

MEMORANDUM

TO: Curators of the University of Missouri
FROM: Dr. Gary L. Ebersole, Chair of UMKC Faculty Senate
DATE: March 18, 2011
RE: Information to Assist in Your Deliberations on UM Retirement Plan Matters

Making any significant change to the nature and design of the UM retirement plan is a momentous act that will directly affect thousands of current and future UM System employees and their families, and indirectly, but also significantly, the University's students and other constituencies for generations to come. Any such decision should be based on careful and thorough study of all relevant issues and options. We can all agree, I believe, that any decision of such consequence should be data-driven, not ideologically driven. The following observations, questions, and suggestions were prepared by the Retirement Plan Subcommittee of the UMKC Faculty Senate Budget Committee (FSBC). This memorandum is being forwarded to you with the formal approval of both the FSBC and the UMKC Faculty Senate as a whole. It takes into account, among other materials and information, the recently issued Report from UM Retirement Plan Advisory Committee March 2011 ("Advisory Committee Report") and the Segal Company report on its Actuarial Valuation of the University of Missouri Retirement, Disability, and Death Benefit Plan as of October 1, 2010 ("2010 Actuarial Report"), which were made available to FSBC representatives on March 11, 2011. As with prior input from UMKC faculty representatives, the goal of this submission is to facilitate well-informed decision making by the Board of Curators on retirement plan matters that will affect UM employees and their families for many years to come.

EXECUTIVE SUMMARY

- The Advisory Committee did impressive and thoughtful work in compiling very helpful information and in developing an outline of a potential plan for new University employees. However, it did ***not*** make a finding that the existing plan is undesirable or not financially viable for the University and its existing and future employees.
- We raised related significant issues in prior input to the Board of Curators and to the Advisory Committee on which the Advisory Committee Report does ***not*** make express findings or address to a sufficient degree. These include:
 - **The reasonableness, on a short- and long-term basis, of the 8% annual investment return assumption, the salary increase assumptions currently used in valuation of the existing plan, and the consequent projections of required contributions to the plan.** The market return for the last plan year exceeded the 8% working

assumption, and for the current year may well do so again. At the same time, actual salary increases the last few years have been well under what was assumed for actuarial purposes, causing significant “actuarial gains.” Key projections of increasing required contributions to keep the plan fully funded in the short-term have been ratcheted down dramatically from where they were just eighteen months ago. An updated long-term view of the reasonableness of these assumptions and their potential effects on required contributions is in order.

- **Testing of the proposition that any new plan under consideration would be significantly better for new employees from a mobility/portability perspective than would the existing plan.** We understand the Advisory Committee reviewed information comparing the cash-out value of the existing plan with DC and DB/DC combination plans after various years of service. We also understand that, based on the information they reviewed, some Advisory Committee members did not see the combo or pure DC plan as being any more beneficial/portable to short-term employees than the current plan, except for those with 3-4 years of service, and those who would fully contribute voluntarily to a DC plan.

- **Clearly stated up-front planning is needed to make sure the existing employees and existing retirees would not suffer short- or long-term personal financial harm if the existing plan were closed to new hires (and by reason of such closure), including a more certain commitment of the stabilization fund approach to support of funding of the retirement plan than is described in an appendix to the Advisory Committee Report.** We recognize and appreciate that the Advisory Committee has recommended continuation of the stabilization fund “with the primary purpose of minimizing mandatory employee contributions.” However, language in the appendix raises the possibility of other uses of the stabilization fund, which we feel would be inconsistent with other statements, discussed below, that have been made about intentions regarding employee contributions. Importantly, the Advisory Committee Report acknowledges projections indicating that closure of the existing plan would increase the required contributions to the existing plan as a percentage of the payroll of the employees covered by the plan. The report does not, however, expressly state that such increase, which would clearly be a cost of the University/employee shifting market volatility risk to new hires, would not be in whole or part, directly or indirectly, borne by the existing workforce and existing retirees.

This memorandum, citing pertinent data and source materials, describes and encourages you to address such unresolved issues.

BACKGROUND

We previously submitted to the Board of Curators a document, dated October 27, 2010, entitled "Preliminary Report & Recommendations of the UMKC Faculty Senate Re: UM System's Study of Possible Defined Contribution Plan for New Hires" ("10-27-10 UMKC Faculty Senate Report"). We appreciate the discussions around several of these issues that occurred at the November 1, 2010 meeting of the Curators' Compensation and Human Resources Committee ("November 1 Meeting"). Since the mid-November 2010 formation of the special Advisory Committee to assist the UM System Vice President of Human Resources with the development of recommendations on retirement plan matters, we have submitted to the Advisory Committee three formal sets of written observations, questions and suggestions.¹

From the information made available to us to date, we believe the Advisory Committee has done a very good job of exploring some alternative options for UM retirement plans going forward, taking into account many critical considerations voiced by various constituencies in recent months. We appreciate and respect the hard and thoughtful work, on complex matters, done by its members and the System staff that supported its work over the past few months, as well as the many helpful reports, summaries, and links to information the Committee and System HR have made available to us and other constituencies. However, we do not believe the Advisory Committee has sufficiently responded to some questions we have asked and to suggestions we have offered in some extremely important areas. We understand, and in fact certain aspects of the Advisory Committee Report reflect, that the Committee may have been precluded from engaging in a thorough analysis of some of the issues we presented because of interpretations of its charge.

