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choices

The Newsletter of the Montana University System's Flexible Benefits Program

Classified Employees' Retirement Choices - Part II

So many choices, so much information, so little time. This could easily serve as the mantra of our benefits program. The choices facing our classified members concerning their retirement plan are certainly among the most important economic decisions they will ever face in their lives. There has now been an avalanche of information put out by the Montana Public Employee Retirement Administration (MPERA), Educational Technologies, Inc., and TIAA-CREF about the upcoming decisions faced by all classified employees; should they remain in the Montana Public Employees Defined Benefits Retirement Plan (DBRP) or move to one of the Defined Contributions (DC) plans - the Defined Contribution Retirement Plan (DCRP) administered by MPERA or the Optional Retirement Program (ORP) administered by TIAA-CREF? Understanding the complexity of the issues involved in these decisions and the limited amount of time that we all have, the *Choices Newsletter* has and will attempt to lead you in a logical fashion through the many essential factors you need to consider in making this one time and non-revokable decision - a decision that you and your beneficiaries must live with for the rest of your lives.

In Part I of this series we considered the timing of your decision and the many sources of information available to help. The bottom line of that first article was that unless you have a 5, 10, 15, or 20 year anniversary date of first hire, you can take the full fiscal year (July 1, 2002 - June 30, 2003) to avail yourself of the many sources of information and make a fully informed choice. In fact, it may even be in your best interest financially to wait until close to the end to submit your election form. For those of you facing one of those anniversary dates, the timing of your decision may be an issue. See the May 2002 issue of the *Choices Newsletter* for details. If you have misplaced this last issue, a copy may be available at your payroll benefits office or you may download a copy at *www.montana.edu/choices/*.

This issue of the *Choices Newsletter* will focus on the differences between defined benefit (DB) plans and defined contribution (DC) plans. We make the assumption that while most of you understand the broad outline of your existing PERS defined benefits plan, few of you understand the details. The devil or the angel may well rest in these details. We will outline those aspects of the DBRP most pertinent to your forthcoming decisions and the basic differences between DB and DC plans. Certain key concepts such as *vesting*, *service credit*, *annuity*, *highest average compensation (HAC)*, *GABA*, *portability*, and *retirement eligibility* are key to understanding your current program. It is essential to understand the various strengths and limitations of your existing program **before** you decide to leave. The next article in this series will focus on the two defined contribution programs, the DCRP and the ORP, and give you guidelines in choosing between them. A final article will offer those of you abandoning the DBRP assistance in choosing among the various investment options available to you and in managing your retirement funds once you get there. Remember that the ultimate goal is a financially secure retirement for you and your beneficiaries irrespective of fluctuations in the financial markets, inflation, and your health and longevity.

The Choices Newsletter is designed to help promote a sense of our ownership and responsibilities within the program.

Defined Benefits vrs. Defined Contributions - The names of these two types of retirement plans are quite descriptive. In a *defined benefit* plan the employer guarantees you a monthly benefit based on your final or highest average salary and your total years of service credit. Formulas for the calculation of these benefits vary somewhat from plan to plan but the PERS DB is fairly typical: 2% x years of service credit x average of the highest 3 consecutive years salary. The 2% applies only after 25 years of membership service. In a *defined contribution* plan the employer agrees to contribute a set percentage of your salary to a tax deferred investment fund in your name. Just as in a DB plan, part of the funds come from your salary and part come from the employer's coffers. Typically, you will contribute about 7% of your salary and the employer will contribute at about 5%. In a defined contribution program you must choose the investment funds and manage those investments over the course of your working life. At retirement, your benefit is based solely upon how well your investments have done and how much money you have accumulated in your retirement portfolio. A closer look at the various types of plans will show that each has its own distinctive strengths and weaknesses.

Defined Benefit Plans - One real advantage of these plans is that it is the plan itself takes all of the investment risks. MPERA contracts with professionals to manage the funds. Stock markets may

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go up and down and Enrons and Worldcoms may come and go and you will continue to be guaranteed that same retirement benefit based on the formula. And after retiring, the financial markets will have no impact on the size of your benefit check.

