A Silk Purse from a Sow's Ear:

Making the Best of a Side-by-Side Hybrid Pension

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KRC Pension Primers: *As policymakers, members of the media, and citizens evaluate pension proposals, the Keystone Research Center's (KRC's) "pension primers" seek to demystify the often-complex details of the pension debate. This is pension primer #15.* **November 17, 2015**

The tentative budget framework negotiated by Gov. Wolf and Republican legislative leaders on Pennsylvanian's 2015-16 state budget reportedly includes an agreement to establish a "side-by-side" hybrid pension for new employees hired beginning next year. Under this plan, new employees would receive a smaller defined benefit (DB) pension than existing employees along with individual 401(k)-style defined contribution (DC) savings accounts. In addition, several changes would be made to benefits for existing workers for their future years of service.

Based on Keystone Research Center's understanding of the budget framework pension plan – the details of which may still be shifting – this brief describes and then analyzes this pension plan. We find:

- While a big improvement on the earlier Senate pension proposal, SB 1, the side-by-side hybrid would cut retirement benefits for young, new employees by an estimated 10.5% to 23% compared to the current (Act 120 of 2010) pension benefits for new employees, which are already among the lowest public sector pension benefits in the nation.[1]
- The proposed hybrid would provide a DB pension substantially inferior to the side-by-side DB pension provided to federal employees. Advocates for a side-by-side pension in Pennsylvania have used the federal plan say as their model. The biggest reason for the superiority of the federal employee side-by-side DB pension is that this pension increases every year based on an automatic cost-of-living adjustment (COLA). This inflation protection translates into a lifetime DB retirement benefit 20% higher for a typical retiree than with DB benefit of Pennsylvania's proposed side-by-side.
- The proposed Pennsylvania side-by-side plan would *increase* the taxpayer cost of retirement benefits for new employees by 18% to 47%.
- The new pension plan design does nothing to reduce the state's unfunded pension liability. In fact, Pennsylvania's unfunded pension liabilities could increase if budget negotiators reduce pension payments in the next few years as is reportedly under consideration. Obtaining temporary budget relief by deferring pension payments requires higher payments down the road, similar to putting pension payments on a credit card.
- Courts are likely to reject as unconstitutional the only savings from the new pension proposal. These savings would result from benefit reductions for existing employees in their future years of service, and thus likely be found to violate a constitutionally protected "contract." In the unlikely event that courts rule one or more of these benefit changes constitutional, the same savings could be achieved without changing the pension design for new employees.

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[1] Keystone Research Center, *Pennsylvania Has Modest Public Pension Benefits*, Pension Primer #13, June 29, 2015; online at http://keystoneresearch.org/sites/default/files/KRC_PensionPrimer13_0.pdf.

While the drawbacks of the side-by-side proposal ought to lead to its abandonment, the demands of the leadership of the legislative majority for at least a partial shift away from traditional DB pensions does not appear to be driven by a policy rationale. Therefore, the fact that this shift hurts retirees, taxpayers, and schools and state agencies as employers (by making it harder to recruit and retain great staff) may not matter.

Based on the assumption that the side-by-side pension will become part of the final budget deal, the end of this brief highlights some ways that this proposal could be improved. Specifically:

- The multiplier (amount by which pension benefits increase with each additional year of service) for the DB portion of pensions for future workers should be increased substantially above the reported 1% of final salary. This could be done without increasing the total DB pension obligation of the state or school districts by combining a "stacked hybrid" design with the "side-by-side." With a stacked hybrid (earlier proposed by Gov. Wolf), salary above a certain level – e.g., $75,000 – does not quality for any DB benefit; instead, contributions for salary about this cut off go into the individual's DC savings account. With reduced DB benefit obligations for higher salaries, the state and school districts would be able to increase DB benefits (and the multiplier) below the cut off without a net increase in taxpayer financial market risk.
- Automatic inflation protection similar to that provided for the federal side-by-side DB benefit should be added to the DB portion of the Pennsylvania hybrid once Pennsylvania's two DB pensions are 80% funded.
- Budget negotiators should commit to exploring the potential for reducing management fees paid to hedge funds and other investment firms that actively manage some of the pooled assets of the Pennsylvania pension funds. This could produce real savings for the state budget rather than savings that will be rejected by the courts, leaving the state in a deeper pension hole when that happens in a few years.
- The pension deal should include a commitment to implement an "ideal" DC savings plan, which would have higher returns and lower costs than typical 401(k)-type plans.
- Since the hybrid pension will require setting up a state-managed pool of DC savings accounts, the state should initiate a process that allows private sector workers the option of saving accounts (technically, individual retirement accounts) that capitalize on the infrastructure set up to manage school and state workers' DC accounts. To make it easy to do this quickly, Pennsylvania could adapt the Connecticut legislation and implementation process for achieving "retirement security for all."

