Testimony of

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Good afternoon Chairman Metcalfe, Chairman Josephs, Chairman Benninghoff, Chairman Mundy, and members of the House State Government and House Finance Committees. I am Jeffrey Clay, Executive Director of the Public School Employees' Retirement System (PSERS). I thank you for the opportunity today to provide brief comments about pension reform, including a summary of HB 2454.

As you are well aware, pension funding is one of MANY significant fiscal issues currently facing the Commonwealth, its public schools and their taxpayers; it is a topic that I have crisscrossed the State speaking about for close to 10 years.

The rising employer contribution rates, which are the driving force behind the pension reform discussion, are required for the payment of pension benefits already earned by public school employees across the Commonwealth. At PSERS that debt is currently $26.5 billion and growing as the System continues to be underfunded.

There is no simple or easy solution to PSERS' debt issue. In all cases, the solution will require substantial funding infusions and consistently higher levels of employer funding over time to make up for the long-term underfunding of the System. It will likely take a combination of solutions, one of which is additional pension reform; notwithstanding that significant pension reform already occurred under Act 120 of 2010.

One of the options for additional pension reform being discussed today is HB 2454. Turning to HB 2454 I will provide a brief overview of it. Attached to this testimony is a more detailed summary of the bill.

Under HB 2454, PSERS' existing defined benefit (DB) plan will be closed and a defined contribution (DC) plan will be established for school employees who begin or return to service on or after July 1, 2015. The Public School Employees' Retirement Board (Board) will be the trustee and administrator of the school employees' DC plan. PSERS will have the authority to contract all or part of the administration of the DC Plan to third party providers.

The PSERS administrative structure for the DC plan and the DC plans' investment expenses and administrative overhead will be funded by fees assessed on the members' assets. It is

important to note that a transition appropriation may be needed during the design and startup phase until the DC plan develops a sufficient critical mass of members and assets that a reasonable fee will support the administration of the DC plan.

SOME OF THE BASIC BENEFIT FEATURES INCLUDE:

The member contribution rate to the DC plan will be 4% of compensation.

The employer contribution rate to the DC plan will be 4% of compensation.

Employer and member contributions to the DC plan will vest immediately.

DC plan distributions will be by lump sum or other potential options as determined by the Board, e.g. a life time annuity.

The DC plan does not have a DB type disability annuity or death in service annuity.

DC plan participants will not be eligible for premium assistance.

ENROLLMENT IN THE DC PLAN

All school employees **who are active PSERS members on June 30, 2015, and July 1, 2015**, will remain active members in the PSERS DB plan until they terminate school service. Such school employees **who begin or return to school service on or after July 1, 2015**, will not be eligible to be enrolled in the PSERS legacy DB plan, even if they were previously school employees or members of the DB plan. These employees must be enrolled in the DC plan.

School employees of the Department of Education, community colleges, state-owned educational institutions and Penn State University **who are active PSERS members on December 31, 2014, and January 1, 2015,** will remain active members in the PSERS DB plan until they terminate school service. Such school employees who return to school service **after January 1, 2015** will not be eligible to be enrolled in the PSERS legacy DB plan, even if they were previously school employees or members of the DB plan. Nor will they be eligible for participation in the PSERS DC plan. They will be eligible for the approved plan offered by these institutions e.g. TIAA-CREF.

INCENTIVE FOR CURRENT PSERS DB PLAN MEMBERS

On an ongoing basis, the DC plan will offer an incentive for current PSERS DB plan members to voluntarily elect prospective participation in the DC plan. For DB members who elect to be DC members, the employer contribution rate will be 7% of compensation until the next termination of service. This election is an irrevocable election that can be made at any time before termination of DB service. All other DC plan terms apply.

In closing, PSERS is aware of the difficult budget challenges facing the Commonwealth and school employers. While PSERS does not lobby or take a position on proposed legislation, we are available to provide objective technical advice, drafting assistance and the identification of potential policy issues for the General Assembly on this bill and any other pension-related legislation.

Thank you for the opportunity to comment, and I look forward to your questions.

HB 2454 – Summary

I. GENERAL FEATURES:

1. A defined contribution (DC) plan will be established via the Public School Employees' Retirement Code for all school employees, with an effective date of July 1, 2015. The Public School Employees' Retirement Board (Board) will be the trustee and administrator of the school employees' DC plan.

2. The plan provides for a general reservation of legislative rights provision to allow the General Assembly to make prospective changes to the DC plan applicable to then-current DC participants.