So while you face no market risks in a defined benefit plan, there are other dangers that you face. Your benefit is based on your highest average salary, and if you are already a relatively low paid employee, that small salary will be perpetuated in retirement. Short of a major promotion or a raise, you will continue to suffer from marginal income. This is not just a theoretical problem. A recent U.S. Census Bureau report indicates that because of low wages, retired Montana government employees receive the lowest average benefits in the nation. The average retired public employee in Montana received $9,183 per year or $765 per month in benefits in 2000 compared with a national average of $16,835 per year or $1,403 per month. In a defined benefit plan anything you can do to increase you highest average salary (a promotion, working extra hours, additional comp. etc.) or increase your years of service (buying eligible service credit, military service, etc.) will benefit you greatly in the long run.

A second major risk of defined benefit programs is inflation. At the point that you retire you are essentially fixing your income for as long as you and your beneficiaries (spouse) live. That could well be 30 years or more. Consider what 30 years of inflation might do to your benefit. That $1 that you receive in 2002 will be worth only 41 cents in 2032. Cost of living increases (COLAs) or guaranteed annual benefits adjustments (GABAs) can at least partially offset the ravages of inflation. The PERS DB plan has a 3% GABA that kicks in January following 12 months in retirement. The 3% GABA should just about offset the average 3% inflation that the U.S. economy has been experiencing over the last century. Remember, however, that averages are just that. During the 1980s we suffered through double digit inflation and there are no guarantees that it will not happen again. Those who survived that period on fixed income DB plans were really hurt. So despite a COLA or a GABA, inflation risk remains very real in all DB plans.

Payment options from defined benefits plans are far more restrictive than in defined contribution plans. **At retirement you must annuitize**. That is to say, you must take a fixed monthly benefit for your life expectancy or jointly on you and you spouse's life spans. There are usually some variations: your surviving spouse may receive !00% or 50% of the benefit should you die and you can sometimes choose a term certain annuity whereby the benefit is paid you or your beneficiaries for a guaranteed 10 or 20 years regardless of whether you survive. The PERS DB has all of these options available.

Defined Contribution Plans - In a DC plan, the greatest risk you assume is market risk. If you were to have approached retirement in the last two years, for example, and were heavily invested in equity (stock) funds, you might have faced a 20%, 30% or even 40% drop in your accumulations. At that point, there are few good options: dramatically increase your supplemental savings in your last few years, delay retirement, continue to work elsewhere after retirement, etc. If you were heavily invested in stocks even after retirement, you might well end up a greeter at Walmart. In a DC plan there is potentially a rosier upside, but you must understand that **you and you alone are taking all of the investment risk**.

Nor does playing it safe in a money market fund eliminate all risk. Inflation still rears its ugly head. If your money market fund is earning 2% and inflation is running about 3% (pretty close to the current situation), you are losing buying power at the rate of 1% a year. Do this for 30 years and you will have an impoverish retirement. Stock funds are inherently risky and volatile, while fixed income funds are vulnerable to the ravages of inflation. Most bond funds lay somewhere in the middle between volatility and safety. What is certain, most experts agree, is that you must take some investment risk and have some exposure to the stock markets both during the accumulation stage and after retirement to be able properly fund your retirement.

Defined contribution plans have no cost of living increases or GABAs. You must understand that in a DC plan you are assuming 100% of the inflation risk. The only way to offset this inflation risk is to be willing to take some market risk. However, there are certain proven strategies that you can use to minimize these risks and the effects of the volatility of the financial marketplace on your accumulations. By choosing a proper *asset allocation* for your situation and stage in life, by making regular contributions (*dollar cost averaging*; something you will do automatically by participating in a DC plan), and by regularly evaluating your accumulations and *rebalancing* when necessary, you can greatly increase your odds of meeting your retirement goals. In fact, you have a real potential of doing better than your colleagues who remains in the DB plan (there will be more detail about these investment strategies in the final article in this series).

If, on the other hand, you have no interest in carrying out these financial chores, no understanding of financial markets and no desire to learn, or if you would simply rather spend your time doing other things, then perhaps a DC plan is not for you. By the same token if you are an individual who for personal or financial reason is simply incapable of assuming any market risk whatever, you likely would be well advised to stay put in your DB plan. Life is simply too short to be unable to sleep at night because the DOW took a 400 point dip that day.

Most DC plans offer far more options in the payout or retirement phase. In a defined contribution plan **you are not forced to annuitize.** Once you reach retirement age (usually 59½), you may cash in all or part of your funds, annuitize all or part of your accumulations, take periodic withdrawals, or take minimum distributions after 70½. You may even be allowed to roll over your account to an IRA or other qualified plan. The variations on these options are far too numerous to detail here. Suffice it to say that payout possibilities in most DC plans are far more flexible than those in a DB plan.

