D R A F T

Remarks of Keith Brainard

To the Little Hoover Commission

Chairman Hancock, members of the commission, thank you for the opportunity to testify before you today. I have been asked to focus my remarks on what other states are doing with respect to changes in pension benefits for public employees. First I would like to briefly elaborate on the broader issue of retirement security and the current condition of the nation's readiness for retirement.

A generation ago, in response chiefly to new federal laws and regulations, corporations began to abandon their traditional pension plans in lieu of defined contribution, or 401k, plans. In the mid-1970s, roughly half of the nation's private sector workforce had a traditional pension plan as their primary retirement benefit. Today, fewer than one-fifth of the private sector workforce is covered by a defined benefit plan, and that figure is likely to continue to decline. Defined contribution plans have replaced traditional pensions as the nation's predominant retirement benefit. Although defined contribution plans can be helpful vehicles for accumulating retirement savings, they have not proven to be effective at providing reliable retirement income.

I sometimes hear people say that if defined contribution plans are good enough for the private sector workforce, then public employees should have them too. This sentiment ignores two important facts: defined contribution plans as they are structured today lack features that are critical for fulfilling the central purpose of a retirement benefit; and that the reasons the private sector has migrated toward DC plans are largely irrelevant to the public sector.

Notably, barely one-half of the private sector workforce participates in an employer-sponsored retirement plan at all. Only two-thirds of the nation's private sector workforce works for an employer that provides a retirement benefit, and about one-fourth of those eligible elect to not participate.

The attention given recently to the problems associated with retirement benefits for employees of state and local government generally overlooks the larger and more important fact that our nation is facing a retirement crisis. Numerous studies demonstrate that most Americans approaching retirement age have saved far too little to replace an adequate portion of their working income. Studies also indicate that many Americans lack financial literacy, including an awareness of how much they will need to retire. This condition can be summed up concisely by quoting a Wall Street Journal editorial from just a couple of weeks ago:

> The biggest, but most underreported, financial story in America is the looming retirement disaster. Eighty million baby boomers are approaching retirement, and most have absolutely no idea what's going to hit them. For them the financial crisis isn't over. It's just about to begin.

With that as a backdrop, I hope that California policymakers will evaluate possible changes to plan designs for public employees in the context of features that are known to promote financial security in retirement. I believe there is common ground among the stakeholders of public pensions, who are public employers, employees, and taxpayers. Each of these stakeholder groups has its own interests in the way public pension plans are designed and funded.

Some of these interests are shared by all of stakeholders, which creates the opportunity for common ground. Perhaps the most definitive common sentiment among the various stakeholders is that retirement security benefits everyone, which is to say that all of us benefit when others have retirement security.

Another belief many may share is that pensions work, which is true, when they are allowed to work. Pension plans have proven themselves to be an effective and efficient method for delivering retirement income. The problems associated with public pensions—chiefly their unfunded liabilities and the cost of amortizing them—are not a function of defined benefit plans per se, but rather are a result primarily of the way these plans have been designed and treated.

Public pension plans have several core elements that play a critical role in meeting the objectives of their stakeholders. These core elements include:

- Mandatory participation
- Cost-sharing between employees and employers
- Pooled assets invested by professionals
- Required annuitization of retirement benefits

An additional core element might be a plan design that replaces an adequate portion—however defined—of income in retirement.

I would encourage this commission and the state's policymakers to consider these factors as core and essential elements in a retirement plan design for public employees in California. It is possible to create a pension plan design and financing arrangement that accommodates the objectives of all stakeholders, using these core elements. A pension plan is not, by definition expensive; it just needs to be designed properly.

Although changes to public pension plan designs and financing arrangements have been occurring all along, the number and magnitude of changes being made to pension plan designs and financing arrangements for employees of state and local government around the country is unprecedented. At its core, a pension plan is a relatively simple financial entity: ultimately, the money that comes in must equal the money that goes out. Changes in pension plan designs and financial arrangements are simply a reshuffling of how much comes in, from whom, and when, and how much goes out, to whom and when.

