a non-covered employer.
County of Denver DPSRS	Up to a maximum of 10 years of service credit for periods of private and public employment not vested in another retirement plan, private sector service credit is limited to 5 years.
CT. TRS	Up to 10 years of service credit, at the rate of 1 year of out-of-state service for each 2 years of full-time service as a CT teacher.
Delaware SEPP	Up to 4 years of credited service for full-time employment performed for another state or political subdivision of the state.
Florida FRS	Up to 1 year of out-of-state service upon completion of each year of service earned under FRS, provided the member has completed a minimum of 6 years of creditable service with FRS.
Georgia TRS	Up to 10 years of out-of-state teaching experience; 1 year of credit for such service for each additional year of membership service; up to 5 years of military service; graduate study, maternity leave and other state employment.
Illinois TRS	Service as a teacher, including in another state, for a period not to exceed the lesser of 2/5.

[1] Data provided in National Education Association Research Division, Characteristics of 100 large public pension plans, September 2000.

Name of Retirement System	Provision
Illinois IMRF	Credit may be purchased for reciprocal service credit for service in other Illinois public pension systems; eligible members may purchase up to 5 years of credit under early retirement incentive plan.
Indiana TRF	Members prior to 7/1/81 may receive up to 8 years of credit at the rate of 1 year of out-of-state service for every 4 years of Indiana service at no cost to the member, provided the member has 10 years of creditable Indiana teaching service; members on or after 7/1/81 are not limited in the number of years of service credit that may be purchased except that members must have at least 10 years of in-state service before claiming any out of state service; service credit may be purchased for private school employment.
IPERS	Members may purchase out-of-state service that is comparable to the employee's employment in Iowa. No limitation on amount of such service which may be purchased. Effective 7/1/00,members may also purchase time for public school service in Canada.
Kansas PERS	Out-of-state teaching service may be purchased and the number of years of purchase is not limited.
Kentucky TRS	Up to 10 years of out-of-state service as certified or licensed teacher as long as member is in active service with System for at least 1 scholastic year following the most recent period of out-of-state service, but not in excess of 1 year of credit for each 2 years of Kentucky service in a covered position.
Louisiana TRSL	Up to 5 years of credit may be purchased for out-of-state teaching service, provided that the member has at least 10 years of service is TSRL.
Maine MSRS	Credit for up to 10 years of out-of-state service may be purchased but the member must have creditable service in Maine of at least 20 years in the aggregate.
Maryland TRS	Credit for up to 10 years of out-of-state public school service may be purchased.
Maryland TPS	Same as above.
Massachusetts TRS	The combination of the purchase of out-of-state public school service and the purchase of out-of-state non-public school service cannot exceed 10 years and the total purchased cannot exceed the amount of the Massachusetts creditable teaching service.

Name of Retirement System	Provision
Michigan MPSERS	Member may purchase up to 15 years of credit for out-of-state teaching service on a matching basis, at the cost of 5% of highest previous year's salary.
Minnesota TRA	Vested members may purchase eligible credit for prior out-of-state teaching service, Peace Corps, or VISTA service, or private/parochial school service, but the option to purchase service credit is scheduled to expire on 5/16/02.
MN-St. Paul SPTRA	Credit may be purchased (prior to 5/16/2000) for up to 10 years of service in private or parochial schools.
Missouri PSRS	Credit may be purchased for up to 10 years of out-of-state teaching service.
Montana TRS	Credit may be purchased for up to 5 years of out-of-state public employment, as long as the member has 5 years of Montana membership, with at least 1 full year of Montana service following the member's out- of-state teaching service.
Montana PERS	Credit may be purchased for up to 5 years of out-of-state public employment, as long as the member has 5 years of active Montana membership at the time of the purchase.
Nebraska SRS	Credit may be purchased for up to 10 years of out-of-state teaching service.
Nevada PERS	Credit may be purchased by vested members for up to 5 years of out-of-state-service.
New Hampshire NHRS	Teachers who become members of the System after 6/30/90 may purchase service credit for all periods of out-of-state teaching.
New Jersey TPAF	Credit may be purchased for up to 10 years of out-of-state teaching or military service.
New Jersey PERS	Credit may be purchased for up to 10 years of out-of-state public service or military service.
New Mexico ERB	Member may purchase up to 5 years of out-of-state public school service.
New York State TRS	Member may purchase service credit for out-of-state service (applies to pre 7/1/73 members).
New York State ERS	Member may purchase service credit for out-of-state service (applies to pre 7/1/73 members).

