Testimony of Antonio C. Parisi of the
Public Employee Retirement Commission to the
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Good Morning Chairman Metcalfe, Chair Josephs and Honorable members of the Committee I am Tony Parisi with the staff of the Public Employee Retirement Commission. Thank you for inviting me to speak today on behalf of the Commission.

As you know, under the Public Employee Retirement Commission Act, the Commission bas two main responsibilities One is to issue the statutorily mandated actuarial notes for proposed legislation affecting the Commonwealth's public employee retirement systems. The other is to study, on a continuing basis, issues of public employee retirement system policy, and the interrelationships, actuarial soundness and costs of the Commonwealth's retirement systems

I've been asked here today to discuss, in general terms, the major retirement system plan designs employed in the public sector Time permitting, I'd also like to take this opportunity to share with you some of the Commission staff's recent observations concerning national trends in this area.

Retirement benefit plan designs generally fall into one of three categories I) defined benefit plans; 2) defined contribution plans, and *3)* hybrid plans.

Defined Benefit and Defined Contribution Retirement Systems

The two main approaches to pension plan design used to provide employee retirement benefits are the defined benefit (DB) plan and the defined contribution (DC) plan. As suggested by the nomenclature, the approaches fundamentally differ in regard to the aspect of the pension plan that is "defined,' or fixed in the plan's governing document.

In a "defined benefit" (DB) plan, the benefit to be provided at retirement is defined, while the contributions necessary to fund the ultimate retirement benefit are made over the period of employment and are variable based on the experience of the pension fund. Upon retirement, a DB plan partiupant is entitled to receive a definitely determinable benefit, often for life, that is calculated using a formula that considers factors such as age, service with the employer and compensation. Because the benefit is defined and calculated using a formula and is not dependent on an individual's account balance, members of DB plans are largely insulated from both favorable and unfavorable fluctuations of the investment markets

By contrast, in a "defined contribution" (DC) pension plan rhe contributions to be made over the period of employment are defined, while the pension benefit to be provided at retirement is variable based on the experience of the pension fund. The employer contributes a fixed amount (the defined contribution), which is usually expressed as a percentage of the employee's salary or an employer match of the employee's contributions, up to a certain limit. The employee chooses how to invest the assets, usually selecting from a menu of investment options offered by the employer. Upon retirement or

separation from the employer, a *DC* plan participant is generally entitled only to the balance standing to the credit of the individual's retirement account. Market performance directly impacts the value of an individual's retirement account.

The distinction between the DB and *DC* approaches is most significant in the placement of the risk associated with investment earnings over the period of employment. The fixed benefit in a DB pension plan means that the Investment experience impacts the employer contribution requirements, increasing them when investment earnings are lower than anticipated and decreasing them when earnings are greater than anticipated. The fixed contributions in a DC pension plan mean that the investment experience impacts on the benefit amount, increasing it when earnings are higher and reducing it when earnings are lower. Therefore, the employer, as contributor, bears the investment risk in a DB plan, and the employee bears the investment risk in a DC pension plan

For most employees, defined contribution plans are generally regarded as more valuable for those in the early stages of their careers or for those who are employed in careers that require greater mobility Defined contribution accounts are portable and can readily move with the employee as that employee moves from one employer to the next. In contrast. defined benefit plans are relatively more valuable for those employees who tend to remain with one employer and to long-service employees in the later stages of their careers, because the value and cost of the defined benefits earned each year increase significantly as employees approach retirement age.

As a means to provide a concise summary of the major differences between the *DB* and DC approaches and thereby facilitate an understanding of each approach, the following table was developed by the Commission staff to contrast the general characteristics of the DB and DC approaches.

TABLE I - GENERAL CHARACTERISTICS OF DEFINED BENEFIT AND DEFINED CONTRIBUTION PLANS

Topic	Defined Benefit	Defined Contribution
Form of Benefit	Benefit is determined by a formula that usually produces a percentage of salary to be provided in the form of a life-time annuity Other equivalent benefit forms, other than lump-sum payments, may be available	Benefit is determined by the balance in the employee's individual account and provided as a lump-sum payment. Other equivalent forms of payment may be available.
Benefit Portability	Limited portability of benefits; may be service purchase authorizations or reciprocity between systems, such as the systems for State and school employees in PA May impede recruitment of younger. mobile employees	Benefit is fully portable May increase labor costs due to Increased employee turnover. Recruitment of younger, mobile employees may be facilitated.
Benefit Risk	Benefit is fixed by a formula and guaranteed by the employer, providing benefit security Predictable amount of benefit makes retirement planning easier for the employee.	Benefit is variable and is impacted by the economic environment before and at retirement, the frequency of cash-out elections made by employee upon change of employers, and the quality of employee investment choices. Variable benefit makes retirement planning more difficult

