# Public Hearing On
# Proposals to Change the Design of Public Pensions


**Testimony of:**
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**Pennsylvania Senate Finance Committee**
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Good afternoon Chairman Eichelberger, Chairman Blake and other members of the Senate Finance Committee. I appreciate the opportunity to testify today on this very important topic. My name is Joe Nichols and I am a pension actuary with FTI Consulting. FTI Consulting provides independent, innovative business, actuarial and strategic communication advice to governments and businesses globally. Opinions stated in my testimony today, including those stated in answers to any questions by the committee members, are mine and not those of FTI Consulting.

I have consulted on actuarial topics related to public pension plans for over 25 years. Until about 2 years ago, I provided annual valuation services very similar to other public pension plan actuaries – but now I consult on a project-to-project basis. This current position places me in a rather unique role – one to provide independent advice. My goal here today is not to argue that one position stands better than another, but to help educate you about the potential outcomes of the important public policy decisions you have before you. I may argue that information on a certain position is incomplete or misleading, but not that one policy position is better than another or that one plan design is necessarily better than another. At the end of the process, that is your job. However, in order for a reform package to be properly implemented, the responsible party must have as much independent information as possible. A successful reform means that, during both the design and implementation phases, the independent information is not only used for modeling, but also properly communicated to all interested parties.

Today, I will use proposed changes from last year's Senate Bill 922 as a starting point for my discussions. Many of you already are familiar with those provisions and the arguments on both sides of the issues. If it is acceptable for you, I will take a few minutes to discuss some of the major discussion points, but I hope that the majority of my testimony time will be directed to answering questions from you, the Members of the Committee. If the questions are sparse (and I find that doubtful), then I can dig a bit deeper into some details of the bill's provisions.

One last thing before I start, though. As I stressed in my testimony before the House State Government Committee last month, despite the significant changes proposed in a bill such as SB 922, and the various other bills under consideration

this year, these changes alone cannot and will not solve the underfunding issue. Underfunding is a separate and distinct issue from considerations like appropriate plan design and should be approached as such. So please keep that in mind as you consider the various viewpoints brought to you today in this hearing.

Now, let's discuss some pension reform topics:

**Changes to the current benefit formula (multiplier, compensation limit)**

Changes to future benefit accruals are a key way to lower costs. A 10% change in overall benefits produces a 10% decrease in the cost of future benefits. However, due to the level of unfunded liabilities, a 10% cut in future benefits only lowers the recommended employer contributions by less than 5%. There are methods to "capture" the projected savings and apply over a shorter period. For example, accrued liability for active employees is based on projected benefits. If the projected benefits decrease (due to the formula change), so does the accrued liability. Past funding proposals have amortized this "gain" over a shorter period than the rest of the unfunded accrued liability. The effect is to lower contributions in the short-term. These methods to defer funding should be avoided.

**Collar adjustments**

Collar adjustments only forego the inevitable, which are higher contribution amounts. They should be avoided. The collars only hide the true cost of the systems and defer funding to the future. Funding progress should be measured by comparing the actual contribution to the full required contribution, not one determined by fabricated limits. For example, if the full required contribution is $2 billion and the collared limit is $1.6 billion, when only $1.6 billion is contributed, there is a perception created that the system has met 100% of their funding requirement, when in fact, only 80% was met.

**Conversion to a Defined Contribution Plan**

In the end, it is my opinion that the ultimate cost of any design (DB or DC or hybrid) is going to be very similar. If the ultimate goal is to switch to a DC arrangement, the energy should be used to determine how to limit the investment and longevity risk to the employees and how to prepare them to manage a large lump sum settlement at retirement. If the decision is made to

stay with a DB plan, the energy should be used to determine how better to deal with volatile contribution amounts and to determine how benefits and expenses can be better managed. At this point, much of the energy is used to argue anecdotal points and the important ones are being missed. Only after all of these elements are adequately studied can true transition costs (if any) be determined.

**Transition Costs**

Of all the topics in the DB to DC conversion discussions, none seem as polarizing as the topic of transition costs. Both sides of the argument site anecdotal, incomplete and/or hypothetical arguments. One argument is that, due to no new employees entering the DB plan, a lower discount rate should be used for determining liabilities. Another argument is that due to the fact that there is no evidence of transition costs when corporations moved to 401(k) plans, there will be none for Pennsylvania. One last argument I will site is that DB plans are more efficient than DC plans. My answer to these three arguments are as follows: Based on what evidence?; The situations are nowhere near the same, and; It depends on your objectives.

I am happy to expand on these answers after my prepared remarks. However, the point I want to make today is that there is nothing inherent in the transition from one type of plan design to another that automatically creates transition costs. Transition costs arise if the new design pays out a level of benefits higher than the previous design and/or increases administrative expenses and/or decreases future investment earnings. With proper design, (which means proper modeling during the design process) transition costs can be minimized, if not eliminated.

In closing, I would like to again thank the committee for inviting me to appear before you today. Actuaries are many times blamed for presenting complex, hard to understand solutions. Today, mine is easy. When preparing your pension reform proposals, remember that for every argument, there is a counter-argument. This may sound too easy, but over the years of pension reform discussions, the rhetoric is too one-sided. I challenge you to identify the negative aspects of your proposals and show how, through proper modeling, not only the desirable results, but how your plan will minimize the undesirable results. The largest “undesirable result” of pension reform is the unfunded liabilities. With the assumption that accrued benefits cannot be changed, there is no amount of plan

design (whether DB, hybrid or DC) that will lower the contributions needed to pay off the unfunded liabilities. A comprehensive pension reform proposal must place the funding of the benefits already earned as an independent provision and it must guarantee that the required contributions are set and followed.

A comprehensive design, with all arguments incorporated and with a strong focus on paying for past benefits, is the only hope for Pennsylvania to implement a successful pension reform plan that will last for the long term.

Thank you and I will now answer any questions from Committee Members.

Respectfully Submitted,

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