Name of Retirement System	Provision
Oklahoma TRS	Credit may be purchased for up to 5 years of out-of-state teaching service.
PA PSERS	Credit may be purchased for up to the lesser of the number of years of school service in PSERS or 12 years of out-of-state public school service.
PA SERS	Credit may be purchased for up the lesser of the number of years of service earned in SERS or 10 years.
Rhode Island ERSRI	Credit may be purchased by vested members for up to 5 years of out-of-state service.
South Dakota SDRS	Member may purchase public service for which the member is not entitled to retirement benefits from another retirement system without limitation on the number of years purchased.
Tennessee CRS	Member may purchase credit for out-of-state service as a public school teacher up to the amount of years of service earned in Tennessee.
Utah SRS	Member may purchase credit for out-of-state public employment up to the amount of service earned in Utah.
Vermont STRS	Member may purchase up to 10 years of service for out-of-state public school service; effective 7/1/2000, up to 5 years of the 10-year maximum may be purchased after 25 years of Vermont service without having actually rendered the service (termed "air time").
Virginia VRS	Credit may be purchased by vested members for out-of-state public employment.
Washington TRS	Credit may be purchased for up to 4 years of out-of-state public employment.
West Virginia TRS	Credit may be purchased for out-of-state public school teaching service for up to 10 years of service at the rate of 1 year of credit for every 2 years of West Virginia service earned.
Wisconsin WRS	Members may purchase service credit for up to the lesser of 10 years of out-of-state public employment or the number of years of participation in WRS.

APPENDIX 2

Special Rules Pertaining to the Purchase of Permissive Service Credit Under Section 415(n) of the Internal Revenue Code

The Taxpayer Relief Act of 1997 added Section 415(n) to the Internal Revenue Code, which contains special rules relating to purchase of permissive service credit under state and local governmental plans.

"**Permissive service credit**" means credit for a period of service:

- recognized by the governmental plan for purposes of calculating a participant's benefit;
- which the participant did not receive under the governmental plan; and
- for which the participant voluntarily contributes to the plan, in addition to any regular employee contributions, an amount determined by the plan, which does not exceed the amount necessary to fund the benefit attributable to such service.

Under Section 415(n) of the Internal Revenue Code, contributions under a state or local governmental plan to purchase permissive service credit must either:

- ➢ Meet the defined benefit plan limitations by treating the accrued benefit derived from the participant's contributions to purchase permissive service credit as an annual benefit (disregarding the additional benefit when determining if the plan satisfies the reduced defined benefit limitation for early commencement of benefits); or
- ➢ Meet the defined contribution plan limitation, determined by treating all of the participant's contributions to purchase permissive service credit as annual additions and adding them to any other annual additions (disregarding the 25% of compensation limitation on annual additions).

The number of years of permissive service credit that can be purchased and which participants may purchase such permissive service credit depends on whether the service is "qualified" or "non-qualified."

What we are referring to as "**qualified service**" is:

1. Service with the United States government, or any State or local government (including any agency or instrumentality thereof), provided the recognition of such service ***does not*** result in the participant receiving a retirement benefit under more than one plan for the same period of service;
2. Service with an association representing employees of the United States government, or any State or local government (including any agency or instrumentality thereof), provided the recognition of such service ***does not*** result in the participant receiving a retirement benefit under more than one plan for the same period of service;
3. Service with an educational organization which:
   - normally maintains a regular faculty and curriculum;

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- normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; and
- is a public, private, or sectarian school which provides elementary or secondary education (through grade 12), as determined under State law;

provided the recognition of such service ***does not*** result in the participant receiving a retirement benefit under more than one plan for the same period of service; or

4. Military service (other than military service required to be recognized under the governmental plan under the Section 414(u) of the Internal Revenue Code (Special Rules Relating to Veterans' Reemployment Rights Under the Uniformed Services Employment and Reemployment Rights Act).

