

# Testimony on Pennsylvania Senate Bill 1



## Issues to consider in transitioning from a traditional DB plan to a DC hybrid plan

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# Notes on Senate Bill 1

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- The proposed bill changes the retirement program from a traditional defined benefit (DB) plan to defined contribution (DC) plan with a cash balance overlay.
- Based on information supplied by Xerox Consulting, the proposed plan reduces expected retirement benefits for future employees by 70%.
- Furthermore page 22 of the actuarial note includes these observations:
  - The proposed bill may be found to impair the rights of affected members.
  - The proposed plans will provide less secure, more volatile and less valuable benefits for employees. Policymakers should consider the appropriateness of such a significant change.
  - The proposed plans do not provide meaningful death and disability benefits. Particularly for public safety employees this is a major departure from past practice.

# In making such a monumental change one should establish the goals for the change

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## Following is the goal stated in Article I, Section 101 (1) of Senate Bill 1:

- It is the intent of the General Assembly to ensure the financial health of the Commonwealth and its school districts by adopting reforms to provide for the sustainability of our public retirement system.

**Since this is such a dramatic change, great care should be taken to assure that the proposed change will indeed attain the stated goal.**



**Multiple Issues must be considered in evaluating whether the proposed bill will meet the intended goals.**

**These issues include:**

- Initial Transition Costs
- Future Plan Costs
- Risk Sharing
- Value for your Benefit Dollars
- Other Cost Impacts
- Human Capital Issues

# Initial Transition Costs

At transition there will be increased costs. These fall in three categories as follows.

- Set up costs, these include
  - Communication requirements
  - Structural modifications
- Behavior impacts
  - Potential short-term increase in retirements



# Initial Transition Costs

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Other transition items are shown below.

- Possible shorter amortization period
  - Without new entrants, a plan will gradually lose its active employees
  - To avoid shifting current liability to future generations of taxpayers the amortization period should be shortened
  
- Long-term investment return
  - Upon transition the plan is no longer perpetually middle-aged
  - Therefore the investment return assumption should be modified to reflect the shorter investment horizon

# Risk Sharing Issues – Investment Return

**The distinct nature of the two types of systems results in significantly different investment outcomes.**

- DB plans pool investment return over generations of taxpayers and plan participants
  - As such an ongoing DB plan can be thought of as being perpetually middle-aged
  - This provides the ability for the plan to diversify investments over a long period of time



# Risk Sharing Issues - Investment Return

**DC plans on the other hand by nature have a limited investment horizon.**

- This limited investment horizon is because a DC plan is essentially for an individual.
  - Individuals age, they are not perpetually middle-age
  - Most financial planners encourage DC plan investors to gradually move their allocation to less volatile securities as they age.
  - This is because they do not have time to recover from a market correction



# Risk Sharing Issues - Investment Return

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Recent estimates indicate that switching from a DB to a DC plan will reduce investment returns from 1% to 2% per year. As DC plans mature, this difference may grow, placing additional burdens on plan participants.

# Risk Sharing Issues - Plan Expenses

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## Expense ratios vary greatly between DB and DC plans.

- Recent studies have shown that DB plan expenses run from 28 to 60 basis points depending on a variety of factors
  - A basis point is 1/100 of 1%
- A Boston College paper indicated that average DB plan expenses were 43 basis points while DC plans were 95 basis points (Other studies have confirmed these findings)

# Risk Sharing Issues - Pooled Mortality

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**A major strength of DB plans is their ability to pool mortality experience.**

- In a DB plan, each participant will receive roughly the same number of monthly retirement payments
  - From the plan's perspective this results in predictable and manageable payment pattern
- DC plan participants on the other hand must
  - Predict their own life expectancy and hope they do not live too long
  - Or purchase an annuity from a private party but that annuity will be priced to protect the private party and further erode purchasing power in retirement