These changes to the budget framework's side-by-side pension deal would mitigate its negative impacts on school and state employees and vastly improve retirement savings options for many private workers, more than half of whom have no savings at all through their job.

The Proposed Pension Deal

The details of the proposed pension deal are still being worked out. Based on available reports, however, we understand the current features of the hybrid pension under discussion to be the following:[2]

- Employees would receive a DB pension with a 1% multiplier, half the size of the 2% multiplier in place since 2010 for new employees.
  - Employees would also receive an individual DC savings account.
  - Employees would contribute 3.25% to the DB plan.
  - Employees would contribute 3% to the DC savings accounts and employers 2% or 3%.

In addition, it is understood that benefit reductions for future years of service will be included for current employees, including:

- adjustments that make less generous and ("actuarially neutral) the cash-out option (Option 4) that allows employees to take the pension contributions they have made to their own pension through their career as a lump sum upon retirement;
- anti-spiking provisions that limit how much pensions can increase in the last few years of service (even if an employee is promoted to a higher-salaried position or works large amounts of mandatory overtime); and
- a reduction to 2% in the multiplier for future years of service for employees hired before 2011. This third provision may not be included because, based on prior court decisions, it is even more likely to be ruled unconstitutional than the changes in the previous two bullets.

Evidence-Blind Policies: Why a Switch to a Side-by-Side Hybrid is a Policy Mistake

Based on a large body of research, replacing Pennsylvania's traditional defined benefit pensions with the hybrid plan described above would be a policy mistake.

<u>It will shift a portion of retirement savings into less efficient DC plans</u>. Some policymakers over the past two years have been fixated on the taxpayer financial risk with defined benefit plans that can result in the state ending up having to pay off a large unfunded liability if financial markets underperform. These policymakers appear to forget that most of Pennsylvania's current unfunded liability results not from taxpayer financial market risk but from failing to make required contributions to pensions each year. Pennsylvania has the second worst record of any state because it has made such a small share of annually required contributions to its two big public pension plans since the early 2000s. Legislators championing DC plans have also stubbornly refused to acknowledge the evidence that DC plans *guarantee* – rather than simply risk – that taxpayers will pay higher costs for future retirement benefits. As a result of the higher fees and lower returns associated with DC plans, delivering the same level of benefits as with a traditional pooled public DB plan can cost nearly twice as much as with traditional DB plans.[3]

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[2] The description of the side-by-side hybrid analyzed in this brief is based on personal communication with pension stakeholders and on Charles Thompson, "From the budget table: Pennsylvania's proposed pension deal trades cuts in future workers' benefits for hoped-for taxpayer savings," Harrisburg *Patriot-News*, updated November 12, 2015; online at http://www.pennlive.com/midstate/index.ssf/2015/11/proposed_pennsylvania_pension.html.

[3] William B. Fornia and Nari Rhee, *Still a Better Bang for the Buck*, National Institute on Retirement Security; online at http://www.nirsonline.org/storage/nirs/documents/Still%20a%20Better%20Bang/bangforbuck_2014.pdf

The side-by-side hybrid will cut retirement benefits for young, new career teachers, nurses and other state employees. Measured by the benefits it provides, the new side-by-side hybrid proposal is much better than the Senate pension proposal, SB 1, vetoed by Gov. Wolf in July. This is obvious because the 1% DB plan ensures that retirement benefits would be at least 50% of the current Act 120 DB plan with a 2% multiplier (whereas SB 1 benefit cuts were projected to be as high as 70%). Assuming a 5% to 7.25% combined contribution from employer and employee to the DC part of the hybrid, and making reasonable assumptions about DC investment returns, the side-by-side hybrid would cut benefits for a typical career teacher by 10.5% to 22.8%.[4] Benefit reductions for SERS employees are likely to be similar.[5] An unnamed "analyst" in the recent *Patriot-News* story on the hybrid pension estimates that it would result in benefit cuts of about 10% compared to Act 120.[6]

