laura and john arnold foundation

April 15, 2015

Senate Finance Committee Public Hearing
Hearing Room 1, North Office Building, Capitol Complex, Harrisburg, PA

Dear Members of the Committee,

Thank you for the opportunity to provide testimony on retirement policy in general and specifically on defined contribution plans and the transition cost myth. This testimony is purely for nonpartisan educational purposes and should not be construed as support for—or opposition to—any legislation.

Retirement benefits are an important and valued part of workers' total compensation package, and the Laura and John Arnold Foundation is committed to ensuring that all workers have a fair and secure retirement. Across the nation, cities and states are facing a looming pension crisis that is threatening workers' retirement security and critical investments in education, public safety, and other essential public services. Governments have failed to responsibly manage their retirement systems. Over the past several decades, policymakers have engaged in a number of practices that threaten the sustainability of these systems. They have used accounting gimmicks, made insufficient contributions, and provided retroactive/unfunded benefit increases. As a result, rising pension costs—particularly pension debt service costs—are straining state and local budgets. Services have been cut, and workers have been forced to endure benefit cuts, wage freezes, and job reductions.

People on both the left and the right have recognized the urgent need for reform, and we are interested in working with all who are pursuing changes that are comprehensive, lasting, and fair. By taking steps to address the issue today, we can prevent a crisis tomorrow.

In order to protect workers and taxpayers, cities and states should adopt comprehensive pension reform. They should implement a fair, workable plan to pay down the accumulated pension debt as quickly as possible and establish a retirement savings system that is affordable, sustainable, and secure. This type of system includes several key elements. First, it should place all workers, regardless of tenure or when they were hired, on a path to a secure retirement. Second, it should remain financially sustainable across multiple generations of workers and taxpayers. Finally, it should have governance structures that ensure key decisions related to investment allocation, benefit design, and actuarial assumptions represent the interests of all stakeholders and are made in a transparent and publicly accountable fashion.

A variety of plans can be tailored to meet these design principles, including final average salary defined benefit (FAS DB), hybrid, cash balance defined benefit, and defined contribution (DC). Retirement plan design does not run on a smooth continuum from FAS DB to DC, with the former offering workers the most protection and the latter the least. There is no one-size-fits-all solution. All plan designs can incorporate important protections for workers including adequate savings/benefit accrual rates; pooled, professionally managed, low-fee, and appropriately allocated investments; and limited lump sums and annuities upon retirement.

While all plan types can be tailored to meet the principles of good retirement plan design, cash balance and DC represent the simplest, most transparent models for providing secure retirement benefits. Cash balance and DC plans tie benefits more closely to contributions and investment returns, eliminate unnecessary variables from cost estimation, and allow governments to more flexibly and transparently offer workers investment and longevity protection.

Unfortunately, reform opponents often use spurious technical or financial arguments to derail potentially productive reform discussions, and this is especially true when jurisdictions are considering moving new employees to a DC plan. Policymakers in Pennsylvania experienced this in 2013 when they were considering legislation that would have placed new state and public school employees into a DC plan. If the state's policymakers consider a similar proposal this year, they are likely to face the same false claims about the effects of such a move. Two primary claims were made in 2013: (1) DC plans are less cost efficient than FAS DB plans, and (2) moving new employees to a DC plan would result in significant transition cost.

The primary proponent of the first false claim—the cost efficiency myth—is the National Institute for Retirement Security (NIRS), a Washington D.C.-based nonprofit created by public retirement plans and their interest groups. NIRS asserts that FAS DB plans have inherent advantages over DC plans. The conclusions reached in the NIRS policy briefs are not simply overstated, they are wrong. The NIRS results are not supported by the empirical evidence, are largely driven by the authors' assumptions, and completely ignore pension debt as a significant cost driver for FAS DB plans. A number of recent papers have debunked various aspects of the NIRS arguments.[1] What is more, there are numerous examples of well-designed, cost-efficient public sector DC plans that deliver adequate, secure benefits to plan members, including plans sponsored by Oregon, Colorado, Michigan, Alaska, Ohio, and the federal government, among others.

The second false claim raised by reform opponents in 2013 is the transition cost myth. It has been perpetuated by the cottage industry of actuarial and investment consultants who work for public retirement plans. The costs that would supposedly result from a transition to DC are the product of an incomplete cost comparison based on poorly justified methodological choices and assumptions. The two transition cost arguments that have been raised in Pennsylvania are: (1) The state must pay off the pension debt on an accelerated schedule if the existing plan is closed to new members and (2) Winding down the closed plan requires more conservative and liquid investments over time.

The first of these arguments is based on actuarial convention and old accounting rules set forth by the Government Accounting Standards Board (GASB). The now-obsolete rules (GASB 25 & 27) called for an accounting switch from level percent of pay (back-loaded) amortization to level dollar (flat) when debt service payments could no longer be spread over a growing payroll. Some have called the switch in amortization schedules a cost because it would lead to higher payments in the short run. However, moving to level dollar would pay off the pension debt faster, resulting in lower payments in the long run and significantly lower overall cost. In the end, if governments were to make this switch, it would **save money**.

Importantly, the pension debt is the sole responsibility of the sponsoring government, and it is up to the government to adhere to a prudent payment schedule for pension debt. In the end, a state's choice of amortization schedule must match the duration of the debt. The way a state chooses to pay its debt service is a matter of public policy over which policymakers have complete discretion. Actuaries tend to apply the convention of accelerated amortization for closed plans with little to no empirical justification.

