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May 29, 2015

The Honorable Daryl D. Metcalfe, Chair
The Honorable Mark B. Cohen, Minority Chair
Pennsylvania House State Government Committee
144 Main Capitol
Harrisburg, Pennsylvania 17120

**Subject: Written Testimony for Hearing on SB 1**

Dear Chairmen Metcalfe and Cohen:

Thank you for the opportunity to provide testimony on Senate Bill 1 (SB 1) before your committee on June 2, 2015. This letter constitutes our written testimony and is organized around three key elements: **funding, investments, and benefits.** Our comments also include recommendations in each of these areas.

Pew's project on Public Sector Retirement Systems performs 50-state and major city research on all aspects of public pension systems, including fiscal health, investment practices, benefits design and governance. The project also offers technical assistance to states and municipalities as they undertake efforts to ensure that their public sector retirement systems are affordable and sustainable, and help put workers on the path to a secure retirement. Our team has been providing research and analysis to policymakers in Pennsylvania for two years, working directly with the Senate finance and appropriations committees, as well as legislators in the House, and other policymakers and stakeholders.

Our previous communications with members of the General Assembly and stakeholders, including letters, testimony and public presentations, provide extensive information on historic challenges, the importance of fully funding pension promises, and how to evaluate the impacts of proposed benefit changes for new workers on both retirement security and cost predictability for the state. The attached charts consolidate this information for your reference.

We previously provided detailed analysis of SB 1 on funding, investments, and benefits to the Senate finance appropriations committees. On plan funding, we support continued commitment to fully funding pension promises as defined by Act 120. The projections indicate that maintaining this path will move Pennsylvania from 49$^{th}$ among states to the top half on plan funding commitment, and directly address one of the primary concerns raised by rating agencies when reporting on recent downgrades. To better protect against growing unfunded liabilities in the future, we have also recommended that policymakers consider further strengthening funding policy based on recommendations of the Society of Actuaries' (SOA) Blue Ribbon Panel on Public Pension Funding. These recommendations include paying off any future pension debt within 20 year, and requiring frequent analysis of the fiscal impacts of investment returns under a variety of market scenarios to better prepare the state for the next economic downturn. In effect,

the Blue Ribbon Panel recommendations offer policymakers the opportunity to enshrine the most prudent funding and reporting standards.

On investments, we have also expressed support for further study of investment practices and fees, along the lines of what is proposed in SB1. SERS and PSERS reported over $78 billion in assets under management as of the end of 2014, with more than half invested in alternative assets including real estate, private equity, and hedge funds. And the fees paid to investment managers associated with fund investments are over $700 million annually. However, well-informed decisions on changes to investment strategy require analysis of long-term risk-adjusted returns, taking into account both bottom line performance as well as the volatility of returns.

Benchmarking studies can provide a useful means of evaluating fees and investments. In addition, we recommend enhancing the reporting on performance and fees by the state's pension systems, but note that the systems already provides a substantial level of information – more than what many other states provide. We view this as an opportunity for policymakers to help make Pennsylvania a model for other to emulate on investment reporting and transparency.

Our analysis of SB1 also includes a summary of the proposed changes to contributions and benefits for current workers, with a clear acknowledgement that current worker benefits have strong legal protections under state law that have been considered in past court rulings. We are not experts on these particular legal matters, and these issues will need to be considered and decided on by legislators, other stakeholders and legal authorities in the state.

While our assessment on funding and investments points towards the potential for common ground and the opportunity for Pennsylvania to adopt model practices, the public debate on benefit changes for new workers is complex and challenging. To date, policymakers in Pennsylvania have mainly expressed two different perspectives on benefits for new workers. One view is to retain the defined benefit plan under Act 120, which included significant benefit reductions and a cost-sharing provision that would require some additional employee contributions if investment return targets are not achieved. In contrast, many recent proposals would shift new workers to a defined contribution model that would improve cost certainty for the state. These models also result in greater benefit uncertainty for workers due to investment risk, and typically increase retirement savings for many workers who change jobs before retirement, while reducing expected benefits for career workers.

There is no one size fits all solution to retirement plan design and any benefit plan can be designed well or poorly. Our analysis of the current benefit structure and recent legislative proposals focus on both the impacts to cost and cost predictability for the state, as well as retirement security for workers. And when evaluating retirement security, we emphasize three central elements to any plan design: the level of employee and employer contributions and their resulting retirement benefits and savings; professionally managed low-fee pooled investments with appropriate asset allocations; and providing workers with access to annuities and lifetime income through retirement.

SB 1 proposes that new workers participate in a hybrid retirement plan comprised of individual defined contribution and cash balance accounts. The projected impacts on cost predictability and retirement security of this proposal are more similar to a defined contribution plan, given that the majority of employee and employer contributions would be allocated to the defined contribution component and because of the particular design features of the cash balance plan. Our attached analysis summarized four effects in comparison to the current benefits provided under Act 120: (1) higher cost certainty as well as lower expected costs; (2) workers' benefits would be less certain because of the risk of investment returns; and (3) expected benefits for career workers' could be reduced by 40 percent while many younger or mid-career workers who change jobs would likely see a significant increase in the level of retirement savings.

The proposed cash balance plan provides a minimum rate of return, or a floor, based on the rate of return for U.S. government treasury bonds, but also includes a ceiling on retirement savings for workers, as the majority of investment returns above the floor would be retained by the state. We note in our analysis that retirement saving for career workers could be improved upon by sharing investment gains with workers in an actuarially neutral manner, by raising contributions, and/or by providing more favorable terms for annuities than the below market rates proposed by SB 1.

In designing a fair and sustainable retirement plan, there is no one-size-fits-all solution. The value of a retirement plan to participating employees and employers depends on its design, and a well-designed plan can help put employees on the path to a secure retirement and provide greater cost certainty for plan sponsors. In addition to analyzing current benefits and recent proposals in Pennsylvania, our research and analysis provided to policymakers has also included information on models used in other states. These models include defined benefit plans with higher levels of cost sharing and proven hybrid models used by a number of states.

As legislators in Pennsylvania continue to evaluate different legislative proposals on plan funding, investments, and benefits, we will continue to provide objective, data-driven research and analysis. The models we have developed to estimate the effects of various proposals on both retirement security and fiscal sustainability can be applied to any plan proposal and we encourage policymakers to utilize them when considering proposals. We look forward to the hearing in your committee on June 2nd. In the meantime, should you have any questions, please contact me at gmennis@pewtrusts.org.

Thank you,

Greg Mennis
Director, Public Sector Retirement Systems
The Pew Charitable Trusts

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**Attachment to Written Testimony on SB 1 for the House State Government Committee on June 2, 2015**

The analysis and recommendations below considers Senate Bill 1 (SB 1), as well as key features of the Governor's budget proposal on pensions. For a more detailed discussion of the points that follow, please refer to our preliminary analysis letter submitted to the co-chairs of the Senate Finance Committee dated May 11, 2015. For further information or questions, please contact Katie Selenski at kselenski@pewtrusts.org.

## FUNDING:

*Maintaining the Commitment to Fully Funding Pension Promises*

SB 1 and the Governor's proposal both maintain the state's commitment to fully funding pension promises, by not proposing changes to the current funding plan established under Act 120. As our previous analyses discuss, the state is on track to reach full ARC payments for both systems by FY18 and to reduce pension debt each year going forward. We applaud policymakers in Pennsylvania for sticking with the funding plan defined by Act 120, which has required dramatic increases in annual contributions over the last four years. Getting to full payments would directly address one of the concerns raised by bond rating agencies in their explanation of recent downgrades, and move Pennsylvania from 49th to the top half of states in terms of the metrics we evaluate on pension funding discipline.[1]

Keeping pace with the Act 120 funding plan will also require annual increases in pension contributions averaging over 15 percent over the next three fiscal years. In the absence of additional resources – and before taking account of the benefit changes and the bonding proposals included in SB 1 and the Governor's pension proposal, respectively - we estimate that these increases would outpace revenue growth by nearly $4 billion over the next three years; an important consideration for policymakers in the broader budget deliberations for Pennsylvania.

We note that the Governor's proposal includes provisions to help ensure that adequate contributions are made automatically for the Public School Employees' Retirement Systems (PSERS). While this mechanism is tied to a broader proposal that includes revenue transfers from the Pennsylvania Liquor Control Board and the issuance of pension obligation bonds, it also stands on its own as a consideration for policymakers to better ensure that pension funding discipline is maintained.

[1] For more information, see public testimony provided by The Pew Charitable Trusts before the Senate Finance Committee on April 15, 2015.

*Potential Improvements to Funding Policy*

The Society of Actuaries' (SOA) Blue Ribbon Panel on Public Pension Funding report provides specific recommendations for consideration by policymakers in Pennsylvania.[2] These recommendations include following policies to amortize unfunded liabilities over time horizons of 20 years or less. In addition, the report recommends that plans regularly produce stress-test or sensitivity analysis, to inform policymakers on the cost implications if plan investment returns are higher or lower than expected.