3. The DC plan will be established as a tax qualified plan, with a specific reservation of rights provisions to accommodate changing tax-qualification requirements. HB 2454 does not make any required tax qualification amendments to the legacy DB system. The DC plan will be operational on the legislatively established date, even if the IRS has not issued a qualification determination letter.

4. The SERS and PSERS DC plans will be separate and independent of each other. Although the DB fund and DC trust will be separate, membership in the DB system will prevent receipt of DC plan distributions, and participation in the DC plan will prevent receipt of DB benefits.

5. PSERS staff and the Board's professional personnel can administer both the DB system and the DC plan. Administrative expenses will be allocated between the system and the plan. The Board will have the authority to contract all or part of the administration of the DC plan investment options and collection, recordkeeping and payment of contributions and benefits to third-party providers. The Board will retain the administrative appeal function as required by the Administrative Agency Law and any other administrative function required by law to be performed by the Board that cannot be delegated.

   NOTE: H.B. 2454 does not provide for a transition appropriation from the General Fund to pay for DC plan expenses during the design and startup phase until the DC plan develops a sufficient critical mass of participants and assets that a reasonable fee will support the administration of the DC plan. Federal tax law puts severe limits on the ability of these costs to be funded by the legacy DB system or appropriations out of the DB assets. Accordingly, a separate transition appropriations bill may be needed.

II. PARTICIPATION FEATURES:

6. School employees of the Department of Education, community colleges, state-owned educational institutions and Penn State University who are active PSERS members on December 31, 2014, and January 1, 2015, will remain active members in the PSERS DB system until they terminate school service. Such school employees who return to school service after January 1, 2015 will not be eligible to be enrolled in the PSERS legacy DB

system, even if they were previously school employees or members of the DB system. Nor will they be eligible for participation in the PSERS DC plan.

7. All other school employees who are active PSERS members on June 30, 2015, and July 1, 2015, will remain active members in the PSERS DB system until they terminate school service. Such school employees who begin or return to school service on or after July 1, 2015, will not be eligible to be enrolled in the PSERS legacy DB system, even if they were previously school employees or members of the DB system. These employees must be enrolled in the DC plan.

8. Note: Area vocational technical schools and technical institutes, while part of the definition of the school employers who can elect SERS or TIAA-CREF, in fact are not permitted to make an election into SERS under the State Employees' Retirement Code, and none currently offer TIAA-CREF. Therefore, new or returning employees will remain in PSERS under the DC plan. The employers will not be permitted to offer TIAA-CREF.

9. Whether a break in service has occurred in the PSERS system will be determined by the current PSERS operational rules. PSERS uses a "90 day presumption" rule, i.e., PSERS will presume a break in service if there is no activity reported for a 90 day period.

10. Current school employees who are not legacy DB system members and who do not elect PSERS membership before the effective date of the DC plan can participate only in the DC plan. This conforms to the Act 120 class of service rules for non-members, and also is congruent with the membership/participation rules for school employees who have breaks in service.

11. Hourly or per diem employees who would be prohibited members of PSERS under 24 Pa. C.S. §8301(a)(2) are mandatory DC participants from the beginning of employment.

12. The ability to opt out of PSERS membership contained in 24 Pa. C.S. §8301(a)(4) (relating to part time membership) will apply to new school employees who otherwise would be DC participants.

13. Current PSERS DB members who are employed in a position eligible for DC plan participation can elect into the DC plan on a prospective basis. This election is an irrevocable election that can be made at any time before termination of DB service.

14. DC plan participation will not allow former or current DB system members to reinstate withdrawn DB service.

III. BASIC BENEFIT FEATURES:

15. DC plan mandatory participant contributions will be 4% of compensation. Mandatory participant contributions are intended to be pre-tax "pickup" contributions.

16. NOTE: Setting the mandatory participant contributions for DB members who elect to be DC participants at a rate lower than the rate they currently are contributing to the DB system could have adverse federal income tax consequences. The IRS is questioning the eligibility for pickup contributions when member elections can change contribution rates. If the IRS determines that school employees cannot receive pickup contributions because they can change their contribution rates by electing into a DC plan, then the mandatory contributions for members who elect into the DC plan may need to be at whatever rate they were contributing to the DB system.

17. DC participants may make optional contributions up to the IRS limits. Optional contributions cannot be picked up under federal tax law.

18. Roll-ins" will be allowed to the extent permitted by federal tax law. §5404(b).

19. There will not be "multiple service" involving either the SERS or PSERS DC plans, but money can be rolled between the SERS and PSERS DC plans.