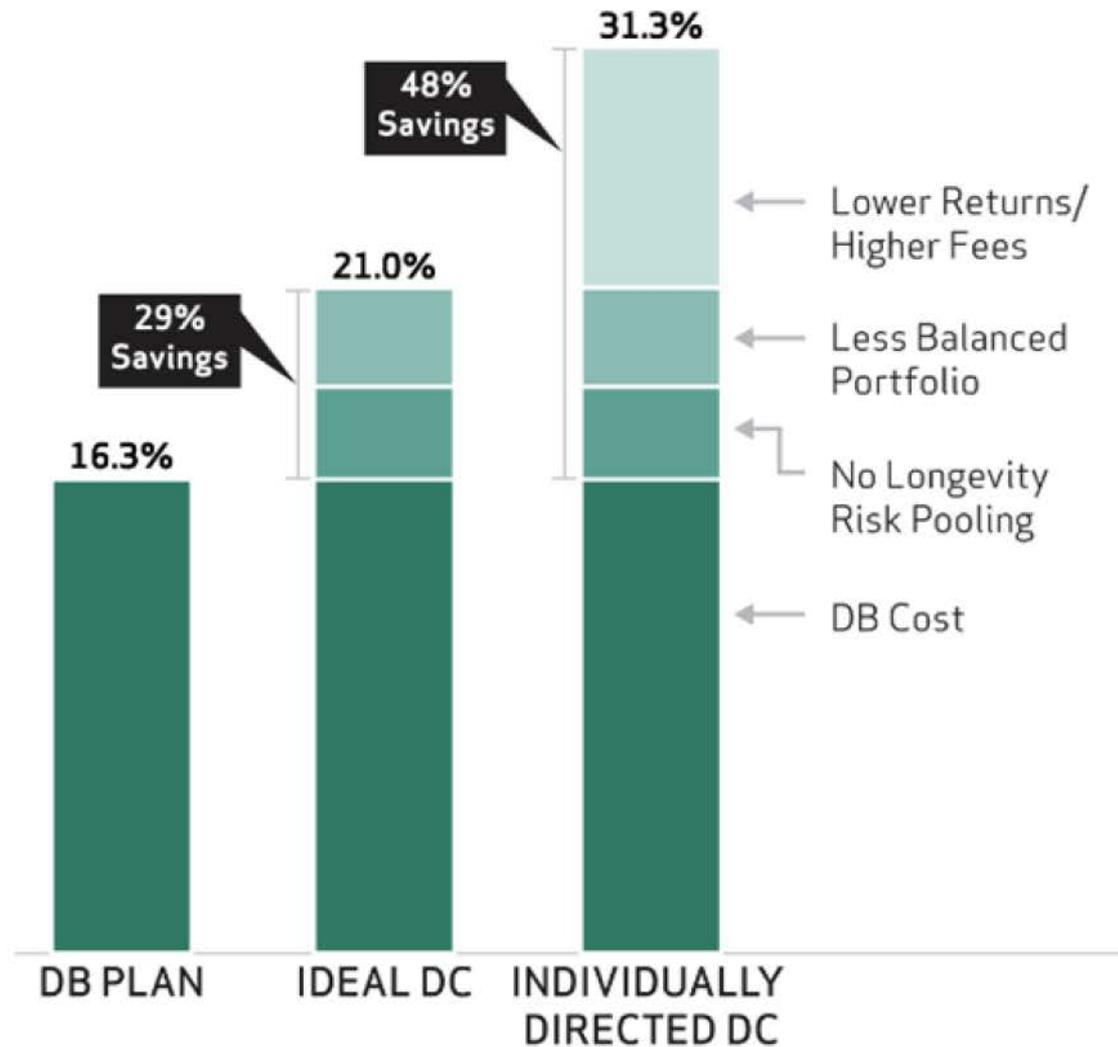
**Mortality pooling allows DB plans to share the risk of retirement longevity over all participants.**

# Value for Your Benefit Dollars

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- In December of 2014, the NIRS released a paper, “Still A Better Bang for the Buck”.
  - The new paper included a comparison of a DB plan, a traditional DC plan and an “ideal DC plan”
  - The “ideal DC plan” is one that uses a pooled investment portfolio with mandatory annuitization at retirement
  - The results are shown on the next page.