As the state approaches making full contributions to fund pension promises, we recommend that policymakers consider adoption of these recommendations in a manner that will not require additional payments in the near-term[3] but will better prepare policymakers for the next economic downturn. In effect, the Blue Ribbon Panel recommendations offer policymakers the opportunity to enshrine the most prudent funding standards.

**Funding Recommendations:**

We support the authors of SB 1 and the Governor for implicitly including in their respective proposals a continued commitment to fully funding pension promises by preserving the funding plan defined by Act 120. Maintaining this commitment will move Pennsylvania from 49th to the top half of states on plan funding.

- Consider adoption of the Governor's proposal to pay PSERS contributions directly from tax revenue upon certification by the plan and the Secretary of the Budget, regardless of any decisions related to proposed pension obligation bonds.

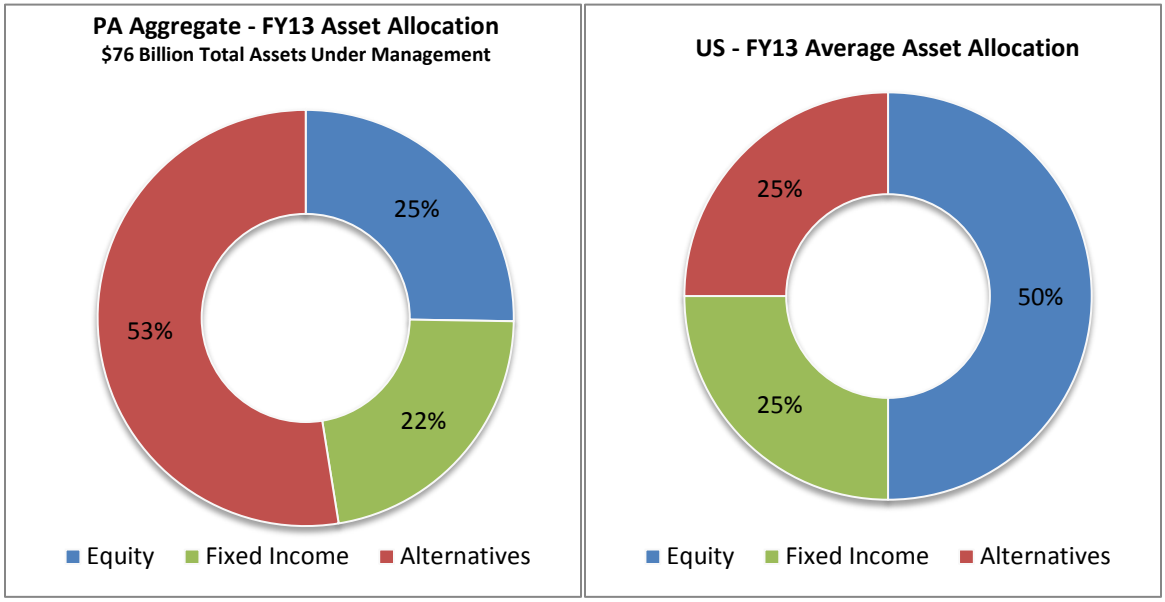
- Further strengthen funding policy based on recommendations of the Society of Actuaries' (SOA) Blue Ribbon Panel on Public Pension Funding[4], including a requirement that plans provide sensitivity analysis on a regular basis to help plan for uncertainty.

## INVESTMENTS:

As of 2013 reporting, the Public School Employees' Retirement System (PSERS) and the State Employees' Retirement System (SERS) have a combined $76 billion in assets under management[5]. As shown below, Pennsylvania's state pension funds are more heavily invested in alternative investments than the average state pension fund, with over half of assets in private

[2] Report of the Blue Ribbon Panel on Public Pension Plan Funding, An Independent Panel Commissioned by the Society of Actuaries, February 2014.
[3] For example, by targeting shorter amortization periods for any future unfunded liabilities rather than accelerating payment on existing unfunded liabilities.
[4] https://www.soa.org/blueribbonpanel/
[5] See Appendix for system-specific details.

equity, real estate, hedge funds, and other alternative asset classes compared with one-quarter for the average of U.S. state pensions.




Sources: Financial reports for SERS, PSERS, and other states; TUCS benchmarking data from Wilshire Associates Incorporated.

Pennsylvania reported over $700 million in external management fees – or more than 90 basis points on assets under management.[6] These fee levels are higher than the average levels across the 50 states, due to the high proportion of alternatives in the state's pension fund portfolios. Our research shows that average reported fee levels for the 71 largest state funds are 35-40 basis points on assets. However, because some fees are charged against assets and not included in public statements, total management fee are estimated to be closer to 50 basis points on average.

Both SERS and PSERS perform better than the median national benchmark looking back over the past 10 years, but underperform the median benchmark over the past five years. We also note that the state provides a greater level of disclosure on pension fund performance and fees than many other states – for example, by reporting 10-year performance on an asset class basis both gross and net of fees.

*Investments Proposals*

SB 1 would create a Public Pension Management and Asset Investment Review Commission that would evaluate and make public recommendations about aspects of the assets under investment for both state retirement systems. The commission's focus would be on investment return performance compared to established benchmarks, while also considering costs and benefits for active and passive investment strategies to maximize future net of fee returns. Presumably, this would include an assessment of the Governor's proposal that the state's pension fund assets be

[6] SERS paid approximately 66 bps; PERS paid approximately 114 bps (over 1% of assets).

invested using passive investment strategies to reduce fees paid to outside investment managers. The commission would operate in an open forum and report back to the Governor and General Assembly within six months of its first meeting.
Well-informed decisions on changes to investment strategy would require analysis of long-term risk-adjusted returns, taking into account both bottom line performance as well as the volatility of returns, and should be benchmarked to provide comparative context. Given the complexity of these considerations, we recommend that policymakers consider further study along the lines of what is proposed in SB 1. Related to this effort, we recommend that the state adopt enhanced financial reporting for pension fund investments, to ensure that the information contemplated by the SB 1 study is reported in the future.

This recommendation is not a critique of current disclosure practices in Pennsylvania. In fact, the state's pension systems provide more information on investment performance and fees than the majority of the largest 71 state sponsored investment funds – including detailed performance data that is net of investment manager fees and separated by asset class. About one-third of the funds that we study, for example, provide performance data that is gross of the fees paid to investment managers, which is allowed for under current accounting standards. Instead, this is an opportunity for the state to build on existing practices and provide a model for pension investment transparency.

More specifically, we recommend consistent disclosures on investment performance over 1, 3, 5, 10, and 20 years on an asset class basis, both gross and net of fees with comparisons to relevant benchmarks, as well as line-item disclosure of fees paid to individual investment managers, and public disclosure of the plans' investment policy statements. Twenty year performance would go beyond the 10 year results that most funds publish and provide stakeholders with a more complete picture of long-term fund performance. Asset class performance allows policymakers to evaluate the results and costs of different investment strategies. If the study proposed under SB 1 is adopted, these requirements could provide the foundation for further enhancements to pension investment transparency.

**Investments Recommendations:**

- Consider further study of various existing and proposed investment approaches, similar to the proposal to establish a review commission contained in SB 1.

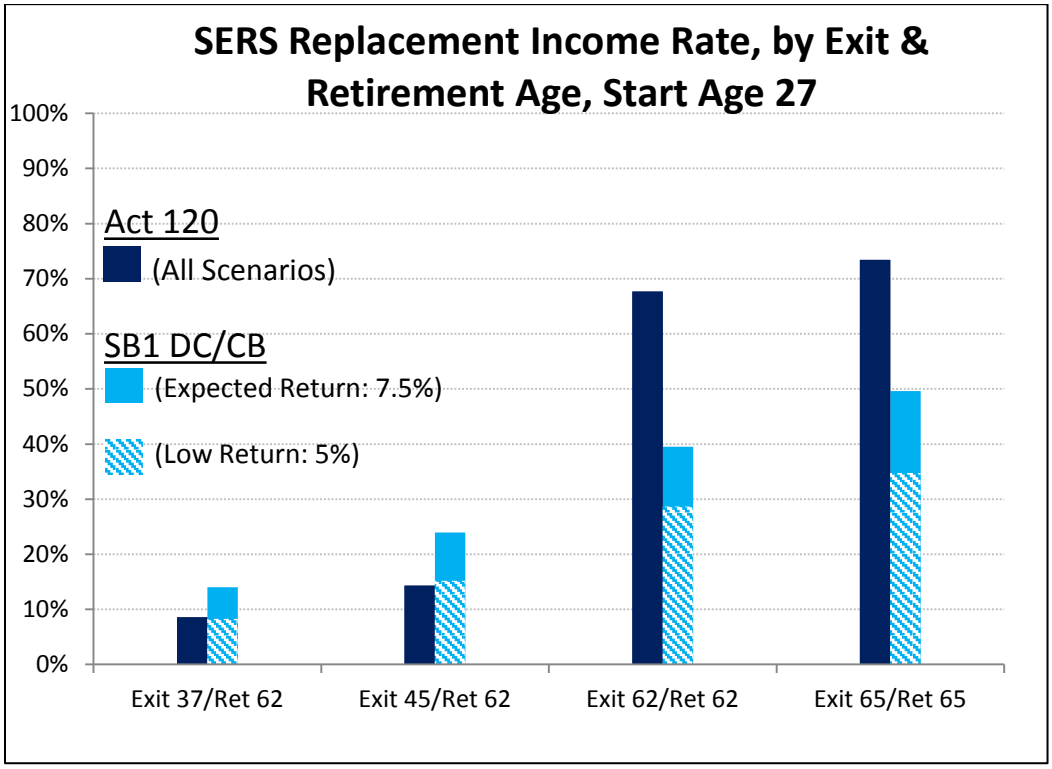
- Enact a provision requiring PSERS and SERS to annually publish detailed information related to investment performance and fees[7], including:
    - Performance over 1, 3, 5, 10, and 20 year periods on an asset class basis, both gross and net of fees
    - Complete disclosure of fees paid to individual asset managers
    - Continued access to investment policy statements online