Changes to retirement plans can affect new hires only, existing employees, existing retired members, or any combination of the three. My understanding of California's legal situation, however, is that changes to retirement benefits for existing plan participants and retirees would be legally difficult.

I would encourage the commission to remember that many state and local government employees in California do not participate in Social Security. This includes substantially all public school teachers and most firefighters and law enforcement personnel. As a result, the state and its political subdivisions are saving 6.2 percent of those employees' salaries, which saves well over $1.5 billion for the state's public school districts alone. Another consequence of not participating in Social Security is that for many of those non-Social Security employees, their employer-sponsored pension will be their only source of reliable retirement income.

I have provided the commission with a grid that lays out some of what I believe are some of the more important and representative changes made recently to public pension plans in other states.

The most common changes affect new hires only, those hired as of some future date certain. Of course, some changes yield more savings than others, and some yield faster savings than others. Changes made to the required age at which an employee can retire and the required number of years of service often produce the most cost savings of available options. At least one dozen states have made such changes to their retirement plan designs in the last couple of years. In almost every case, these changes have been applied to new hires only.

One exception is Rhode Island, which approved an increase in the normal retirement age from 60 to 62. Although this change affected existing plan participants, the changes were made proportionate to the participant's proximity to retirement, such that those who are close to retirement eligibility are affected less than those who are further away. Combined with other changes made by the Rhode Island legislature affecting the final average salary period and cost-of-living adjustments for future retirees (including existing plan participants), a group of unions representing public employees in Rhode Island has filed a lawsuit challenging the legality of the benefit reductions.

Several states have recently increased employee contributions. This includes New Mexico, which in 2009 reduced the employer contribution rate by 1.5 percent and increase employee contribution rates by the same amount. A lawsuit was filed by some public employee unions, but so far that legal challenge has not progressed in the state's court.

Earlier this year, legislatures in Colorado, Minnesota, and South Dakota took the unusual step of reducing automatic cost-of-living adjustments for existing retired members, along with other changes. Lawsuits have been filed in each state by retirees, and these legal challenges in each case are still pending.

A number of states have made other changes to their retirement plan provisions, that have smaller cost consequences. In some cases, the changes are targeted more toward preventing misuse of the pension fund, such as through spiking of pension benefits or poorly-designed return-to-work policies. It takes only a few instances of pension benefit misuse and abuse to tarnish the public's confidence in the integrity of these benefits. These plans are in place not to enrich anyone, but to serve as an income replacement vehicle in retirement. To preserve or restore both the financial integrity of these systems and the public's trust in them, pension plan provisions should be designed as much as possible to prevent misuse and abuse.

Pension policies have long-term impacts, and relatively minor changes can result in major cost savings in the future. I commend this commission for taking time to consider and evaluate such policies, rather than making a hasty recommendation.

That concludes my prepared remarks; I would be happy to answer your questions.

Selected approved changes to state public pensions to restore or preserve plan sustainability						
System	**Contributions**	**Benefits**	**Early retirement**	**Actuarial methods/processes**	**Study commission**	**Notes**
Retirement Systems of Alabama				Increase statutory max amortization period from 20 years to 30		
Arizona SRS	Employee and employer contributions are matched and adjusted annually based on actuarial results; they will rise from 9.0% to 9.6% on 7/1/10; this includes the retiree health insurance benefit.	For new hires: • Change from Rule of 80 to Rule of 85 • Change FAS from high 3 years to high 5 • Eliminate access to ER contributions for terminating participants Also, • Made service purchases cost-neutral • Decreased interest rate paid on refunds • Requiring ERs to pay ASRS for early retirement incentives • Rescinded modified DROP Program	Early retirement provisions revised commensurate with change in normal retirement eligibility			
Colorado PERA	Employee and employer contribution rates will rise incrementally for several years.	• Lower auto-COLA for existing retirees, to lesser of CPI-W or 2.0% • Require future retirees to be retired for 1 year before receiving a COLA • 5-year service credit required on 50% employer match on contribution refunds, effective 1/1/11	Increased actuarial reduction for early retirement		Proposed changes were preceded by a statewide listening tour	A group of retirees has filed suit opposing the COLA reduction; bill also includes an anti-spiking provision.
Illinois statewide		For new hires as of 1/1/11: • Normal retirement age	Early retirement provisions			Suspends pension benefits for those

