HOUSE COMMITTEE ON APPROPRIATIONS

FISCAL NOTE

SENATE BILL NO. 1071 **PRINTERS NO.** 1481 **PRIME SPONSOR**: Browne

COST / (SAVINGS)

FUND	FY 2015/16	FY 2016/17
General Fund	**$0**	**See fiscal impact**
State Employees' Retirement Fund	**$0**	**See fiscal impact**
Public School Employees' Retirement Fund	**$0**	**See fiscal impact**

SUMMARY: Senate Bill 1071, printer's number 1481, amends Titles 24 (Education), 51 (Military Affairs) and 71 (State Government) of the Pennsylvania Consolidated Statutes to establish a side-by-side hybrid pension plan for future state and school employees and modify future benefits of current members of the Public School Employees' Retirement System (PSERS) and the State Employees' Retirement System (SERS). The bill also provides for Public Pension and Asset Review Commissions for both PSERS and SERS.

The effective date is immediately upon enactment for all provisions of the bill except for the establishment of independent counsel for PSERS and SERS, where the effective date is 365 days after enactment.

ANALYSIS: The bill establishes a new side-by-side hybrid pension plan for SERS and PSERS, effective for most state employees hired on or after January 1, 2018 and for all school employees hired on or after July 1, 2017. The bill also makes changes prospectively to certain retirement benefits for current state and school employees. The actuarial funding method utilized by SERS to determine the normal cost rate (a variation of the Entry-Age actuarial cost method) is modified by the bill to be the traditional Entry-Age Normal actuarial cost method.

<u>Side-by-Side Hybrid Plan</u>

The new side-by-side hybrid pension plan establishes a Defined Contribution (DC) retirement plan and adds a new Defined Benefit (DB) tier to the existing DB plan structure.

<u>DC Plan</u> –

- Mandatory 3.5% of salary minimum employee contribution rate for PSERS members and mandatory 3.25% of salary minimum employee contribution rate for SERS members. Mandatory contributions are considered pickup contributions and are therefore made with pre-tax dollars.
- Employer contribution of 2.5% of salary for both PSERS and SERS members.

- All Plan Participants will have an individual investment trust account established for their benefit. All participant and employer contributions, investment earnings and any fees or costs shall be credited or charged to each participant's trust account.
- Plan participants are permitted to make voluntary contributions up to the extent allowed by the Internal Revenue Code. Voluntary contributions to be made with after-tax dollars.
- No employer match for additional voluntary contributions.
- PSERS and SERS boards may establish procedures for automatic increases in employee contributions. Procedures must also be established for employees to elect to not have automatic increases in voluntary contributions.
- Vesting provisions – employee contributions and earnings thereon vest immediately. Employer contributions and earnings vest after 3 years.
- At retirement, DC plan benefits can be taken at a different time than the DB benefit.
- At retirement or separation, employees may elect a full or partial lump sum payment of the vested balance in their individual retirement investment account, which can be rolled over into another account to the extent the IRS allows, or a single life annuity based on the actuarial value of employee account.
- PSERS and SERS boards must provide not less than ten (10) options which are offered by three or more providers of investment options when establishing standards and criteria for investment options for eligible Defined Contribution (DC) plan participants.
- School districts that establish or maintain a 403(b) plan or a 457 plan must select a minimum of 4 financial institutions or pension management organizations, in addition to the financial institution or pension management organizations that entered into an agreement with the PSERS board.
- The provisions of Act 44 of 2010, known as Protecting Pennsylvania's Investments Act, will apply to investments under the DC plan.
- Loans, including hardship or unforeseeable emergency distributions, from the plan to active employees are not permitted, unless required by law
- All expenses, fees and costs of administering the plan and the trust and investing assets of the trust shall be borne by the participants and paid from assessments against the balances of the individual participant's investment accounts. There is an exception for fiscal years 2015-16 and 2016-17 for PSERS and fiscal years 2015-16, 2016-17, and 2017-18 for SERS when the expenses, fees and costs of establishing and administering the DC Plan and trust shall be paid by the Commonwealth through an annual appropriation.

<u>DB Plan</u> –

- Mandatory 4% of salary employee contribution for PSERS and 3% of salary employee contribution rate for SERS.
- Multiplier of 1%.
- Final Average Salary based on highest average compensation received during any 5 nonoverlapping periods of 12 consecutive months.
- Vesting at 5 years for PSERS and 10 years for SERS.