# Value for Your Benefit Dollars



# Value for Your Benefit Dollars

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- The chart on the preceding page from “Still a Better Bang for the Buck” illustrates the impact of the structural efficiencies inherent in DB plans.
- For an individually managed DC plan, a DB plan is 48% more cost effective in delivering benefits.
- As noted on the prior page, the efficiency is 29% better than an “ideal” DC plan



# Value for Your Benefit Dollars

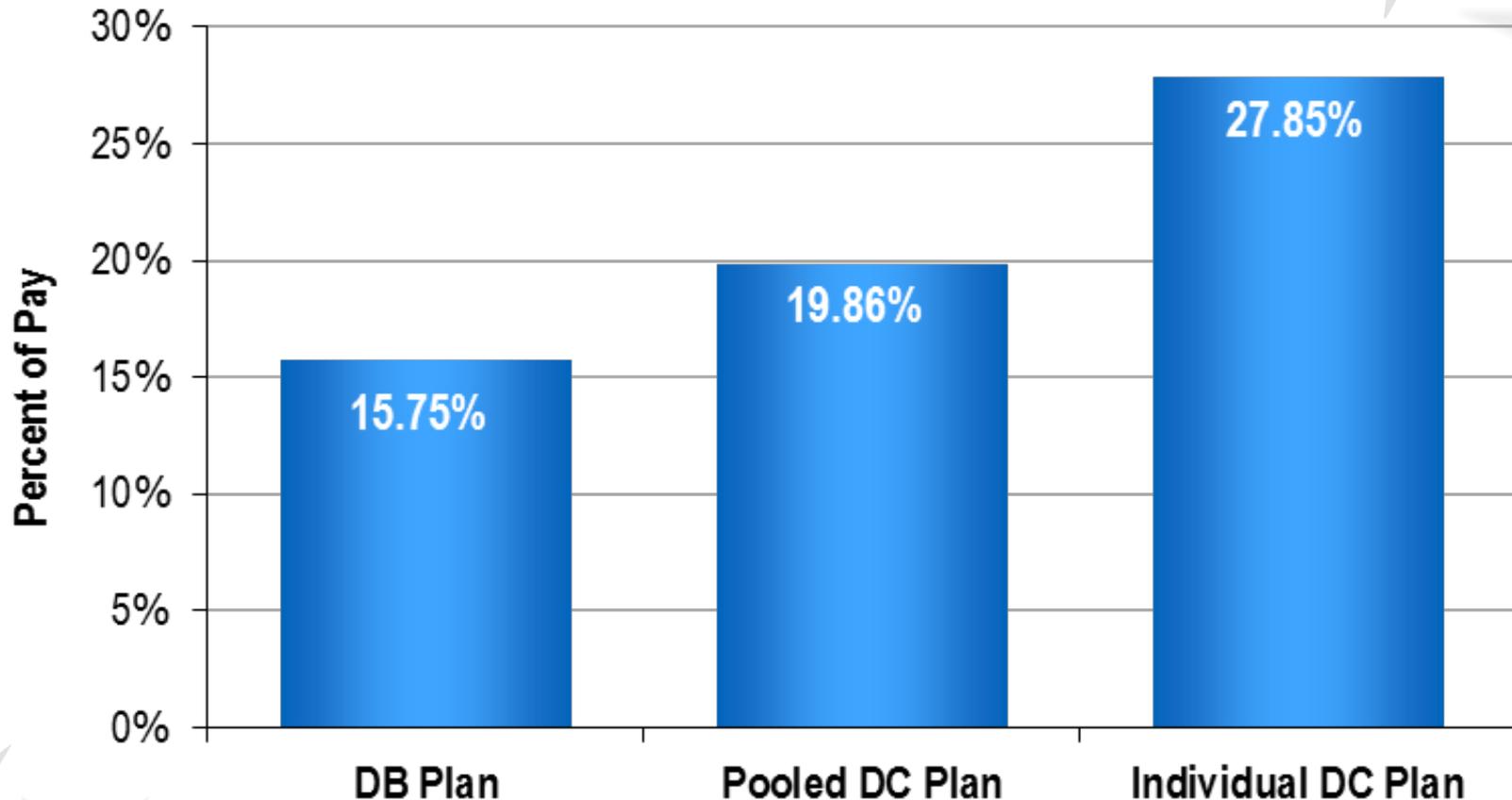
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- Since 2008, improvements have been made in benefit delivery for some DC plans.
  - The Better Bang paper refers to these as “ideal DC” plans, also known as pooled DC plans.
- These plans remove asset allocation and selection from the individual to a professional manager.
- Even with this improvement DB plans are 29% more efficient than an “ideal” DC plan