Topic	Defined Benefit	Defined Contribution
Investment Risk	Employer makes investment decisions and assumes all investment risk Favorable earnings decrease the employer contribution requirements, while unfavorable earnings Increase the employer contribution requirements	Employee makes investment decisions and assumes all investment risk Favorable earnings increase the benefit amount, while unfavorable earnings decrease the benefit amount
Funding Risk	Employer assumes future funding risk and is responsible for funding any unfunded liability that may occur as the result of unfavorable plan experience.	Employer assumes no future funding risk. Funding obligation fully satisfied concurrently with payroll, providing budgetary predictability and precluding the occurrence of unfunded liabilities.
Design Flexibility	Greater design flexibility, including disability and death benefits may be included. Cost-of-living adjustments may be provided to retired employees. Purchases of service may be authorized; other ancillary benefits.	Preretirement benefits limited to monies accumulated in employee's individual. account.
Personnel Management	Attracts arid retains (and is more beneficial to) long-service employees.	Attracts (and is mare beneficial to) more mobile employees.
Administration	Complex administration due lo greater degree of regulation and actuarial calculations. Long-Lerm budget projections difficult due lo variations in funding rcquiremenrs.	Simple administration, with complexity increasing as investment allocation flexibility increases. Long-term budget projections arc facilitated by predictable funding requirements.
Benefit Accrual	Back-loaded. Benefit accrual rate great est in years immediately before retirement. Favors long-term employees.	Front-loaded. Benefit accrual rate greatest in initial years of employment. Favors short-term employees.
Benefit Distribution	Benefit is only available upon retirement.	Benefits may bc accessecl pre-retirement under certain circumstances as loans or actual disbursements.
Employee Comprehension	Benefit formula is an abstract concept and may be difficult for employees to appreciate, particularly in early years of employment.	Account balance is easily understood and appreciated by employees throughout, their careers.

Hybrid Benefit Plans

A third category of retirement benefit plan design is the hybrid plan. In the context of pension plan design, the term "hybrid" is a generic term, and there are many variations in plan design. Typically, hybrid plans combine both defined benefit and defined contribution elements Hybrid plan designs usually require some level of mandatory participation by employees, often pool all or a portion of assets for investment purposes, require both employer and employee to share responsibility for funding the plan, guarantee a certain level of benefits to employees, and also share investment risks between employee and employer.

Combined DB/DC Retirement Benefit Plans A combined defined benefit—defined contribution plan can be thought of as "two plans" that exist side-by-side. Plan design specifics vary considerably. In some cases, participation in the DB plan may be mandatory, while DC plan participation may be optional, or participation in both the DB and DC plans may be mandatory Generally, the employer's contribution funds a smaller DR plan benefit, which may or may not include an employee contribution component, while all or some portion of the employee's contribution is used to fund the DC benefit. Depending upon the plan, the employee may or may not have some rights to direct how the DC portion is invested

Cash Balance Retirement Benefit Plans. A cash balance plan is a type of nontraditional defined benefit (DB) plan with defimed contribution-like funding and portability elements A cash balance plan calculates benefits in a manner similar to a defined contribution (DC) plan. Under a cash balance arrangement, benefits accumulate throughout a worker's years of employment However, the cash balance retirement benefit differs from the traditional defined benefit formula. Rather than receiving an annuity based upon a fixed benefit formula (accrual rate x years of service x final average salary), the cash balance benefit is simply equal to the value of all accumulated employee and employer contributions plus interest credited to the member's cash balance ledger account at the time of retirement.

A cash balance plan ***is*** classified as a defined benefit plan because, like a traditional DB plan, the employer bears the investment risks and rewards along with the mortality risk if the employee elects to receive benefits in the form of an annuity and lives beyond the anticipated retired life expectancy. Unlike a traditional DB plan, a cash balance plan establishes allocations to a hypothetical individual account [the cash balance) for each participant (individual account balances are usually segregated for accounting purposes only and are pooled for investment purposes). Benefits under cash balance plans may be paid as a lump sum or annuitized over the retiree's expected remaining lifetime

Similar to what tends to occur with DC plans, employees who move from employer to employer frequently, or othenvise leave service early, will tend to benefit more from a cash balance plan than a traditional DB plan, because the accrued benefits will tend to be greater than would be the caseunder the traditional defined benefit formula. Conversely, long-service employees will tend to benefit less from a cash balance plan arrangement as compared with a traditional DB plan, because the portion of the benefit accrued in later years of service will tend to be less than under a traditional DB plan.

