1 HOUSE OF REPRESENTATIVES
COMMONWEALTH OF PENNSYLVANIA
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* * * *
3 PUBLIC SYSTEM TRENDS AND STATE POLICY
CONSIDERATIONS
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5
House State Government Subcommittee
6 on Public Pensions, Benefits and Risk Management

7
Ryan Office Building
8 Room G-50, Irvis Office Building & Virtual
Harrisburg, Pennsylvania
9

10 Thursday, August 18, 2021 - 10:04 a.m.

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12
SUBCOMMITTEE MEMBERS PRESENT:
13
Honorable Brett Miller, Majority Subcommittee
14 Chairman
Honorable Dawn Keefer
15 Honorable Frank Ryan
Honorable Paul Schemel
16 Honorable Benjamin Sanchez, Minority Subcommitte
Chairman
17 Honorable Joe Webster

18 NON-SUBCOMMITTEE MEMBERS:

19 Honorable Seth Grove, Majority Chairman State
Government Committee
20 Honorable Russ Diamond (virtual)
Honorable Matt Dowling
21 Honorable Andrew Lewis (virtual)
Honorable Clint Owlett (virtual)
22 Honorable Scott Conklin, Minority Chairman State
Government Committee
23 Honorable Maureen Madden (virtual)

24

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16 SUBMITTED WRITTEN TESTIMONY

17 (See other submitted testimony and handouts
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1 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
2 Good morning, everyone. Welcome to this
3 public hearing of the Pennsylvania House State
4 Government Subcommittee on Public Pensions,
5 Benefits and Risk Management. The title of our
6 hearing over the next two days is Public Pension
7 Trends and Policy Considerations.
8 I'm the Subcommittee's Chairman Brett
9 Miller representing the 41st District in Lancaster
10 County. I'd like to call this meeting to order and
11 ask everyone to please rise for a moment of
12 silence, followed by the pledge to the flag which
13 will be led by Chairman Representative Sanchez.
14 Please rise for a moment of silence.
15 (Audience complied).
16 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
17 Thank you. Representative Sanchez.
18 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
19 Thank you, Mr. Chairman.
20 (Pledge of Allegiance).
21 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
22 Today is the first hearing of two days
23 of hearings during which we will hear from
24 testifiers from across the nation on current trends
25 and policy considerations that we, as lawmakers,

1 and county and municipal officials should consider
2 as we seek to strengthen our statewide and local
3 pension systems. By way of the scope of this
4 issue, consider the following:
5 Our state's two statewide pension
6 systems, PSERS and SERS collectively have
7 approximately 357,000 active participants and
8 approximately 373,000 retirees, for a combined
9 total of 792,000 individuals all across
10 Pennsylvania. This number does not include the
11 many thousands of individuals who are either
12 actively involved or retirees of a local public
13 pension plan.
14 In addition to the impact on citizens
15 who rely on the state's two statewide pension funds
16 for their current or future financial security, the
17 financial impact on providing these benefits in our
18 statewide pension system impacts nearly 14 percent
19 of our entire General Fund budget, which translates
20 to 2.7-billion in payment to PSERS, and for SERS
21 2.1 billion, for a combined total of 4.8 billion
22 when using the most available numbers for both our
23 systems. These figures do not include the amount
24 of money represented by our county and municipal
25 governments.

1 In addition to this, we also need to
2 consider the taxpayer who also directly -- who also
3 directly participate in the state and local pension
4 funds by paying their property taxes, which is the
5 primary source of funding for these pension plans.
6 With this broad impact on the lives of
7 so many Pennsylvanians and their families who are
8 depending on a solid pension fund, the broad impact
9 on our state budget and the taxpayers who pay for
10 these benefits, it is incumbent upon us to ensure
11 that we carefully review our pension systems and
12 remain current with the best practices available to
13 us.
14 It is hope that today and tomorrow's
15 hearing will both educate and inform us on how we
16 can all work together to have the strongest
17 possible pension systems to benefit all
18 Pennsylvanians.
19 With that, I'd like to turn it over to
20 Subcommittee Chairman Representative Ben Sanchez
21 for any opening remarks.
22 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
23 Thank you, Mr. Chairman Miller. I
24 appreciate that and very well said there.
25 I'll be brief and just thank you for

1 holding these hearings, a very important topic,
2 obviously, for the financial security of many
3 people in our Commonwealth and our Commonwealth as
4 well. So, looking forward to a very interesting
5 couple days of testimony. And I'll leave it right
6 there. So, thank you.
7 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
8 Okay. Thank you very much.
9 We have members and testifiers in
10 attendance virtually, as well as the public viewing
11 via live stream. Due to Sunshine Law requirements,
12 if either of these platforms experience technical
13 difficulties, we will pause the meeting in order to
14 correct these issues.
15 All members participating virtually,
16 please mute your microphones. Please know that
17 when you speak, we all hear you. If you want to be
18 recognized for comments, please use the raise-hand
19 function. After being recognized prior to
20 speaking, please turn on your camera and un-mute
21 your microphone. After you have completed your
22 question, please mute your microphone.
23 We will start with Committee members in
24 the room. For members attending virtually, I will
25 call on you one by one after the introductions

1 here.
2 REPRESENTATIVE RYAN: I'm state
3 Representative Frank Ryan, 101st District, Lebanon
4 County, Pennsylvania.
5 And by way of full disclosure, I am the
6 Vice Chair of the Public School Employee Retirement
7 System, as well as the Chair of the Audit
8 Committee. All of my comments and representations
9 today are in my official capacity as a legislator
10 and do not reflect the views, perspectives, and/or
11 thoughts of the Public School Employee Retirement
12 System.
13 Thank you.
14 REPRESENTATIVE KEEFER: I'm
15 Representative Dawn Keefer in the 92nd Legislative
16 District, York and Cumberland counties.
17 REPRESENTATIVE SCHEMEL: I am Paul
18 Schemel representing portions of Franklin County.
19 And similar to my colleague from Lebanon County, I
20 am an appointed member of the board of SERS, and
21 the comments I have today are in my capacity as a
22 legislator.
23 REPRESENTATIVE DOWLING: Hello. I'm
24 Representative Matthew Dowling. I serve the 51st
25 Legislative District in parts of Fayette and

1 Somerset counties.
2 REPRESENTATIVE WEBSTER: Good morning,
3 everyone. I am Joe Webster. I represent House
4 District 150, the 150th, Montgomery County.
5 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
6 Good morning again. I'm Ben Sanchez,
7 representing the 153rd District in Montgomery
8 County.
9 REPRESENTATIVE CONKLIN: And I'm Scott
10 Conklin, 77 District, the Chair of the State
11 Government Committee, and today the cohort event
12 who will running this meeting.
13 I want to thank everyone for coming out.
14 I want to thank for giving me the opportunity to be
15 here. But most of all, I want to thank this
16 pension folks as an individual who had to oversee
17 the county pension for seven years from 2000 to
18 2007. I can tell you I've seen ups and downs. And
19 everybody has an opinion on how -- how the game
20 should have been played after it's all down and
21 over.
22 So I'm anxious to hear the testimony
23 today. And I'm anxious to see how we can find
24 improvements at the end of the day.
25 Thank you.