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plans (except judges and legislators)		increases to 67, from 60 • Minimum retirement age set at 62 • FAS basis is now highest 8 of last 10 years, up from final 4 • Limits pension benefit to 75% of FAS or $106,800, indexed to the lesser of 3% or half of CPI • COLAs will be lesser of 3% or half of CPI, non-compounded, from current auto 3% compounded • COLAs begin at age 67	revised commensurate with change in normal retirement eligibility			who return-to-work for another public employer in the state.
Iowa PERS	Contribution rates will rise incrementally, from 4.7% to 5.3% for EEs and 7.25% to 8.15% for ERs. Thereafter, the board has authority to adjust the total rate by up to 1%.	• Vesting period for those not vested (currently 4 years) on 7/1/12 will increase to 7 years. • Increased FAS period from 3 years to 5	Increased actuarial reduction for early retirement			
Kentucky TRS		For new hires after 6/30/08: • Increased normal retirement eligibility from 55/5 to 55/10; retained 60/27 • Established graduated retirement factor schedule that is lower for those who accrue less than 30 years of service, beginning with 1.7% for	Increased actuarial reduction for early retirement			

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		10 years and less				
Michigan Public School ERS		New school system hires will have a hybrid plan instead of the current DB plan				Reform bill includes an early retirement incentive, creating a window during which retiring school EEs will receive a bump in retirement benefit and payments toward a retiree health care benefit.
Minnesota PERA	Employer contribution rates will rise from 7.0% to 7.25% and employee contributions will rise from 6.0% to 6.25%, on 1/1/11.	• Reduction in COLA for existing retirees from 2.5% to 1.0%, until funding ratio=90% • Reduction in interest paid on inactive and terminating accounts. • Increase in vesting period, from 3 years to 5			Directors of the 3 statewide systems were directed to conduct study of cost, benefits, and feasibility of DB, DC, and other plans, and report back by 6/11.	A lawsuit has been filed against the COLA reduction.
Minnesota SRS		• Reduction in COLA for existing retirees from 2.5% to 2.0%, until funding ratio=90% • Reduction in interest paid on inactive and terminating accounts. • Increase in vesting period, from 3 years to 5		Extended amortization period from 2020 to 2040.	Directors of the 3 statewide systems were directed to conduct study of cost, benefits, and feasibility of DB, DC, and other plans, and report back by 6/11.	A lawsuit has been filed against the COLA reduction.
Minnesota Teachers	Employer and employee contributions will rise by 0.5% each year, from 5.5% each to 7.5%, phased over 4 years. After the phase-in, the	• For existing retirees, 2-yr suspension of COLA followed by permanent reduction in COLA from 2.5% to 2.0%, until funding ratio=90%			Directors of the 3 statewide systems were directed to conduct study of cost, benefits, and feasibility of DB, DC,	A lawsuit has been filed against the COLA reduction.