Regardless of the reasons for the limited scope of the Advisory Committee's report, we are concerned that we have not seen, and fear that you do not yet have before you, some significant information on issues material to the Board fulfilling its fiduciary responsibilities in a well-informed manner. We note that important components of what we view as missing from the record to date include adequate follow-up on questions raised by some Curators at the November 1 Meeting.

Accordingly, the purpose of this memorandum is to reiterate and amplify our principal due diligence

¹ These were on November 16, 2010 ("UMKC Faculty Senate Recommendations to UM Special Advisory Committee on Retirement Plans Project"); December 7, 2010 ("Follow-Up Re: Draft Document Entitled 'University of Missouri Defined Benefit Plan'"); and February 16, 2011 ("Memorandum re: Information to Assist Curators' Deliberations").

concerns and to urge you to gather and consider related data and analyses in your deliberations. The discussion below is in two parts. Part I is a General Summary, which includes observations on what the Advisory Committee Report does and does not say on some key issues and a summary of recommendations we urge you to consider as you approach your deliberations on UM retirement plan matters. Part II contains more detailed discussion of the key issues, citing materials made available to us by the Advisory Committee and System HR, and sets forth the reasoning behind our recommendations.

I. GENERAL SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS

A. Findings the Advisory Committee Did Not Make

The formal recommendation made in the Advisory Committee Report reads as follows:

The Committee has reached consensus that if, after thorough and careful study of the viability of the current UM DB plan (both short-term and long-term), the Board determines it is not in the University's interest to continue to bear the financial risks implicit in the current UM DB plan, the preferred alternative plan design is a new retirement plan, for new employees only, that provides a 'combination' of defined benefit and defined contribution elements, along with other mechanisms for reducing risk.

It is essential that all stakeholders understand the importance of the “if” in this recommendation. The Advisory Committee did **not** in its report make a finding that the existing defined benefit/hybrid plan (the “Existing DB/Hybrid Plan”) is financially unviable for both current employees and new hires. Indeed, its recommendation expressly leaves it to the Board of Curators to draw a conclusion in that regard “after thorough and careful study.”

We note that we have tried to be clear throughout the ongoing study that we are simply seeking a rigorous and realistic assessment of both the short-term and long-term viability of the Existing DB/Hybrid plan, with key assumptions tested and sensitivities analysis projected out. We do not know what such a thorough and careful study might show. As scholars and researchers, we are just looking for a transparent and well-supported assessment. We understand full well the University cannot be reckless with regard to gauging its ability to meet all of its obligations. However, before making a major change in the University's approach to its core retirement plan, there should be a thorough and clearly-communicated analysis, on various ranges of assumptions. We have seen statements from System Administration suggesting that a thorough analysis has been done, but see little concrete reporting of that analysis in other than cursory summary terms. Moreover, for reasons discussed in detail in Part II below, it appears there is a distinct possibility that there has been an over-emphasis on short-term effects of the market crash of 2008-2009 to the exclusion of a longer term view of realistic possibilities

along the lines suggested by one or more Curators at the November 1 Meeting.

Apart from the lack of a finding on the threshold matter of assessing the financial viability of continuing the Existing DB/Hybrid Plan for all UM employees, the Advisory Committee did not report findings on four other significant issues on which we had recommended it undertake analysis and report conclusions and reasoning, echoing themes in our 10-27-10 UMKC Faculty Senate Report. Specifically, the Advisory Committee:

- Did **not** state a finding as to whether the 8% investment return assumption seems reasonable going forward;
- Did **not** state a finding as to whether the salary increase assumptions being used in the actuarial valuations continue to be reasonable going forward;
- Did **not** state a finding as to whether a defined contribution plan (“DC Plan”) is really a better financial proposition for various groups of employees from a “mobility” perspective than is the Existing/Hybrid Plan (when the latter’s Minimum Value Accumulation component is taken into account);
- Did **not** state a finding as to whether, if a new retirement plan for new hires were adopted, based on a range of reasonable long-term market assumptions (i.e., sensitivity analysis), the current Existing DB/Hybrid Plan for existing retirees and existing employees can continue to completion at the same level of retirement benefits formula (no freeze or change in benefits computations) with an acceptable employer contribution, the stabilization fund in place permanently, and no increase in the employee contribution.