1 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
2 And, once again, I'm Brett Miller, state
3 Representative in the 41st District.
4 Now for our remote members, we'll start
5 with Representative Diamond.
6 REPRESENTATIVE DIAMOND: Good morning,
7 everyone. I'm Representative Russ Diamond. I
8 represent the 102nd District, which is the northern
9 and eastern portions of Lebanon County.
10 And let me say, Chairman Miller, this is
11 a very, very detailed subject matter, and I think
12 that you are an excellent person to chair this
13 meeting. So I look forward to this. Thank you so
14 much.
15 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
16 Thank you, Representative.
17 Representative Owlett.
18 REPRESENTATIVE OWLETT: Representative
19 Clint Owlett serving all of Tioga, parts of
20 Bradford, and parts of Potter County, 68th
21 Legislative District.
22 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
23 And I'm looking for staff. I think
24 that's everybody? Okay. Very good.
25 Thank you, everyone, for those in the

1 room for attending as well as those remotely.
2 For today's hearing we will have four
3 testifiers, the first of which is Anna Petrini,
4 Senior Policy Specialist with the National
5 Conference of State Legislatures. Miss Petrini,
6 will you please come forward here. I'll let you
7 get set up.
8 MS. PETRINI: Okay. I'm set up.
9 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
10 Okay. All right. I will be swearing in
11 each testifier prior to their testimony. So we
12 want to first thank you for being here today. Will
13 you please raise your right hand?
14 (Testifier was sworn by Chairman
15 Miller).
16 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
17 Very good. Thank you so much. Are you
18 all set up technologically and everything with your
19 PowerPoint?
20 MS. PETRINI: I believe so.
21 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
22 All right then. So the floor is yours.
23 MS. PETRINI: Thank you so much.
24 Good morning, Chairman Miller,
25 Representative Conklin, Representative Sanchez,

1 other members of the Committee. Thank you for
2 inviting NCSL to provide an introduction of public
3 pension design, as well as some perspective on
4 recent state legislative developments.
5 My name is Anna Petrini. I am a senior
6 policy specialist at NCSL. I work in our
7 employment, labor, and retirement program. And I
8 focus on pensions and retirement issues.
9 For those who are less familiar with
10 NCSL, the National Conference of State
11 Legislatures, is the country's most trusted
12 bipartisan organization serving legislators and
13 staff for more than 40 years. We promote policy
14 innovation. We create opportunities for lawmakers
15 to share knowledge with each other, and we ensure
16 that state legislatures have a strong cohesive
17 voice in the federal system.
18 I'm here today to derive a sort of
19 policy 101 for pensions and review the sorts of
20 retirement system reforms that we have seen states
21 enacting over the past dozen years or so. So if
22 you want to join me on slide 2, I'll just kind of
23 outline where I'm headed today.
24 I've arranged my presentation to offer
25 an introduction to pension plan design. I will

1 touch very briefly on funding issues, but my real
2 emphasis is gonna be design considerations and
3 changes in the state legislative landscape.
4 So we'll begin by taking a look at the
5 key characteristics of public employee plans and
6 talk about how they're structured, and we're gonna
7 cover some of the most widespread changes that
8 don't involve sort of massive structural overhauls.
9 So, these are things like the creation of new
10 tiers. We'll touch on funding issues in the
11 context of our conversation about contribution rate
12 increases, higher age and service requirements, and
13 cost-of-living adjustment changes.
14 Then we'll see which states have
15 replaced traditional design benefit plans with
16 alternative arrangements since 2009, so we'll take
17 a look at how those are structured, and what
18 accounts for the significant variation among
19 alternative arrangements in the states. And then
20 we'll wrap up with a discussion of how recent
21 reforms seem to be playing out in the post
22 recession and pandemic eras.
23 So, if you want to move onto slide 3,
24 just very briefly, key characteristics of public
25 plans. I will try to be somewhat organized about

1 this and talk about the who, what, where, when and
2 why. In terms of who participates in state and
3 local retirement plans, nearly 21 million people in
4 the U.S., and that includes active public
5 employees, former employees who have earned
6 benefits that they're not yet collecting, and then
7 current retirees.
8 Approximately one-fourth of employees of
9 state and local governments participate in a public
10 retirement system in lieu of Social Security. So
11 this includes about 40 percent of public school
12 teachers and over two-thirds of firefighters,
13 police officers, and other first responders. This
14 is a relic of the 1930's, and sort of then
15 prevailing federalism concerns, and we don't really
16 need to get into all of that today.
17 For our purposes, the upshot is, that in
18 those systems where public workers are not covered
19 by Social Security, the benefits and employer
20 contributions are generally going to be higher in
21 order to compensate for that lack of coverage. In
22 case you're curious, I tracked down March 2021
23 report from Segal that estimated that about 24,000
24 state and local workers in Pennsylvania were
25 excluded from Social Security coverage.

1 Moving on to why and what. So public
2 sector retirement plans for state and local
3 government employees have been around since about
4 the late 1800s. In many cases they were offered in
5 order to make public employment more competitive
6 with employment in the private sector which often
7 paid higher wages, right?
8 So the thinking was that, although an
9 employee might learn -- earn a lower salary with
10 government work, the retirement benefits would be
11 guaranteed, and this would be a draw. This would
12 help attract and retain a skilled public workforce.
13 There are several thousand government-
14 sponsored retirement systems in the U.S. As you
15 all know in Pennsylvania, locally-administered
16 pension plans vastly outnumber their state
17 counterparts. So, nationwide, we have well over
18 5,000 locally-administered plans and closer to 300
19 state-administered plans. However, most plan
20 members that's 90 percent, and most plan assets
21 that's 82 percent nationally, are in the
22 state-administered systems.
23 So while you've got this huge number of
24 individual systems out there, the data I'm
25 presenting today is going to be focused on the main

1 state-administered systems, generally, those for
2 state employees and teacher systems around the
3 country.
4 And finally, when. So I'm gonna be
5 talking about trends throughout my presentation
6 today. Basically, all states have enacted major
7 changes to their public pension systems in order to
8 try to reduce costs in recent years. We'll talk
9 in-depth about some of the more frequent and
10 widespread reforms which include reduced benefit
11 levels, increase agent service requirements, and
12 higher contributions from employers and employees.
13 If you want to join me on slide 4, just
14 a little bit about NCSL's work tracking legislation
15 in the states. This year I'm tracking legislation,
16 I think, in 44 states so far. I'm still working on
17 reviewing legislation. But, I think I have my eye
18 on about 135 bills that have been enacted so far
19 this session. Last year I think I tracked about
20 175 that were actually enacted.
21 If you look in the right-hand column,
22 you can see that the first few years after the
23 Great Recession were a very busy period for major
24 state legislative activity in the pension arena,
25 but things sort of slowed down in bit recent years.