**The following pages illustrate the impact of providing the contribution rate necessary to provide an equivalent benefit and the benefit provided by an equivalent contribution.**

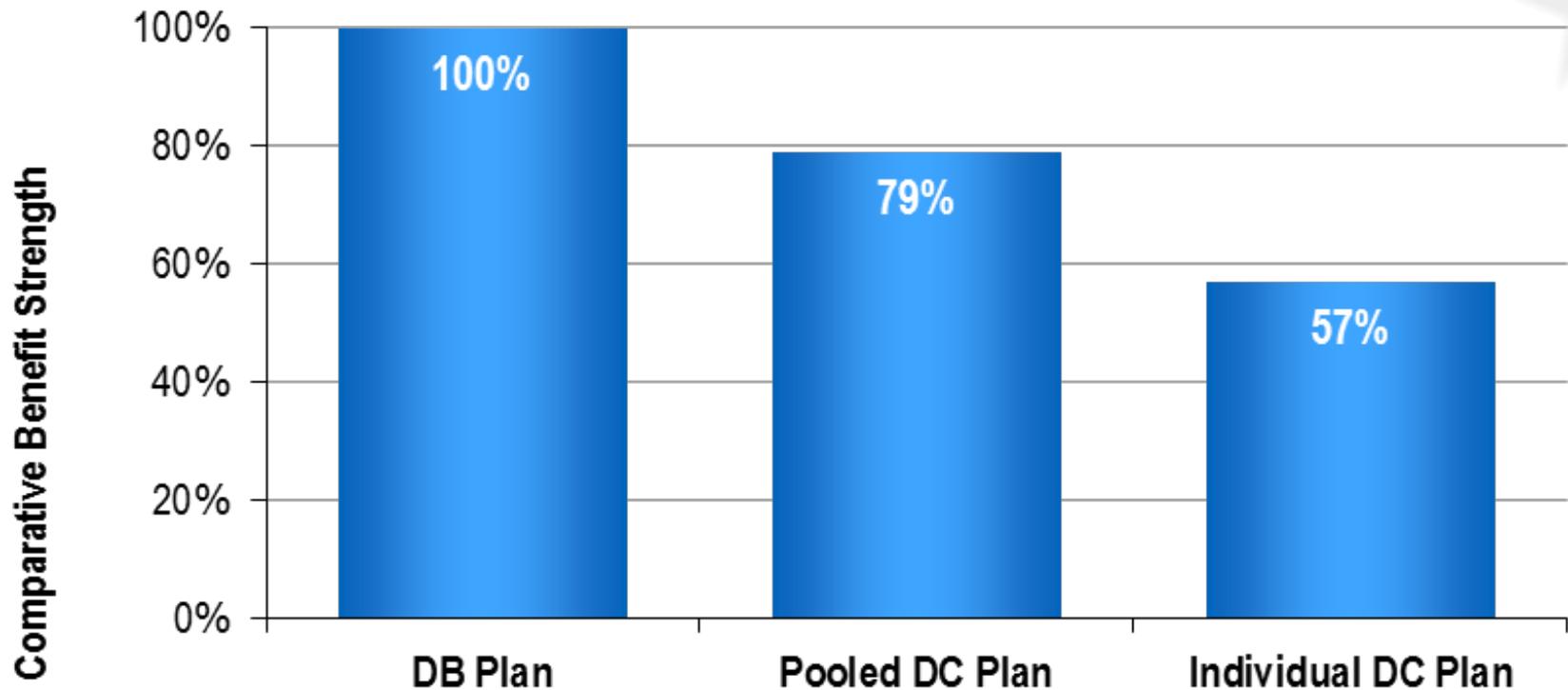
# Value for Your Benefit Dollars

## CONTRIBUTION RATE REQUIRED TO PROVIDE EQUIVALENT RETIREMENT BENEFIT



# Value for Your Benefit Dollars

## COMPARATIVE BENEFIT PROVIDED BY THE SAME CONTRIBUTION RATE



# Value for Your Benefit Dollars

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These efficiencies in delivering benefits are due to three structural advantages of DB plans.

- 1 Longevity risk pooling
- 2 Asset allocation
- 3 Low fees and professional management

**Any savings as a result of shifting from a DB plan to a DC plan is due to decreased retirement income.**

# Other Cost Impacts

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## Legacy DB plan as noted earlier

- Without new entrants, a plan will gradually lose its active employees
- This will increase the cash-flow requirements for the investments of the plan
- Without new entrants, any fluctuations in liability will be more acutely felt on a diminishing population

