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Retirement Security
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Statement of Diane Oakley
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Introduction

Thank you for the opportunity to share research conducted by the National Institute on Retirement Security, or NIRS. I am Diane Oakley, executive director of NIRS. Established in 2008, NIRS develops data-driven research on a wide range of retirement issues. We are a nonpartisan organization with a broad range supporters. Our vision is to help ensure a U.S. retirement system that simultaneously meets the needs of employers, employees, and the nation's economy.

Today, I would like to share the findings of two recent research reports. The first study offers case studies of other states that shifted from a defined benefit (DB) pension plan to defined contribution (DC) 401-(k) style individual accounts. The second compares the costs of DB pensions to DC accounts. I hope these data inform your consideration of the best path to cost efficient and sensible solution for the stakeholders here in Pennsylvania.

A Cautionary Tale: DB to DC Switches Increase Costs, Does Not Address and Actually Worsen Underfunding

The three states in the case study report that shifted retirement plans from DB pension plans to DC individual accounts experienced higher costs. Moreover, the current financial data indicate that the DB to DC switch in fact worsened the pension underfunding issues.

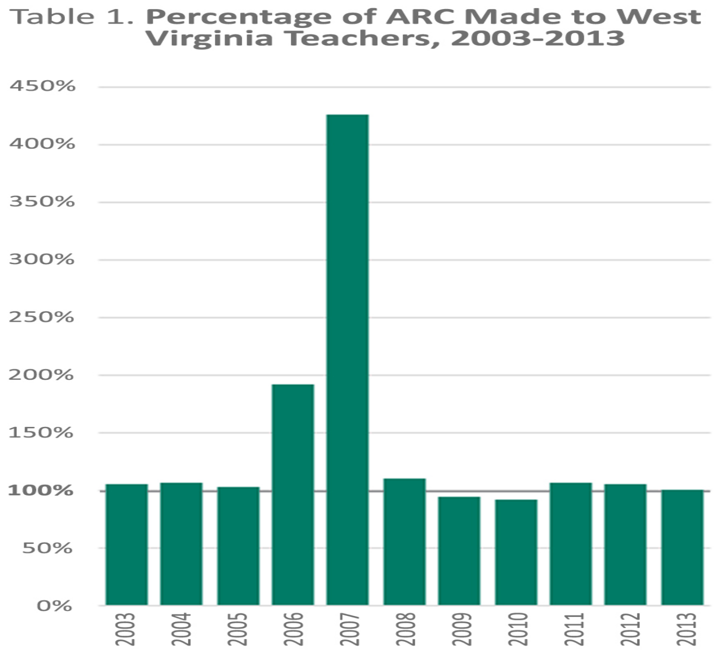
Some states have experimented with shifting employees from DB pensions to individual DC accounts. *Case Studies of State Pension Plans that Switched to Defined Contribution Plans*, presents summaries of changes in three states – Alaska, Michigan, and West Virginia – that made such a switch.

These case studies are important cautionary examples for policymakers. It's clear that closing a pension plan to new employees doesn't fill overdue funding gaps or reduce the cost of providing employees' pensions. In fact, it had the exact opposite effect of increasing costs to taxpayers.

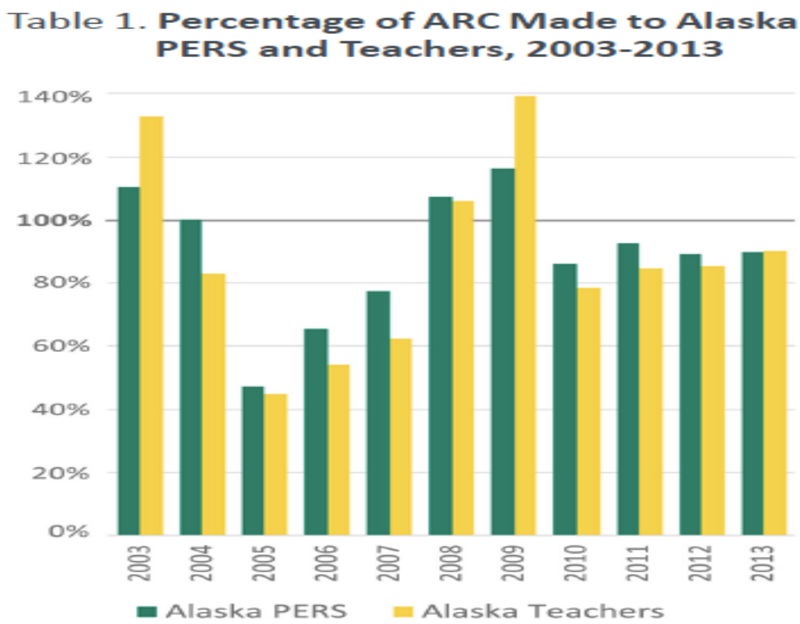
The case studies indicate that the best way for a state to address any pension underfunding issue is to implement a responsible funding policy with full annual required contributions, and for states to evaluate assumptions and funding policies over time, making any appropriate adjustments.