There is no special limitation on the number of years of "qualified service" that a participant may purchase under a governmental plan. In addition, any participant of the plan may purchase "qualified service" credit.

The rules regarding the inclusion of "non-qualified service" are much more restrictive. "**Non-qualified service**" is:

1. Service with the United States government, or any State or local government (including any agency or instrumentality thereof) where the recognition of such service ***does*** result in the participant receiving a retirement benefit under more than one plan for the same period of service;
2. Service with an association representing employees of the United States government, or any State or local government (including any agency or instrumentality thereof) where the recognition of such service ***does*** result in the participant receiving a retirement benefit under more than one plan for the same period of service;
3. Service with an educational organization which:
   - normally maintains a regular faculty and curriculum;
   - normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on; and
   - is a public, private, or sectarian school which provides elementary or secondary education (through grade 12), as determined under State law;

   where the recognition of such service ***does*** result in the participant receiving a retirement benefit under more than one plan for the same period of service; and
4. Service with any other employer

No more than five years of permissive service credit that can be purchased for "nonqualified service." In addition, a participant with less than five years of plan participation is not permitted to purchase permissive service credit for nonqualified service.

APPENDIX 3

Caps On Benefits in Other Systems[1]

Name of Retirement System	CAP
CALIFORNIA UCRS	100% FAS
COLORADO PERS	75%
CONNECTICUT (2)	100%
GEORGIA TRS	40 Years
ILLINOIS (3)	75%
ILLINOIS SRS	80%
ILLINOIS CHICAGO/PSTPRF	75%
IPERS	**65%**
LOUISIANA(2)	100%
MASSACHUSETTS TRS (2)	80%
MINNESOTA (5)	100%
MISSISSIPPI PERS	$125,000
MISSOURI PSRS	100%
MISSOURI - ST. LOUIS PSRS	60%
NEVADA PERS	75%
NEW MEXICO PERA	80%
OHIO (3)	100%
RHODE ISLAND ERSSRI	80%
RHODE ISLAND (Optional)	75%
TENNESSEE CRS	94.5%
TEXAS	100%
VERMONT (5)	50%
WASHINGTON (2)	60%
WISCONSIN WRS	65%

[1] Data provided in National Education Association Research Division, Characteristics of 100 large public pension plans, September 2000. 34 Systems (above) have a cap; 64 systems in survey have no cap; only 3 other systems (NYS) provide a lesser fraction for later years of service (2.0% for first 30, 1.5% thereafter). IPERS is the only system among 100 surveyed that provides no service credit for years after 35.

APPENDIX 4

Selected Defined Contribution and Hybrid Plans in Other Systems

West Virginia Teachers' Retirement System

West Virginia adopted a defined contribution plan for new members, effective 1991. Teachers hired after July 1, 1991 are mandatory members of the defined contribution plan. Teachers hired before that date have the option of remaining in the defined benefit plan or transferring to the defined contribution plan. The state legislation requires employees to contribute 4.5% of their gross compensation and the employers to contribute 7.5% of members' gross compensation. One-third of employer contributions becomes vested after six years, two-thirds become vested after nine years, and 100% become vested after twelve years. The Plan provides members with their choice of seven separate investment options.

Washington Teachers' Retirement System

Washington adopted a hybrid plan (PERS Plan 2), for teachers only, effective for members who joined the system on or after July 1, 1996. The state adopted a new hybrid plan (PERS Plan 3) that will go into effect March 1, 2002 for state and higher education employees and September 1, 2002 for local government employees. The defined benefit portion of the new plan is calculated using a 1 percent formula (years of service x 1 percent) instead of the 2 percent formula used in PERS Plan 2. The defined benefit provided in Plan 3 is funded solely by employer contributions. The defined contribution portion is funded by employee contributions (5 to 15%), a transfer payment, gain-sharing payments, and investment returns. Members are provided with investment options and contribution rate options by the Employee Retirement Benefits Board (ERBB).