## Other DC plan issues

- DC plans do not provide meaningful death and disability benefits during a working career
- To provide these benefits an employer will have to secure life insurance and long-term disability from another source

# Human Capital Issues

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DB plans are designed to encourage certain career behaviors. Without this potential changes in employment behavior could impact an entity's ability to provide constituent services. Examples are:

- As shown earlier, DC plans are not expected to provide the same level of benefit as a DB plan thus encouraging employees to work beyond normal retirement
- The portability of DC plans may also result in shorter service employees leaving sooner than desired by the entity.

**Each of the above possibilities may increase the cost of supplying community services.**

# Why Switch?

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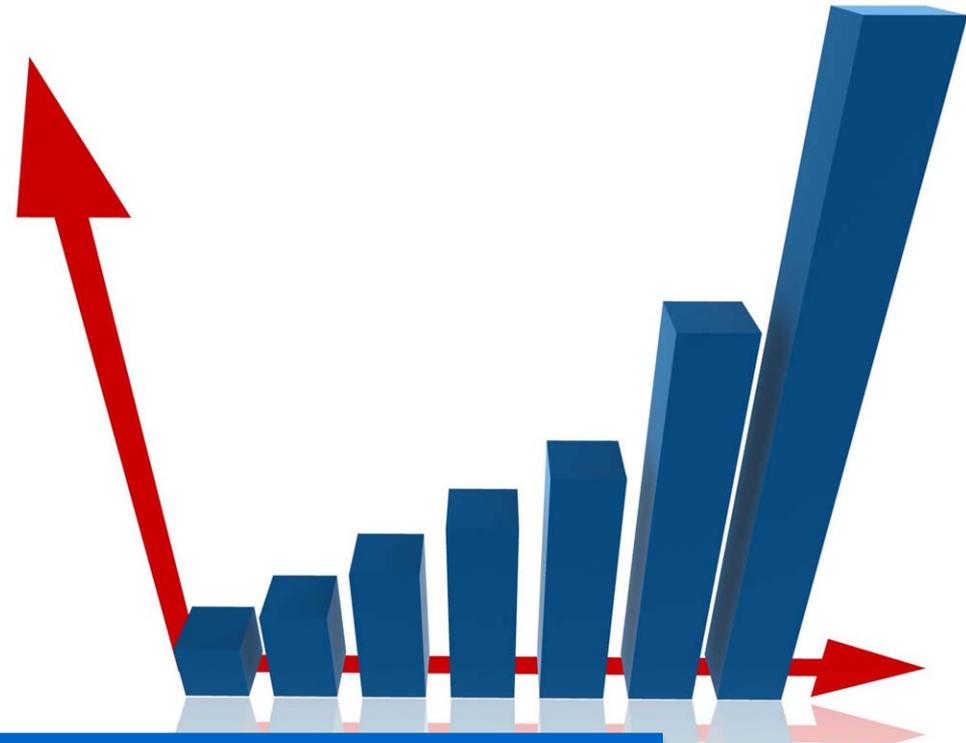
**If DB plans are so clearly more efficient in providing benefit dollars, why would an entity consider a change?**