1 Although I will say that 2021 has seen some major
2 reform efforts come to fruition in certain states,
3 so...
4 We want to move on to slide 5. I don't
5 want to dwell too much on how pensions work. I
6 suspect this audience has a very good sense of
7 that.
8 Plan design is the framework that we're
9 going to be dealing with. It includes the
10 characteristics, um -- and the characteristics,
11 sorry, include participation requirements. Is the
12 plan optional or is it mandatory? What are the
13 required contribution levels for employers and
14 employees? What are investing requirements? What
15 are benefit levels, that kind of thing.
16 Notably, nearly all employees of state
17 and local governments are required to share in the
18 cost of their retirement benefits. Pension
19 benefits for state and local governments are paid
20 out from trust funds, to which employers and
21 employees contribute during an employee's working
22 years.
23 Employee contributions are typically set
24 as a percentage of salary, either by statute or by
25 the board that oversees the retirement system, and

1 employee contribution rates typically range between
2 4 and 8 percent of salary. And the basic
3 retirement funding equation, you have contributions
4 from employer and employees, those get invested.
5 And those investment earnings, you have those two
6 things taken together on one side, and those equal
7 the benefits that get paid out, and then the
8 operational expenses for the systems on the other
9 side.
10 Let's move on to slide 6, and think sort
11 of generally about recent plan modifications in the
12 states. Like I said, all states have enacted major
13 changes to their pension systems in order to reduce
14 costs in recent years. The most frequent reforms
15 reduced benefit levels, longer vesting periods,
16 increased age, and service requirements,
17 limitations to cost-of-living adjustments, and
18 increased employer and employee contributions.
19 As we'll talk about more in-depth today,
20 some governments have also moved new employees into
21 plans with entirely different structures, but are
22 designed to shift risk from employers to employees.
23 Importantly, there have been court challenges to
24 many of these new arrangements. That's sort of
25 outside the scope of our work today. But if you're

1 interested in litigation in this area, I'm happy to
2 follow up with some resource in that department.
3 Even in states that have retained their
4 traditional defined benefit pensions, and we'll
5 talk about what that means, one type of reform that
6 seems to have gained growing attention and adoption
7 in recent years involves variable benefit features.
8 So, as we talk today, just sort of keep your eye on
9 this as an important trend.
10 The idea here is that, these mechanisms
11 distribute costs among stakeholder's employees --
12 employers' retirees by following pre-designed rules
13 that automatically adjust benefits or
14 contributions. It's this automatic adjustment
15 feature that I really want to talk about. And
16 those adjustments can be made based on investment
17 performance or demographic changes, or other types
18 of factors like that.
19 With that in mind, let's go to slide 7.
20 And I want to take just a really quick detour into
21 the pension funding realm. I know that you will
22 hear from other presenters who are going to provide
23 considerable detail on this subject. So I just
24 want to offer a little bit of context for our
25 conversation about legislative trends.

1 This slide is from the Pew Charitable
2 Trust. It shows how well-funded the major
3 statewide retirement plans, those covering state
4 and local public employees, teachers, and public
5 safety workers for this sample; how well-funded
6 those plans are in each state.
7 Why do policymakers expend so much time
8 and energy thinking about the funded ratio of their
9 plans? Well, a big part of the reason is that, a
10 well-founded system in the public sector can cost
11 billions of dollars less each year than a severely
12 underfunded one.
13 In a well-funded system, the state or
14 local government is setting aside money each year
15 while people are working to pay for their benefits
16 when they retire. When states do that, compounded
17 investment earnings wind up paying for the majority
18 of the benefit. So, in severely underfunded
19 systems, you're losing out on those compounded
20 investment earnings, and as a result, more of the
21 cost has to come out of the state and local budget.
22 While many public pensions are on a
23 sustainable-funding path, a few have fallen
24 conspicuously behind. So the gap between pension
25 assets and liabilities for all states, when this

1 sample was taken in fiscal year 2018, the gap stood
2 at 1.2 trillion, that's trillion with a T, dollars.
3 That's the entire GDP of Spain. Now, this map
4 shows aggregate data for major public plans. And I
5 think Pew included about 230 in its sample.
6 But, I want to note that aggregate
7 figures can be a little tricky. They can be kind
8 of deceiving because they mask wide variation in
9 experiences of states, and even in the experiences
10 of systems within a state. So, there are different
11 pension contribution experiences and different
12 funding goals in the states and different
13 demographic characteristics. So it's important to
14 bear all that in mind as we're comparing what's
15 happened in the states legislatively.
16 Pennsylvania's funded ratio stood at
17 54.8 percent, according to the data on this map.
18 However, as our counterparts at NASRA, and I think
19 others are going to discuss, Pennsylvania has
20 returned to a program of making full contributions
21 in recent years after a period of underfunding.
22 Let me see here. So I think I'm going
23 to leave it to others to talk about more recent
24 projections and what's going on in 2021 with
25 funding activity.

1 Let's move on to slide 8. So here we're
2 looking at increases in employee contributions. A
3 lot of the legislation in the past few years has
4 been concerned with this. In a surprising number
5 of states, increased contribution requirements have
6 affected current employees. That's something that,
7 historically, like prior to the Great Recession,
8 had not been the case. That was an extremely rare
9 type of enactment. Not surprisingly, a number of
10 these changes have been challenged in the courts.
11 You'll note that each state that increased employee
12 contributions also increased employer
13 contributions.
14 Importantly, this map does not represent
15 increases in employer contribution rates, but
16 occurred due to annual actuarial adjustments or
17 retirement plan board initiatives. These are
18 legislative changes that we're looking at on this
19 map.
20 I just wanted to highlight a few changes
21 maybe look to my home state of Colorado. There the
22 legislature adopted changes to the employee
23 contribution rate for active members of our PARA in
24 2018, so we increased the rate from 8 percent to
25 10 percent and phased that in over a period of

1 three years.
2 And then this same 2018 legislation
3 provided the potential for future rate increases of
4 half a percentage point per year based on
5 risk-sharing cost management mechanisms. So when
6 there's a discrepancy between the rate set out in
7 the statute and actuarially determined contribution
8 rate, then this half a percentage point increase
9 can kick in. This is one of those variable
10 features that I flagged earlier in the
11 presentation. Just keep an eye out for those as we
12 proceed today.
13 I'll mention one other contribution rate
14 increase that was a bit dramatic. So, in 2019,
15 Oregon adopted a huge reform package that reduced
16 benefits for members of its public employee plan.
17 And among other changes, the legislation diverted
18 some worker retirement contribution from their own
19 accounts to paying down per debt. So Oregon has a
20 hybrid arrangement as you all do. And with this
21 new legislation from 2019, depending on their date
22 of hire, it redirects a portion of the 6 percent
23 employee contribution, which was previously
24 committed to the DC part of their hybrid to the DB
25 plan, so their DB plan was previously