All employees hired after the implementation date of the bill will have the option of joining PERS Plan 2 or PERS Plan 3. Members of PERS Plan 2 will have the option of transferring during a pre-established transfer window. If they do not transfer to PERS Plan 3 within the open window, they will have an option to do so each January. However, to receive the transfer payment, members must transfer during the initial transfer window. Once a member selects PERS Plan 3, he or she cannot move back to Plan 2.

PERS Plan 2 members who transfer to PERS Plan 3 during the open window and earn service credit in February 2003 will receive a transfer payment in June 2003. For state and higher education employees it is equal to 110 percent of the employee contributions and interest in their accounts on March 1, 2002, and 111 percent of local government employees' accounts on March 1, 2002.

The gain-sharing component of Plan 3 is a way to pass on to members a portion of extraordinary investment returns earned by the state on invested retirement trust funds. When the average earnings on assets invested average greater than 10 percent over 4 fiscal years, 50 percent of the amount over 10 percent will be distributed to Plan 3 members based on their service credit. The gain-sharing amount will be allocated to the members' investment accounts in January of even-numbered years when there are extraordinary returns.

Michigan State Employees' Retirement System

All new employees hired on or after 3/31/97 participate in a new defined contribution plan. Under the plan, the state contributes 4% and will additionally match employee contributions of up to 3%. One-half of employer contributions are vested after two years, two-thirds are vested after three years, and 100% are vested after four years. The Plan offers over 20 investment options.

Ohio State Teachers' Retirement System

Ohio STRS will be offering a DC Plan option to new members by July 2001. The plan will also be available to current non-vested members.

Indiana PERF

Indiana PERF is a hybrid DB/DC Plan. For the DB component, the formula = 1.1% x years x FAS + employee money purchase annuity. For the DC component, the employer contribution rate is 5.1%. The state pays the 3% required employee contribution. Full vesting occurs after five years. Members have five investment options available.

Montana Public Employees' Retirement System

A new optional defined contribution (DC) plan will be implemented by 7/1/2002, and once implemented, all current and new members will be given the opportunity to choose membership in either the current DB plan or the new DC plan.

Vermont State Retirement System

Vermont's Defined Contribution Plan is eligible to members hired on or after January 1, 1999 who are not members of the classified system. Employees will contribute at the rate of 2.85% for each payroll period. The state shall contribute at the rate of seven percent of the employee's compensation. Employees may make additional contributions to the plan, provided that they do not exceed the maximum permitted by the United States Internal Revenue Code. An employee becomes vested after completion of one year and 11 months of creditable service as a state employee.

Nebraska Public Employees Retirement System

All state employees hired since 1/1/64 participate in Nebraska's Defined Contribution Plan. The employer contribution rate is 6.75% on the first $19,654 and 7.5% on compensation above $19,654. The employee contribution rate is 4.33% on the first $19,654 and 4.8% on compensation above $19,654. Full vesting occurs at five years or age 55. Members have eleven investment fund options available to them. Nebraska PERS also provides financial planning and investment seminars for their members.

North Dakota Retirement System

North Dakota's defined contribution plan, a 401(a) plan, covers elected officials and non-classified employees. These employees were given the option of staying in the defined benefit plan or rolling over their assets into the new 401(a) plan when it was instituted. In the 401(a) plan, each participant contributes 4% of his or her compensation to the plan monthly while the state contributes 4.12 % of each participant's compensation monthly. Employee contributions are always immediately 100% vested. After two years of service, 50% of the employer contributions are vested; after three years of service, 75% are vested; after four years of service, 100% are vested.

Florida Proposals

Florida currently plans to institute a new, optional retirement plan in the year 2002. However, this could be delayed as legislators are still debating its details. The plan will allow members to control their own investment accounts, called 401(a) accounts.

APPENDIX 5

Characteristics of Current IPERS Defined Benefit Plan

Chapter 97B of the Iowa code sets out the IPERS provisions, which are briefly summarized as follows:

Participation: In general, the System covers people in non-federal public employment within the State of Iowa. Exceptions to this are set out in the law. A notable exception are those covered by another public system in Iowa (such as judges, state patrol, and policemen and firemen in cities having civil service), employees of the Regents' institutions, and employees of the community colleges who elect alternative coverage under TIAA. Membership is mandatory if a person is in covered employment.