The proposed side-by-side hybrid would provide a DB retirement benefit inferior to the DB benefit provided to federal employees and also inferior to many other hybrid plans. Recent advocacy by the Pew Trust for a side-by-side hybrid pension has used the federal retirement system as a "model." This system, in place since the late 1980s, includes a DB plan with a 1% multiplier and a DC plan. Until 2013, employees contributed only 0.8% of salary to the DB plan, although they now contribute 4.4% of salary.[7] Even with this increase, which means federal employees contribute 1.15 percentage points more (7.4% versus 6.25%) to their hybrid plan in total than would Pennsylvania employees, the federal hybrid is far superior to the one proposed in Pennsylvania. There are three reasons for this: first, the employer contributes as much as 5% to the DC part of the federal hybrid compared to the 3% in Pennsylvania; the federal DB benefit includes an automatic cost-of-living adjustment (COLA) similar to the one that protects Social Security benefits against erosion by inflation; and, last, retirees from the federal government receive health benefits in retirement whereas future employees in Pennsylvania would not. By itself, the protection against inflation in the federal DB plan is worth roughly a 20% increase in the inflation-adjusted value of DB benefits compared to Pennsylvania's proposed DB plan.[8] Put differently, a

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[4] Keystone Research Center based on estimates by Corry Schachern of the Pennsylvania State Education Association. Our lowest estimated hybrid retirement benefit assumes a 2% employer contribution and a 3% employee contribution. Our highest estimated hybrid retirement benefit (hence smallest cut relative to Act 120) is based on a 3% employer contribution and a 4.5% employee contribution. A 4.5% employee DC contribution brings the total employee contribution under the hybrid plan – for DC and DB – to 7.5%, the same employee contribution as under Act 120. For state employees, employees' currently contribute only 6.25% under Act 120 so the range of plausible combined contribution is 5% to 6%, depending on whether employers contribute 2% or 3%.
[5] The bottom end of the benefit-cut range for SERS employers could be higher than 10.5% because the top end of the plausible total contributions to the DC plan would be 6% not 7.25% as with PSERS. As per the previous footnote, this is because SERS employees contribute 6.25% to their DB pensions now, not 7.5%; that 6.25% contribution is matched with a 3% contribution to the DC plan.
[6] Charles Thompson, "From the budget table**,"** Harrisburg *Patriot-News*, updated November 12, 2015. This estimate at the bottom end of our range implies assumptions that increase the value of benefits from the DC plan – i.e., a DC option close to the "ideal DC plan" referred to in the text.
[7] Andy Medici, "Feds should watch out for pension contribution hikes," *Federal Times*, July 6, 2015; online at http://www.federaltimes.com/story/government/management/compensation/2015/07/06/retirement-congress/29228567/
[8] This estimate assumes that typical retirees draw their pensions for 20 years and that inflation averages 2.5%. With these assumptions, DB retiree benefit in the 20th year are only 61% of their value in year one – and only 61% of the value of the federal DB benefit in the 20th year of retirement. The twenty-year average of a federal DB benefit that goes from 100% in year one to 61% of that benefit in year 20 is 80.5% -- i.e., the 20% cut referred to in the text.

side-by-side retirement benefit modelled on the federal employees' plan would provide a retirement benefit similar to the Act 120 DB benefit even though the proposed Pennsylvania hybrid would not.

The DB part of the proposed Pennsylvania hybrid is also inferior to most of the other DB plans in state hybrids surveyed recently by the Pew Trust. Eight of these 12 state plans have an automatic cost-of-living adjustment (COLA). Six of the 12 have higher multipliers.[9]

The side-by-side would *increase* the cost of retirement benefits for new employees by an estimated 18% to 47%.[10] This increase is conservative because it assumes no erosion of investment returns (see the discussion of transition cost below). High costs alongside reduced benefits in the proposed side-by-side reflect the inefficiency of DC plans compared to DB.