[7] As noted in our preliminary analysis, SERS and PSERS voluntarily provide most of this information already, including 10 year returns net of fees and by asset class and fees by asset class. This recommendation would include some additional disclosure and call for consistent presentation of data by both systems.

## BENEFITS

*Analysis of New Worker Benefits*

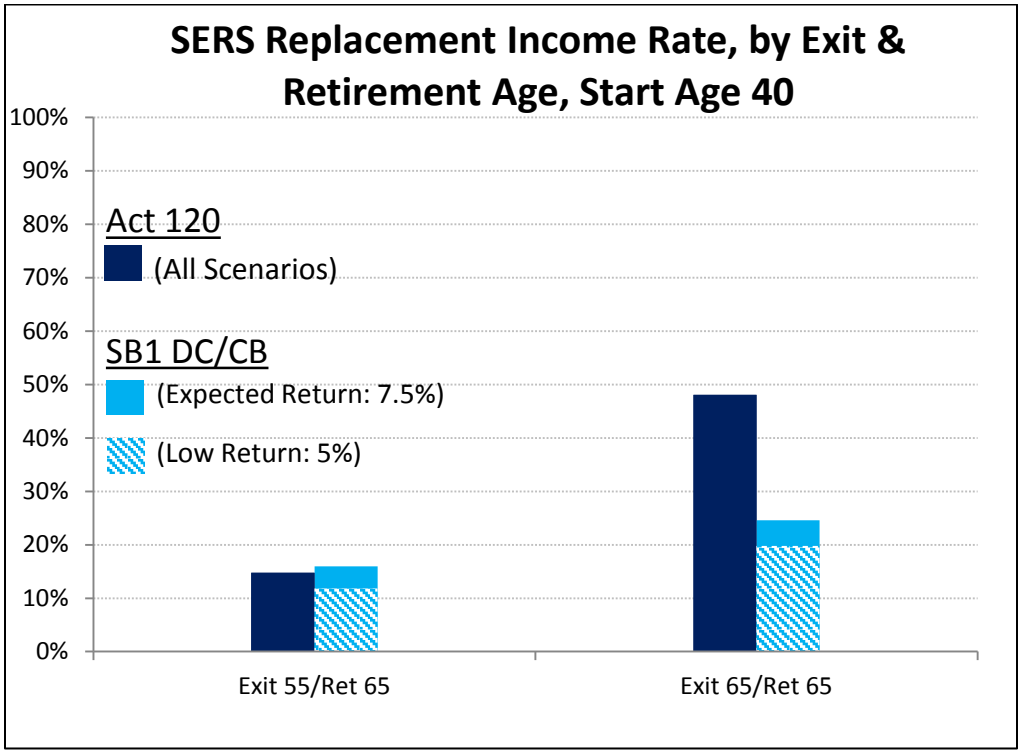
The charts below summarize our analysis of the value of the benefits provided by SB 1's hybrid defined contribution and cash balance plan compared to those provided by the post-Act 120 defined benefit plan. The analysis assumes a start age of 27, based on common start age suggested by plan data.




**Graphical results based on plan assumptions in addition to the following: 5.0% - 7.5% expected DC investment returns, 5.2% expected cash balance ICR, 6.25% employee contributions to DC and CB, annuities converted based on 4% returns and inflation of 2.25%. Replacement rate measures the percentage of pre-retirement income replaced by Pennsylvania retirement benefits at time of retirement—it does not include benefits from Social Security or from individual savings nor does it factor in the effect of inflation on benefits over the course of retirement.*

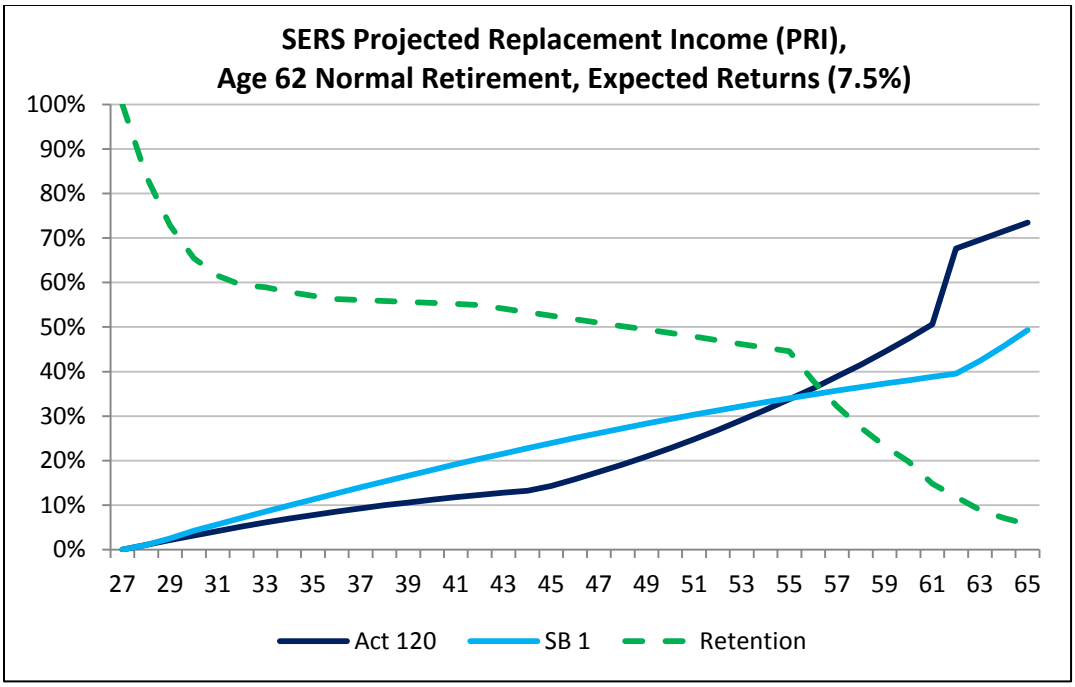
- A worker beginning with SERS at age 27 and exiting at age 45 is estimated to experience over an increase in benefits from those 18 years of state employment under SB 1, because the value of the DB/DC account is greater than the annuity income that the DB plan will provide by the time workers reach retirement age, although this improvement is very small if investment returns are only 5 percent.

- The same worker who joins at age 27 and instead stays with SERS for his or her whole career would see an approximate 40 percent reduction in benefits under SB 1. This reduction is greater still for PSERS plan participants.