- Superannuation age would be age 65 with 3 years of service or the Rule of 92 with 35 years of service (as currently applicable to Act 120 members).
- Cost neutral Option 4 permitted.
- Employees subject to Shared Risk/Shared Gain provisions (outlined below),

Exempt Groups – the following SERS groups of public safety and enforcement officers are exempt from participating in the new hybrid plan and maintain current pre- and post-Act 120 plan design but are subject to the plan changes being made to current plan members:

- Pennsylvania State Police Officers (DiLauro award still applies for members accruing 20 or more years of service as a State Police Officer)
- Enforcement Officers
- Corrections Officers
- Wildlife Conservation Officers
- Other Commissioned Game Commission law enforcement personnel
- Delaware River Port Authority Police officers
- Park Rangers
- Capitol Police Officers
- Campus Police Officers employed at State-owned Educational Institutions and Community Colleges
- Campus Police Officers at the Pennsylvania State University
- Police Officers employed at Ft Indiantown Gap and other designated military installations & facilities

Opt In Provision – Current school and state employees, except for the exempt groups listed above, have a one-time option to elect to participate in the new hybrid plans. Current active school employees can elect to join the hybrid plan no later than June 30, 2017. Current active state employees must make an election to join the hybrid plan no later than December 31, 2017.

Inactive PSERS and SERS members, or individuals with previous PSERS or SERS credit who return to work after a break in service, may make an election to participate in the hybrid plan within 45 days of returning to service. If such an election is not made individuals who return to service will be placed in their previous class of service.

Current Member Changes

The bill also imposes changes on future service of pre-Act 120 and post-Act 120 members of PSERS and SERS, including public safety and enforcement officer groups previously outlined and members of the General Assembly. The changes in benefits would occur on service accrued on or after July 1, 2016 for the changes that apply to both PSERS, and SERS, and on or after January 1, 2017 for the change that applies only to SERS.

Actuarially Neutral Option 4 Retirement – For pre-Act 120 members who choose Option 4 retirement on or after July 1, 2016, the annuity calculation for all service attained after July 1, 2016, will be actuarially neutral meaning that the annuity will be discounted by the assumed rate of return versus the current 4%. Actuarially neutral Option 4 will also be provided to post-Act 120 members who do not currently have that option.

Shared Risk/Shared Gain Provisions - For Pre-Act 120 PSERS and SERS members a shared risk/shared gain calculation will be made every 3 years comparing the actual and assumed rates of return, net of fees, for the prior 10 years. For every percentage point in system earnings in excess of or below the assumed rate of return, the employee contribution rate will be reduced or increased by 0.5%. The shared risk/shared gain rate cannot be 2 percentage points more or less than the base employee contribution rate. The first look-back period shall be for the period ending June 30, 2020 for SERS and June 30, 2021 for PSERS.

For post-Act 120 members, who currently are subject to Shared Risk provisions will also now be provided with the possibility of Shared Gain adjustments.

Final Average Salary/Anti-spiking – for SERS members only, a member's final average salary on all service attained after December 31, 2016, will be calculated using the higher of the highest five years of salary including overtime or the highest three years of salary excluding overtime. Service that occurred on or before December 31, 2016, would be calculated using the three highest years of salary.

<u>Other Provisions</u>

Public Pension and Asset Investment Review Commissions are established for both PSERS and SERS to make recommendations regarding active and passive investment performance and strategies. Each Commission will include 5 members appointed by the following: the Governor, the President Pro Tem of the Senate, the Speaker of the House, the Senate Minority Leader, and the House Minority Leader. The appointees shall be investment professionals and retirement advisors and shall be appointed within 90 days of the effective date of the act. The Commissions are to submit their findings and recommendations to the General Assembly and Governor within six months of their first organizational meetings, as well as publish extensive and detailed findings online. The Joint State Government Commission shall provide logistical and other support. Temporary staff may also be employed as needed. The Commissions shall expire within 60 days of submitting the required report. At that time any unspent appropriation shall lapse back to the General Fund.

Strategies to Reduce Management Fees – The PSERS and SERS Boards are directed to implement strategies to reduce pension management fees to be within the 75% least expensive systems compared to other statewide public pension funds performing in the United States by the fifth fiscal year after the report from the Public Pension and Asset Investment Review Commissions publish their reports, based on benchmarking analysis provided by a consultant with data and expertise on pension funds. Subsequent to the five-year period, the PSERS Board and the SERS Board shall implement an additional strategy to reduce total pension management fees to be within the 60% least costly statewide public pension systems performing in the United States by the tenth fiscal year based on benchmarking analysis. Pension management fees are defined to mean investment management fees expressed as a percentage of assets under management.

Mandatory Training - Board members of both PSERS and SERS will be required to obtain eight hours of mandatory training in investment strategies, actuarial cost analysis and retirement portfolio management on an annual basis.

