

**A Critique of “Response to ‘A Dissenting Statement
by Staff and Academic Senate Members of the Work Groups of
The President’s Task Force on Post-Employment Benefits’ (9-25-10)”**

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All seven faculty and staff members of the work groups of the President’s Task Force on Post-Employment Benefits (PEB) submitted a Dissenting Statement on 8/25/10; this was transmitted to President Yudof by Henry Powell and Daniel Simmons, the then Chair and Vice Chair of the Academic Senate, and posted at

http://universityofcalifornia.edu/sites/ucprfuture/files/2010/08/peb_dissenting_082510.pdf.

On 9/14/10, Executive Vice President and Provost Lawrence H. Pitts, Executive Vice President and Chief Financial Officer Peter J. Taylor, and Executive Vice President Business Operations Nathan Brostrom posted a Response to the Dissenting Statement on the UCOP website. I pointed out a number of factual errors in their posted response. They posted a revised version on 9/23/10:

http://universityofcalifornia.edu/sites/ucprfuture/files/2010/09/response_dissenting_statement_final0923b.pdf.

While the factual errors have been corrected, The Response to the Dissenting Statement contains a number of assertions that do not withstand careful scrutiny:

- On page 2, the Response asserts that “experts advise that employees need between 70-90 percent of pre-retirement income to achieve the same after-tax income since they no longer contribute to Social Security or their pension plan and incur no work-related expenses.” In support of this assertion, they cite a one-paragraph aside in a secondary source addressing a different question.² The secondary source itself uses a target of 83 percent of pre-retirement income. Neither of the two primary sources cited by the secondary source support the 70 percent figure:
 - Aon Consulting’s 2008 Replacement Ratio Study <http://www.aon.com/about-aon/intellectual-capital/attachments/human-capital-consulting/RRStudy070308.pdf>, and additional material from Aon Consulting supplied to the Task Force by Hewitt Associates indicates that retirees need 94 percent of preretirement income at a final salary of \$20,000, declining to a minimum of 77% of preretirement income at \$70,000, then rising again to 84% at \$150,000 and continuing to rise with higher incomes.

¹ Anderson is Vice Chair of the UC Academic Senate, and Coleman Fung Professor of Risk Management, and Professor of Economics and Mathematics, at UC Berkeley. These comments are the views of the author, and do not represent policies of the Academic Senate or of the University of California.

² Beth Almeida and William B. Forneia, A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans, National Institute on Retirement Security, August 2008.
http://universityofcalifornia.edu/sites/ucprfuture/files/2010/08/peb_ax_k-4_overview-discussion-db-dc-plans.pdf.

- The Aon Consulting study does not take into account the increase in health care costs following retirement. The secondary source cited by the Response³ quotes Hewitt Associates, *Total Retirement Income at Large Companies: The Real Deal*, 2008 as finding that "employees will actually need *more* money in retirement than during their working years, and suggests a target replacement ratio of 125% to cover both healthcare and other expenses."
- For an employee with a full-time salary rate under \$46,000 in 2010, the employee contribution for HealthNet two-adult coverage is \$987.60, paid from pre-tax dollars. The retiree contribution for HealthNet two-adult non-Medicare coverage is \$2062.80, paid from after-tax dollars; this figure will rise sharply as the maximum UC contribution to retiree health is reduced to 70% of the total premium.
- Because Options A, B and C, in common with the current UCRP terms, provide less than complete inflation protection, any option which provides income replacement just above the target initially will soon fall short of the target in terms of purchasing power, requiring a reduction in lifestyle.
- On page 2, the Response asserts that "All options for a new tier of the defined benefit pension plan must still address ... the unfunded liability that has accrued (and will continue to increase until we reach total contributions that equal the annual normal cost)."
 - Even if we eliminated all future pension accruals, so the normal cost would be zero, it would have no effect on the unfunded liability, which is entirely based on past service. Indeed, the unfunded liability would continue to grow at 7.5% in this case.
 - The unfunded liability continues to grow at a rate of 7.5%, even if contributions cover normal cost and the investment earnings match the 7.5% actuarial assumption.
- On page 2, the Response asserts correctly that "Under Option A, income replacement for an employee at age 65 with 30 years of service and a final salary of \$60,000 is estimated at 79% of pre-retirement income when combined with Social Security."
 - This obscures the fact that if annual inflation exceeds 2%, then income replacement will fall within a few years below 78%, the income replacement necessary to maintain the same after-tax real income for this employee, according to the Aon Consulting study cited above.
- On page 3, the Response asserts "For employees with a final salary of \$40,000 or less, the combined benefit [from Social Security and Option B] exceeds 100% [of preretirement income]."
 - This is correct, but ignores the effect of retiree health premiums and inflation.
- On page 3, the Response asserts that Option C "has an added average annual cost of \$211 million more over the next 30 years than option A."

³ See footnote 2.