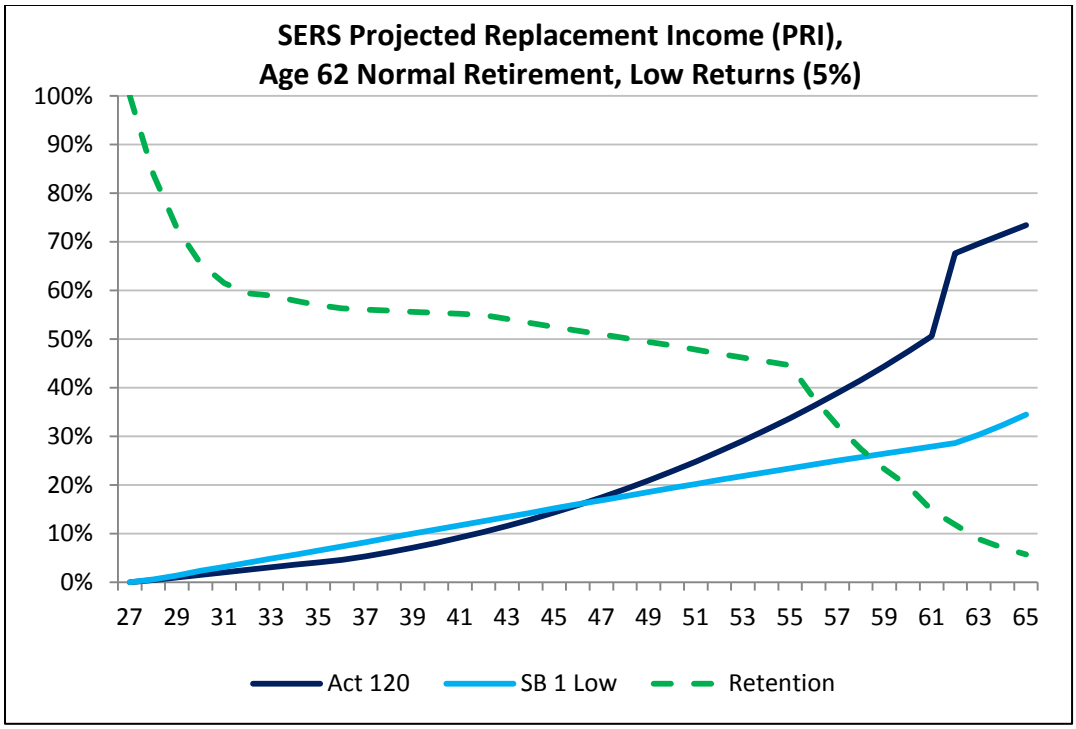

- Our analysis also compared a worker beginning with SERS at age 40; this employee could expect to receive approximately the same benefit if they stay with the system for only 15 years.

- This same worker can expect to see over a 40 percent reduction in benefits if he or she stays until retirement at age 65.




**Graphical results based on plan assumptions in addition to the following: 7.5% expected DC investment returns, 5.2% expected cash balance ICR, 6.25% employee contributions to DC and CB, annuities converted based on 4% returns and inflation of 2.25%*

- Comparing replacement income over the career of an age 27 starter (based upon 7.5 percent projected investment returns for the DC benefit and 5.19 percent for the cash balance) SB 1 outperforms Act 120 benefits until the worker hits 29 years of service. Based on plan assumptions, 38 percent of workers starting at age 27 are expected to hit that point. The largest separation between SB 1 and Act 120 is for participants with 35 years of service—a worker starting at age 27 and retiring at 62 would get a 42 percent cut under SB 1 compared to Act 120, even if investments achieve the same 7.5 percent targeted rate of return for SERS. For PSERS participants, the crossover point happens earlier, at 25 years of service, and the decrease in benefits is larger.




- Under a low return scenario (5 percent long-term returns for the DC account), the crossover point for SB 1 is after 19 years of service—52 percent of starting workers are expected to get to that point. Furthermore, for the years where SB 1 is a better benefit, the difference is less pronounced while at age 62 SB 1 represents a 58 percent benefit cut.

**Plan Design Recommendations:**

As noted in our May 11 letter, there are a variety of options that policymakers in Pennsylvania may consider based on their goals to improve cost predictability while continuing to provide workers with a path to a secure retirement.

- The state could maintain the defined benefit plan while improving cost predictability for the state by raising the cost sharing formula to a 50/50 split. (See the Arizona State Pension plan for an example.)

- The SB 1 DC/CB hybrid could be modified to improve benefits for career workers while still retaining a high degree of cost predictability by:
    - increasing contribution levels
    - raising the workers' share of cash balance upside returns to an actuarially neutral level
    - providing access to annuities on more favorable terms

- The state could consider a hybrid plan based on proven models used in other states.

We will continue to provide in-depth analysis of the impact of different proposals on retirement security and cost predictability using our analytic framework.

*Cost Predictability for New Workers*

The new plan design proposed by SB 1 would improve cost predictability for the state while posing a benefit reduction for career tenure workers and a benefit increase for younger and mid-career workers who change jobs, as described in more detail below.

- The SB 1 hybrid would make the state's costs more predictable as compared to the current defined benefit (DB) plan. The DB plan for SERS is expected to cost the state 5 percent of payroll for those individuals hired under Act 120 but, depending on investment returns, may cost less than 2 percent (if returns exceed expectations) or as much as 10 percent (if returns fall short). We estimate that the expected cost of the SB 1 DC/CB hybrid would be less than the 4 percent employer contribution rate. The driver of this is the cash balance component—the interest workers get for their accounts is projected to be less than the plan will make on its investments, even if returns are lower than expected. As a result, in most investment return scenarios, we project the cost of the SB 1 hybrid benefits to be between 2 percent and 3 percent of payroll.

*Current Worker Benefits*

Before considering the potential impacts on plan funding of these proposals, we would emphasize the need to consider the legal protections for current workers under Pennsylvania state law. Current worker benefits in Pennsylvania have legal protections under state contract and constitutional law that have been considered in past court rulings[8]. Most other states have similar legal protections, although a number of states have increased current worker contributions. We are not experts on these particular legal matters, and these issues will need to be considered and decided on by legislators, other stakeholders and legal authorities in the state.

Under SB 1, current workers hired before the Act 120 benefit changes would be given a choice to either raise contributions by 2.5 percent of salary for a SERS employee or 3 percent of salary for a PSERS employee in order to maintain expected benefits at current levels or receive a lower increase in the benefit formula for each additional year of service in exchange for a reduction in employee contributions of 1.25 percent of salary.

- Because the change only applies to future years of service, a worker near retirement would see very little change in his or her benefits.

[8] The Association of Pennsylvania State College and University Faculties, et.al, v. The State System of Higher Education, et.al. 505 PA 369, (July 6, 1984). Also see Catania, et. al. v. Commonwealth, et. al., 498 PA 684, (1982)

- Someone hired just before Act 120 went into effect would see close to a 20 percent reduction. This provision in SB 1 makes the benefit formula for an affected employee match what was in place prior to the 2001 and 2002 benefit increases.

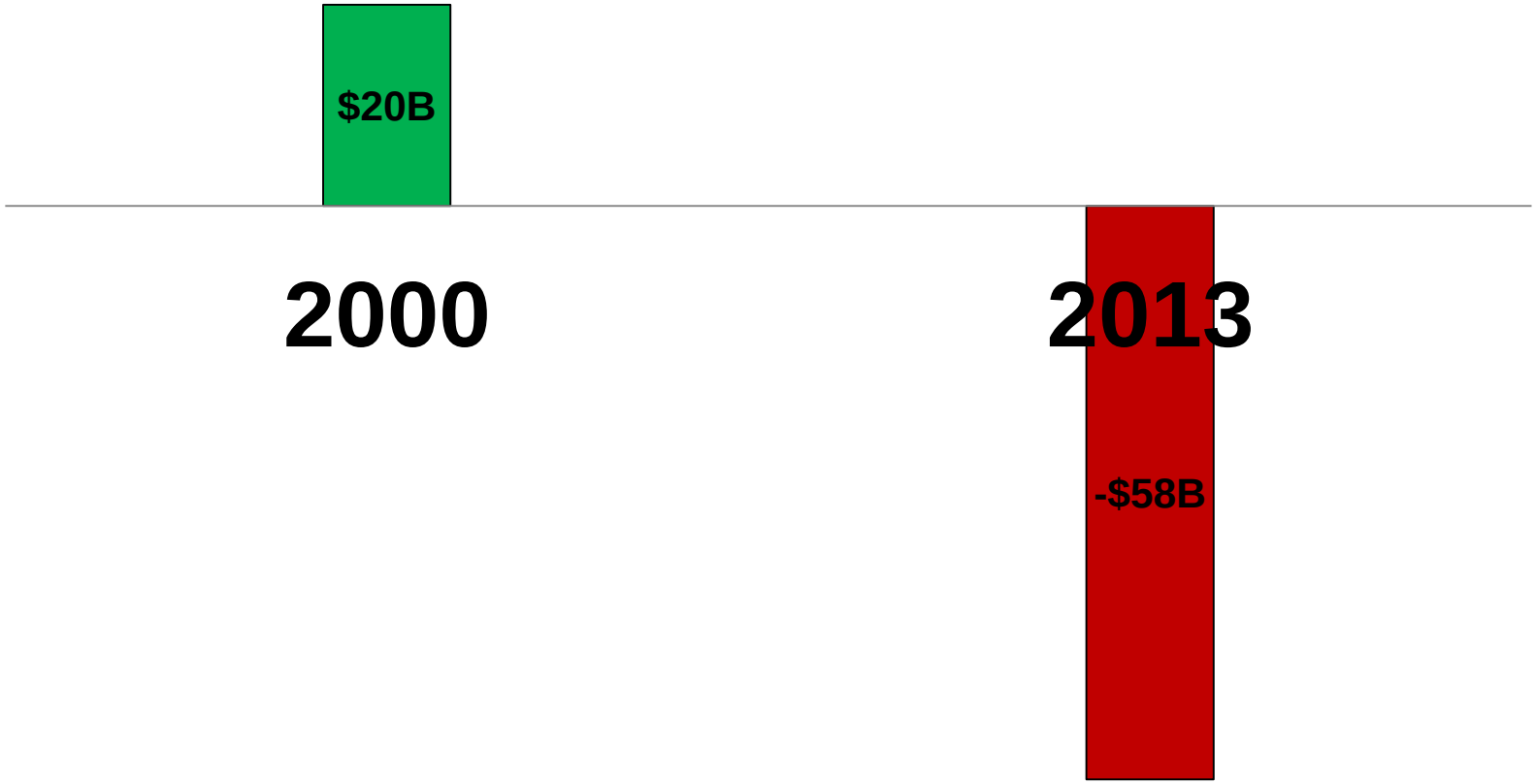
SB 1 also includes a provision that would change the terms of the "Option 4" lump sum payment – which allows workers to take up to their full accumulated employee contributions plus interest as a lump sum.