Vesting - One of the most important concepts effecting your decision and one of the most misunderstood is *vesting*. In any retirement plan there are always two components: your contributions and accruals and the employer's contributions and accruals. Regardless of what happens, you or your beneficiaries are always entitled to your contributions and earnings. Consider it part of your pay. **Vesting is what entitles you to the employer's contributions.** Vesting eligibility varies between plans and even when fully vested, you will have to wait until you reach retirement eligibility before you have access to the funds. The goal should always be to maximize your rights to as much of the employer's portion as possible. As we shall see, getting the employer's money out is not always so easy.

Both the PERS DB and DC plans require 5 years of membership service in order to be vested; that is to say, after 5 years you are eligible for a retirement benefit if you keep your funds in the plan and meet the retirement eligibility requirements (described below). Note that if you should decide to

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transfer from the PERS DB to the DC plan, your years of service will transfer as well. If your are currently vested in the DB plan, you will be vested in the DC plan immediately upon transfer. In the ORP the vesting is immediate and both the employee and employer contributions are available to you upon retirement or termination.

Retirement Benefits Eligibility - Retirement eligibility requirements vary from plan to plan. In the PERS DB plan you become eligible for retirement if you meet any **one** of the following standards:

- Age 60 with 5 years of service,
- Age 65 and in active service, or
- 30 years of service at any age.

The PERS DB plan does have an early retirement benefit for those age 50 with 5 years of service or those with 25 years of service at any age. There is some reduction in benefits for early retirees. See the *PERS Member Handbook* for details. In the PERS DC program you must have 5 years of service and usually be age 59½ to be able to withdraw retirement funds without tax penalties. In the ORP you typically need to be age 59½ and retired to begin your withdrawals. Note that there are some exceptions in the tax law to the age 59½ requirement.

Portability - The concept of portability is especially important to MUS employees who tend to change jobs and careers at a higher rate than the average. Portability simply relates to the ease by which you can take your retirements funds with you should you leave MUS or state employ. If you plan to remain at your current job until you retire, portability is not important. If, however, you are likely to leave your current job or the State before retirement, then portability becomes an important factor in your decision.

The PERS DB plan is the least portable of the three plans. If you should leave MUS employment but take another State job eligible for the PERS plans, your funds and service credit will transfer seamlessly. There are other Montana public retirement systems that may allow you to roll over your funds without penalty. If you should leave public employment, you must either cash out or, if vested, leave the funds in the system until you reach retirement eligibility.

The PERS DC is slightly more portable. If not vested, you may cash out your portion of the funds (often with a 10% tax penalty if under age 59½), roll your funds over to another qualified plan, or simply leave your funds in the plan. If vested (5 years of service), you have all of those same options except that the employer's contributions and accruals go with you as well.

THE ORP offers the greatest portability. Your vesting is immediate and you are always entitled to the employer's contributions. The same 10% tax penalty still applies for early withdrawals, however. TIAA-CREF plans are available at almost all public and private colleges and universities nationwide and many nonprofit institutions. Should you continue your career in higher education, it is likely you will be able to continue to participate in the TIAA-CREF programs.

Cashout - If you have understood the concepts of *vesting, retirement eligibility,* and *portability* so far, you will now see why cashing out your retirement funds is **always, always** a bad idea. Yet year after year the vast majority of our short term employees cash out their retirement plans when leaving. First, you must pay taxes on the withdrawal in a single tax year, and if your account is sizable, that may throw you into a higher tax bracket. Second, you often must pay a 10% tax penalty for early withdrawal. Third, you may be jeopardizing your hopes and plans for a financial secure retirement. Finally and most importantly, if you are not yet vested or a member of the PERS DB plan and not yet eligible for a retirement benefit, you leave behind forever the entire employer's contribution and accruals for someone else to enjoy.

Strategies - In light of the discussion above, there are a few clear strategies that you might consider in making your decision. If you are certain that you will be leaving MUS employment before you are vested, the ORP is your clear choice. It is the only option that allows you to take a portion of the employer's contributions (65.53%) with you. If you are approaching retirement eligibility in good health and reasonable prospects for a long life, consider staying put in the DB plan. Should you live until 90, you will take out way more than you and your employer contributed. If you hate finance and investment, stay put; if you love managing your financial affairs, consider a DC plan. And always remember that a financial secure retirement remains the ultimate goal.