- This obscures the facts that the employer normal cost—the cost to the University—of Option C is identical to that of Option B, and that under the proposed financing scheme, Options A, B and C all require identical contributions from the operating budget—ramping up to 20%, and then staying there—through the 2028-29 fiscal year. The operating budget contribution for Option A starts to decline in the 2029-30 fiscal year; for options B and C, the decline is deferred three years until 2032-33. I suspect that the Response’s figure of \$211 million per year is calculated by taking dollar amounts paid in the period 2029-30 through 2039-40 without discounting to reflect the fact the expenditures are 19-30 years in the future.
- On page 4, the Response asserts that “Option C would impact lower wage employees most negatively, while lowering anticipated contributions from the highest paid staff and faculty.”
 - This obscures the fact that lower paid employees receive substantially higher pension benefits under Option C. Indeed, as Figure 2 shows, the Total Remuneration Value of Option C is higher than that of Option B, which in turn is substantially higher than that of Option A, for all five employee groups reported. The Total Remuneration Value is computed by taking the value of the eventual pension benefits, then *subtracting off the employee contributions*.
- On page 7, the Response asserts “Given this logic, if UC changed to a DC plan, the contribution would result in a higher remuneration value than a DB contribution of the same amount.”
 - As Jim Chalfant, Helen Henry, and I pointed out in our contribution to Appendix S of the Task Force report, Options B and C are found to be uncompetitive in the Total Remuneration Study for two primary reasons. First, UC salaries are uncompetitive, and raising salaries to competitive levels would result in corresponding increases in the value of the defined benefit pension. Second, the assumptions about salary growth differ between the Total Remuneration Study and the Actuarial Study’s computation of normal cost. Indeed, as UCRP actuary Paul Angelo of the Segal Company testified to the Board of Regents in response to a question from me on 9/16/10, using the salary growth assumption from the Total Remuneration Study in the Actuarial Study would lower the normal cost of UCRP. If UC salaries were competitive, and the assumptions of the Actuarial and Total Remuneration Studies were harmonized, equal DB and DC normal costs would result in roughly equal DB and DC Total Remuneration results. There is, however, no way to make a DB plan with a 7.3% employer normal cost competitive with a DC plan that features a 9% employer cost.
- Figure 3 depicts the case of a faculty member initially hired at age 40.
 - Defined contribution plans build most of their value early, due to the long period of earnings compounding; typically, with a DC contribution equal to a fixed percentage of salary, the first year of employment will generate a larger number

- of dollars at retirement than the last year of employment, despite the much higher salary in the last year.
- The choice of 40 as the age of hire provides a biased comparison between DB and DC plans, since it omits the years in which DC plans accumulate most of their value and considers only the years in which DB plans accumulate most of their value.
 - The value of Option A is also very sensitive to the assumption about U.S. wage growth (which determines Social Security Covered Compensation) and the wage growth of the individual employee. The most recent UCRP experience study produced the following actuarial assumptions:
 - U.S. wages grow at an average rate of 3.75%;
 - Individual faculty salaries grow initially at a 7% annual rate, declining steadily to a 5.25% annual rate after 20 years of employment;
 - Individual staff salaries grow initially at a 7% annual rate, declining steadily to 5.15% after 10 years and 4.35% after 20 years of employment.
 - Figure 3 assumes an age at hire of 40 and the actuarial assumption on wage growth of a faculty member. The Response says "The difference in values of the DB and DC plans is less if the hypothetical employee is hired at age 30, or if different assumptions are made for salary increases." In fact, changing the assumptions reverses the valuation of the plans at some or all ages:
 - If one substitutes a flat 4.5% salary growth assumption, and keeps the other assumptions of Figure 3 the same, *the value of Option A is below that of the 9% DC plan at all ages, and below the value of the 7.3% Employer Contribution DC plan at all ages below 60 and above 68.*
 - If one substitutes an age at hire of 30, and keeps the other assumptions of Figure 3 the same, *the value of Option A is below that of the 9% Employer Contribution DC plan at all ages below 60 and above 70; it is below that of the 7.3% Employer Contribution DC plan at all ages below 58.*
 - If one substitutes an age at hire of 30 and a flat 4.5% salary growth, and keeps the other assumptions of Figure 3 the same, *the value of the Option A is below that of the 9% and 7.3% Employer Contribution DC plans at all ages.*
 - Regardless of the specific assumptions on age at hire and wage growth, the DB plan builds value rapidly in mid-career, as correctly shown in Figure 3 by its steeper slope between ages 50 and 65. This rapid build-up is forfeited if the employee leaves UC employment; this is the "Golden Handcuff" that provides significant benefit to UC in retention of employees.
 - Regardless of the specific assumptions on age at hire and wage growth, the DB plan builds value slowly, as correctly shown in Figure 3, after the maximum age factor is reached at age 65; indeed, with long service or lower salary growth, the value may actually decline. By contrast, the DC plans build value more rapidly

than Option A after age 65, as correctly indicated in Figure 3 by their steeper slope; this is the "Golden Tennis Court" which encourages faculty at institutions with DC plans to postpone their retirement, even if their research productivity has declined, and forces institutions with DC plans to offer, either on a general or individually negotiated basis, financial inducements to get faculty to retire. These financial inducements are ignored in both the Total Remuneration Study and Figure 3.