There is some limited discussion touching on these areas in the Advisory Committee Report, which is discussed in Part II below. But such discussion in the Report does not reflect the degree of analysis we feel is in order for the magnitude of issues involved, and certainly does not constitute “findings.” Thus, while we see great value in the work the Advisory Committee did in outlining a “Combo Plan,” fulfilling what turned out to be its principal charge by thoughtfully addressing such issues as whether employees at various levels on the pay scale can afford to make contributions, as well as how the shifting of risk of market volatility to the employees might be managed to try to avoid a severe lack of retirement security for new employees, it is apparent from its Report that the Committee’s work to date does **not** provide justification for closing the Existing DB/Hybrid Plan to new employees. Nor does it explain in anything like sufficient detail how such a closure could be accomplished without by itself causing financial harm to the existing employees and retirees through increases in required employee contributions or loss of benefits in coming years. While it is clear that the Advisory Committee spent significant time exploring possible effects of retirement plan design on competitiveness in recruitment and retention, its Report

draws no express conclusions on whether adopting a new DC Plan or Combo Plan for new hires would be a competitive advantage or disadvantage for the University.

B. Questions We Urge You to Address

For the reasons summarized in general terms above, and discussed in much more detail in Part II below, we urge you to take steps to ensure that you will have before you all material information you need in your deliberations to reach well-informed answers to the following questions:

- (1) Is the push to consider adopting a new retirement plan for new hires over-reaction to recent market downturns? Has it been clearly demonstrated that the Existing DB/Hybrid plan cannot be maintained (for the short- and long-term) for all benefits-eligible employees at acceptable levels of annual contributions?²
- (2) If the Existing DB/Hybrid plan, which the Advisory Committee Report notes has been much better managed than many DB plans across the country, is financially viable, with the “stabilization fund” feature made permanent, might continuation of that plan for all benefits-eligible employees: (a) deliver much better retirement security to the University’s employees than would a DC Plan or Combo Plan; (b) give the University a competitive advantage in recruiting; and (c) avoid the awkwardness of having, for many years, employees who work side-by-side on dramatically different retirement plans (a concern cited by at least one Curator at the November 1 meeting)?
- (3) From a policy perspective, if a choice has to be made among viable alternatives, is it more important to have a plan that rewards long careers with the University or one more attractive to prospective employees who highly value mobility?
- (4) On the mobility issue, how do results of the MVA feature of the Existing DB/Hybrid Plan, combined with the existing opportunities to contribute to other deferred compensation vehicles, compare, in typical ranges of scenarios, to results under DC Plan or Combo Plan options under consideration?
- (5) Given that Segal projections show that closing the Existing DB/Hybrid Plan to new hires

² We note in this regard that a major study of possible UM adoption of a DC plan occurred in 2006 and reports to the System President and Curators at that time recommended maintaining the Existing DB/hybrid plan for all benefits-eligible employees. See Report of the Retirement and Staff Benefits Committee to System President Elson S. Floyd: May 2006; Actuary’s Perspectives on the University’s Post-Retirement Benefits Programs report to the UM Board of Curators (Segal, May 4, 2006); Evaluating Retirement Programs, presentation for UM Board of Curators by Dallas L. Salisbury, President and CEO of Employee Benefit Research Institute (May, 2006).

would, with other assumptions remaining constant, significantly increase the annual contributions to the existing plan as a percentage of payrolls of the employees covered by the plan, how--and by whom--would that increase be borne if the existing plan were closed to new hires?

The remainder of this memorandum discusses data and analysis that we urge you to consider in addressing those five questions. These are, of course, not the only questions you should address in connection with the retirement plan project, but we believe that they should be part of your deliberations.

II. DETAILED DISCUSSION OF SUGGESTED DATA REVIEW AND ANALYSIS

A. Checking and Updating Key Actuarial Assumptions and Required Contributions Projections

We have on several occasions urged that all significant actuarial assumptions that affect projections of the annual “required contribution” to keep the Existing DB/Hybrid Plan fully funded be revisited to take into account recent actual experience and forecasts of future circumstances. All such analysis should be shared in detail with the faculty, staff, and other constituencies. That approach would facilitate informed shared governance and would allow UM employees to better understand and assess the reasonableness of the key assumptions (and, thus, the reasonableness of the projections of sharply increasing required contributions that appear to have fueled the recent call for exploration of adopting a DC plan for new hires).

We understand that this is not an exact science. This is evident in projections of future required contributions made over the last approximately two years. For example, the required contribution, as a percentage of payrolls, for either plan for UM fiscal year³ ending in 2012, has been projected at:

- 12.30% to 13.54% “**employer**” contribution⁴ (depending on market rate of return for plan year ending 9-30-2009) in an April 19, 2009 memo from Howard Rog of Segal and essentially reiterated in an August 2009 report to the Curators Compensation & Benefits Committee;
- 8.55% to 11.59% “**total**” contribution (depending on market rate of return for plan year ending

³ Reports we have seen appear to occasionally refer to the required contribution on a plan-year basis, but most often on a UM-fiscal-year basis.