- The effect of using 4 percent for calculating the lump sum reduction, while using 7.5 percent for other actuarial purposes, increases the total value of retirement benefits for those who select the Option 4 retirement benefit relative to workers who do not.

- Act 120 eliminates the subsidized Option 4 lump sum for anyone hired after the Act went into effect. SB 1 would apply that change to those hired before Act 120 who have not yet retired. This would increase the cost of taking a lump sum benefit, in terms of the reduction in the annuity benefit, by up to 40 percent.

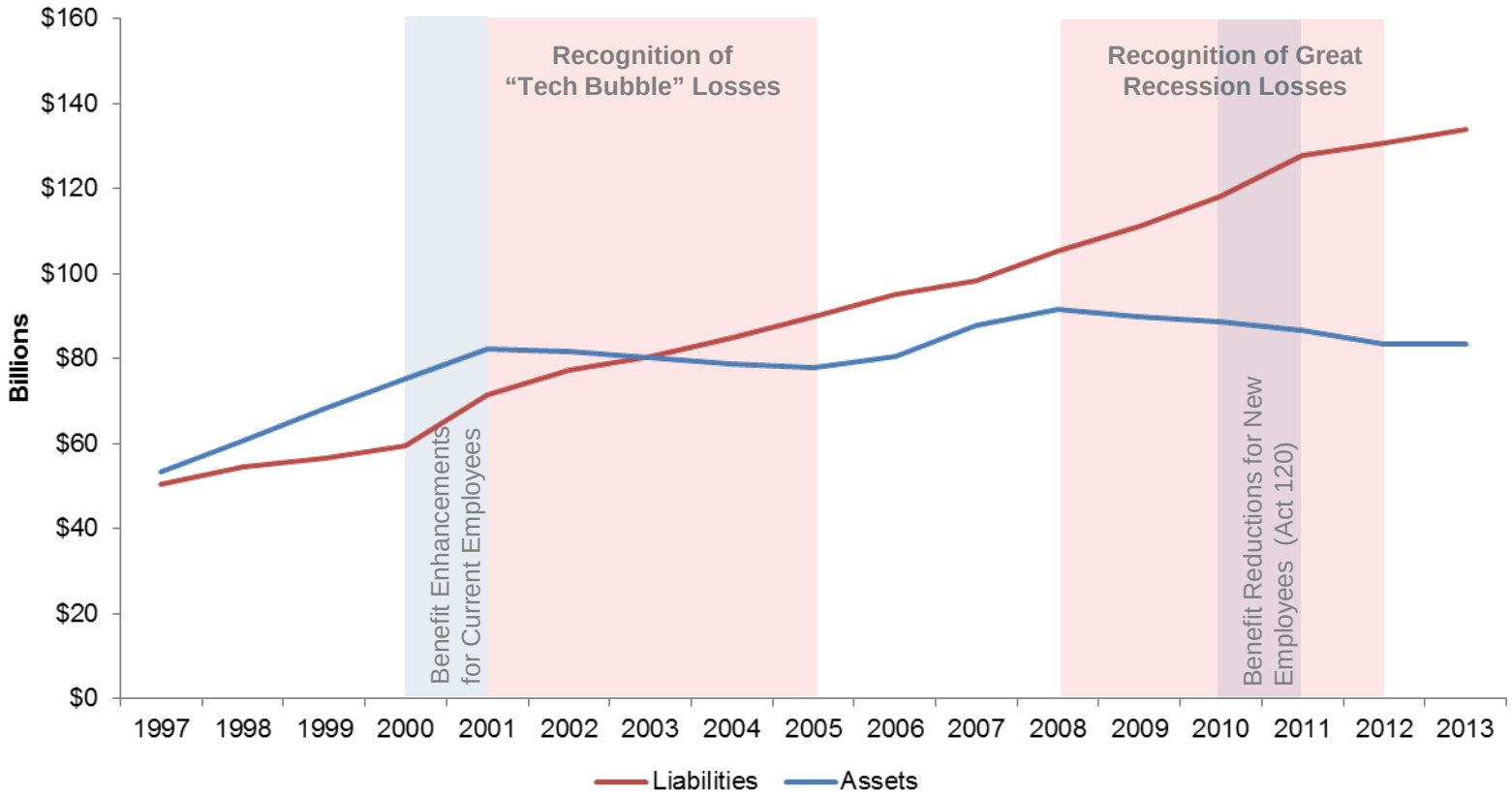
Changes to current employee benefits are responsible for the majority of the projected savings from SB 1. The actuarial analysis for the changes to PSERS from SB 1 found a present value reduction in employer costs of close to $6 billion. Of those reductions, 10 percent were attributable to the new plan design, 40 percent to the change to Option 4 withdrawals, and 50 percent to the new benefit tier for future accruals for current employees.

# Pennsylvania Pensions: A $78B Swing in 13 Years – From $20B Surplus to $58B Debt




*Sources: SERS and PSERS actuarial valuations and CAFRs. As of 1/26/15, the SERS 2014 AV is not yet available.*

# Pennsylvania's Pension System: From Surplus to Growing Funding Gap

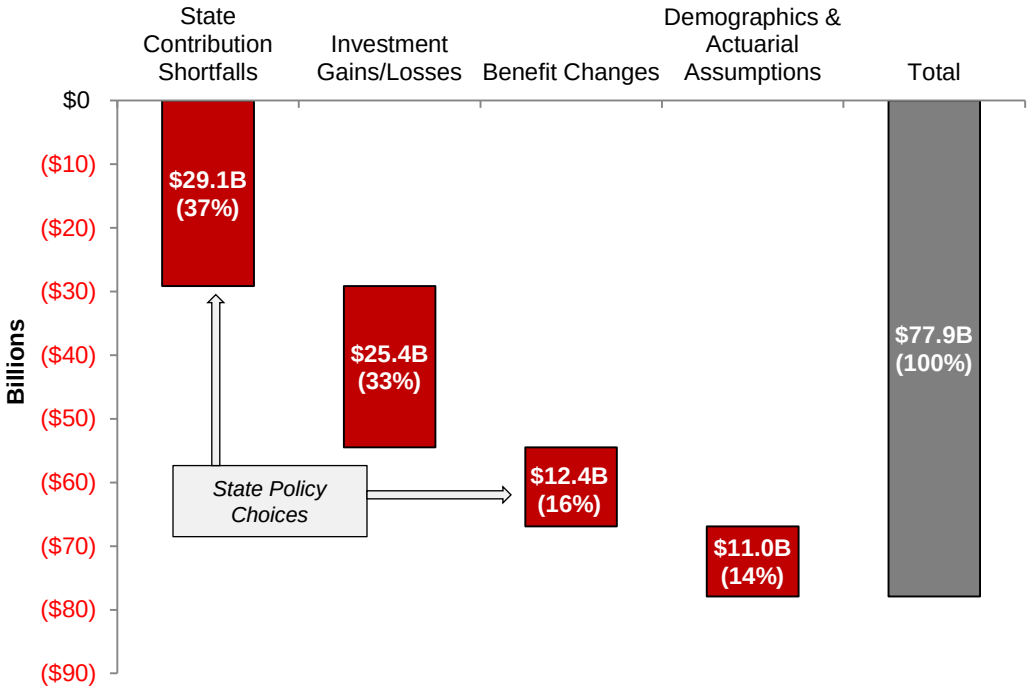



*Sources: State and pension plan CAFRs and pension plan actuarial valuations (SERS and PSERS)*
*Note: As of 1/26/15, the SERS 2014 AV is not yet available. According to PSERS' 2014 AV, PSERS' funded ratio was 62% as of 6/30/14.*

# From $20B in Pension Surplus to $58B in Pension Debt

- $78B swing has three main causes:
  - Poor funding practices
  - Low investment returns
  - Unfunded benefit increases
- Over half of unfunded liability is the result of state policy choices

