Senate Finance Committee
Hearing on pension Changes and SB 922
Monday, May 29, 2013

Ted Kennedy, Assistant General Counsel, Office of State Relations for American Life Insurance Company

Mr. Chairman and members of the Committee,

My Name is Ted Kennedy. I serve as Assistant General Counsel- Office of State Relations for American International Group (AIG). I am here today on behalf of The Variable Annuity Life Insurance Company (VALIC) part of the AIG Life and Retirement companies. VALIC is a leading provider of retirement products offered to the public sector with a specific concentration in education. Educators (including k-12 and higher education) typically comprise ~70% of a state's public sector workforce.

VALIC is the leading provider of voluntary supplemental savings plans offered to educators across the country. In fact, VALIC was the entity that petitioned the federal government and helped create the voluntary supplemental plans preferred by most educators today- 403(b) plans. Together with TIAA, VALIC is also a leading provider of defined contribution pension plans offered in the public sector (more on that later).

VALIC manages over 85 Billion dollars of assets for clients across the country which is part of 290 Billion dollars of assets under management for AIG Life and Retirement companies domestically not to mention our Property and Casualty companies domiciled right here in Pennsylvania. Locally, VALIC has over 30 retirement plan specialists in Pennsylvania providing service to over 55.000 clients.

My goal today, based on my 24 years working with public sector retirement plans, is to urge you to strengthen your public sector pension plans while preserving existing voluntary supplemental plans. In other words, as you support one leg of the "three legged stool" of retirement (pension), be careful not to alter the other legs (social security and personal savings).

I'll not advise as to the merits of a mandatory prospective defined contribution pension versus modifications to the existing defined benefit pension or other models including cash balance plans, hybrids and optional defined contribution plans other than to note the opposition of our client groups and tell you that most all states in the last five years have undertaken some type of public sector pension reform and only Alaska has adopted a program like the one before you.

That said, I understand you are looking for comments on the legislation currently under consideration so I provide the following observations. Please appreciate, however, that I am not an expert on Pennsylvania Code construction so to the extent my comments are determined inaccurate in this instance, forgive me.

Sections 101- 115 of the bill primarily deal with modifications to the existing defined benefit plan, Since my area of expertise centers primarily around defined contribution plans, I will forgo comment here other than to note section 104 which stipulates that new defined contribution pension plans shall be established by this legislation and such plans shall be mandatory prospectively and also available for all existing public sector workers to opt into.

Section 115 of the bill seeks to create a new defined contribution pension plan for school employees under Title 24 by creating section 8400 of the Code. (Note: the bill replicates most of the language created for school employees under Section 8400 in Section 5400 for state employees. Rather than provide comment to both, I will address my comments to the school employees plan, but also note as necessary the applicable sections to the state employees plan.)

School Employees Defined Contribution Pension

Section 8401 requires the plan to be organized as an IRS section 401(a) type plan. I agree this is the best plan type so as to not limit employee voluntary plan contributions into 403(b) and 457 plans.

Section 8404 establishes employee contribution rates at 7.5% of pay and also allows for additional voluntary contributions and possible rollover contributions from other plans. My only comment here is to note the difference with section 5404 for the state employees. Under that section, state employees are to contribute 6.25% so educators must pay more for their plan.

Section 8406 identifies employer contributions, but does not identify a rate or even a range of rates. I understand a 4% rate is contemplated, but I do not see it stipulated here. It is important to note that contribution rates in defined contribution plans have a direct impact on an individual's retirement benefit whereas such is not the case in defined benefit plans. If the state intends to move forward with this program and require employees to contribute, the legislation should provide some level of certainty that employers will bear a share of the funding burden as well.

Section 8407 requires participants in the defined contribution plan to annuitize at least the vested employer contributions. Although this limits some of the flexibility of a defined contribution plan, I like this provision since the plan is a pension and not a voluntary supplemental plan. Separately, this section states no loans or hardship withdrawals will be allowed. Again, these are restrictions on some of the flexibility generally found in defined contribution plans. To the extent labor finds value in these options, I suggest these provisions might be part of a negotiated compromise.

Section 8408 deals with death benefits and allows the Board to hire provider(s) to offer annuities to death benefit recipients. I'm okay with this.

Section 8409 deals with vesting by stipulating that employee contributions shall be immediately vested and any employer contributions shall be subject to a four year gradual vest. I'm good with that. However, the section also seems to indicate that any employer contributions defaulted by a participant who fails to vest shall be used as a credit by that participant's employer for any future employer contributions required into the plan. Although that is a nice feature, it might be better to use those defaulted contributions to help offset the unfunded liability of the system since the UAL is the reason you are considering these changes today.