20. For DB members who elect to be DC participants, the employer contribution rate will be 7% until the next termination of State service. There will not be different employer contribution rates based on the type of job involved.

21. The maximum employer contribution rate to TIAA-CREF for employees of Penn State University, State System of Higher Education, State-owned educational institutions and community colleges remains at the current 9.29% of compensation instead of the 4% or 7% employer contributions made to the DC plan.

22. Employer and participant contributions to the DC plan will vest immediately.

23. DC plan distributions will be by lump sum or such other distributions as the Board allows. Distributions will be required to meet the required minimum distribution rules of IRC §401(a)(9). There will not be a Commonwealth-guaranteed life annuity payment option, but the Board may contract with third-party providers to make a life annuity option available.

24. A DB type disability annuity or death in service benefit will not be grafted onto the DC plan. The DC plan death in service benefit will be a lump sum distribution of the balance in the participant's individual investment account. The Board may contract with third party providers to allow beneficiaries to receive their death benefits as annuities.

25. Spouses of married members are the default beneficiaries or successor payees of participants regarding plan asset. Spousal consent is required for the nomination of a non-spouse beneficiary or successor payee, unless a court names an irrevocable beneficiary or successor payee under an approved domestic relations order. Participants can receive a lump sum distribution without spousal consent. Spousal consent will be needed to waive benefits. The spousal consent rules will not apply to the legacy DB system.

26. Plan loans will not be allowed. IRC §401(a) defined contribution plans are not permitted to make hardship distributions or emergency distributions.

27. Domestic relations orders for DC participants will be handled differently than in the DB system. Alternate payees who are receiving DC assets as part of an equitable distribution of marital property will receive an immediate cash out of their interests even if the participant has not terminated school service. Separate accounts for alternate payees will not be permitted.

28. Because of the way DC participation and benefit eligibility and amounts are determined, it will not be necessary to track service credit or eligibility points for DC plan participants.

29. In many cases, when a former DC plan participant returns to school service, there will be no impact on payments because the participant will have received a full distribution from the DC plan. If, however, a DC plan participant who is receiving distributions, or who is eligible to receive distributions returns to school service, then distributions will stop and no distributions can be made during employment.

30. There will be a mandatory cash out of small benefits as required by the IRC, or if permitted, but not required, then as desired by PSERS.

IV. MEMBERSHIP/PARTICIPATION AND BENEFIT COORDINATION FEATURES FOR COMBINED SERVICE EMPLOYEES

31. Some school employees will be both DB members and DC participants. These school employees will be combined service employees.

32. When an existing DB member elects into the DC plan, the effect will be that: (1) Members' benefits under the legacy DB system benefits will be determined using reduction factors and other actuarial factors based on their ages at the time of retirement, not their ages when they elect DC participation; (2) No more service credits will accrue in the DB system; (3) No more eligibility points (vesting credits) will accrue in the DB system; (4) No additional purchases of nonschool or previous school service credit in the DB system can be made; and (5) Final average salary is calculated based solely on compensation earned while an active member of the DB system.

33. A special transition rule will apply to school employees with less 10 eligibility points who elect to transfer into the DC plan. If they do not terminate school service for three years after they elect DC participation, they will be deemed to have either 5 or 10 eligibility points as necessary to qualify for certain DB system benefits, and the three years of credited school service required to qualify for a superannuation annuity. These special transition rules are based on a straight three years between election and termination because credited service, hours worked, part-time service, etc. will not be relevant or tracked as part of DC plan participation.

34. Combined service employees can have different beneficiaries and different survivor annuitants/successor payees. The benefits are separate, with different applications and effective dates. Combined service employees can receive one benefit and delay receiving the other.

35. A DB annuitant who returns to school service will have his or her annuity cease, the present value of that annuity frozen, and become a participant in the DC plan unless any of the current exceptions that allow annuitants to return to school service and continue to receive an annuity, apply. In that case, the annuity will continue and the annuitant will not be a DC plan participant. Frozen present values of annuities cannot be "thawed" after 3 years of DC plan participation. DC service will not count towards the time periods necessary to convert Class T-C service to Class T-D, or to receive 5-year vesting instead of 10-year vesting.

36. Currently, members with 24 ½ years of service credit, or members with 15 or more years who retire on or after superannuation age, qualify for up to $100 per month to reimburse certain out of pocket expenses incurred by annuitants for health care. This benefit is known as premium assistance. Because PSERS will no longer track service credit in the DC plan, DC plan participants will no longer be eligible for premium assistance.