Editor's Note - Part III of this series in the Dec. 2002 Choices Newsletter will describe the PERS DC and the ORP plans and the fundamental differences between them. ■

The Director's Chair *by Glen Leavitt*

We have just come off a very busy year from a Montana University System benefits perspective. One year ago we implemented a new prescription plan, with a tiered copay at the local pharmacy and mail order, a new pharmacy benefits manager (PBM), and new in-state and out-of-state mail order options. There were some problems at first, but pharmacy problems of a year ago seem to be mostly solved.

Then during the year, we worked on converting our HMO options to self-funded plans and to contracting with hospitals for discounted services in our indemnity plans. The self-funding of the HMOs should provide cost savings for the plan, and a collateral benefit is that there is now another HMO option available to many of our plan members. These changes were implemented in July, and again, we are working on implementation problems. The largest problem concerned eligibility conversion between the HMOs and the new drug program manager. As I write this, I think we have most of these problems solved.

This past year we saw very good claims experience in the HMOs. In the self-funded indemnity plans, we also completed the year with better than expected claims experience. While our costs did exceed revenues, the trend was not as bad as anticipated at mid-year. National data predicted fifteen percent increases on a per member basis while we experienced just over nine percent. And the good news is that the pharmacy costs went down for the first time ever.

However, again the national data, and our consultants are predicting fifteen percent medical cost increases and twenty percent pharmaceutical cost increases in FY 2003. We were able to buck the trend this last year, but it would be unrealistic to expect that to continue into the future. At fifteen percent inflation, costs double in five years.

This fall, the Inter-Unit Benefits Committee will wrestle with these and other problems. One option the committee will explore is a high-deductible plan with accompanying health spending accounts. These new plans, which go by several names, including defined contribution health plans, have employer contributions to a spending account. Unlike employee financed flexible spending accounts, any unused balances can be carried over to the next year. In theory, this gives employees the incentive to manage medical spending to both their

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Questions & Answers

Q *A few months ago I saw a physician at the Western Montana Clinic in Missoula. I am a member of the New West HMO. Since this particular physician was not on the provider list, I asked the office manager if this doctor was a New West provider. The office manager said that she thought he was, took my card and the $15 copay, and filed a claim. Well it turned out that the physician was **not** a member and the claim was denied. Now I am out the full $500 cost. Is there anything I can do about this. S. M., UM - Missoula*

A. Unfortunately, this situation comes up far too often. You simply cannot rely on the word of an office manager about whether a particular provider participates in your plan. Most physicians participate in dozens of plans and, in a large clinic, one physician may participate with New West or accept Medicare while another one in the same clinic will not. Office managers often have a hard time keeping track of the various plans each physician has contracts with. Also, most office managers are very reluctant to turn away business. Once we realized that there may be a problem with the Western Montana Clinic and our New West members, we contacted them and asked to post a sign indicating that their doctors were not New West members. They stated that they could not do that.

Members must always beware: Know for sure what doctors are on your plan. Call customer service and find out **before** you accept services:

New West - 800 290 365
PEAK - 888 256 6556
BC/BS - 800 820 1674

If you go out of network on an HMO plan, you revert to the $500 deductible point of service option. If out of network on the indemnity plans, your reimbursement will be reduced 10% and you may be subject to balance billing. ■

Linda Ryckman, Group Benefits Representative

The Director's Chair *by Glen Leavitt*

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own, and the plan's advantage. Such plans require an educational component to help employees make good health care decisions.

Another problem the committee will look at is the rapidly escalating costs to retirees. This summer, for the first time I can remember, the number of retirees on the plan decreased. There may be many reasons for this, but I suspect that the major reason is that more retirees can no longer afford to continue coverage. This is not an easy problem to address. Retirees, because of their age, are a high cost subgroup of the plan. Retirees also have lower incomes than active members, and there is no state contribution to help with premium expenses.

The committee will have a full agenda again this year. It is not always fun. I am glad that so many are willing to give up so much time and to work hard to tackle these difficult issues. ■

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Since each individual and family situation is unique, you should always consult your family physician before taking action on any medical advice given here and you should consult your personal financial advisor before acting on any financial advice in the Newsletter. Consult plan documents for complete information.

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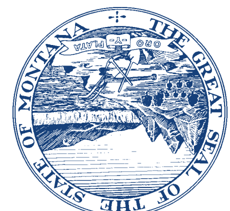

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