1 noncontributory. This was a pretty dramatic step.
2 Let's move on to slide 9. Another type
3 of widespread pension reform in recent years has
4 been enacting a higher age and service requirements
5 for normal retirement. And by normal retirement, I
6 mean the age and service at which a person is
7 entitled to the benefits under their standard
8 formula; not reduced benefits associated with early
9 retirement.
10 At least 39 states have done this kind
11 of thing between 2009 and today. Just a few
12 notable changes in Louisiana. There was 2015
13 legislation that increased the retirement page from
14 60 to 62. Other states have also moved their
15 retirement ages from 60 to 62. Some have moved
16 from 62 to 65. A few states like Missouri and
17 Illinois and South Dakota moved it all the way up
18 to 67. There was a big jump in Colorado. In our
19 2018 legislation, we switched it from 58 to 64.
20 And then bucking the trend slightly this
21 year was Texas, they had a major overhaul. They
22 adopted a new cash balance plan, and there are a
23 couple of formulas that they use for retirement
24 eligibility there. But, one of them with the new
25 plan is retirement at age 65 with five years of

1 service. And under their existing arrangement,
2 there were, again, a couple of formulas in play.
3 But the standard was retirement at age 65 with
4 10 years of service.
5 Let's move on to cost of living
6 adjustments and slide 10. I want to spend a fair
7 amount of time here just giving you a general sense
8 of what these are. So, as the price of goods and
9 services increases over time, the purchasing power
10 of retirement income is going to decrease, so post-
11 employment, benefit increases or cost-of-living
12 adjustments, or COLAs, they're all referencing the
13 same thing. And the idea is to help insulate
14 retirees from the effects of inflation.
15 These are an important feature of most
16 state and local government pension plans. Many
17 states started adopting these in the '70s and '80s
18 during a period of high inflation. This valuable
19 benefit comes at a cost. There are a number of
20 studies out there, but one of them that I'll cite
21 found that offering a 3 percent compounded COLA
22 adds about 26 percent to the cost of benefits paid
23 out over the course of an average retirement.
24 Just how much a COLA costs and how much
25 inflation protection it affords depends on how it's

1 structured, and states have adopted a variety of
2 different COLA structures. There are two main
3 types. There's an ad hoc COLA and an automatic
4 COLA.
5 So, an ad hoc requires active approval
6 from a governing body, like a legislature or a
7 decision-making board. And then an automatic one
8 doesn't require that kind of approval. The latter
9 are often determined by a set rate, so it's
10 3 percent just to pull a number out, or by a set
11 formula.
12 Many state COLAs also fluctuate with
13 inflation, or other states link them to plan
14 funding levels or investment returns, so there's
15 all kinds of kind of contingencies in play with
16 COLAs. At least 29 states have attempted to scale
17 back cost by suspending or reducing, or even
18 eliminating post-employment COLAs for new hires,
19 current workers, or some cases even retirees since
20 2009. A number of states have revised their COLA
21 formulas multiple times during this period.
22 So, if we move to slide 11, we can see a
23 map. You will note that this represents a very
24 widespread and significant kind of policy change.
25 As I noted, these can be expensive benefits. And

1 like I said, a number of states have postponed
2 them, in some cases canceled them, and in some
3 cases pinned them to the funding levels of their
4 plan. So this is, again, an area where you see
5 states creating these types of contingencies.
6 One other option is sort of delayed
7 onset formula where states will say, yes, you're
8 entitled to a COLA, but you have to wait until you
9 reach a certain age in order to qualify for it, or
10 you have to wait until a certain period of time has
11 elapsed since your retirement in order to receive
12 it. Or states may only apply it to a portion of
13 the benefit, or like I said, link it to investment
14 performance or make it contingent on the actuarial
15 soundness of the plan.
16 So, if you look at this map, you will
17 see that over the last 12 years a number of states,
18 the green ones, have made changes that only affect
19 future hires. I think seven states made changes
20 for active employees, and then a number made them
21 for people who are already retired in addition to
22 those other classes who will retire in the future.
23 Not surprisingly, there have been court challenges
24 in this area as well.
25 Important with COLAs is really sort of

1 an uneven area of state policy. You see some
2 states that have really retained meaningful COLAs,
3 and then you see other states that have,
4 practically speaking, eliminated them.
5 With that, let's turn our attention to
6 major plan design considerations. So, as I'm sure
7 you know, there are two main types of retirement
8 plans, defined benefit plans, DBs, and defined
9 contribution plans, or DCs. Among employees of
10 state and local government, the vast majority
11 participate in defined benefit plans.
12 A DB plan provides guaranteed lifetime
13 retirement income, while a DC plan functions more
14 like a savings account. Some retirement plans,
15 often referred to as hybrid plans, as you know, in
16 Pennsylvania, combine features of DB and DC plans.
17 And then there's one specific type of hybrid that
18 is used by public sector plans, and that's a cash
19 balance approach. So we're gonna talk about all
20 these things.
21 It's important to keep in mind that most
22 local workers and all state workers who have access
23 to a defined benefit plan also have access to,
24 like, supplemental DC plans. These are things like
25 403(b) plans or 457s. That's not what I'm going to

1 be focusing on today. For our purposes, when I
2 reference DC plans or hybrids, I'm talking about
3 the primary benefits; not those sort of optional
4 supplemental add-on plans.
5 Defined benefit background, if you move
6 to -- It's labeled five seven here, and I apologize
7 for my error. I think it should be slide 13. But
8 this is just a little bit of background about how a
9 defined benefit plan works. I don't want to focus
10 too much on this, but the idea is that these
11 provide a guaranteed lifetime benefit. It's that
12 guarantee that's really crucial, right? And it's
13 based on an employee's year of service and final
14 salary.
15 And although most of these plans require
16 employee contributions for DBs, the amount of the
17 benefit that's paid out is not really based on
18 those contributions. Instead, it's a function of
19 years of service with the employer and the worker's
20 pay at the end of his or her career, and then a
21 multiplier that is a facet of the plan.
22 So, if you want to take a look at those
23 examples that I have provided here, this is an
24 example of a final average salary calculation. I
25 just picked numbers out. These are not necessarily