Legal counsel to the PSERS and SERS boards shall serve independently of the Governor's Office of Chief Counsel, the General Assembly and the Attorney General.

PSERS and SERS Boards – Board membership for both PSERS and SERS is increased by one member as the Secretary of Banking and Securities is added as an ex officio member of both boards (PSERS will now have 16 board members and SERS will have 12 board members). Language is added to the Retirement Codes to specify that no member of the board who represents active members or annuitants or is a current member of the General Assembly can serve as chairman.

SERS Specific –
Blended Normal Cost Calculation – The bill amends Section 5508(b) to revise the actuarial funding method SERS has used to determine the normal cost rate. SERS has been using a variation of the Entry-Age Actuarial Cost Method as opposed to the traditional Entry-Age Actuarial Cost Method. The difference between the method SERS is currently using and the method imposed by the bill is that the normal cost is currently based upon the benefits and contributions for the average new employee whereas, under the proposed method, the normal cost is based upon the benefits and contributions for all current employees in the pension plan from their date of entry into the system. The proposed method provides a more realistic normal cost estimate because it represents the entire membership of SERS rather than just the last group that entered (the post-Act 120 and potentially post-SB 1071 employees).

The change in the unfunded accrued liability that results from the change in actuarial funding methodology is amortized over 30 year level-dollar amortization period.

IFO Study – The Independent Fiscal Office is directed to study and analyze the implementation of Shared Risk/Shared Gain contributions and adjustments and its impact on SERS. The study is to be completed by December 31, 2015 and be submitted to the Appropriations Committees and Finance Committees of the Senate and the House of Representatives.

PSERS Specific – The bill adds provisions to address delinquent school entity payments to PSERS. A subsection is added to the School Employees' Retirement Code to provide that a school entity is still expected to make full payment to the PSERS fund in the event the receipt of the Commonwealth's portion of the employer liability is delayed because of delinquent salary reporting or other conduct by the school entity. Language is also added to provide that employers whose payments to the PSERS Fund are delinquent shall be charged interest at the annual interest rate adopted by the board based on the assumed rate of return in effect in the fiscal year in which the payments are required to be paid.

FISCAL IMPACT: Based on an actuarial note prepared by the Public Employee Retirement Commission (PERC), the enactment of this legislation is projected to result in the savings shown below for the pension funds over PERC's 32-year projection period. The present value of the expected cash flow savings as of June 30, 2015 (based on current assumed rate of return of 7.5%) are also shown:

	(Dollars in Thousands)		
	SERS	**PSERS**	**Total**
Total Projected Cash Flow Savings	($2,644,000)	($716,000)	($3,360,000)
Present Value of Cash Flow Savings	($887,000)	($910,000)	($1,797,000)

PERC's actuary provided work to differentiate the projected costs and savings from the implementation of the side-by-side hybrid (cash flow costs of $4,251.0 million for PSERS and $1,710.0 million for SERS) and the prospective design changes for current plan members (cash flow savings of $4,967.0 million for PSERS and $1,496.4 million for SERS). Actuarial funding methodology changes and the change in amortization period provides another $2,858.0 million in cash flow savings for SERS.

There will be costs incurred by PSERS and SERS for the implementation of the new pension plans and to accommodate changes to the existing DB pension plan. Costs will be incurred to develop IT systems necessary for the new pension plan design. Both systems will need to secure additional legal counsel and consulting services to make system changes on a relatively short timeline. Costs to establish the new hybrid plans shall be paid by the Commonwealth through annual appropriations. PSERS estimates start-up costs to be $9,000,000 in 2015-16. Second year costs for PSERS are estimated to be $7,000,000. Beginning in 2017-18 PSERS plan participants will cover all expenses, fees and costs of administering the DC plan and trust through assessments against the balances of individual participants' investment accounts. SERS estimates start-up costs to be $16,400,000 over the three-year period from 2015-16 through 2017-18. Like PSERS plan participants, SERS plan participants will cover all expenses, fees and costs of administering the DC plan and trust through assessments against the balances of individual participants' investment accounts beginning in 2018-19.

Costs will also be incurred for the Public Pension and Asset Investment Review Commission both SERS and PSERS are to establish for investment strategy review. It has been projected that costs will be approximately $150,000 for each Commission. The Joint State Government Commission is to provide staff and administrative support so it is estimated that the Commission may need $300,000 in additional funding to cover the costs to help the Commissions complete the asset and investment strategy review and produce the specified report.

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House Appropriations Committee (R)

DATE: December 19, 2015

Estimates are calculated using the best information available. Actual costs and revenue impact incurred may vary from estimates.