The new pension design does nothing to reduce the state's unfunded pension liability. In fact these liabilities could increase if budget negotiators reduce pension payments in the next few years, increasing required pension payments down the road. A press report indicates that negotiators are considering reducing near-term pension payments, unavoidably increasing pension payments down the road.[11]

Courts are likely to reject as unconstitutional the only savings from the new pension proposal. These savings would result from one or more of the three benefit reductions for existing employees in future years of service that were described earlier. These cuts would likely be rejected by the courts because they violate a constitutionally protected "contract" that promised retirement benefit provisions would be maintained throughout employees' careers. In the unlikely event that courts rule one or more of the benefit cuts constitutional, the same savings could be achieved without changing the pension design for new employees.

It will reduce the quality of public employees. A 50% cut in the defined benefit pension will rob Pennsylvania schools and public agencies of their best asset when attracting and retaining high quality staff. Pennsylvania's public employers will have a particularly difficult time retaining the college-educated employees who make up more than half the public sector workforce. College-educated

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[9] Pew Charitable Trust, *Hybrid Public Pension Plans: A Primer*, April 2015; online at http://www.pewtrusts.org/~/media/assets/2015/04/hybrid-public-pension-plans_brief.pdf

[10] This estimate is derived as follows: the current (normal) cost of benefits for retirees under the Act 120 DB plan is 10.09 percent for employees in the Pennsylvania Public School Employees' Retirement System (PSERS) (employees' contribute 7.5% and employers 2.59%). (Employer normal cost provided by PSERS.) This 10.09% current combined normal cost means the normal cost for a DB benefit half as big would be 5.045%. With employees putting in 3.25%, employers would have to put in 1.8% to the side-by-side DB plan; adding to this employer DB contribution a 3% employers contribution to the DC side of the hybrid brings the employer cost for PSERS with the side-by-side to 4.8%, nearly twice 2.59%. For the State Employees' Retirement System (SERS) the Act 120 combined (normal) cost is 11.2%, 6.25% from employees and 4.95% from employers. That means the combined DB normal cost under the hybrid would be 5.6%; with employees paying 3.25%, employers would have to pay 2.35%. Adding that to a 3% bring the employer (normal) cost to 5.35%. Weighting PSERS two thirds to reflect the relative size of the two plans means that the overall employer normal cost goes from 3.38% to 4.98%, an increase of 47% or nearly half. If the employer contribution to the side-by-side DC plan is 2% instead of 3%, then the combined employer normal cost for the side-by-side hybrid is 3.98%, an increase over 3.38% of nearly a fifth (18%).

[11] According to Charles Thompson: "…some Senate leaders have apparently advanced a plan to refinance the state pension systems' existing unfunded liability again, in the interest of producing about $170 million in savings for fiscal 2016-17." See "From the budget table**,"** Harrisburg *Patriot-News*, updated November 12, 2015.

Pennsylvania employees in the private sector enjoy salaries at least 25% higher on average than public employees

The proposed hybrid could lead to a transition cost: a hybrid plan means few contributions for future employees going into the existing pooled pensions. It also means that the demographic profile of the two plans' benefit obligations will age considerably. This aging could lead to a more conservative investment approach by the pension plans, reducing investment returns and thus increasing contributions needed to meet plan obligations – i.e., it could lead to a transition cost. This cost would be below the $42 billion cost estimated by actuaries with a complete switch to DC savings accounts but could still be considerable.[12]

Wrapping up our discussion of the flaws of the proposed Pennsylvania hybrid pension, some proponents of a switch to DC or hybrid pensions oppose DB pension because they expose taxpayers to "financial market risk" – the possibility of future unfunded liabilities if investment returns fall below actuarial projections. It makes no sense to avoid the possibility of future higher costs for pensions by guaranteeing higher costs through a partial switch to inefficient DC savings accounts. Furthermore, taxpayer financial market risk can be reduced by adopting best DB pension practices (e.g., making required contributions each year) and sharing risk with employees (as Pennsylvania has since 2011). These are better approaches than switching to inefficient DC savings plans. (It should also be noted that schools and the state are better positioned to cope with financial market risk than individual employees and their families.)

But If You Must Switch to a Side-by-Side Hybrid…

To the extent that, despite the evidence, agreement has been reached to adopt a side-by-side hybrid, the details of the hybrid matter a lot. Here are some guidelines for policymakers negotiating final details.