⁴ Stated to be projected “net of the anticipated employee contributions effective July 1, 2009.” In the “total” contribution figures in the following bullet points, we understand each includes the currently required employee contribution of approximately 1.23% of payroll.

9-30-2010) in a March 4, 2010 memo from Howard Rog of Segal;

- 8.5% total contribution in September 23, 2010 and January 27, 2011 System HR reports;
- 8.3% total contribution in the 2010 Actuarial Report.

This shows that the required contribution projections decreased substantially in less than two years of study. Decreases in the previously projected levels of required contributions for years after 2012 have also occurred. Given that each 1% represents approximately \$10 million, the differences among those projections are significant.

The 8.3% for FY 2012 is higher than the 7.25% “normal cost,” though we note that the projected “employer” contribution for FY 2012 is only about 7.07% (as the “employee” contribution is approximately 1.23%). This total required contribution is not the highest it has been over the last ten years and, moreover, there have been many years when it has been significantly lower. As the Advisory Committee Report (p. 15) notes, over the last ten years “the retirement plan cost as a percent of payroll has ranged from a low of 2.56% to a high of 8.69%.” It appears the decreases from the previous, more dire, projections of required contributions for future years are largely due to post-2008/2009 market crisis rates of investment return exceeding prior expectations. Since concerns over investment return have been placed front-and-center in statements regarding the drivers of the present project,⁵ the benefit that the plan accrues from the upside of the market, as well as the downside, merits consideration, as noted at the November 1 Meeting.

Investment Return on the Current DB/Hybrid Plan—Is it now “Decreasing”? Is 8% a reasonable assumption?

We understand that in discussions at the November 1 Meeting, a representative of the investment firm Rocaton reported that they believe the assumed 8% return continues to be reasonable. Also at that meeting, one or more of the Curators urged that data on actual results be compiled going back several years to provide some potentially useful information on the Existing DB/Hybrid Plan’s investment return track record. We understood that the latter data were being compiled,⁶ but do not see such data

⁵ See, for example, Retirement Plan Project Update for Board of Curators, January 27, 2011 at first bullet point on Slide 1a (Why there is concern about this type of plan for the future), listing: “8% (long-term) investment return—decreasing and volatile.”

⁶ See November 16 Faculty Senate recommendations to the Special Advisory Committee at 2 (“As the result of the November 1st meeting, reports on historic returns are being compiled for study along with the forward-looking projections presented by Rocaton.”).

reported in detail and addressed in the Advisory Committee Report. We have only been presented with the statement that “Over the last 10 years, the returns have ranged from positive 17.5% to negative 17%.”⁷

In terms of recent portfolio market return results, Nikki Krawitz, UM System Vice President for Finance & Administration, reports that the “portfolio total return for the one-year ended September 30, 2010, was 9.7%” (up from 0.9% for the plan year ending 9-30-2009, and -17% for the plan year ending 9-30-2008). She also reported that the estimated return (again, portfolio return, not actuarial computation) for the calendar year ending 12-31-2010 (for which the accounting is not yet completed) is 10.6%. A September 15, 2010 report from Vice President Krawitz showed that on a System fiscal year basis (July 1-June 30), the return on the retirement fund net of fees was 12.7%. In addition, we note that it has been reported that the System and Board of Curators have made a conscious effort to reduce the percentage of the retirement fund investment in equities and we understand there is optimism about that strategy.⁸ Vice President Krawitz noted that the actuaries compute the actuarial value return.

To get a better understanding of the actual historical experience on the investment return and its effects on the computation of required contributions to the plan, we have studied the annual actuarial reports delivered by Segal for all plan years from the year ending 9-30-2001 through the year ending 9-30-2010. The 9-30-2001 report included information on the rate of return for the previous four years as well, so we have figures before us for the last 14 reported years. Importantly, in doing this we have focused not on the rate of return on portfolio market value, but rather on what Segal refers to in recent reports as “the total actuarial rate of investment return on the prior actuarial value.”⁹ This seemed appropriate as that is the rate of investment return used in the section of the Segal Reports that speaks to “Analysis of Actuarial Experience,” which includes the “5-year smoothing” approach to investment gains and losses, and leads to the computation of actuarial gain or loss (versus the 8% assumption) that we understand is a key element of computing the “amortization percentage” that directly affects the computation of the

⁷ From document presented to the Special Advisory Committee entitled “University of Missouri Defined Benefit Retirement Plan,” at 1. We presume these are returns as a percentage of market value, as opposed to the returns on actuarial value computed by Segal discussed in text below.

⁸ See Retirement Trust Fund and Endowment Fund Investment Report for UM Board of Curators Finance Committee: Sept. 23-24, 2010, at Slide 1ee. Of course, strategy on the mix of debt and equity investments must be constantly updated and reconsidered to account for market condition and opportunities.

⁹ See, for example, Segal 2009 Report at 6. We note that in the Segal 2001 Report the investment experience discussion referred to “the total rate of investment return on the prior book value on an actuarial basis,” but the more recent Segal Reports use the language quoted in text above, which may be the result in changes in methodology or terminology (we would appreciate further guidance on that).