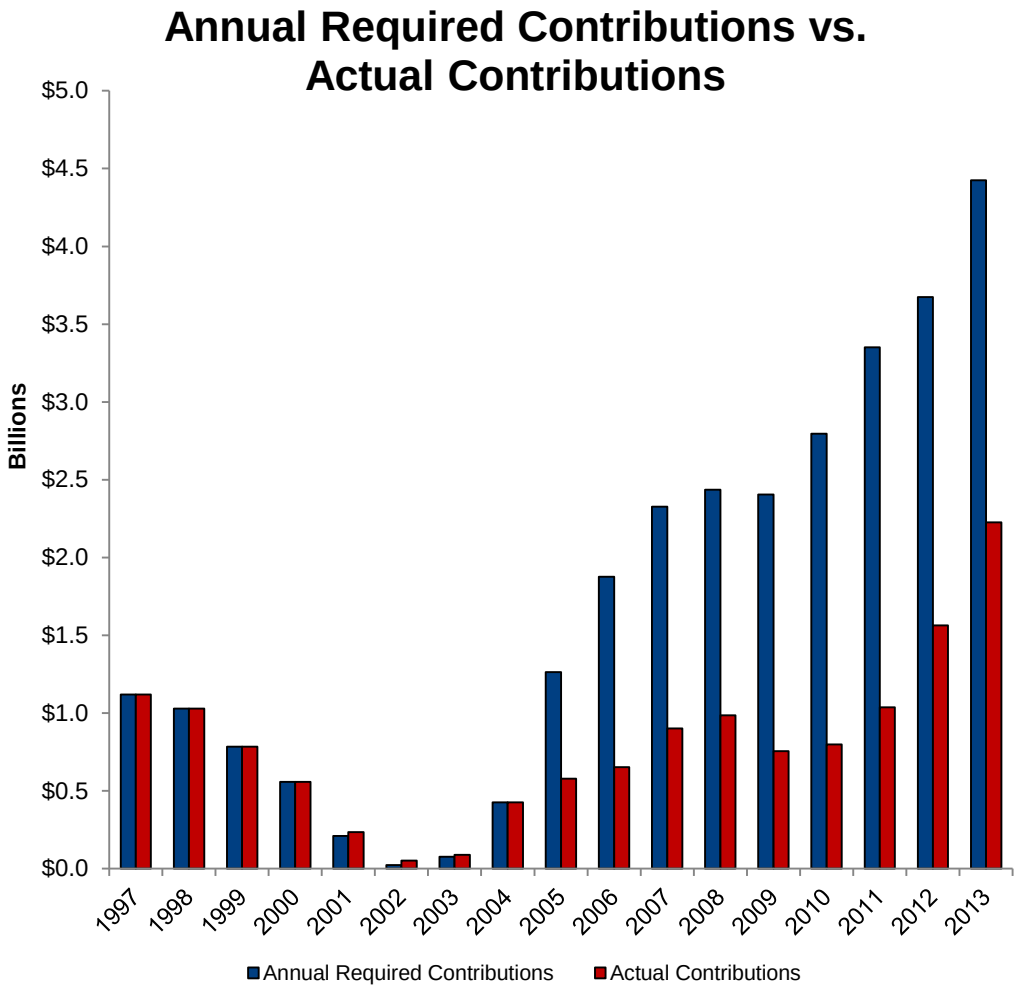
**Unfunded Liability Growth Drivers***
**2000-2013 (Market Value Basis)**




**Values calculated using market value of assets. State contribution shortfalls reflect ARC underfunding and negative amortization. Benefit changes reflect the change in the liability at the time the benefit changes were implemented; cumulative impact as of 2013 reporting is substantially higher.*
*Sources: Primary data from plan CAFRs and actuarial valuations; analysis provided by the Terry Group*

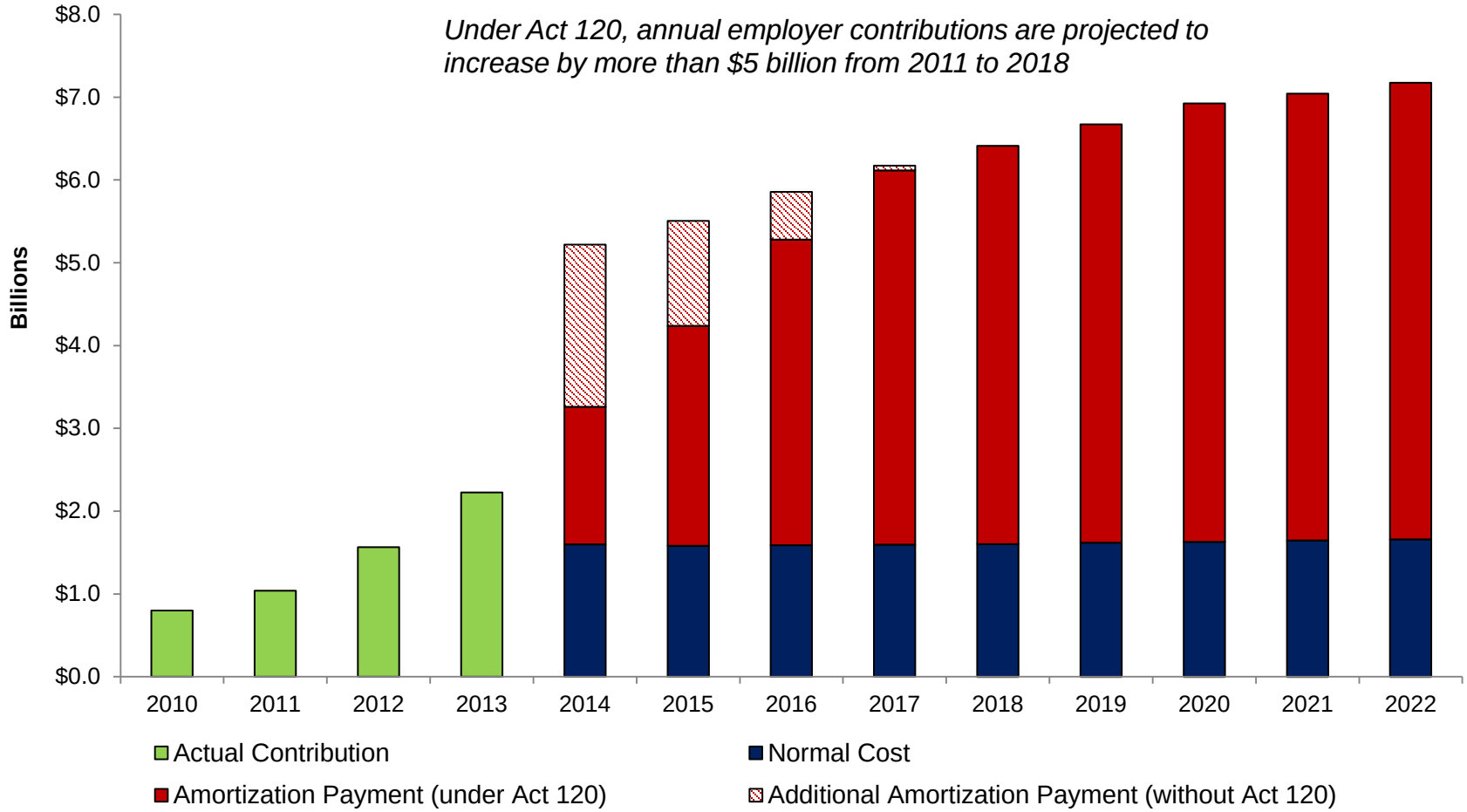
# Pennsylvania's Contribution Shortfalls

- Since 2003, PA has made only 40% of its annual required contributions (ARC)
- PA ranks 49th in ARC payments in recent years
- US Average (excluding PA and NJ) = 87%