The case studies provide in-depth details for the following states:

- In **West Virginia**, the state closed the teacher retirement system in 1991 to new employees in the hopes it would address underfunding caused by the failure of the state and school boards to make adequate contributions to the pension. As the pension's funded status continued to deteriorate, retirement insecurity increased for teachers with the new DC accounts. Legislation was enacted to move back to the DB plan after a study found that providing equivalent benefits would be less expensive in the DB than in the DC plan. By 2008, new teachers were again covered by the pension, and most teachers who were moved to the DC plan opted to return to the pension. After reopening the DB pension, the state was disciplined about catching up on past contributions, and the plan funding level has increased by more than 100 percent since 2005. The teacher pension plan is expected to achieve full funding by 2034.



- In **Alaska**, legislation was enacted in 2005 that moved all employees hired after July 1, 2006 into DC accounts. Like Pennsylvania, the state faced an unfunded liability – to the tune of $5.7 billion for its two pension plans and retiree health care trust. The unfunded liability was the result of the state's failure to adequately fund pensions over time, stock market declines and actuarial errors. The DC switch was sold as a way to slow down the increasing unfunded liability, but the total unfunded liability more than doubled, ballooning to $12.4 billion by 2014. In 2014, the state made a $3 billion contribution to reduce the underfunding. Legislation has been introduced to move back to a DB pension plan.



- In **Michigan**, the pension plan was overfunded at 109% in 1997. The state closed the pension plan to new state employees who were offered DC accounts. The state thought it would save money with the switch, but the pension plan amassed a significant unfunded liability following the closure of the pension plan. By 2012, the funded status dropped to about 60% with $6.2 billion in unfunded liabilities. In recent years, the state has been more disciplined about funding the pension plan, making nearly 80% of the ARC from 2008-2013.

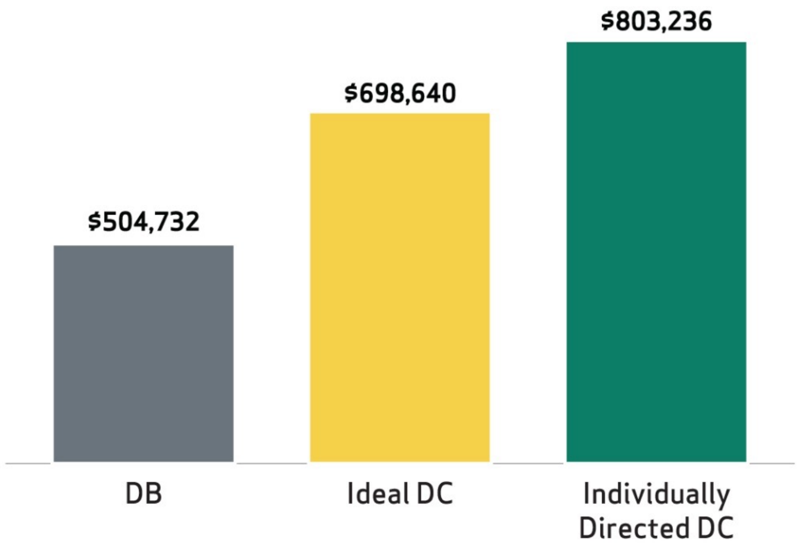
DB Pensions are HALF the Cost of Individual Accounts

The second study, *Still a Better Bang for the Buck: Update on the Economic Efficiencies of Pension Plans,* calculates that the economic efficiencies embedded in pensions enable these defined benefit retirement plans to deliver the same retirement income at a 48% lower cost than 401(k)-type DC accounts.