“required contribution” to the plan.

The average such actuarial rate of annual return for that 14-year period is approximately 9.03%. The average annual investment return on actuarial value for the last 10 reported years is 5.51%. It is important to remember the 5-year smoothing component in all of these figures. We have not seen a compilation going back for a longer than 14-year period. We urge you to review actual results going back for at least twenty years, and discuss with Rocaton its most recent thinking in terms of potential rates of return going forward. We also urge you to consider potential effects of inflation. Based on prior experiences, and given the recent and contemplated cuts in the State Appropriation, it seems unlikely that UM salaries (which obviously drive plan liability) would keep pace with any significant inflation for the foreseeable future. Thus, inflationary investment return years may very well be a net plus to the actuarial value of the plan, though we certainly understand inflation can significantly increase various costs in the University’s budget.

Salary Increase Assumption

Another actual-experience-to-assumption comparison in the annual Segal Actuarial Reports that regularly results in a computation of actuarial gain/(loss) and, in turn, affects the amortization percentage, and thus the computation of the required contribution, is “salary experience.” The relevant sections of the Segal Reports explain that “for actuarial experience purposes, only those employees who were active in both years [presumably the plan year being reported on and the prior plan year] are considered.” The reports then discuss, separately, the increases in average salaries of “previous active academic and administrative employees” and of “previously active clerical and service employees”. The most recent Segal Report indicates that it assumed average increase in salaries of 5.3% for academic and administrative employees and 4.5% for clerical and service employees (2010 Actuarial Report at page 39, GASB Statement No. 28).

The comparison of actual to assumed salary increases first drew our attention last October when we saw the Segal 2009 Report, which showed actuarial salary increases much less than assumed, resulting in a \$46.6 million actuarial gain for the plan year ended 9-30-2009. Given that, and the circumstance that the assumed level of salary increases seemed rather high compared to the personal experiences of many faculty, the UMKC Faculty Senate urged in its 10-27-10 UMKC Faculty Senate Report that the System and Curators study the salary increase assumption to determine if it might have the effect of overstating liability and thus understating the net actuarial value of the fund. This request was reiterated in our subsequent recommendations to the Special Advisory Committee.

We have seen a response that explains various aspects of what the components of the salary increase assumptions are and how related computations are made, which includes the statement that: “These assumptions lead to an *annual level percentage increase* earned in each year (for purposes of setting the

annual required contribution) although in actuality the increases may be more sporadic.”¹⁰ But what we have not seen is an analysis of whether the salary increase assumptions being used for actuarial valuation purposes are considered to be reasonable going forward.

We were told that the plan year 2009 actuarial gain from salary increases being far less than assumed was unusually large. And, having reviewed the Segal Reports for 2001 through 2008, we would generally agree with that assessment, though we note that there was a \$30.6 million gain from this item reported for plan year 2002. But the 2010 Actuarial Report showed another year of actual salary increase experience being much less than assumed, and reported another very large actuarial gain from this item--\$45.3 million. So we reiterate our recommendation that consideration be given to the extent to which the salary increase assumption may be unreasonably high, thereby overstating plan liability.

Other Actuarial Assumptions & Projection of Required Contribution

While review of the last ten years of annual Segal actuarial reports suggests that the investment return and salary increase assumptions play a prominent role in annual adjustments to the required contributions, we are mindful that many other actuarial assumptions are also involved in assessing the financial health of the Existing DB/Hybrid Plan. For example, a September 23, 2010 System HR report to the Curators highlighted, in addition to the investment return assumption, mortality rates and turnover rates. However, we note that the Advisory Committee’s Report states in an appendix (p.17):

Each assumption is set using accepted actuarial standards, and all assumptions are reviewed every five years. A report is produced and is available upon request. Even with asset smoothing, the assumption with the most impact on the normal cost and therefore on the annual required contribution is the investment return as shown in Table 3 below. There is much less volatility (gain/loss) from all the other actuarial assumptions combined and they tend to offset each other over time.

For the reasons stated above, we question whether the last sentence of that statement continues to be a reasonable observation in view of the last two years of salary increase experiences that were well under actuarial assumptions. In addition, we note that the fact that other assumptions may have netted out in past years does not mean they do not merit reconsideration going forward, so urge you to study all actuarial assumptions mentioned in the Advisory Committee Report and reach conclusions on the reasonableness of each significant assumption going forward.