V. INVESTMENT FEATURES:

37. Each DC participant will have an individual investment account to which all participant and employer contributions, investment gains and losses and fees and costs are credited or charged.

38. The Board will have the discretion to provide the various investment options and how they will be provided. Within the range of investment vehicles provided by the Board, the investment decisions are made by the participants. The Board will establish a default investment option. The Board will offer an investment option with an annuity investment feature if possible. The board will do so to the extent commercially available. This would be through a third party investment manager/insurance company.

39. Individual investment account holdings and participants' voluntary contributions, account balances, benefit payment options and beneficiary/successor payee identity are not subject to disclosure under RTKL.

40. The Act of July 2, 2010, P.L. 266, No. 41, known as the Protecting Pennsylvania's Investments Act, will not apply to the individual investment accounts, but the Board is authorized to make such investment vehicles available.

VI. FUNDING THE LEGACY DB SYSTEM

41. The current funding method, including the employer contribution rate collars, is in effect through June 30, 2015.

42. The actuarial valuation of June 30, 2014, will be used to determine the funding for fiscal year 2015-2016.

43. The accrued liability contribution rate is computed as a level percentage of compensation of all active members and active participants (including a special adjustment for education employers) using an amortization period of 30 years.

44. DC participant employers will be surcharged the accrued liability contribution rate to the legacy DB system in addition to the employer defined contribution payments made to the DC plan. The education employers that will not have new DC participants entering the plan will make additional monthly contributions to PSERS so that they are paying the same proportion of the total annual accrued liability contributions as they would have paid had the DC plan remained open to their new employees.

45. The experience adjustment factor will be calculated as a level percentage of the compensation of all active members and active participants using a 30-year amortization period.

46. Increases in the accrued liability of the DB system caused by legislation are funded in equal dollar installments of the compensation of all active members and active participants using a 10-year amortization period.

47. Any change in accrued liability created by H.B. 2454 is funded as a level percentage of compensation over 30 years starting July 1, 2015 and is subject to the employer contribution rate collars.

VI. MISCELLANEOUS AND NON-RETIREMENT CODE FEATURES:

48. The Board is not being expanded. Board membership requirements will be amended to recognize the existence of DC plan participants. Board members for whom active plan participation or distribution eligibility are required as a condition of office may complete their terms of office if they cease to be an active plan participant or if they receive a total distribution of interest in the DC plan while a board member.

49. Act 1978-140 forfeitures will apply only to the employer contributions and investment earnings on those contributions. Participant contributions (including rollover contributions) and investment earnings on those contributions are vested employee moneys and will be returned to the employee and will not be subject to forfeiture although they will still be subject to payment of fines and restitution. Because DC plan alternate payees will be cashed out through an immediate distribution, the issue of whether or not an alternate payee's benefit is forfeited should not arise, but if it does because of quirks of timing, then a DC plan alternate payee's share is not forfeited.

50. The DC plan is HEART Act and USERRA compliant, using the same compliance structure as in the general HEART Act and USERRA compliance draft legislation being proposed by PSERS. Credit for military service by DC participants will be removed

from the existing Military and Veterans Code provisions and placed totally under Retirement Code, which will incorporate the HEART Act and USERRA requirements. The existing Retirement Code provisions for purchase of service credit for intervening and nonintervening military service will not be applicable for DC participants. H.B. 2454 does not amend the legacy DB plan to conform to the HEART Act or USERRA requirements. PSERS has prepared separate stand-alone legislation to address those issues.

51. Approved leaves of absence (sabbatical, union officer leave, service as exchange teacher, and professional study leaves) under §8302(b) will still exist, but will be in the DC plan under the DC plan contribution and benefit regime. Other creditable leaves will apply only to members of the DB system and not to plan participants.[1]

52. Statutory references to the Public School Employees' Retirement System also include references to the Public School Employees' Defined Contribution Plan, and references to the Public School Employees' Retirement Fund include references to the Public School Employees' Defined Contribution Trust.

53. Although the DC plan and corresponding changes to the DB plan become operational via the internal workings of the statutory provisions, the enabling legislation itself will be effective immediately, so that the Board has the authority to actually establish the plan, provided that the necessary ancillary funding legislation also is enacted.

[1] This does not mean that the leaves cannot be granted, simply that no employer or employee DC plan contributions will be made while on leave.