1 representative. They're just easy numbers to work
2 with. But, if we have a multiplier that's
3 2 percent of pay, and we have an employee who has
4 30 years of service who ends his or her career with
5 an average salary of a hundred thousand dollars,
6 that employee's annual pension income is gonna be
7 $60,000.
8 Other models have existed for a long
9 time, but they've attracted a fair amount of
10 attention in recent years. So let's turn to those
11 now. Join me on slide 14.
12 So this is a map of states with
13 non-defined benefits statewide retirement plans.
14 Beginning in September of 2022, with the
15 implementation of that new law in Texas, there are
16 going to be 16 states where new employees cannot go
17 into a pure defined benefit plan. So those are the
18 orange, purple, and green states on the map, plus
19 Utah and Pennsylvania.
20 Utah and Pennsylvania are teal because,
21 like the other six teal states, employees there get
22 a choice of their primary plan. In Utah and
23 Pennsylvania, the choice is between a hybrid and a
24 defined contribution plan. In Washington State,
25 employees get a choice between a defined benefit

1 and a hybrid plan. And then the rest of the teal
2 states offer employees a choice between a DB and a
3 DC plan.
4 Let's move on and look at activity in
5 the last dozen years or so. So this is the states
6 that have made fundamental changes in their
7 retirement plan design in the last 12 years. And
8 by fundamental changes, again, I mean a shift from
9 a traditional defined benefit plan to a defined
10 contribution or a cash balance or a hybrid
11 arrangement. So, this map shows 11 states, plus
12 Puerto Rico, that have made this type of change
13 from 2009 through today.
14 Slide 16 we'll just touch on defined
15 contribution arrangements quickly. So, until 2014,
16 we hadn't seen any new pure defined contribution
17 plans created since the Great Recession. But, in
18 2014, that's exactly what Oklahoma did. They
19 enacted a pure DC plan. Of course, we know there's
20 a DC component to all hybrid plans, and we've seen
21 several states create those. But in terms of a
22 pure DC, Oklahoma stands alone in this post-
23 recession period.
24 DC plans function like 401(k) accounts.
25 They can help stabilize state costs for new hires

1 as a fixed percentage of salary with the potential
2 for slight variations based on how the employer
3 matching contributions are structured. They allow
4 for easier mobility in and out of state service,
5 and they offer sort of less incentive to stay on
6 with government employment than with DB plans.
7 There's no penalty for employees who want to move
8 on after only a few years of service.
9 This next bit is important. The main
10 idea with these DB plans is that they're shifting
11 risk and responsibilities from employers to
12 employees. So with these risks and
13 responsibilities shifting, there can be an
14 increased need for employee education. Employees
15 generally have to make more decisions with DC plans
16 than with DB plans. It's simply investment
17 decisions and then sometimes their level of
18 contributions.
19 So, with that let's move on to hybrid
20 plan design. So, hybrids combine elements of DB
21 and DC plans, and they can come in two varieties.
22 You have a side-by-side hybrid, which I'm sure
23 you're intimately familiar with in Pennsylvania.
24 This plan combines a DB component with a separate
25 DC retirement savings accounts, and they operate

1 independently and sort of side by side.
2 There's another concept out there, a
3 stacked hybrid. And here the defined benefit is
4 the primary benefit up to a specified income level.
5 And then you have a DC that sort of kicks in above
6 that threshold and covers higher income above it.
7 So, I've seen this threshold called an integration
8 point. The idea is that, it can be based on a
9 relatively low level of salary or a relatively high
10 level of salary.
11 But, importantly, no state has adopted
12 this stacked hybrid approach. I gather that it did
13 gain a fair amount of consideration, as you all
14 were thinking through your 2017 reforms, but no
15 state has gone this route. I think the City of
16 Philadelphia has a stacked hybrid arrangement in
17 place since 2016, and I think internationally this
18 idea has gained a fair amount of traction, I
19 believe, in Canada. There are some examples.
20 So, the rest of our time together when I
21 talk about hybrids, I'm going to be talking about
22 side-by-side hybrids; not stacked hybrids.
23 While side-by-side hybrids have existed
24 for decades, I believe Texas has had its municipal
25 employees in one since the 1940s, these plans have

1 been increasingly discussed and implemented during
2 this 12-year period that I've been talking. They
3 are frequently proposed as alternatives to
4 traditional defined benefit plans in states that
5 are considering major forms.
6 So Utah and Michigan are among the
7 states that have adopted hybrid plans for certain
8 public employees in recent years. 2017 was a big
9 year for hybrids. Connecticut, Illinois, and
10 Pennsylvania all adopted hybrid arrangements as
11 options or requirements for new hires. Connecticut
12 established a hybrid plan for new hires in its
13 state employees' plan. Illinois did this as an
14 option for its statewide plan, and then there were
15 Michigan public school employees as well.
16 And as you'll recall, new hires in
17 Pennsylvania's public school and statewide systems
18 have had a choice between a default hybrid, and
19 then an alternative hybrid arrangement, and then a
20 DC plan structure. And this had been in place
21 since 2019. The alternative, as I understand it,
22 features a lower multiplier, lower contribution
23 rate for the DB component, and higher employee
24 contribution rates for the DC piece.
25 Let's move on and talk about cash

1 balance plans. And I know we're running into a
2 little time crunch, so I will move quickly here.
3 In June of this year, the Texas
4 Governor, Greg Abbott, signed a bill into law that
5 was designed to address funding issues in its state
6 employees retirement system, and it also creates a
7 new cash balance plan for new hires. Traditionally
8 this type of plan has been fairly rare in the
9 public sector.
10 But, if you look back to 2012, there
11 were three major reform initiatives in the state,
12 and two of them were cash balance plans, Kansas and
13 Louisiana. Now, Louisiana was ultimately declared
14 unconstitutional. But, if you look in the very
15 next year, Kentucky came along and adopted a cash
16 balance plan for its general state employees in
17 2013.
18 And then in April of 2018, Kentucky came
19 back and tried to enact legislation to create a
20 mandatory cash balance plan for new hires in its
21 teacher's plan. But, that was also declared
22 unconstitutional, so they revisited the issue again
23 for their teachers this session in 2021.
24 In March of this year, the Kentucky
25 lawmakers overrode the Governor's veto and enacted

1 a hybrid retirement plan for newly-hired teachers,
2 and that has a DB component and a cash balance
3 component as well.
4 So, what is a cash balance plan? Well,
5 in some ways it's like a defined contribution plan.
6 A cash balance plan gives every member an
7 individual account. The employee and the employer
8 each contribute to that account. Here's where it
9 diverges from a DC plan. It's that members don't
10 have any choices about how the money is invested.
11 So, members' accounts are managed in one trust
12 account just as they would be with a traditional DB
13 plan. And the point of that is, obviously, to
14 achieve economies of scale and economies of
15 management that come along with having a merged
16 trust account.
17 In public sector cash balance plans,
18 members are guaranteed a rate of return on their
19 investment. This return can take various forms.
20 But that guarantees return kicks in if, for
21 example, a trust fund's earnings make it feasible.
22 Member accounts can receive this additional return
23 above and beyond that guarantee.
24 So, finally with cash balance plans,
25 when a member retires, he or she has the option of

