



GFOA Recommended Practice

Essential Design Elements of Defined Benefit Retirement Plans (2008) (CORBA)

Background. In its Recommended Practice, *Developing a Policy for Retirement Plan Design Options* (2007), the Government Finance Officers Association (GFOA) recommends that public sector employers or plan sponsors have a policy statement that will guide their plan design decisions. Once a pension plan design decision has been made, GFOA members can refer to this RP on Essential Design Elements of Defined Benefit Retirement Plans to review the essential elements of offering a defined benefit plan to employees.

Separate recommended practices have been adopted in the *Essential Design Elements of Defined Contribution Retirement Plans* and the *Essential Design Elements of Hybrid Retirement Plans*. These recommended practices should be consulted accordingly.

A majority of public sector employers offer defined benefit plans as the primary retirement plan for their employees. A defined benefit (DB) plan provides employees with a predictable retirement benefit for life. DB plans are based upon an established formula and defined by a legal plan document. DB plans may be funded by employee and employer contributions and investment returns. The investment related risks are typically borne by the plan sponsor. The benefits formula is calculated by multiplying the benefit percentage based on the years of service times the final average compensation.

Recommendation. Should a public sector employer choose to provide a defined benefit plan, GFOA recommends that pension administrators and finance professionals consider the following essential elements in their plan design:

1. Key plan design considerations should include:
 - a. The desired amount of the benefits to be provided by the plan. This may be identified as the intended income replacement level. Consideration may include future purchasing power retention for retirees through the use of other post retirement benefit adjustments, such as cost of living adjustments (COLAS).
 - b. Employee groups that will be eligible to participate in the retirement plan. Determine if eligible employees will be designated by the employer (plan sponsor) or if eligibility will be negotiated with organized employee groups.
 - c. The vesting requirements for members of the plan. When and under what circumstance will members become entitled to some form of benefit? This should include a policy for the refund of employee contributions, if any, to members leaving the plan and the interest rate credited on those contributions.
 - d. Components of the formula to achieve desired benefits (benefit percentage, years of service and final average compensation).
 - e. Other benefit options such as early and disability retirement, joint and survivor options and lump sum withdrawals.

- f. A determination as to whether the plan should include purchase of service provisions, such as prior military or other government service.
2. Funding considerations. Funding sustainability is vital to the functioning of a DB plan. A plan must be funded in a sustainable manner to ensure its long-term viability and fiscal integrity. As a result, GFOA has dedicated an entire Recommended Practice to issues of funding (see *Funding of Public Employee Retirement Systems (2005)* for details.) In addition, plan sponsors should consider the following:
 - a. Establish a funding policy that considers the plan’s funding goals.
 - b. Understand the key components associated with the cost of the plan, which are determined through actuarial analysis.
 - c. Ensure manageable funding mechanisms are in place to meet the desired benefit levels. Determine the cost sharing strategy between the employer and employees, specifically if employee contributions will be participatory. Investment returns on the funds assets are also an important part of the funding structure.
 - d. Develop a comprehensive investment program designed to meet the desired level of investment return determined by the plan sponsors. The Board of Trustees should adopt an investment policy which contains the elements set forth in the GFOA Recommended Practice on *Pension Investment Policies (2003)* and the associated *Investment Policy Checklist for Pension Fund Assets (2003)*. For additional recommendations on investment and allocation policies, consult the GFOA Recommended Practice on *Asset Allocation – Guidance for Defined Benefit Plans (1999)* and *Public Employee Retirement Systems Investment (1997)*.
 - e. Have all benefit enhancements actuarially valued before they can be approved in order to ensure a complete understanding of their long-term financial impacts.
 3. Other plan design considerations should be examined, including:
 - a. Board Governance. DB plans are usually governed by a Board of Trustees (Trustees). Board governance is a crucial component of a properly managed DB plan. It is the manner and process by which Trustees exercise authority and control over all plan activities. DB plan sponsors should pay particular attention to the composition of the Board of Trustees and make efforts to ensure that varied interests are represented and balanced among those of employers, employees, retirees, taxpayers and unions, if applicable. Criteria for governing board selection are crucial to ensure a competent board oversees the policy development of all plan activities. Criteria for the selection of most public pension boards are commonly set by the governing statute or other authority establishing the public pension system.¹ The Trustees should focus on policy decisions, which ensure that the DB plan assets are used for the exclusive benefit of the plan members. Plan governance by the Trustees and staff must differentiate core responsibilities. Trustees and staff have a fiduciary duty to administer the plan for the exclusive benefit of plan members (duty of loyalty) and must act in accordance with reasonable standards of prudence.