Cash balance plan designs have the potential to provide the plan participant with the benefit predictability and security of the traditional DB plan, while providing budgetary predictability to the employer by limiting employer contribution requirements to a fixed amount, similar to a defined contribution plan.

Recent Trends

In December 2002, the Commission issued a report in response to House Resolution Number 266, adopted in the session of 2001-2002. As part of the Commission's report, entitled *Selected* Issues Related to *Governmental Defined Benefit &* Defined *Contribution Pension* Plans, the Commission staff conducted a national review of statewide public employee retirement plans and Identified the plans by plan type – DB, DC or hybrid. In the course of its research for the 2002 report, the Commission staff identified a total of 21 state-level public employee retirement plans in 16 states that were DC or had a DC component. Nearly one-quarter of these plans had been implemented during the five years immediately preceding the staffs review, suggesting that the strong investment returns of the late 1990s may have influenced the increasi- of DC plans at that time.

The staff updated the original 2002 review for today's testimony, with an emphasis on retirement benefit plan changes that have occurred in recent years. The following summarizes the staff's findings

Pure Defined Contribution Plans. In 2002, the staff identified nine public employee retirement systems with pure defined contribution plans. Of these, four required employees to participate in the defined contribution plan and five made participation optional As of 2012, the number of systems with pure defined contribution plans had declined from nine to seven. Alaska and Michigan remain the only states with retirement systems that require mandatory participation in a defined contribution plan Also, West Virginia, which had transitioned to a inandatoiy DC plan for public school employees in 1991, returned to a mandatory DR plan beginning in 2005.

Hybrid Defined *Contribution Plans*. In 2002, the staff had identified twelve systems with hybrid defined contribution plans. Of these, seven were combined defined benefit-defined contribution plans, one was a money purchase option plan (a type of DC plan),and foui used some other hybnd plan design. As of 2012, the number of systems with hybrid defined contribution plans has increased to sixteen. Retirement systems in Georgia (beginning in 2009), Michigan, for public school employees (beginning in 2010), Utah (beginning in 2011), and Rhode Island (beginning in 2012) have all transitioned to mandatory hybrid defined benefit-defined contribution plans, with only Utah being an optional plan.

Cash Balance *Plans*. Nebraska switched from a mandatory defined contribution plan to a mandatory cash balance plan for new employees beginning in 2003. To date, Nebraska is the only statewide system to have adopted the cash balance approach. However, several other states, including Louisiana, Maryland anti Kansas are considering cash balance proposals

Defined *Benefit* Plans. The majority of legislative changes enacted in 2009, 2010 and 2011 remained within the framework of a traditional defined benefit retirement plan. These changes were implemented as benefit cost containment measures and generally took the form ofreduced benefit tiers applicable to new employees. Here in the Commonwealth. such benefit reductions were implemented with the passage of Act 120 of 2010 From 2009 to 2011, a total of 40 Stales have implemented some form of DB plan benefit reduction.

Table II – CURRENT DISTRIBUTION OF STATEWIDE DEFINED BENEFIT, DEFINED CONTRIBUTION AND OTHER RETIREMENT PLANS BY STATE

Plan Characteristics	State Employees' Plan	State Teachers' Plan
DB plan only	35 [1]	42
DC plan only	3 [2]	1
DB/DC Hybrid plan	7 [3]	7 [3]
DB plan, plus optional DC plan	6	1

[1] includes New Jersey, where, depending on amount of maximum compensation some employees are eligible to join a supplemental defined contribution plan

[2] includes the Nebraska cash-balance plan for state employees

[3] Not including Virginia, where, beginning 1/1/2014, all new employees will he enrolled in a mandatory hybrid plan

Sources: Based on the *Checklist of State DB, DC and Other Retirement Plans*, National Conference of State Legislatures, January 2012, updated and revised by Commission staff

Conclusion

In conclusion, it appears that for state-level plans, the majority of states have elected to retain the DB design as the sole or primary retirement benefit plan, but have implemented some form of benefit reduction in the interests of cost containment. Relatively few states rely solely on DC plans. However, in certain jurisdictions, there does appear to be interest in moving toward hybrid plans that combine both DB and DC elements.
That concludes my testimony today. I'll be happy to answer any questions from the Committee members at this time.