1 a lifetime annuity based on the account balance,
2 and the plan may or may not provide for some sort
3 of cash withdraw at retirement as well.
4 So, if we want to think about what
5 accounts for the significant variation among
6 alternative designs in the states, we can look at
7 when and where and why certain plans designs were
8 adopted, as well as who participates in them.
9 Before the financial crisis a number of
10 states had introduced defined contribution
11 arrangements into their plan structures, but these
12 were often optional. It was really only Michigan
13 and Alaska that had mandatory defined contribution
14 plans in place before the Great Recession.
15 I don't want to talk too much about
16 those individual states. I will mention that,
17 also, before the Great Recession, Indiana,
18 California, and Oregon had hybrid arrangements in
19 place for certain employees. Much of the
20 pre-recession activity occurred in the wake of the
21 fantastic performance of the stock market in the
22 1990s.
23 So, in the post-recession period, you'll
24 see that these new alternative benefit designs are
25 increasingly mandatory and they apply to new

1 employees. Though, only Oklahoma has followed the
2 Alaska and Michigan model and required employees to
3 go into pure contribution plans.
4 In terms of where these non-DB plans
5 have been adopted, so, since 2009, eight states,
6 Arizona, Connecticut, Michigan, Pennsylvania, Rhode
7 Island, Tennessee, Utah, and Virginia have all
8 created those DB-DC hybrids that we were talking
9 about. Then you have three states, Kansas,
10 Kentucky, and Texas that created cash balance
11 arrangements for newly-hired state or educational
12 employees, or both.
13 Rhode Island did something interesting.
14 They were the only state that passed the new plan
15 type, the hybrid plan, and then required
16 participation from current plan participants in
17 that new plan. And then, like I mentioned,
18 Oklahoma adopted this defined contribution
19 arrangement, and...
20 So, let's move on and talk about why
21 non-DB plans were adopted. So, I think others can
22 speak to this, and you'll no doubt hear from them
23 about what was motivating lawmakers to make these
24 changes. But, generally speaking, before 2008, I
25 think a lot of the motivation appears to have been

1 offering employees an opportunity to manage their
2 own money and participate directly in a rapidly
3 rising stock market. But and after the financial
4 crisis, I think it's a different set of motivation
5 that have been driving a lot of the state
6 legislative activity in the states.
7 I think folks are concerned about the
8 high cost associated with unfunded liabilities and
9 are interested in unloading some of the mortality
10 and investment risk that's associated with defined
11 benefit plans. And also, I think many lawmakers
12 have been interested in creating less back-loaded
13 benefit structures, so that they're increasing the
14 amount of money that short-term employees are able
15 to take with them when they leave government
16 service.
17 I will leave it to others to talk about,
18 sort of, the political philosophy and how that is
19 playing into this decision making.
20 In terms of who participates in non-DB
21 plans, let's see. (Pause).
22 I think there are -- If you look at that
23 previous map, it makes it look like, just by the
24 shear number of initiatives, that there is a lot
25 happening on the DC front in the states, or the

1 hybrid front or the cash balance front.
2 In reality, the amount of assets bound
3 up in these types of plans is for now quite small.
4 Why is that? Well, if you have states that
5 introduce optional DB plans, that can have a
6 limited effect, very few public sector workers with
7 a choice are opting into DC plans, although there
8 are exceptions, and Florida is an important one.
9 Also remember that only three states
10 have mandatory DC plans. However, mandatory hybrid
11 plans will ultimately have an impact on the
12 allocation of assets between DB and DC designs.
13 They are relatively new, and so, this effect is
14 maybe not as pronounced now as it will be in the
15 future, but that's coming.
16 And also, keep in mind that new
17 employees in entering non-DB plans are a tiny
18 fraction of the workforce now, but is growing.
19 They're going to be an increasing percentage of the
20 public sector workforce over time.
21 Let's move on to slide 23. This is
22 taken from an interesting report that an
23 organization did on states where there are choices,
24 and you can see a cite to that report there. I
25 think this is a really interesting exploration, and

1 I will just refer you to that for your own review
2 at some point in the future.
3 Let's move on to slide 24 instead, and
4 talk very quickly about some other recent trends.
5 I think I just picked out four because I suspect
6 you will hear from others during the course of
7 these next couple of days about these, so I wanted
8 to kind of tee up those conversations and just flag
9 a few things that we've been observing in terms of
10 state legislation.
11 One is stress testing. So, as you in
12 Pennsylvania know, this is about assessing risk so
13 states can think through a range of possible
14 scenarios it's a stimulation technique that
15 projects important actuarial and financial data for
16 pension funds. Thirteen states have now adopted
17 legislative mandates that require this practice,
18 and North Carolina, Montana, and Pennsylvania are
19 among the states that have done this recently, and
20 Nebraska and Arizona took up legislation in their
21 2021 sessions. Arizona actually enacted it.
22 The idea with stress testing is that
23 you can help states identify problems before they
24 emerge, suggest methods for addressing issues as
25 they arise, and then inform the budget process in

1 times of turmoil and uncertainty like what we've
2 seen with the pandemic.
3 There are many trends related to pension
4 investments that are playing out in the states, and
5 I know other presenters are gonna elaborate on
6 these. So, very briefly, I will just mention one
7 that I've been tracking, and this is the
8 integration of ESG factors into investment decision
9 making. This has been accelerating in recent
10 years.
11 I'll just highlight one state. This
12 year Maine became the first one to enact a law
13 requiring its 17-billion-dollar public employee
14 pension fund to divest from fossil fuel holdings by
15 2026. So, I don't want to get into the details too
16 much here, but I will say, just to give you a sense
17 of the scope of this endeavor, Maine is a
18 relatively small state, but its fossil fuel
19 investments represent $1.3 billion, or 7.6 percent,
20 of pension fund assets. This is according to
21 Maine's PSERS' executive director. So that's
22 fairly substantial. And this law is really
23 targeted at the 200 companies with the largest
24 fossil fuel reserves, as well as those with fossil
25 fuel infrastructure.