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	TRA board has authority to adjust future rates (within limits) should the system have a contribution deficiency or sufficiency.	• Reduction in interest paid on inactive and terminating accounts.			and other plans, and report back by 6/11.	
Mississippi PERS	Raised contribution rates for all employees by 1.75%.	For new hires after 7/1/11: • Retirement eligibility will be based on 30 years, up from 25 • Effective 7/1/11, ERs will be required to pay contributions on any re-employed retiree, and a 90-day break in service will be required (up from 45, with an emergency provision). • Effective 7/1/10, local elected officials who retire and continue in office must meet the minimum in-service distribution age as prescribed by the IRS. Additionally, the ER must pay the ER contributions on the salary in effect for the position at retirement.			An ad hoc committee of the MS PERS board has been established to look at the overall sustainability of PERS and its benefits, with the following objectives: ♦ What is a career in public service? ♦ How much should the benefit be following that career? ♦ What is an appropriate amount for the EE and ER to pay to fund that benefit? It is expected that the PERS will develop a legislative packet for 2011 based on the outcome of this committee.	Statute requires increase in EE rate to be accompanied by commensurate benefit increase; because approved benefit improvement was minor, a legal challenge is likely
Nevada PERS		For new hires as of 7/1/10: • New minimum retirement age • Lower multiplier	Increased actuarial reduction for early retirement			Changes were made in '09 and reflected a consensus among affected groups.

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		• Anti-spiking provision				Changes apply to all participants.
New Jersey Division of Pension and Benefits	Requires, for the first time, contributions of 1.5% from current participants for retiree health care benefits	For new hires: • Reduces retirement factor for general EEs and teachers from 1.82 to 1.67 • Increases FAS period for general EEs and teachers from 3 years to 5, and for public safety workers from 1 year to 3 • Limits use of sick leave payouts for pension benefits and limits access to DB plan for part-time workers.				
New York State & Local RS	Most new hires must now make contributions of 3% their entire career, instead of only first 10 years.	For new hires as of 1/1/10: • 10-year vesting, from 5 • Limit on use of OT in benefit calculation	Increased actuarial reduction for early retirement			
New York State TRS	New hires must now make contributions of 3.5% their entire career, instead of only first 10 years.	For new hires as of 1/1/10: • 10-year vesting, from 5 • Full retirement factor of 2.0% after 25 years of service, up from 20 • Normal retirement at age 57 with 30 years of service, up from age 55 • Limit on use of OT in benefit calculation	Increased actuarial reduction for early retirement			

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North Carolina RS					Blue ribbon study commission is taking a bottom-up look at retirement benefits; results scheduled for November	NCRS benefits and costs are modest already
Rhode Island		Reduced benefits for state EEs, teachers and judges not eligible to retire on or before 9/30/09, by increasing retirement age to 62 with a methodology that proportionally changes age requirement based on years of service, so the closer one is to retirement, the less the impact. Also, increased FAS period from 3 years to 5 and reduced COLA to lesser of CPI or 3.0%.				A group of public employee unions has filed suit against the benefit reductions.
South Dakota RS		• New COLA format, affecting existing retirees, based on plan funding level • Eliminate first-year pro-rated COLAs • Reduce refunds of ER contributions				New limits on return-to-work
Texas ERS		For new hires, retirement eligibility increases to age 65 with 10 years of service, from 60/5				Changes made in '09 and are similar to those made in '07 for the TRS of Texas

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Utah RS	Plan currently is non-contributory. New hybrid plan is projected to cost 7.5%. ERs will fund first 10% of the hybrid or the DC plan. Difference between the cost of the hybrid and 10% is deposited into EEs' DC account. If the cost of the hybrid exceeds 10%, EEs will pay the difference.	• New hires as of 7/1/11 will have their choice of DC or hybrid, and employers will fund the first 10% of either.			State will be studying projected costs of approved changes and may make additional changes	
Vermont TRS	Raises contributions for current employees from 3.54% to 5.0%.	For current teachers 5 years or more from normal retirement eligibility: • raises normal retirement to 65 or Rule of 90, from 62 or any/30 • increases max benefit to 60% of FAS, from 50% • increases multiplier for those w/20 years of service, to 2.0 from 1.67	Increases penalties for early retirement			Also increases limits on maximum permissible benefit and includes anti-spiking provision.
Virginia RS	New hires as of 7/1/10 will be required to make contributions, of 5%	For new hires as of 7/1/10: • Normal retirement age tied to Social Security retirement age, from 65 • Lower auto-COLA • FAS of 5 years, up from 3	Early retirement provisions revised commensurate with change in normal retirement eligibility			Will continue as non-contributory for existing employees