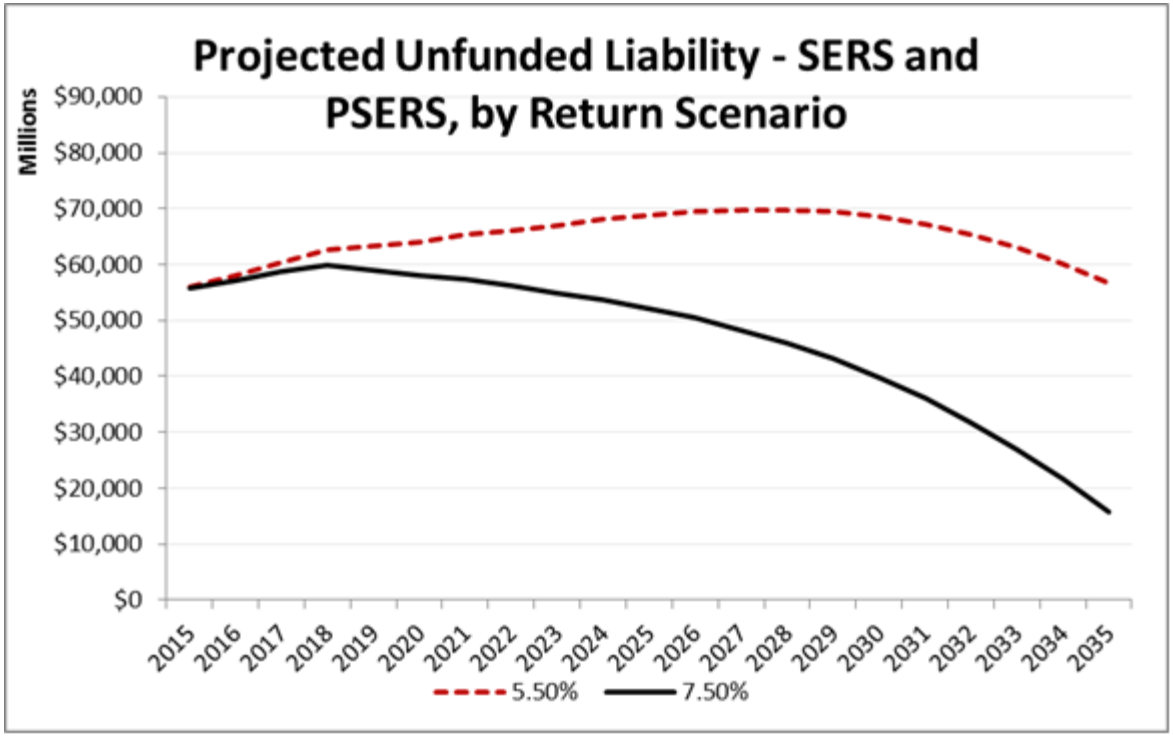



*Sources: State and pension plan CAFRs and pension plan actuarial valuations (SERS and PSERS)*
*Note: As of 1/26/15, the SERS 2014 AV is not yet available. According to PSERS' 2014 AV, the 2014 PSERS ARC was $3.41B, of which $1.99B was actually contributed (58%).*

# Expected PA Total Pension Costs




*Sources: Analysis by The Pew Charitable Trusts and The Terry Group based on data from SERS and PSERS actuarial valuations and CAFRs*
*Note: As of May 2015, the SERS 2014 AV is not yet available. According to PSERS' 2014 AV, the contribution was $1.99B.*


Projected Unfunded Liability - SERS and PSERS, by Return Scenario
Millions
$90,000
$80,000
$70,000
$60,000
$50,000
$40,000
$30,000
$20,000
$10,000
$0
2015
2016
2017
2018
2019
2020
2021
2022
2023
2024
2025
2026
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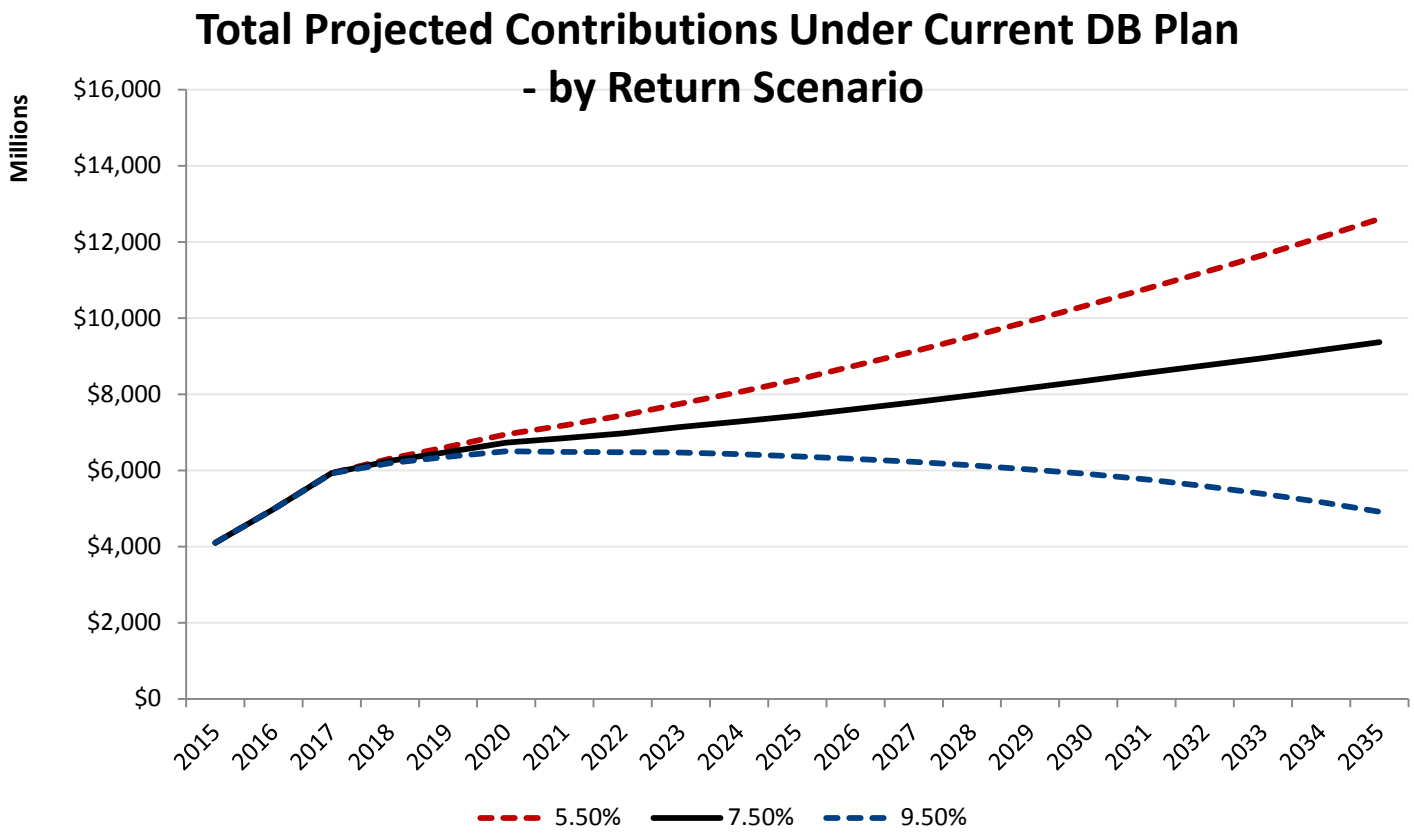
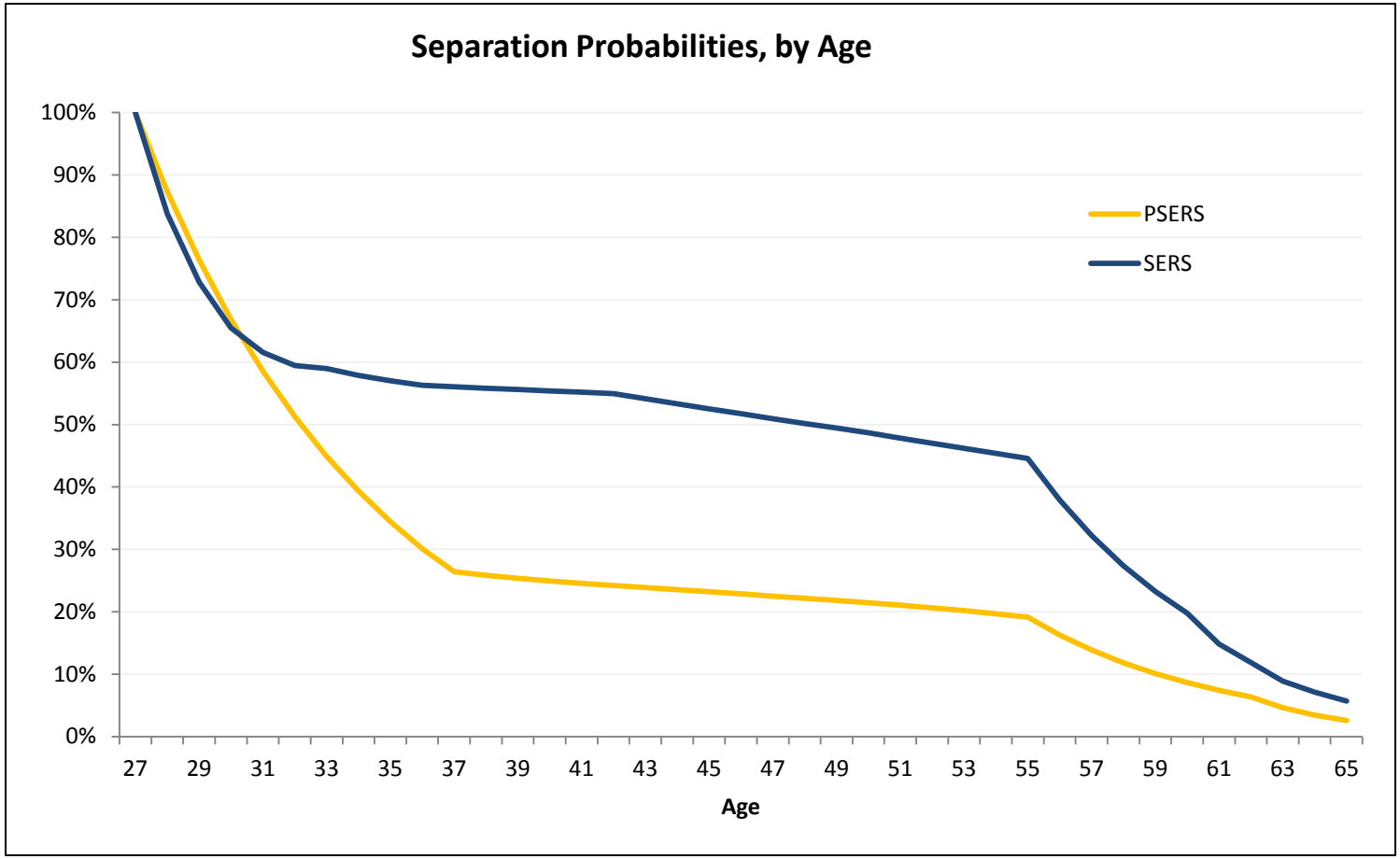
2030
2031
2032
2033
2034
2035
5.50%
7.50%