¹ In 2000, the APPFA created a “key risk framework”, which included governance risk. Governance risk, in this context, refers to the risk that the board, staff, or agents of a public pension system will, either intentionally or unintentionally through their management actions or lack thereof, cause the assets of the System to under perform expectations. For details on how to mitigate governance risks, see *Public Pension Systems: Statement of Key Investment Risks and Common Practices to Address Those Risks*. Association of Public Pension Fund Auditors (APPFA), July 2000.

- i. Ethical Standards. Each Trustee and staff person that has fiduciary responsibilities should file annual reports certifying compliance with all required legal and ethical standards.
 - ii. Education for Trustees. New Trustees should receive orientation training explaining their responsibilities and fiduciary duties as well as the responsibilities and fiduciary duties of the plan staff and plan's agents (such as actuaries, outside investment managers and attorneys). A program of continuing education for Trustees and staff should be developed and encouraged.
 - iii. Trustee and Staff Succession Planning. To ensure the continuity of sound Board governance, a program should be developed for a smooth transition of leadership positions.
 - b. Risk management. DB plan administrators and Trustees must adopt policies that address risk management, including both investment risks² and operational risks³. Actions taken by plan administrators and board members should identify, manage, and to the extent possible, control, or at least mitigate, these risks.
 - c. Legal Counsel. Experienced legal counsel should be retained to advise the Trustees on all legal matters, including possible securities litigation lawsuits or class actions, proposed changes to Federal, state or local laws that might impact the plan, legal exposure to some forms of liability, loss of revenue through improper corporate activities and proper legal design of the plan to facilitate qualified status under the Internal Revenue Code.
 - d. Consultants. Engage the services of experienced industry consultants, including actuaries who can recommend sustainable funding measures to cover the plan costs, investment managers who can manage and realize the plan's investment strategy, investment consultants who can help in establishing investment policies, conduct manager searches and evaluate performance, and a custodian, which is typically a bank or financial institution.
4. Participant Education.
- a. Develop participant education programs for employees to gain a better understanding of the benefits available from their retirement system. A summary plan description providing information on the retirement plan should be available to participants in a written document. For more information on this topic, please review the GFOA's Recommended Practice, *Preparing an Effective Summary Plan Description (1996)*.
 - b. Emphasize the purpose and goals of retirement planning, including the possibility of integrating the employer's DB plan with other potential retirement income sources, such as defined contribution savings plans, personal savings, and Social Security.
 - c. Discuss retiree health care options and health insurance costs, including Medicare.
 - d. Provide tools, such as worksheet templates on estimating retirement benefits. Recommendations on this topic can be found in the GFOA's Recommended Practice, *Retirement and Financial Planning Services (2003)*.
 - e. Communication formats may include video media, payroll stuffers, newsletters and written materials available to explain important information.

² For an in depth discussion of investment risks, see *Public Pension Systems: Statement of Key Investment Risks and Common Practices to Address Those Risks*. Association of Public Pension Fund Auditors (APPFA), July 2000.

³ For an in depth discussion of operational risks, see *Public Pension Systems: Operational Risks of Defined Benefit Plans and Related Plans and Controls to Mitigate those Risks*. Association of Public Pension Fund Auditors (APPFA), July 2003.

References

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- *Profitable Prudence: The Case for Public Employer Defined Benefit Plans*, Gary W. Anderson and Keith Brainard. Pension Research Council, Pension Research Council Working Paper (PRC WP 2004-6), 2004.
- *Public Pension Systems: Operational Risks of Defined Benefit Plans and Related Plans and Controls to Mitigate those Risks*. Association of Public Pension Fund Auditors (APPFA), July 2003.
- *Defined Benefit Answer Book*, 3rd Edition, G. Neff McGhie, III, Aspen Publishers, Inc., 2003.
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- *An Elected Officials Guide to Public Retirement Plans*, Cathie G. Eitelberg, Government Finance Officers Association, 1997.
- *Planning and Establishing Preretirement Education Programs*, David Amick, Ann Risdon and Sheryl Wilson, Government Finance Officers Association, 1994.

Approved by the GFOA's Executive Board, February 22, 2008.