In this connection, we note that we understand the projected required contribution through UM fiscal year ending June 30, 2016 previously reported to you is based on the Segal/Rog March, 2010

¹⁰ From document presented to the Special Advisory Committee entitled “University of Missouri Defined Benefit Retirement Plan,” at 3; reiterated in Advisory Committee Report at 18.

projection.¹¹ This required-contributions projection, and the similar one from the prior year, reflect acknowledgement that market investment rates of return may differ from actuarial assumptions used for other purposes. For example, in the April, 2009 Segal/Rog projection, there is an assumption of 0% market return for the plan year ending 9-30-2010; in the March, 2010 projection that market rate assumption was changed to 8% in one scenario, and left at 0% in another. As noted above, Nikki Krawitz reports that the market return for the plan year ending 9-30-2010 turned out to be 9.1%. So, we urge you to get an updated required contribution projection from Mr. Rog that takes into account the latest information about market conditions and re-assesses the salary increase assumption and perhaps other actuarial assumptions.

We also urge you to obtain an updated long-term sensitivity analysis with reasonable variations (at base assumption, below, and above) on all significant assumptions, including investment return, of the type we previously recommended, that would project the required contribution to the Existing DB/Hybrid Plan (if not closed to new hires) for several additional years on ranges of possible results on key assumptions, isolating each significant assumption for an assessment of reasonableness and impact of volatility, and consider that in developing your findings.¹²

B. The “Stabilization Fund”

The implementation of the “stabilization fund” approach was recommended to the System President and the Curators at least as early as May, 2006 (and may have been considered long before that), but we understand was not commenced until FY 2008. The Advisory Committee Report notes (p.19) that “One of the key reasons for a stabilization fund is to have resources readily available to counter the volatility of the financial markets.” Had it been started, say, ten years earlier, the down years at the beginning and end of the last decade would have been much more manageable, as the stabilization fund directly addresses market volatility, and could have used high investment yields from some years to offset low yields in other years. Instead, the University significantly reduced its contributions to the retirement fund following high investment return years.

¹¹ See document presented to Special Advisory Committee entitled “University of Missouri Defined Benefit Retirement Plan,” at 5. We assume the reference there is to Howard Rog’s 2-page March 4, 2010 memo to Michael Paden.

¹² We note that some of the reports Howard Rog presented at the November 1 Meeting made projections based on multiple variables and potential outcomes. Thus, it would seem that the type of updated sensitivity analysis we have suggested is doable and well within reach.

We have recommended for several months that consideration be given to making the stabilization fund approach a permanent part of the Existing DB/Hybrid Plan, as was recommended by System HR in 2006. We were pleased to see the Advisory Committee recommend in its report (p. 3): “Commitment to continue the stabilization fund (as defined in the Q and As) with the primary purpose of minimizing mandatory employee contributions.” This is critically important to the continued health of the plan and to following through on what we have been told was the intent when the decision was made to start requiring employees to contribute to the fund.

However, we are concerned that later discussion in the Advisory Committee Report states: “The decision of how much of the stabilization fund to use will be made annually taking into consideration projected required contributions and other budget issues.” The possibility of the stabilization fund being used for purposes other than support of the Existing DB/Hybrid Plan seems to potentially erode its value as a cushion against market downturns.

Moreover, we remind you of concerns regarding the implications on the “employee contribution” we voiced in our 10-27-10 UMKC Faculty Senate Report (pp.14-15). Shortly after the impending Curators’ vote on the measure was first announced at a UMKC Faculty Senate meeting in February, 2009, we were told by Vice President Rodriguez that: “the System is anticipating making the full required contribution. The employee contribution is to begin funding what we anticipate as a significantly increased required contribution in the next year or two.” However, the 2009 Actuarial Report showed that the employer contribution to the existing plan fund was reduced well below 7% by the amount of the employee contribution for FY 2010 and FY 2011 (see 2009 Actuarial Report at pages 5,23 Table 13; 9/23/10 Project Report to Curators at Slide 2h; August 2009 Salary/Benefits Review at page 58). In response to a question about this issue, Vice President Rodriguez explained that the System had followed through on the intent to make its full contribution in the 7% range by depositing into the stabilization fund an amount equal to the reduction in the employer contribution to the plan trust fund. It seems to us that if any part of the stabilization fund were used for purposes other than contributions to the Existing DB/Hybrid Plan, then the spirit of what we were told about the intent that the required employee contribution be in addition to, and not in lieu of, the University/employer contribution would be contravened.

We urge you to consider an approach whereby the stabilization fund would be firmly committed to the plan. If the plan were to reach a sufficient level of over-funding then it seems the sequence would then be to first use the stabilization fund to eliminate the need for the required employee contribution (which was not part of the overall compensation arrangements for UM employees prior to the market crash of 2008-2009) and only then look at the possibility of using any excess in the stabilization fund (after a reasonable assessment of future market volatility risk) for purposes other than support of the retirement plan trust fund.