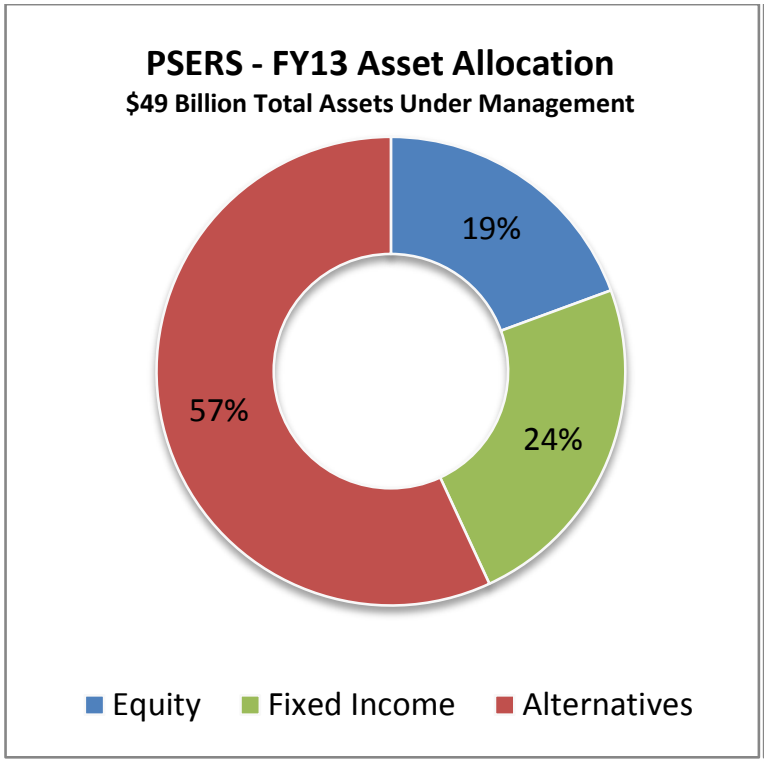
# Cost Variability of Current Plan

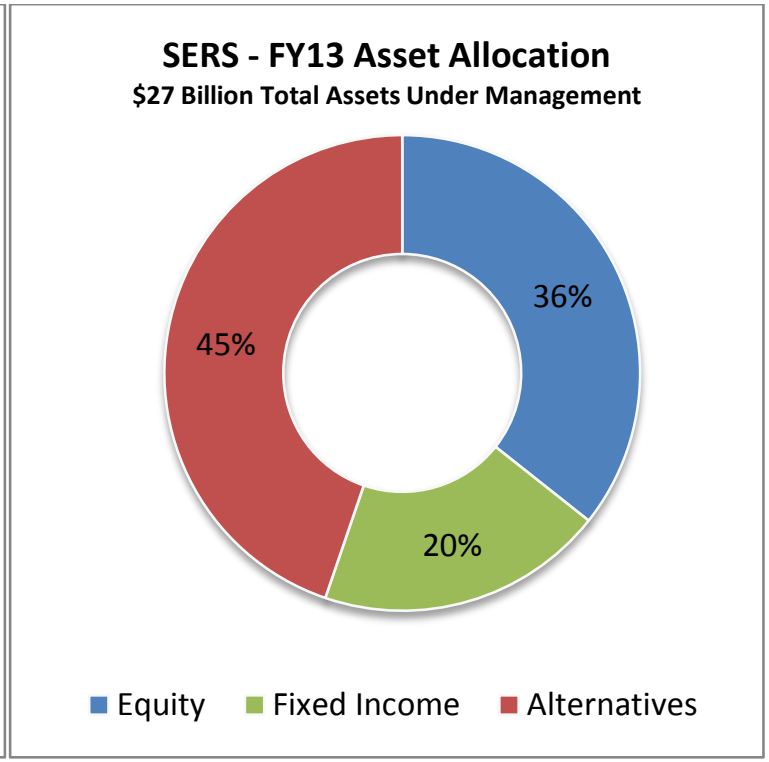


# Attrition Rates for PSERS and SERS

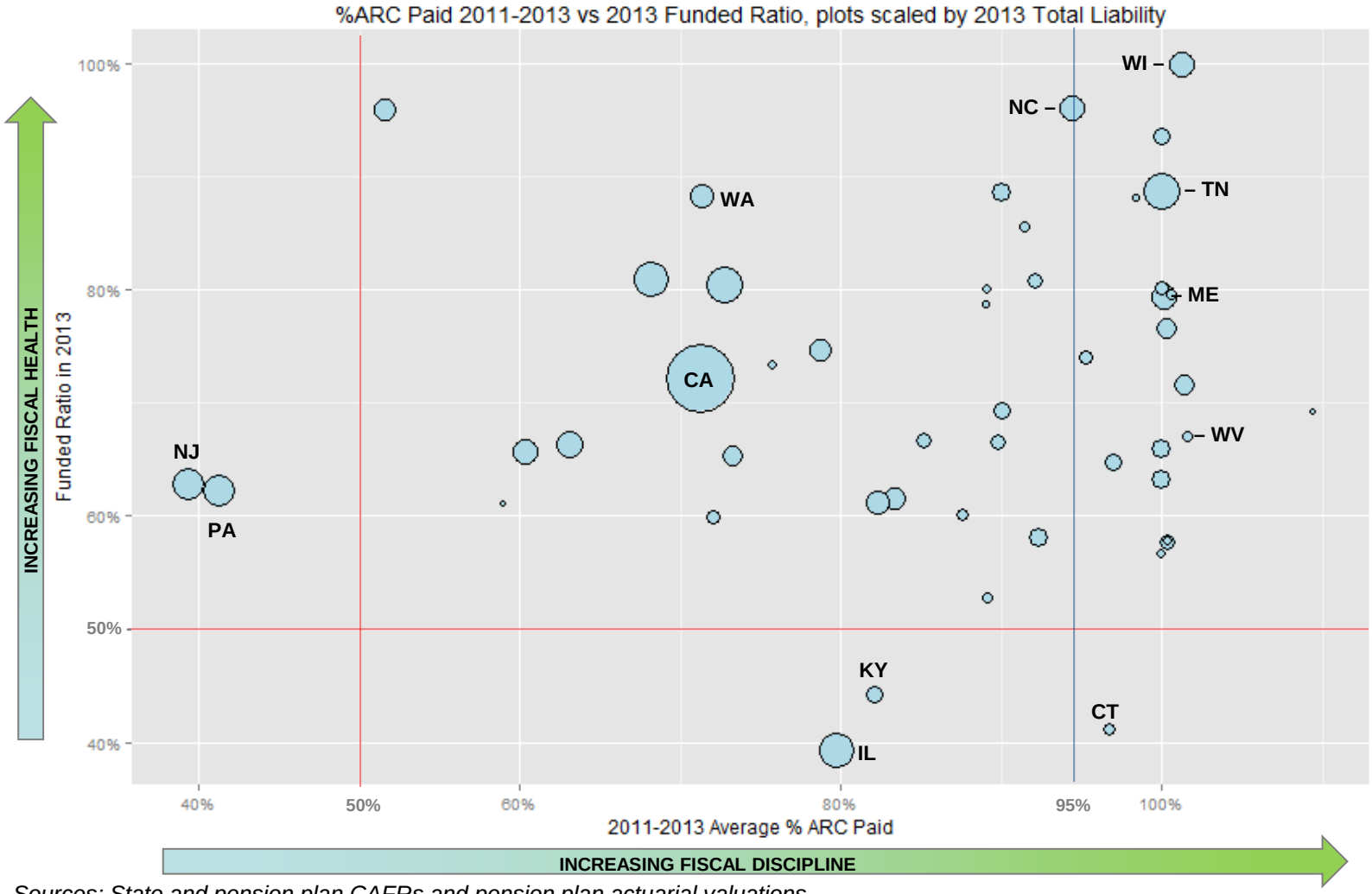


# Investment Asset Allocations by System



# Pennsylvania is an Outlier in Pension Underfunding




*Sources: State and pension plan CAFRs and pension plan actuarial valuations*