- DB plan contributions are subject to market fluctuations. The contribution rate is not set in stone.
- If markets go down, the DB contribution will go up resulting in a higher cost for the employer.
- In a DC plan, if the market goes down, employee benefits are decreased but the employer contribution rate remains the same.

# Why Switch?

## Alternatively,

- If markets go up, the DB contribution will go down resulting in a lower cost for the employer.
- In a DC plan, if the market goes up, employee benefits are increased but the employer contribution rate remains the same.



The nature of the promise has changed in shifting from a DB to a DC plan, resulting in tremendous differences in where plan risks lie.

# Guidelines in Making a Decision

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The American Academy of Actuaries established a set of principles to guide plan sponsors and participants in understanding the retirement promise and to assist in setting priorities. These principles are on the following page.

**The principles are referred to as Retirement for the AGES and can help in addressing which party can best handle which type of retirement risk.**

# Guidelines in Making a Decision

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**A**lignment: A retirement system should align stakeholder roles with their skills.

**G**overnance: Good governance provides a balanced framework for making and implementing good decisions.

**E**fficiency: Systems should maximize retirement income while avoiding excessive risk.

**S**ustainability: The system should be designed to support retirement income over all generations of participants while being able to withstand financial shocks, such as recession or prolonged inflation.

# Summary

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- DC plans provide less benefits per dollar of contribution.
- Employer cost reduction in changing from a DB to a DC plan results from lowered retirement benefits, not from any intrinsic design unique to a DC plan.
- DC plan contributions are by design insulated from market fluctuations shifting that risk for adequate retirement income to the plan participant.
- A DB to DC transition may also impact other aspects of an entity's ability to serve its constituency.

**Transitioning to a DC plan is not the panacea some tout them to be. Care must be taken to assure that all aspects have been considered.**

# Summary

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**At the beginning, the stated goal of Senate Bill 1 was stated as:**

- It is the intent of the General Assembly to ensure the financial health of the Commonwealth and its school districts by adopting reforms to provide for the sustainability of our public retirement system.

Is the Bill projected to do so?

Based on the reports of three different actuarial firms, all of which indicate concern that they have not had sufficient time to thoroughly study the proposed changes, it does not appear that sufficient information is available to support the premise that the proposed bill will accomplish its stated aims.

# Summary

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“If the motivation for a conversion to DC is to reduce costs, then it should be noted that shifting to DC actually increases the cost of delivering a comparable retirement benefit.”

“If the motivation for a conversion to DC is to reduce government’s exposure to the financial risks associated with sponsorship of the pension plan, then it should be noted that other plan design options are available for reducing or transferring risk that do not require sacrificing the plan’s investment efficiency.”

“If the motivation for a conversion to DC is to address an existing unfunded liability, then it should be noted that converting to DC does nothing to address past-service unfunded liability that a plan may have accumulated.”

# Questions

# Cathie G. Eitelberg

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## Expertise

Ms. Eitelberg is a Senior Vice President in Segal's Washington, DC office. She has over 30 years of public policy experience with a focus on employee benefits and public finance. Ms. Eitelberg is the firm's National Director of the Public Sector market and a member of its Senior Management Team.