Final Average Salary: The average of covered salaries for the highest paid three years of the member's service.

Age and Service Requirements for Benefits:

Normal Retirement:	Earliest of the first day of the month of the member's 65th birthday, age 62 with 20 years of service or Rule of 88 with a minimum age 55.
Early Retirement:	First day of any month starting with the month of the member's 55th birthday but preceding the normal retirement date.
Late Retirement:	After normal retirement date.
Deferred Vested Benefit:	Before age 55 with at least four years of service, or age 55 or older.

Retirement Benefits:

Normal Retirement:	An annual annuity equal to 2% of Final Average Salary (FAS) for each year of service up to 30 years plus 1% of FAS for each of the next 5 years of service. Maximum years of service recognized for benefit accrual purposes is 35.
Early Retirement:	An annuity, payable at the normal retirement date, determined in the same manner as for normal retirement. A reduction of .25% per month is applied for each month the benefit commences prior to normal retirement age.

Late Retirement: An annuity, payable after covered employment ends, determined as for normal retirement.

Form of Annuity: The base form, or normal form, is a life annuity with a guaranteed return of employee investment. Optional forms include a straight life annuity, a ten-year certain, life thereafter annuity, and joint and survivor annuities (with 25%, 50% or 100% to the surviving joint annuitant), and a life annuity with guaranteed lump sum death benefit.

Termination Benefits:

With less than four years of service: A refund of the member's contributions under the plan with interest.

With four or more years of service: At the member's election either:

(1) a refund of the employee's contributions under the plan with interest plus a portion (years of service divided by 30) of the employer's contributions with interest, or

(2) a deferred retirement income determined as for normal retirement. Payments can begin with normal or early retirement.

Note: A person eligible for, and receiving, federal social security disability may begin IPERS benefits, unreduced, at any age.

Post-retirement Benefit Increases: Annual dividends are paid to those retired prior to July 1990. Effective with the November 1997 dividend payment, the dividend will be adjusted by the least of the following percentages: (1) 100% of the change in the CPI, (2) percentage certified to by the actuary as affordable by the System, and (3) 3%.

For person who retired after June 30, a Favorable Experience Dividend (FED) is paid each January (provided that the Fund's "favorable experience" has provided sufficient dollars for this distribution). While the precise amount of this FED is not specified by Code language, the "target" percentage is the amount paid to the November dividend group.

Death Benefits:

A lump sum equal to the member's contributions with interest, plus 1/30 of the member's salary times years of membership service; or

A lump sum benefit equivalent to the actuarial present value of the member's accrued benefit as of the date of death. If the beneficiary is a sole individual, the benefit may be paid as a monthly lifetime annuity.

Source of Funds:

General Membership:

Member Contributions	3.7% of covered pay.
Employer Contributions	5.75% of covered pay

APPENDIX 6

DROPs in Other Systems

Florida Retirement System

Eligibility:
You are eligible to participate in the DROP when you are vested and have reached your normal retirement date.

Participation Limit:
You may participate for a maximum of 60 months following the date on which you become eligible for DROP.

DROP Benefits:
DROP accounts earn interest compounded monthly at an effective annual rate of 6.5%. Retirement benefits paid into the DROP are increased by a 3% cost-of-living adjustment each July 1.

Maryland Retirement System (State Police)

Eligibility:
State Police members are eligible to participate when they have at least 22 years but less than 28 years of service *and* are under age 60.

Participation Limit:
DROP participation is limited to the lesser of

- Four years
- Difference between 28 years of service and the member's eligibility service upon election
- Difference between age 60 and the member's age as of the date the member elects to participate in DROP
- A term selected by the member (not to exceed four years)

DROP Benefits:
DROP accounts earn interest at a rate of 6% a year, compounded monthly. Cost-of-living adjustments tied to the U.S. Department of Labor's Consumer Price Index are applied.

South Carolina Retirement System

Eligibility:
Active members eligible for service retirement may participate in the DROP program, which is called the Teacher and Employee Retention Incentive (TERI) program.

Participation Limit:
TERI participation is limited to five years.