Include a higher DB multiplier. As noted, hybrid pensions in other states often include DB plans with multipliers that vary. For example, the hybrid pensions in Utah and for Michigan School Employees include a 1.5% multiplier.[13] A multiplier of 1.5% as opposed to 1% makes it more likely that employees will receive – *throughout their retirement* – a retirement income equal to the 70%-80% replacement income recommended by retirement experts. (Replacement income equals retirement income relative to income before retirement.) In Pennsylvania, where public sector DB retirement benefit provide no automatic inflation protection (or cost-of-living-adjustment (COLA)), if inflation equals 2.5% annually, a 1% multiplier shrinks in inflation-adjusted terms to a 0.61% multiplier after 20 years of retirement – e.g., for people 82 who retired at 62. Thus, even for someone with a 30-year career in public employment, the DB benefit would by 82 replace only 18% of final salary, putting retirement security at risk.

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[12] For references to the actuarial studies that estimated a $42 billion transition cost with a straight switch to DC savings accounts for new employees, with url's where the studies can be found online, see the first end note in www.keystoneresearch.org/sites/default/files/KRC_TP_CorbettDCPlan_06252014.pdf

[13] Alicia H. Munnell, Jean-Pierre Aubry, and Mark Cafarelli, "Defined Contribution Plans in the Public Sector: An Update," State and Local Pension Plans #37, Center for Retirement Research at Boston College, April 2014, online at http://crr.bc.edu/wp-content/uploads/2014/04/SLP_37.pdf;
https://www.urs.org/mango/pdf/urs/Miscellaneous/tier2FAQ.pdf

It might be possible to achieve a higher multiplier on the first part of salary without increasing taxpayer financial market risk by combining the side-by-side hybrid with a stacked hybrid that eliminates the DB plan completely on salary above a certain level. In a hybrid pension that is both side-by-side and stacked, the total pension obligation of the DB part of the hybrid can be kept the same even while employees with middle-class salaries enjoy a higher multiplier (hence pension benefit). For example, if the DB portion of the hybrid covers only the first $75,000 of salary (with a built-in escalator on this amount tied to increases in the maximum wage subject to Social Security taxes), employees might be able to receive a 1.5% multiplier up to $75,000 salary even while the total benefit obligations of the DB remain the same.[14]

Provide automatic inflation protection for the DB part of the Pennsylvania side-by-side hybrid similar to that provided for the federal employee side-by-side DB benefit once Pennsylvania's DB pensions are 80 percent funded. Federal employees DB benefits increase each year by the percentage increase in the most widely Consumer Price Index (CPI) (the CPI for all urban wage earners and clerical workers).

Reduce fees paid for investing Pennsylvania's pooled pension funds, including to hedge funds. In his budget proposal, Gov. Wolf estimated that $200 million could be saved on investment fees paid to managers of portions of Pennsylvania's pension plans. A new report validates the potential of such savings and recommends that public pension funds conduct an asset allocation review to examine less costly and more effective diversification approaches; and also to require full and public fee disclosure from hedge fund managers and consultants.[15]

Enact an "ideal" DC plan to increase returns above – and reduce costs below – those of typical 401(k)-style individual savings accounts. The inefficiency of DC savings accounts can be mitigated by providing a limited range of high-quality savings options from which employees may choose, each with sufficient pooled funds to achieve economies of scale and low costs. These savings options should include low-cost index funds through which savers "passively" invest in a tiny portion, for example, of the stock market rather than paying higher costs for "active management" by financial firms that may achieve returns no higher than index funds.

Establish an option for private sector workers to establish retirement saving plans that leverage the administrative infrastructure and pooled assets of the DC part of the hybrid for public sector workers. About half of private sector workers in Pennsylvania have access to no retirement savings plan at all through their job. Most of the rest have an inadequate 401(k) plans into which neither employee nor employer contributes adequately. This is the real retirement security crisis in Pennsylvania and America. If the state establishes an "ideal" DC plan as part of a hybrid pension, however, it could use the administrative infrastructure for this DC plan to set up – at very little additional cost – retirement

[14] Exactly how much the multiplier can increase to on the first $75,000 of salary if the retirement benefit is all DC above that level depends partly on how much of the aggregate of school and state salaries are accounted for by the portion of salaries over $75,000. If the total of all salary above $75,000 is one third of the total of all salaries, then the multiplier can be increased to roughly 1.5% on the first $75,000 of salary while DB benefit exposure of the state and schools remains the same. A precise calibration of DB benefit obligations under a double (stacked and side-by-side) hybrid versus a straight side-by-side with a 1% DB multiplier would require a more complicated model that takes into account career trajectories (vesting rates, age of hire, and years of service profile) of employees earning more and less than $75,000.