We partnered with a highly respected actuary who spent his career working in the retirement industry to outline the economics of retirement plans. The study looks at three retirement plans a traditional DB plan, a so called "ideal" DC plan and an typical DC plan

The analysis finds that pension plans are a far more cost-efficient means of providing retirement income as compared to individual DC accounts because of the unique economic efficiencies embedded in pensions. A pensions plan can deliver the same retirement benefit as an individual account at half the cost for three simple reasons:

Figure 7:
Per Employee Amount Required at Age 62
DB Plan vs. DC Plan



1. **Pensions pool the longevity risks of large numbers of individuals**. Said another way, pensions only have to save for the average life expectancy of a group of individuals. Absent a group retirement plan, individuals must save enough on their own should they be among the half of retirees who will live longer than the average life expectancy. This DB pension longevity risk pooling feature generates a **10% cost savings**.

2. **Pensions are "ageless" and therefore can perpetually maintain an optimally balanced investment portfolio**. In contrast, a typical individual investor must down shift investments over time to a lower risk portfolio of cash and bonds, sacrificing higher investment returns generated from stocks. This DB pension balanced portfolio feature generates an **11% cost savings**.

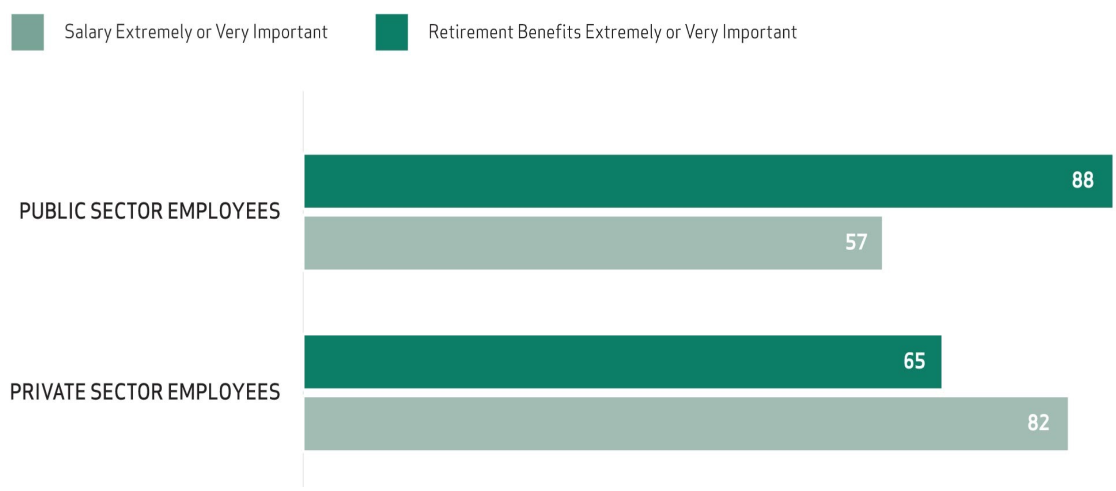
3. **Pensions achieve higher investment returns** as compared to individual investors because they have lower fees and are managed by investment professionals. This lower fees and higher returns DB pension feature generates **a 27% cost savings**.

In recent years, 401(k) plans have been modified with target date funds and annuities. But even with these changes, DC plans cannot replicate the economic efficiencies of a well-managed pension plan.

Lastly, it is important to remember that the state offers a pension plan to help manage its workforce – to attract, retain and transition employees into retirement. The retirement plan is an extremely or very important job feature to nearly 9 out of 10 public employees while salary is extremely or very important job feature to less than 6 our of 10 public employee. This preference contrasts with workers in the private sector where salary is more important. Changes to retirement benefit will likely result in greater demands for higher earnings so that employees can achieve a secure future.

Figure 24: **Retirement Benefits are Significantly More Important to Public Workers as Compared to Private Sector Workers**

When making job decisions, how important are the following job features to you?



Conclusion

The state of Pennsylvania adopted a plan and stepped up to the significant challenges to meet its retirement commitments to its employees in 2010. Those plans take time as you can see from West Virginia's experience to reach their goals.

Our research finds that the best path forward for states in situations similar to Pennsylvania has been to implement and stick to a disciplined funding plan to close the unfunded liability. The experience in other states clearly shows that switching from a pension to individual accounts doesn't just magically close funding shortfalls. In fact, the switch opens a new funding hole causing shortfalls even worse by starving the pension of future contributions.

Our research also shows that pensions are the most economically efficient means of providing retirement benefits – half the cost of individual accounts.

We hope that this research is helpful as you examine policy options to protect both taxpayers and the state's public workforce.

I would be happy to answer your questions.