DROP Benefits:
DROP accounts earn interest and cost-of-living adjustments.

Louisiana State Employees' Retirement System

Eligibility:
Members must meet one of the following requirements

- 30 years of service at any age
- 25 years of service at age 55
- 10 years of service at age 60

Participation Limit:
DROP participation is limited to 36 months.

Louisiana Teachers' Retirement System

Eligibility:
In order to participate in the current DROP plan, regular members must be:

- any age with 30 years of service
- at least age 55 with 25 years of service; or
- at least age 65 with 20 years of service

Participation Limit:
DROP participation is limited to 36 months and 60 days. The extra 60 days allows time for members to have service credit certified by their employers.

Texas Teachers' Retirement System

Eligibility:
TRS members are eligible to participate in the DROP plan if they meet all three of the following conditions:

- be active contributing members;
- be eligible for a service retirement annuity that is not reduced for early age; and
- have at least 25 years of service credit in TRS.

Participation Limit:
Members may elect to participate in DROP for a period of one to five years, in yearly increments.

DROP Benefits:
Interest is credited at the rate of five percent per annum to members' DROP accounts until final distributions are made.

APPENDIX 7

Portability of Benefits Among Iowa Systems

Municipal Fire and Police Retirement System of Iowa (MFPRSI):

Iowa Code Chapter 411 does not provide for portability between IPERS and MFPRSI retirement plans. According to MFPRSI there are few inquiries or requests from MFPRSI members regarding transfer of IPERS-earned benefits into MFPRSI. MFPRSI representatives note that portability would be difficult due to the differences between the benefit plans. There is portability with POR.

Police Officers' Retirement Accident and Disability System (POR):

There are currently no provisions for portability between IPERS and POR provided for in Chapter 97A of the Iowa Code. However, there is portability with MFPRSI.

Portability Provisions between POR and MFPRSI:

97A.17 Optional transfers with chapter 411.

1. For purposes of this section unless the context otherwise requires:

   a. "Average accrued benefit" means the average of the amounts representing the present value of the accrued benefit earned by the member determined by the former system and the present value of the accrued benefit earned by the member determined by the current system.

   b. "Current system" means the eligible retirement system in which a person has commenced employment covered by the system after having terminated employment covered by the former system.

   c. "Eligible retirement system" means the system created under this chapter and the statewide fire and police retirement system established in chapter 411.

   d. "Former system" means the eligible retirement system in which a person has terminated employment covered by the system prior to commencing employment covered by the current system.

2. Commencing July 1, 1996, a vested member of an eligible retirement system who terminates employment covered by one eligible retirement system and, within sixty days, commences employment covered by the other eligible retirement system may elect to transfer the average accrued benefit earned from the former system to the current system. The member shall file an application with the current system for transfer of the average accrued benefit within ninety days of the commencement of employment with the current system.

3. Notwithstanding subsection 2, a vested member whose employment with the current system commenced prior to July 1, 1996, may elect to transfer the average accrued benefit earned under the former system to the current system by filing an application with the current system for transfer of the average accrued benefit on or before July 1, 1997.

4. Upon receipt of an application for transfer of the average accrued benefit, the current system shall calculate the average accrued benefit and the former system shall transfer to the current system assets in an amount equal to the average accrued benefit. Once the transfer of the average accrued benefit is completed, the member's service under the former system shall be treated as membership service under the current system for purposes of this chapter and chapter 411.

Section History: Recent form

96 Acts, ch 1187, §98

APPENDIX 8

Key Public Pension and Benefit Provisions in the

Economic Growth and Tax Relief Reconciliation Act of 2001 (H.R. 1836)

And Impact on IPERS Membership

(Signed into law June 7, 2001)[1]