Section 8411- 8412 identify the possible use of professional private sector services. Section 8411 says the Board may hire one or more vendors, but does not otherwise identify what the vendors might do (investments?, education?, compliance and recordkeeping?, enrollment and administration?). Section 8412 stipulates the plan shall offer participants at least ten investment options including a default option, but also specifies that at least one annuity should be offered and that the Board may contract for additional services and provide for educational materials. VALIC believes in competition and that only through competition are consumers sure to receive the best available products and services at the best possible price on an ongoing basis. Further, choice allows participants to choose a vendor offering the right level of service and education in relation to cost as best meets their personal circumstance while also protecting the employer and ultimately the state from possible fiduciary liability should a single vendor be selected and perform poorly. Finally, choice is what educators already have and expect in defined contribution plans. Most voluntary supplemental 403(b) plans administered today offer participants freedom of choice. In addition, most of the existing optional defined contribution pension plans for higher education also offer a multiple provider construct. If change is necessary, it might be better to at least provide folks something they are familiar with.

Section 8415 identifies start-up costs for the new plan shall be borne by the general fund. This would seem to indicate that the state will need to spend more money initially before any cost savings resulting from the implementation of these plans might be brought to bear. However, some of the materials I read in preparation for this testimony indicate these initial expenses might at least partially be covered by state contribution surpluses identified for the last two years.

Section 8416 addresses the right of existing employees to opt into the new DC plan if they wish. This is not uncommon. However, the option for existing employees to freeze their DB benefit and move to the DC plan appears to be open ended rather than a one time election window. Therefore, existing employees who might not yet be vested in the DB plan have an incentive to stay in the DB long enough to vest and then move to the DC. Alternatively, most DB to DC conversions require employees to choose upon plan implementation. Thus, any non-vested employees choosing to move to the new DC plan forfeit employer contributions made into the DB on their behalf. These forfeitures are typically used to help the system pay for its unfunded accrued liabilities.

Other interesting sections of the bill

Section 117(b) establishes code section 8502 for school employees. The same provisions are found in Section 5902 for state employees. There are two items of interest in these sections. First, they seem to indicate employer contributions shall be determined annually. Although I do not have a problem with annual fluctuations, I would advise the law should provide employees some level of comfort by at least stipulating a range for employer contributions. Second, the Board is given authority to use existing vendors already under contract with the retirement system for purposes of the new plans. I first would want to check state procurement law to determine whether or not bids might be necessary considering the scope and nature (tax dollars) of the new plans. I would also question whether entities offering institutional services for the DB plan or voluntary supplemental plan services through a 457 plan should be selected by caveat over other vendors experienced and active in offering public sector defined contribution pension plans. As an example, I refer you to the existing optional DC pension plans in place for higher education. Optional defined contribution pension plans for higher education have been around for over 100 years and have a proven track record over multiple generations. Based on their success in providing participants with optimal savings for retirement, these plans enjoy an 80% plus participant selection rate even though they are completely optional. A key component of these plans is choice. On average, these plans across the country use 3-4 vendors.

Section 304 establishes code section 5301. (a)(12) of this section seems to allow employers to establish their own plans. I question who this applies to. Is it intended to protect existing plans already offered by local government and the higher education plans I describe above or does this section allow any employer to prospectively opt out of any state-wide program and create their own plan? Separately, it is important to know the intent of (a)(1)(2). Would this terminate the existing pension plans locally administered and administered by higher education? If so, it violates my first admonition to “do no harm.”

Section 314 establishes section 5501.1and item (9) provides the Board may determine annually a contribution rate to pay for the unfunded liabilities of the system. Although defined contribution plans by their nature may never create an unfunded liability, I do not argue that DC plan participants, even new employees, should not help pay the system’s existing UAL. However, the amount of UAL should be capped upon plan implementation and once that amount has been paid, DC participants should have no further obligation to the UAL. Without this provision, future administrators of the DB plan will have an incentive to perpetuate a UAL knowing it to be a source of revenue from DC participants as well as DB participants.

Summary of primary points and an extra note

1) As you seek to repair your public sector pension program, do no harm to other complementary plans.
2) If you decide to create a defined contribution pension plan, do not feel like you need to navigate unchartered waters. Defined contribution pension plans for higher education are available in 48 states and have been around even before the creation of state defined benefit programs.
3) Extra: Use this financial crisis to avert another looming, but never mentioned issue. Due to a more mobile workforce than was envisioned in the 1930s, most public sector employees never vest in the pension plan. Many of those that do end up vesting in two or three plans rather than contributing to a single plan. In the defined benefit world, two halves do not make a whole. Statistically, an employee with two defined benefit plans each representing 15 years of service can expect a pension 30% less than an employee participating in one plan for 30 years. While I defend the employees benefiting from the existing system, I suggest some form of an optional alternative should be made available for the many that are not well served in the existing construct.