Pennsylvania House State Government Committee

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Statement by Susan D. Diehl

Practices for Consideration by Pennsylvania as Compared to other States

INTRODUCTION

Good morning Chairs Metcalfe and Cohen and Members of the House Standing Committee on State Government. Thank you for this opportunity to provide testimony with regard to this important issue.

My name is Susan Diehl and I am President of PenServ Plan Services, located in Horsham Pennsylvania. PenServ is an independent retirement plan administrator and national consulting firm. We specialize in consulting and administration of defined contribution and hybrid retirement plans for governmental and non-profit organizations with a focus on public and charter schools. PenServ administers over 3000 plans in 25 states serving 564,000 participants and recordkeeps approximately 9 billion in assets. We also consult to over 2000 financial institutions in all areas of retirement plans ranging from IRAs to employer sponsored pension and defined contribution plans.

In my role with PenServ I have participated on several IRS and DOL committees and work on industry liaison groups with the IRS. I also actively serve in professional organization as a credentialed member of the American Society of Pension Professionals and Actuaries, past president of the National Tax-deferred Savings Association and current board member of the American Retirement Association.

What this means is that every day for the last 30 years I work with employers and participants that are contemplating new plan designs and grappling with all of the issues concerned with legacy pension plans and developing new plans that work for participants.

The Commonwealth of Pennsylvania is not unique in in contemplating redesign of its public employee retirement system. Public pension liabilities have spiked since the great recession partially as a result of poor investment returns but mostly due to budgetary constraints that led to significant underfunding of pension obligations. Over the past three years 19 states have introduced public pension reform initiatives and 4 states have enacted some form of public sector retirement plan reform.

Each state has unique circumstances to consider so it’s not surprising that there have been many different approaches to public pension reform. However, common to all states are two critical components of the public pension reform conversation, addressing the unfunded liabilities that drive present day budget issues and designing new retirement plan schemes that share or shift more of the funding and investment risk from the state to the state employees.

By order of magnitude, funding for current obligations is the most important aspect of public pension reform. That however does not diminish the necessity to make sure that any redesign of the public retirement system is done properly. Changing the system going forward will not have significant positive impact on the debt to the pension system, but getting the redesign wrong can have a significant negative impact.

WHAT WE'VE LEARNED FROM OTHER STATES

The experience of Alaska and West Virginia pension reform initiatives are instructive examples of what happened when participants were shifted to a new plan design without addressing funding issues for the existing plan.

West Virginia converted from a pension to a defined contribution plan for public employees in 1991. Because the funding issues were not addressed, the pension system funding dropped to 18% in 2003. The result is that to help address rising required contributions and cash flow issues, West Virginia was forced to reopen its defined benefit plan in 2006.

Alaska transitioned state employees to a defined contribution plan in 2006. By 2012 required contributions doubled for the state retirement system from 12.4% to 22.5% of payroll and increased from 24.6% to 36% percent of payroll for teachers. Alaska is now looking to follow West Virginia in abandoning the 401(k) plan structure and returning employees to the pension scheme as a way to shore up funding and cash flow.

Perhaps learning from these examples, many new proposals are based on moving employees from the traditional pension to a combination pension and defined contribution plan commonly called a hybrid retirement plan. In fact variations of hybrid retirement plans were introduced in the Pennsylvania house last year by Representatives Grell and Tobash.

While not a silver bullet for the unfunded liability, hybrid plans are seen as favorable policy alternatives because they continue regular funding to the pension and introduce a defined contribution plan shifting some of the funding and investment risk from the state to the employees.

The biggest problem with hybrid retirement plans so far is that the administration and service of the defined contribution "401k style" retirement plan has been delegated to state agencies. This required massive expansion of state bureaucracy into aspects of retirement plan service where it had little to no experience. Simply stated, state retirement systems understand how to run a pension system but not a defined contribution plan. There are even examples of states that had existing state administered defined contribution systems to leverage for the hybrid plan. What they found was that there is a big difference between offering an elective plan that supplements a pension that is the primary retirement vehicle and creating a successful 401k style plan that is the primary retirement vehicle for employees.

Two examples of state legislatures that passed pension reform that relied upon state government to exclusively run the defined contribution component of hybrid retirement plans are Virginia and Michigan.

Virginia passed legislation in 2012 to introduce a hybrid retirement plan for state employees starting in 2014. The defined contribution portion of the plan has a mandatory employee contribution and offers an employer match on voluntary employee contributions. The Virginia Retirement System created as plan and hired a firm to provide services VRS thought necessary. The result is less than 5% of participants are making voluntary contributions to the plan. That means that 95% of participants are passing on the opportunity to receive matching contributions to their retirement plans. The most important metrics for a successful defined contribution plan are participation rates and contribution rates. By these measures, the plan failed at the start.