C. The “Mobility/Portability” Issue

While market volatility and the ability to make the anticipated required contributions to the Existing DB/Hybrid Plan have been cited as the primary reason for the study of possible adoption of a DC Plan for new hires, a secondary objective identified during the course of the project is addressing the desire for prospective new hires to know that, if they leave UM employment before retirement--perhaps many years before--they will have some significant retirement funds to take with them. This issue was addressed in the 10-27-10 UMKC Faculty Senate Report, which in part observed:

One relevant question here is the extent to which mandatory entry of new hires into a DC Plan would be a good recruiting and retention policy, especially in the context of all types of employees and possible ranges of years of service involved. This is not a simple question by any means. It appears that when the possible adoption of a DC Plan was considered in 2006, it was deemed advantageous to “short service (non-career) faculty and staff,” but less consistent than is the Existing Plan with the University recruiting “design strategy” (see 2006 Segal Report at page 5). The latter focused on attracting and retaining the best faculty and staff for long careers, which was deemed to be in the best interest of our students (see May 2006 System Benefits Committee Report at pages 4-6). Significantly, in terms of concerns about employees staying employed “too long,” a paper published by the TIAA-CREF Institute cites aspects of both defined benefit plans and DC plans that can tend to cause that result (see May 2007 Crane-Heller-Yakoboski Paper at pages 24 and 27).¹³

There is, of course, a policy issue to be addressed here in terms of relative importance of the objective of recruiting and retaining great employees for long careers with the University and recruiting other great employees who may not be destined for long-term careers with UM, but who, while here, add value to our core missions. Ideally, a retirement plan would have significant benefits in it for both groups. Importantly, as pointed out in the 2006 study of possible UM adoption of a DC Plan, the Minimum Valuation Accumulation (“MVA”) feature in the Existing DB/Hybrid Plan, which involves an annual credit of 5% of salary, and a guaranteed rate of return at 7.5% per annum, positions it to offer significant value to both groups.

On the policy issues in terms of recruiting goals and effects, we have recommended collaborative

¹³ UMKC Faculty Senate October 27, 2010 Report & Recommendations at 10-12 (citing Actuary’s Perspectives on the University’s Post-Retirement Benefits Programs report to the UM Board of Curators (Segal, May 4, 2006), Report of the Retirement and Staff Benefits Committee to System President Elson S. Floyd: May 2006, and Designing Public-Sector Pensions for the 21st Century: A Risk-Managed Approach paper by Roderick Crane, Michael Heller, and Paul Yakoboski, published in May, 2007 by TIAA-CREF Institute).

discussion of goals and recruiting considerations. We understand the Advisory Committee engaged in extensive discussion and compiled and studied data on recruiting effects and employee turnover, and competitiveness, but did not draw any conclusions as to a frontrunner type of plan in this regard.¹⁴ We also appreciate that issues of career longevity and related views of retirement security needs can differ for various categories of employees. But apart from those complex policy and planning issues (which the Advisory Committee properly noted yield the reality that it is unlikely one can design a perfect plan that completely suits each group's preferences), we recommended that the Advisory Committee obtain and review comparative illustrations—in varying pre-retirement age and length of UM service before termination scenarios. We had urged the Advisory Committee to address the relatively straightforward question of just how much better off, in financial terms, varying groups of employees might be if they left UM employment at varying years of service under a DC Plan or Combo Plan as compared to under the existing UM retirement plan arrangements (including the very important Minimum Value Accumulation component discussed in the System's 2006 retirement plan study report).

We note that the "MVA" is briefly described in the Advisory Committee Report (p. 21-22) where, among other things, it is explained that: "The MVA can be compared to the lifetime benefit that would be received should the employee choose to defer the retirement benefit until they become eligible. Up to about age 48, the MVA is usually the higher benefit." Unfortunately, and although we understand that some graphs were studied in this connection, and the Advisory Committee discussed employee turnover and the portability issue in some detail, the Advisory Committee Report does not address comparisons with financial results to an employee who terminates UM employment prior to retirement age under the Existing DB/Hybrid Plan versus the types of DC Plan or Combo Plan the Committee was exploring. We were disappointed to see no such comparative discussion in the Advisory Committee Report. We note in this connection that we understand that after reviewing graphs comparing the cash-out value of different pension options as a function of years of service, some of the Advisory Committee members did not see a DC Plan or Combo Plan as being any more beneficial/portable to short-term employees than the current plan except for those with 3-4 years of service, and those who fully contribute to the DC plan.

So, to the extent "mobility" or "portability" is considered in your deliberations—and we understand it is much less of a consideration than the shifting of market risk away from the University (and by definition onto the workforce) that has clearly been cited as the primary motivation for the current study—we urge you to obtain comparative illustrations along the lines we recommended to the Advisory Committee, so that no decision will be based on misconceptions that under-value the MVA.

¹⁴ Document presented to Special Advisory Committee entitled "University of Missouri Defined Benefit Retirement Plan," at 10-11; Advisory Committee Report at 1-2, and 5.