1 Another noteworthy trend is innovative
2 funding practices. And some public pensions have
3 been receiving a growing portion of their funding
4 from dedicated funding sources. So this is a
5 one-time or ongoing revenue stream that must, by
6 law, be contributed to the pension fund. There's a
7 lot of interesting activity in this area. I'll
8 just highlight a couple of states.
9 Kansas, Oklahoma, and Oregon have been
10 diverting gaming and lottery revenues or proceeds
11 from various sin taxes to their state pension
12 systems in recent years. And you may recall New
13 Jersey garnered a bunch of headlines when it
14 transferred ownership of its state lottery to its
15 pension fund in 2017.
16 And finally, retiree health care I think
17 sometimes get short shrift. There have been a
18 number of benefit reforms introduced in the states
19 that create less generous coverage tiers or
20 eliminated subsidies for some participants
21 altogether.
22 But there's also this other trend that
23 even while you have states cutting OPEB benefits,
24 many others are taking steps toward pre-funding
25 benefits by creating these irrevocable retiree

1 health care trusts, so they're pre-funding in the
2 same way that traditional defined benefits pensions
3 are pre-funded in the states. North Carolina is
4 one example of a state that has recently eliminated
5 retiree medical benefits for employees hired after
6 a certain point.
7 I have a fair amount to say about sort
8 of reform implementation and benefit adequacy and
9 competitiveness and how we think about benefit
10 portability, and those kinds of considerations. I
11 will just sort of preview it by saying that states
12 assess the cost and benefits of various plan
13 designs and various reforms in different ways.
14 So, they have to look at how they are
15 affecting interested parties, our public employees,
16 in guaranteed competitive compensation and adequate
17 retirement benefits. What about employer's ability
18 to attract and retain a skilled public workforce?
19 And then what about taxpayers? Are they being
20 guaranteed that the cost of the public services
21 they receive are stable and predictable?
22 I think important questions of
23 intergenerational equity come into play here. So,
24 are today's taxpayers the ones who are paying for
25 today's services, or are we unfairly burdening

1 future generations? The short answer is, it
2 depends on the system. It depends on the type of
3 reform, and it depends on who you ask. There is no
4 one-size-fits-all recipe for sustainable benefits.
5 And I think I will leave it there. I
6 apologize. I've eaten so much time, but I am
7 delighted to answer any questions you have right
8 now, and I am more than happy to follow up after
9 the hearings and get you answers to questions I'm
10 not able to address right now.
11 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
12 Well, thank you, first of all, for this
13 very helpful handout and presentation, and your
14 comments were very good.
15 I would like to just open it up for
16 questions to the Committee and those who are
17 attending virtually. Just, anyone here, just get
18 my attention. Representative Ryan.
19 REPRESENTATIVE RYAN: I have to say,
20 this has been fascinating. I truly appreciate it.
21 A couple of comments I want to make.
22 On slide 7 slash 13, there's a
23 calculation, without spending a lot of time on
24 that, of the last few years of service. Does that
25 create an automatic underfunding problem when the

1 contributions are made by the governmental entity
2 earlier in the person's career, and then that
3 person's salary is continuing along and increases
4 toward the tail end of their career that might
5 create an underfunding issue systemically because
6 of the way that's funded?
7 MS. PETRINI: You know, it's possible,
8 but I think I might leave others to address sort of
9 the funding ramifications of those particular types
10 of decisions, just because I think it's heavily
11 dependent on sort of the fact pattern that you lay
12 out in terms of when the person retires and that
13 kind of thing.
14 REPRESENTATIVE RYAN: Thank you. I
15 appreciate that. I will ask that later on.
16 We have a dual pension system in
17 Pennsylvania at the level of the state where we
18 have the public school employee retirement system
19 and the state employee retirement system. From
20 your experience, is that normal in most states, or
21 do they have a singular system?
22 MS. PETRINI: You know, in terms of like
23 the breakdown, I think a number of states have sort
24 of major plans for their teachers, major plans for
25 their public safety workers, major plans for their

1 state employees, major plans for their municipal
2 employees. States structure those arrangements in
3 different ways so many of them will have sort of a
4 unified system in place, and others will have
5 things the way you do in Pennsylvania where it's
6 divided like that.
7 In terms of the breakdown of how many
8 states have which type of arrangement, I don't know
9 that off the top of my head, but I'd be delighted
10 to look at that for you.
11 REPRESENTATIVE RYAN: That would be very
12 helpful --
13 MS. PETRINI: Sure.
14 REPRESENTATIVE RYAN: -- if you wouldn't
15 mind. Do you see anything in Pennsylvania that's
16 an outlier compared to other states of -- or
17 funding?
18 MS. PETRINI: Oh, goodness. Wow.
19 You know, that's another thing where I
20 think I would want to do a little bit of digging.
21 I don't want to speak out of turn. But, I'm happy
22 to look at things that are sort of specific to
23 Pennsylvania policy and outcomes for retirees and
24 other types of stakeholders.
25 REPRESENTATIVE RYAN: Then two other

1 relatively quick questions, if you don't mind.
2 And, Mr. Chairman, thank you for your
3 understanding.
4 In terms of a -- most of the, when there
5 are multi-employers involved, such as, in
6 Pennsylvania we have a multi-employer plan for the
7 Public School Retirement System. When you do your
8 analysis for other states, I'd appreciate to see if
9 many of the other states have similar types of
10 multi-employer plans, and does that introduce any
11 complexities into your system and your analytics
12 from your perspective of how organizations would
13 deal with that from one perspective versus another?
14 MS. PETRINI: I'll be happy to look into
15 that.
16 REPRESENTATIVE RYAN: Then the last
17 question is, Maine is using the ESG and the concept
18 that -- the original concept by ESG did not
19 necessarily go into.
20 So the question I'm going to ask you,
21 from a fiduciary perspective and from a funding
22 perspective, does that have any implications long
23 term from a policy level that NCLS (sic) might be
24 -- I'm sorry, NCSL would be concerned about, from a
25 fiduciary perspective; should start pulling some of

1 those asset allocations off the table that could
2 create some challenges relative to funding? I'm
3 just curious about your perspective on that as
4 well.
5 MS. PETRINI: There are all kinds of
6 really interesting questions bound up in
7 conversations around ESG and fiduciary
8 responsibility. I don't know the extent which
9 they've been resolved sort of at the state level,
10 and certainly at the federal level. I think
11 there's a lot of uncertainty about, like, ERISA
12 plans and the private sector and how fiduciary
13 responsibility plays into ESG decision making and
14 investment.
15 And I think there is -- definitely a lot
16 of that that is under discussion in states that are
17 thinking about integrating ESG factors more
18 actively into their pension fund investing.
19 REPRESENTATIVE RYAN: With that answer,
20 then, from a policy maker perspective or a
21 legislative perspective, do we need to be more
22 careful while we're doing that type of thing or
23 less careful, or just take a wait-and-see attitude?
24 MS. PETRINI: Um, wow, I don't know that
25 I want to be making pronouncements about what

1 policy makers should or shouldn't be doing, but I
2 am happy to give you a sense of what other states
3 are looking at as they're considering sort of
4 integrating ESG more heavily into their investment
5 decision making.
6 REPRESENTATIVE RYAN: Thank you for
7 doing that. Mr. Chairman, thank you.
8 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
9 Representative Webster.
10 REPRESENTATIVE WEBSTER: Thanks, Mr.
11 Chairman. I'm going to make a comment and little
12 bit of a question.
13 From my colleague from Lebanon County,
14 you asked about the systematic part of that
15 calculation on slide 7-13. I wanted to suggest
16 that that calculation obviously needs to be a
17 little more complex, because if the compounded
18 interest of the previous years is sufficient, then
19 it's not a systematic underfunding.
20 Obviously, if the criteria is not right
21 and we're not managing correctly, and we have some
22 evidence of that in our current system here in
23 Pennsylvania, then we could be creating the
24 calculation that says we're providing funding late
25 in the game rather than early in the calculation,