[1] Ambachtsheer (2012), McGee (2013), and Brown and Weisbenner (2014)

Regardless of any proposed change in plan design for new employees, it is imperative that Pennsylvania adopt a responsible, sustainable pension debt payment plan that is consistent with the recommendations of the Society of Actuaries Blue Ribbon Panel on Pension Plan Funding.[2] Any funding plan that fulfills these recommendations will be fiscally prudent regardless of how new employees earn benefits. If actuaries wish to argue that the amortization schedule should be accelerated due to a policy change, they must first demonstrate that today's payment plan is prudent and that the change in policy would necessitate an accelerated amortization schedule because following the current payment plan would lead to harm. It is simply not acceptable to blindly apply convention.

The second transition cost argument is that, over time, it is necessary to lower the discount rate used by a closed plan because increasing benefit payments relative to assets necessitates a shift to more liquid investments. While it is certainly true that a closed plan would need increased liquidity at the very end of its existence, any assumption about a shift in investment policy should be based on empirical evidence showing that projected levels of liquidity under the current/preferred investment policy would be insufficient. Given that the projections provided by the actuarial firm Milliman demonstrate that benefit payments relative to assets will be relatively constant for decades, it is hard to believe that any dramatic shift in investment strategy would be necessary in the foreseeable future. Moreover, illiquid asset classes make up a minority of the plans' portfolios and the Governor has called for a reduction in those holdings, further limiting the potential impact of any change in investment policy. There is simply no evidence that the very aggressive reduction of discount rates, which drove the cost estimates of both Buck Consulting and the Hay Group back in 2013, is necessary. The plans' actuaries failed to provide any empirical justification for the shift. It appears they simply assumed that a dramatic shift would be necessary—manufacturing a large cost in the process.

Alaska and Michigan provide useful case studies as to how these transition cost arguments play out in practice. Alaska remains on a level percent of pay amortization schedule despite closing its defined benefit plan to new entrants in 2005 and the initial recommendations of its plans' actuaries to accelerate payments. Alaska has been rewarded for the action it took to reform its pension systems. Ratings agencies have upgraded the state's credit rating twice since 2005, both times citing pension reform as one of the reasons. Neither Alaska nor Michigan has shifted its investment portfolio to more liquid assets since closing its DB plans, and I am not aware of any discussions to do so. In fact, both states have actually moved in the opposite direction. They are investing a larger proportion of plan assets in alternatives and private equity, which follows the broader trend for public plans.

Some have recently claimed that the cases of Alaska and Michigan demonstrate that moving new employees to a DC plan would cost more, but these claims reflect either a fundamental misunderstanding about how pension plans work or a purposeful attempt to mislead policymakers. Costs for both states' legacy DB plans have increased in recent years, but these increases have absolutely nothing to do with their move to DC plans. Rather, the rise in their retirement cost is due solely to the legacy promises made under the DB plans, and those costs would be even higher had the states not placed new employees in DC plans years ago.

In addition to the flawed arguments noted above, the plans' actuaries' previous cost estimates also contain two methodological errors. First, the 2013 estimates dramatically overstated the cumulative cost/savings figures by inappropriately summing nominal dollars across the entire projection period. When comparing

[2] https://www.soa.org/blueribbonpanel/

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a time series of dollar amounts over a number of years, it is proper to adjust the yearly figures to account for the time value of money. That is, it is not appropriate to count a payment today on a dollar-for-dollar basis with a payment to be made many years in the future. Discounting the yearly figures makes them comparable across time on a present value basis. This is the same concept that compels the plans to discount their future benefit payments. Appropriately discounting the time series would erase much, and in some cases all, of the headline-grabbing cost number. For example, discounting the Hay Group's projections for SERS using a reasonable estimate for future inflation (3 percent) would result in a cumulative cost of $194 million, which would nearly eliminate the claimed $3.2 billion cost. Discounting Buck Consulting's projections using the same rate would reduce its claimed $33.8 billion cost to $14.5 billion.

Second, at least one of the 2013 cost projections failed to account for the fact that the terminal unfunded liability for the reformed plan would be lower than under its baseline projections. Any projected future cost should both account for government contributions to the plan and the pension debt at the end of the projection period. Ignoring the pension debt results in an incomplete cost picture in which governments could lower cost simply by borrowing more from public employees' retirement plans.

Finally, the 2013 cost estimates also completely ignored the cost uncertainty of the current plan, a striking omission given that this is a significant reason why Pennsylvania is considering placing new employees in a DC plan. Under the plans' assumptions, a 7.5 percent average annual investment return is the median or 50th percentile value. That is, the plans believe there is a 50 percent probability that the long-term average annual return will be less than 7.5 percent. And the potential cost of missing this benchmark is considerably larger than the estimates for transition cost. Comparing the certain cost of a DC plan to the very uncertain cost of the current FAS DB plan only at the median is inappropriate. Any complete, honest projection of plan cost should provide policymakers with an understanding of the risk associated with a traditional FAS DB pension plan.

Policymakers should not be deterred by false claims about DC plans or overblown estimates of transition cost raised by those who have a vested self-interest in maintaining the status quo. Instead, they should take steps to protect workers and taxpayers by adopting comprehensive pension reform that will help to ensure that the state's pension systems are affordable, lasting, and fair.

I appreciate the opportunity to present testimony.

Sincerely,

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