D. The “No Harm” Issue

The January 27-28 Report to the Curators (at Slide 1h) lists as one of the items under Advisory Committee Findings: “No inherent harm to UM DB plan if closed to new hires.” The Advisory Committee’s Report states a similar conclusion (p. 23). We feel it is important that everyone have a clear understanding of what this means. The issues of potential harm to the employees covered by a “closed” DB plan, as well as harm to the plan itself, need to be clearly addressed. In the 10-27-10 UMKC Faculty Senate Report, the relevant question was framed as:

If a proposed DC Plan for new hires were adopted, based on a range of reasonable long-term market assumptions (i.e., sensitivity analysis), can the current DB plan for existing retirees and existing employees continue to completion at the same level of retirement benefits formula (no freeze or change in benefits computations) with an acceptable employer contribution, the stabilization fund in place permanently, and no increase in the employee contribution?

In this connection we noted in our earlier input to the Special Advisory Committee that, at the November 1 Meeting of the Curators Compensation and Human Resources Committee, Howard Rog presented projections which included one showing that closing the Existing DB/Hybrid Plan to new hires would increase the annual required contribution to the plan as a percentage of the payroll of the employees covered by the plan. The Advisory Committee Report (p. 7, and 23-24) notes and discusses that projection. The Advisory Committee suggests in its report (p.7):

Most importantly, if a new retirement plan is introduced and the existing UM DB is closed to new employees, the University must determine and clearly communicate in advance to employees how it intends to administer funding of the plans. As the UM DB plan winds down, the cost for that plan (while shrinking in total dollars) will rise as a percentage of payroll associated with those employees who remain in the plan. Both current and future employees will be justifiably concerned regarding differences in cost between plans and who will be asked to bear those costs. The Committee strongly recommends that funding of both plans be managed by the University to mitigate these concerns.

In earlier comments on drafts of the Advisory Committee Report we urged the Committee to make a much clearer statement of the intent to spare the existing workforce from an increase in their required contributions to, or reduction of benefits under, the Existing DB/Hybrid Plan. We fear that many stakeholders may be interpreting the many statements of “no inherent harm to the plan” from closure as no harm to the existing employees. That would be a false assumption unless the employees are in fact held harmless, from their individual financial perspectives, were a closure of the plan to occur. To be clear, we are speaking here to an issue where the only variable is closure versus non-closure, with

other assumptions being constant. We also question the suggestion of the Advisory Committee that the shrinking size of the Existing DB/Hybrid Plan fund under a closure scenario would not significantly weaken the fund's investment earnings potential (p. 24). In the discussion focused on management fees and, most especially, two pages later, in comparing expected returns on DB and DC plans generally the Committee itself notes (p.26): "About 1% less return on a DC plan than a DB plan; the issue is not fees—it is risk tolerance and access to high risk/high yield options." ¹⁵

We feel that it would be inappropriate for the University to, as part of mitigating the University/employer's market risk, impose on the existing workforce any or all of the cost associated with that employer risk reduction. After all, as the Advisory Committee (p.5) notes, "Over the years, direct compensation paid to our employees has been less than that provided by our peers." This is an acknowledgement that the existing retirement plan has for many years operated as an offset to the low UM salaries. In addition, the existing workforce has already suffered a cut in take-home pay when the required employee contribution was put in place a few years ago. Thus, if the Board considers a closure of the Existing DB/Hybrid Plan to new hires, we would urge you to condition any such closure discussion on a clear and demonstrably achievable "hold harmless" plan with respect to existing employees (and existing retirees). A general statement about "managing both plans" is simply not sufficient to let the workforce know where they would stand in this important regard.

SUMMARY

The Special Advisory Committee did a commendable job in covering a lot of ground and on many complex matters, within a relatively short time frame. Indeed, on many issues the Committee has been thoughtful and responsive to concerns raised by various constituencies and has done a very good job of developing a Combo Plan option the Board should consider if, after thorough and careful study, you determine that a new plan should be adopted for new hires. However, many of the important questions and recommendations outlined above, that we have submitted to the Committee and/or to System HR since October, have not been adequately addressed to date. These unresolved issues go directly to the questions of:

- (1) Whether all material (and updated) information has been considered on the threshold issue

¹⁵ See also discussion of this issue in our 10-27-10 UMKC Faculty Senate Report at 7-8 (citing May 2007 Crane-Heller-Yakoboski Paper, published by the TIAA-CREF Institute, at pages 37-38, discussing higher rates of return often enjoyed in defined benefit plans which "may result from economies of scale and the ability of such plans to take additional risk in investments because of a longer investment time horizon" and the ability of such funds to invest in "highly specialized asset classes," while arguing that well-structured DC plans can mitigate many of the investment inefficiencies of traditional DC plans and "realize a significant portion of the available higher-risk managed returns.").

of whether there is a need at this time to shift the market volatility risk from the University to the University's future employees;

(2) Whether there is clear understanding of the *incremental* benefits of a DC Plan or Combo Plan on the "mobility" issue; and

(3) Whether there is clear understanding of the meaning and scope of the "no harm" proposition if the Existing DB/Hybrid Plan were to be closed to new hires.

Accordingly, we urge you to act on the recommendations described in this memorandum. We look forward to continued collaborative dialogue on these challenging and important matters.