[15] Elizabeth Parisian and Saquib Bhatti, *All That Glitters Is Not Gold: An Analysis of U.S. Public Pension Investments in Hedge Funds*, American Federation of Teachers, Roosevelt Institute, and the Refund America Project, online at http://www.aft.org/sites/default/files/allthatglittersisnotgold2015.pdf.

savings vehicles for private workers. As well as private workers receiving the same savings options as in an "ideal" DC plan, funds in savings accounts for private workers could be co-mingled and invested jointly, achieving the same combination of low cost and high returns enjoyed by public workers in an ideal DC plan.

In moving in this direction, Pennsylvania would join a growing movement of other states, including California, Oregon, Illinois and Connecticut.[16] These states are seeking to provide private-sector workers with the ability to save through state-managed retirement savings accounts. On Monday of this week, in fact, the U.S. Department of Labor issued a notice of proposed rulemaking (NPRM) and interpretive bulletin to support states trying to promote more access to workplace retirement savings vehicles for private workers. [17] The timing is thus perfect for Pennsylvania to leverage the creation of the DC part of a hybrid as a launching pad for strengthening a private retirement security system in tatters.

To work out the details, Pennsylvania could emulate Connecticut, which established a Private Retirement Security Board that is charged with developing a comprehensive private savings plan by 2016 that requires minimal need for financial sophistication from plan participants; allows automatic enrollment of qualified participants at a standard (default) contribution rate;[18] includes the option of annuitized benefits, spousal benefits, and death benefits to designated beneficiaries; has administrative costs below an annually specified percent of total plan balances; and is self-sustaining (i.e., the participation of private employees would not require state funding although it would leverage the setup costs already absorbed by the state to set up the hybrid DC plan options).[19]

A Silk Purse from a Sow's Ear

To address the private sector retirement security crisis, Pennsylvania should couple the enactment of a best-practice hybrid pension with giving private workers access to a powerful new savings option. By taking this step, Pennsylvania can turn a policy mistake on public pensions into a net gain for retirement security in Pennsylvania as a whole.

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[16] Technically, the plans in these four states are Individual Retirement Accounts, which are not subject to federal ERISA law. These IRAs also allow "auto enrollment" of individuals (employees automatically contribute unless they choose not to) and a requirement that employers give their employees access to these IRA savings options (unless they have a qualifying alternative). One drawback of using IRAs exempt from ERISA is that these accounts can only accept employee money and employer contributions are prohibited. Still, for many private employees these types of accounts with auto enrollment would be a start.

[17] U.S. Department of Labor, "Fact Sheet: State Savings Programs for Non-Government Employees," Employee Benefits Security Administration, November 16, 2015; online at http://www.dol.gov/ebsa/. The proposed rule outlines how states can set up IRA savings programs in which employees can be automatically enrolled, with contributions made through payroll deductions, but without requiring employers to create plans that meet the requirements of the federal ERISA law. In addition, DOL issued guidance describing how states can promote the creation of ERISA-covered plans, without triggering ERISA preemption. These plans would be fully subject to ERISA's rights and protections.

[18] Connecticut Public Act No. 14-217, http://www.cga.ct.gov/2014/ACT/PA/2014PA-00217-R00HB-05597-PA.htm, Section 185((a)(10), and Report and Recommendations of the Oregon Retirement Savings Task Force Created and Tasked Pursuant to HB 3436 (2013)https://olis.leg.state.or.us/liz/2013I1/Downloads/CommitteeMeetingDocument/40906 , recommendation (2), page 23

[19] Connecticut Public Act No. 14-217 http://www.cga.ct.gov/2014/ACT/PA/2014PA-00217-R00HB-05597-PA.htm, Section 185(a) (5) and (7).