Provisions	H.R. 1836	Impact on IPERS Membership
Portability of Pension Assets	Will permit rollovers between and among governmental section 457(b) plans, section 403(b) plan, and qualified plans, effective for distributions after 12/31/2001. A rollover notice would be required to include a description of the different distribution restrictions and tax consequences applicable to distributions from the transferee plan compared to distributions from the distributing plan. The new rollover rules would apply to distributions made after 12/31/2001. 457(b) plans must agree to maintain separate accounts for money rolled in from qualified plans and those separate accounts would be subject to the 10% early distribution penalty (if applicable). After-tax employee contributions could be included in a direct rollover to an IRA or another qualified plan (if the plan agrees to separately account for such contributions and earnings). However, after-tax contributions could not be rolled over from an IRA to a retirement plan, and could not be rolled over to 403(b) or 457(b) plans. Effective for distributions made after 12/31/2001. Surviving spouses also could roll over distributions to a qualified plan, 403(b) plan, or governmental 457(b) plan in which the spouse participates effective for distributions made after 12/31/2001.	Will positively contribute to portability for IPERS members who have accounts in 457(b), 403(b) and other qualified plans.

[1] Analysis of H. R. 1836 provided by NASRA.

Provisions	H.R. 1836	Impact on IPERS Membership
Purchase of Permissive Service Credit	Funds from 403(b) plans and 457(b) plans could be transferred to a governmental qualified defined benefit plan to purchase permissive service credit or for the repayment of refunds, effective for transfers made after 12/31/2001.	Will positively contribute to portability by permitting IPERS members to pay for service credit purchases with funds transferred into IPERS from a 403(b) or 457(b) plan.
State and Local Government 457 Plan Flexibility	Would provide flexibility in distributions for 457(b) plans by repealing the 457 irrevocable distribution election and 15 year minimum distribution rule, generally making 457(b) plans subject to the standard minimum distribution rules; effective for distributions after 12/31/2001. Distributions from governmental 457(b) plans would be subject to the withholding, notice and 1099-R reporting rules applicable to other pension arrangements.	Will encourage participation in 457(b) plans.
Equitable Treatment of 457 Benefits Upon Divorce	Would apply the tax treatment applicable to domestic relations orders of other governmental plans to domestic relations orders for section 457(b) plan benefits, effective for transfers, distributions, and payments made after 12/31/2001.	
Waiver of 60-Day Rule for Hardship	Provides the Secretary of the Treasury authority to waive the 60-day limit on rollovers in the case of casualty, disaster, or other events beyond the control of the individual, effective for distributions after 12/31/2001.	
Rollovers of Certain Hardship Distributions	Hardship distributions (whether or not attributable to elective deferrals, including 457(b) plan hardship distributions) generally would not be eligible for rollover, effective after 12/31/2001.	
Modification of Safe Harbor Relief for Hardship Withdrawals	The suspension period would be reduced to 6 months, effective for plan years commencing after 12/31/2001.	
Repeal of "Same Desk" Rule	Effective for distributions made after 12/31/2001, the "same desk" rule would be repealed for 401(k), 403(b) and 457(b) plans.	Will encourage participation in 403(b) and 457(b) plans.

Provisions	H.R. 1836	Impact on IPERS Membership
Default Rollover of Small Distributions	Plans would be required to automatically roll over distributions of between $1,000 and $5,000 to a designated IRA, unless the participant affirmatively elects to receive the distribution. This rule would be effective for distributions made after final DOL rules are issued (no later than 3 years after enactment) providing fiduciary "safe harbors" for the designation of an institution and the investment funds. At the moment, it is unclear how (or even if) this is applicable to governmental plans. Presumably, if this provision does apply, public retirement plans would not be protected by these DOL safe-harbors and would need to consider state remedies for potential liability.	Will encourage tax-sheltered savings
Defined Benefit Dollar Limit	Defined benefit dollar limit is increased to $160,000, effective for limitation years ending after 12/31/01, and indexed for inflation in $5,000 increments (as under current law) thereafter. This limit would apply to benefits beginning at age 62 (rather than Social Security Retirement Age), for all plans, effective for limitation years ending after 12/31/2001 - this would allow public plans that exercised the 1988 TAMRA grandfather election to treat their post-1990 hires the same as the grandfathered participants. The age 55/$75,000 floor for governmental employers would also be repealed (which essentially has no effect, as the dollar limit at age 55 is now greater than $75,000 floor).	Could increase benefits for certain members.
Compensation Limit	The qualified plan and 403(b) plan compensation limit will be increased to $200,000 with indexing in $5,000 increments, effective for plan years beginning after 12/31/2001.	
Percent of Compensation Limits and Maximum Exclusion Allowance	Effective for limitation years beginning after 12/31/2001, the 415(c) plan limit for 401(a), 401(k) and 403(b) defined contribution plans is increased from 25% of compensation to 100% of compensation effective for plan years beginning after 12/31/2001. The 457(b) limit is increased from 33-1/3% of includible compensation to 100% of includible compensation and the general maximum exclusion allowance under 403(b) is eliminated.	Will provide opportunities for additional elective deferrals. State should explore activating grandfather 401(k) plan in order to make Roth Account available for all employees.