Virginia recognized the issue and acted quickly passing new pension reform legislation in 2015 that now includes competitive offerings through private companies that deliver services at the local level.

The story is very much the same in Michigan. The legislature there allocated $5m to the Michigan Office of Retirement Services to implement the defined contribution portion of the hybrid retirement plan for public school employees. The result is a participation rate of less than 20%. Five million dollars spent and 80% of the eligible participants are not saving as they should.

Michigan is following Virginia and legislation is moving through the Michigan Assembly to allow private local offerings that will meet the needs of participants and get the plan working like it should.

The important learning here is that neither plan needed to end up this way. Virginia and Michigan could have leveraged the existing infrastructure of private local retirement plan providers at the outset. The key point for this committee is that every public school district in the Commonwealth has a defined contribution plan in place today and the infrastructure exists to launch a plan that works without rebuilding the wheel.

What's more, many Pennsylvania charter schools have already made the transition from the straight defined benefit plan to a hybrid retirement system. Charter Schools in Pennsylvania offer "PSERs Alternative" retirement plans that are working quite well and may serve as an instructive model for a new plan design.

PSERs ALTERNATIVE

The Pennsylvania Charter School Law (CSL) provides flexibility to charter schools in Pennsylvania with regard to the selection of retirement plans applicable to its employees. Under Charter School Law (24 P.S. §17-1724-A(c)), employees of a charter school must be enrolled in PSERS unless the employer provides an alternate plan that covers the employees.

Thus, charter schools must offer a retirement plan for their employees, but are not obligated to enroll their employees in PSERS. The charter schools may also offer membership in PSERS to some of their employees and provide an alternate plan to other employees.

The CSL is also clear that, if a charter school offers an alternate plan to any of its employees, then those employees will not be able to obtain concurrent service credit in PSERS for this time. Finally, a charter school is deemed to be a "public school" as defined under section 8102 of the Retirement Code.

There are approximately 175 Charter Schools in Pennsylvania and more than half have amended their current DC plan (403(b)) to include new hires after a future date that will not be enrolled in PSERs but instead participate in the 403(b) by making a mandatory contribution and receiving an employer contribution as well. This is referred to in many schools as the PSERs Alternative.

Since most employees want the option to electively defer into a retirement plan, the 403(b) is the likely alternative to accept elective deferrals AND the contributions that would need to go into the plan to replace PSERs.

Typically the PSERs Alternative design is as follows:

- All new employees hired after some future date would automatically have 5% contributed to the 403(b) as a mandatory employee contribution. (Compare - PSERs requires on average 7.46% to be deducted from employees' salaries on a mandatory basis.)
- The Employer contributes 5% of salary. (Compare - Employer contribution to PSERs for 2014-2015 year is 21.40 % for all employees and this is projected to go up next year to over 25 %.)
- Note: An Employer can contribute more than the 5%, but that is up to the Employer.
- This design has been approved through PSERs for any Employer who has submitted a PSERs Alternative Plan within the last few years. Each Charter School needs to submit a copy of the Plan to PSERs and receive their approval before setting up the Plan. Once the Charter School has employees that are covered under PSERs they cannot waive participation in the future.

Additional Contributions

In addition to the PSERs Alternative portion (5% Employee contribution plus the 5% Employer Contribution), an eligible employee may also:

- Defer up to an additional $18,000 (the 2015 limit) per calendar year; and
- If they are age 50 or older in a calendar year, contribute an age 50 catch-up of $6,000 (the 2015 limit).
- These deferrals can be made by salary reduction as a regular deferral (tax-deferred) or as a Roth deferral (post-tax).

Example

Harley is hired after 7/1/2015 at age 51. Her annual compensation is $30,000. Below is a breakdown of her contributions into the 403(b) Plan for the first full tax year.

The PSERs Alternative 403(b) Plan

Amount of Contribution	Type of Contribution
$1,500.00	(5% Mandatory Employee Contribution)
$1,500.00	(5% Employer Contribution)
$18,000.00*	(Elective Deferral Max)
$ 6,000.00*	(Age 50 Catch-up)
$27,000.00	**TOTAL PERMITTED CONTRIBUTION**

*Can be Pre-tax or Roth Elective Deferrals

Note - Employees who are hired by the School AND were already participating in PSERs may be given the option to stay in PSERs, if the Charter School wishes.

CONCLUSION

Thank you again Chairman Metcalfe and Chairman Cohen for the opportunity to speak with you today. I would be happy to answer any questions you may have as well as be available for any future discussions.

SIGNOR TO THIS TESTIMONY

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