Ms. Eitelberg's specialized expertise includes:

- Public pension policy, design and governance,
- Public finance and plan administration, and
- Total rewards strategies.

Ms. Eitelberg's past and current clients include: the State of Nevada Public Employees' Retirement System, the State of North Dakota Public Employees' Retirement System, the Maryland Supplemental Retirement Plan, National Conference of Public Employer Retirement Systems (NCPERS), Ohio Public Employees Retirement System, the City of Duluth Teachers' Retirement Fund, the Indiana Public Employees' Retirement Fund and Indiana Teachers' Retirement Fund, the American Federation of Teachers, the New Jersey Education Association and the Nebraska Public Employees Retirement System.

## Professional Background

Ms. Eitelberg serves on the advisory committee to the Board of the National Association of State Retirement Administrators (NASRA), the Industry and Legislative Committee of the National Association of Government Defined Contribution Administrators (NAGDCA) and as an advisor to the Committee on Pension and Benefits Administration of the Government Finance Officers Association (GFOA). She has also served on several committees of the International Foundation of Employee Benefit Plans (IFEBC) and is a founding member of the Arthur N. Caple Foundation managed by NAGDCA. Ms. Eitelberg received the 1995 Private Sector Financial Excellence Award from the Association of Government Accountants.

## Publications/Speeches

Ms. Eitelberg lectures and writes on public retirement and health topics. She is frequently quoted in the press and is an accomplished speaker.

Recent articles by Ms. Eitelberg include:

- "Taking Control: How Effective Communications Can Help Public Employers Navigate Change" by Cathie Eitelberg and Tupper Hillard, IPMA HR News, November 2014
- "Actuarial Funding Policy Guidance: Comparison of Recommendations Reveals Considerable Consensus — and a Few Notable Differences," Public Sector Letter, October 2014
- "GASB Exposure Drafts Propose New Disclosures for Other Postemployment Benefits (OPEB)," Bulletin, September 2014

- "GASB's Second Implementation Guide on Pension Plan Financial Reporting Provides Guidance for Employers," Compliance Alert, June 10, 2014
- "Moody's Revised New Approach to Adjusting Reported State and Local Government Pension Data," Segal Bulletin, April 2013
- "Competing for Talent as the Economy Improves," by Cathie G. Eitelberg and Elliot R. Susseles, IPMA HR News, March 2013
- "Gearing Up to Comply with GASB's New Accounting Standards for Public Sector Pension Plans and Sponsoring Employers," co-author, Segal Public Sector Letter, November 2012

Ms. Eitelberg frequently leads webinars and speaks at conferences that educate clients about important developments affecting retirement and health benefit plans. Some of the issues she has addressed include:

- "The Future of Public Employers in Health Benefits," Washington, DC, NCPERS 2015 Healthcare Symposium, January 2015
- "The Future of Retirement in America," Public Pension Forum, October 2014
- "Building on the Past to Prepare for the Future," Segal's 16th Annual Fund Administrator's Seminar, May 2014
- "How to Think About the Future of Health Care," National Conference on Public Employee Retirement System, January 2014
- "Five Steps to Saving Pensions," CoRPaTH Winter Think Tank, December 2013
- "What They Don't Know Might Hurt You: Trustee and Fiduciary Education," 107th Government Finance Officers Association Annual Conference, June 2013
- "Claims and Insurance Coverage Issues," Public Sector Fiduciary Liability Insurance Webinar, April 2013
- "The Appian Way to Plan Reform," 15th Annual Klausner, Kaufman, Jensen; Levinsen Client Conference, March 2013
- "Blue Cross Blue Shield Labor: A Working Advantage," National Labor/Management Healthcare Strategies Conference, March 2013
- "Planning a Successful Funding Policy," Segal Webinar, January 2013
- "Public/Private Retirement Security: The New Dating Game," National Conference on Public Employee Retirement Systems 2012 Public Safety Conference, October 2012 and NASRA Directors and Affiliate Directors Workshop, August 2012

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# Thank You!

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