Provisions	H.R. 1836	Impact on IPERS Membership
Deferred Compensation and Defined Contribution Dollar Limits	The limitation on the exclusion for elective deferrals to 401(k) and 403(b) plans is increased to: $11,000 in 2002, $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006; and indexed in $500 increments thereafter. The limitation on deferrals under governmental 457(b) deferred compensation plans and tax-exempt organizations would be increased to: $11,000 in 2002, $12,000 in 2003, $13,000 in 2004, $14,000 in 2005, and $15,000 in 2006; and indexed in $500 increments thereafter. The maximum dollar limit on annual contributions is increased to $40,000 with indexing in $1,000 increments, effective for plan years beginning after 12/31/2001.	Will provide opportunities for additional elective deferrals.
Repeal of Coordination Requirement for 457(b) Plans	The coordination requirement between 457(b) plans and other plans would be repealed, effective for years beginning after 12/31/2001. Thus, separate limits generally would apply to 457(b) plans and other types of plans, although the elective deferral limits would continue to apply to combined 401(k) and 403(b) deferrals.	
Catch-up Contributions	The 457(b) catch-up provision would be increased to twice the regular deferral limit. The current 457(b) catch-up rule would be retained. Additional catch-up contributions would be provided for individuals age 50 and over and would increase the otherwise applicable contribution limits for 401(k), 403(b), 457(b) and other salary reduction plans by $1,000 in 2002, $2,000 in 2003, $3,000 in 2004, $4,000 in 2005, and $5,000 in 2006 and thereafter; indexed in $500 increments after 2006. These catch-up limits cannot be used in the same years a 457(b) plan catch-up applies.	

Provisions	H.R. 1836	Impact on IPERS Membership
Income Tax Credit For Low and Middle Income Savers	A temporary (would sunset after 12/31/2006) nonrefundable income tax credit of up to $1,000 would be available for certain low and middle income savers for 2002 through 2006. The credit would not otherwise affect the tax treatment of the contributions. The credit would apply to taxpayers with AGI of not more than: $50,000 (married filing joint), $37,500 (head of household), and $25,000 (single), who are at least 18 years of age and not full-time students or claimed as dependents on another taxpayer's return. The amount of the credit would depend on the AGI level, 10% - 50% of up to $2,000 in annual pre-tax or voluntary after-tax contributions to 401(a) plans, 401(k) plans, 403(a) plans, 403(b) plans, governmental 457(b) plans, traditional and Roth IRAs, SIMPLEs, and SEPs. The eligible contribution amount is decreased by any taxable plan distributions (and any Roth distributions) received in the year of the credit, the preceding two years, and through the due date for filing the tax return.	Will encourage participation in pension plans by providing tax-credits.
Deemed IRAs under employee plans	Would allow governmental 401(k), 457(b) and 403(b) plans to offer an IRA through the employer plan effective for plan years beginning after 12/31/2002. The Act is silent on the question of whether or to what extent fiduciary duties apply to deemed IRAs of public sector plans.	Would permit IPERS to offer an IRA.
Creation of "Roth" 401(k) and 403(b) Accounts	Effective after 12/31/2005, employers may allow employees to make "Roth" contributions to 401(k) or 403(b) plans. Such contributions would need to be accounted for separately. An employee would be taxed immediately on such contributions, but (as with Roth IRAs) both the contributions and earnings generally would not be subject to tax upon a qualified distribution from the plan (e.g. after reaching 59-1/2).	Would allow members to contribute to a 403(b) "Roth" IRA.