1 how that all comes together. I wanted to throw
2 that out there.
3 I want to thank you for being here. I
4 wanted to ask, maybe just for, I was going to say
5 opinion, but a concern, an analytical perspective.
6 I'm being a little bit of an English professor.
7 But in these buildings that are legislative and
8 political, we sometimes say the word reform over
9 and over. You know, by a normal definition of
10 reform, it indicates an improvement to the process;
11 not just that we change something.
12 So I'd like to ask from NCSL's
13 perspective if there are improvements that you see?
14 I sort of looked at the education you gave us here
15 this morning. But what are the improvements we
16 really should be considering?
17 MS. PETRINI: Well, first of all, I
18 think that's really an important decision to make
19 between the language of reform and the language of
20 change and the language of improvement.
21 You know, my organization is not
22 necessarily in the business of making policy
23 prescriptions, so I would really hesitate to point
24 to one particular state and say, this particular
25 reform activity has been valuable or important or

1 noteworthy or is going to lead to greater outcomes
2 down the road.
3 I think the really important thing to
4 keep in mind is that, states are fundamentally
5 different. They have different funding history.
6 They have different funding goals. They have
7 different demographic experiences. And so, I think
8 there really is no kind of one size fits all
9 elegant solution to a lot of the problems that you
10 see in states, but I think there's a tremendous
11 amount of innovation in this policy sphere.
12 So, I know that didn't necessarily
13 answer your question very precisely, but I think
14 that's the answer I'm able to give right now.
15 Thank you.
16 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
17 Representative Grove.
18 REPRESENTATIVE GROVE: Thank you.
19 I appreciate the information today as we
20 launch a deep dive into pensions and very excited
21 for Representative Ryan to have a PSERS meeting
22 tonight at 5:30 for more pension fund.
23 I'm very interested in the pension
24 system for governance and how states develop it.
25 Are most states -- And here in Pennsylvania we have

1 an executive branch, a legislative branch
2 appointees. Do most states operate that same form
3 of board governance, or are there other various
4 methods of board governance that states have
5 utilized?
6 MS. PETRINI: So this is an area I am
7 delighted to do some research on, kind of,
8 legislative trends in it. I don't have kind of a
9 clear picture of what that breakdown is from state
10 to state that I can offer you.
11 I will say that the folks at NASRA, who
12 are gonna be up next, have wonderful information
13 that they've been compiling over the course of a
14 couple of years on governance trends and
15 developments. So they may be able to speak to that
16 question a little bit better than I can right now.
17 REPRESENTATIVE GROVE: Thank you.
18 Thank you, Mr. Chairman.
19 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
20 Representative Keefer.
21 REPRESENTATIVE KEEFER: Thank you,
22 Mr. Chairman.
23 For the states that have migrated to the
24 defined contribution plans, have you seen or have
25 any statistics of the impact on the retention of

1 employees that are under the new plan versus under
2 the old defined benefit plans?
3 MS. PETRINI: Yeah. My organization
4 hasn't looked closely at statistics around that
5 specifically. I think it may be a little early for
6 some states to have a great read on exactly what
7 the future will look like in terms of recruitment
8 and retention.
9 I will say that there are plenty of
10 studies out there that are trying to anticipate
11 what those trends are gonna be. And if you'd like,
12 I am delighted to refer you to a few of those.
13 I'll follow up with you after the hearing and share
14 those with you.
15 REPRESENTATIVE KEEFER: Thank you.
16 One other question. Regarding the COLAs
17 you had referenced that 30 states have reduced or
18 suspended or eliminated the COLA since 2019, I know
19 that you gave a scenario, like a 3 percent
20 compounded interest at 26 percent savings, I
21 believe you said.
22 MS. PETRINI: Yeah.
23 REPRESENTATIVE KEEFER: So what kind of
24 actual stating -- some of these states that have
25 the COLAs in place, what have they -- savings have

1 they actually realized?
2 MS. PETRINI: Yeah. I think, again,
3 this is an area where you see a lot of projections
4 that come along in fiscal notes when states are
5 making these changes or outside groups are making
6 projections.
7 In terms of sort of follow-up studies
8 that are done or analyses after the fact, after
9 these enactments have been enforced for a long
10 time, off the top of my head I'm struggling to come
11 up with something that would be useful, but I bet
12 there's something out there. I'll be happy to look
13 into it and see what I can track down for you.
14 REPRESENTATIVE KEEFER: Thank you.
15 I'm understanding there's some contracts
16 in place or holding. You have these obligations
17 but going forward, kind of something in place,
18 there's a known expectation and there's
19 predictability.
20 Thank you. I appreciate all that.
21 Thank you, Mr. Chairman.
22 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
23 Chairman Sanchez.
24 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
25 It's kind of following up a little bit

1 on the lady's, first part of it, question there and
2 understanding you may have to get back to us
3 because you might not have this at your fingertips.
4 I too would be curious to know, you
5 started this with a lot of the pension system,
6 retirement security comes about equalizing wages
7 and compensation over time that may be lower in the
8 governmental sector when compared with the private
9 market, although, you know, many jobs are quite
10 comparable to the private sector and their
11 requirement of expertise and in-depth knowledge,
12 and certainly, you know, hard work. So, if you
13 have that data, we'd love to have that.
14 If you have any comment on it now, just
15 about how states evaluate as they either change
16 these plans, you know, what will make them in the
17 competitive market -- competitive in the
18 marketplace to get the best and brightest talent,
19 and how they, you know, manage that moving forward
20 not even so much in the, you know, retention
21 aspect.
22 But, really, I know some of us struggle
23 within our district offices from time to time the
24 recruitment of people when there's other jobs that
25 are paying more and people are looking at the

1 fullest packet of benefits.
2 So, anything you could share on that
3 would be most appreciated.
4 MS. PETRINI: Sure. I think this is a
5 widely studied area, and there are a number of
6 groups out there that do good work, so I'm happy to
7 relay that to you.
8 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
9 Thank you.
10 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
11 I have a couple questions for you.
12 Pennsylvania has multiple -- We have a
13 DB, we have a hybrid, we have a DC. You had talked
14 about the cash balance plan. Are there any states
15 out there that have a DB, a hybrid, a DC, and a
16 cash balance plan?
17 MS. PETRINI: Oh, wow. I have to think
18 about that for a second, and I don't want to
19 misspeak. Off the top of my head, I'm not aware of
20 a state that has that sort of full spectrum of
21 arrangements in place. I'm not aware of one that
22 has sort of that full plan of plate. But, if I
23 think of one, I will follow up with you and let you
24 know.
25 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:

1 Would you -- Is it a fair representation
2 to say that cash balance is a rising trend at this
3 point nationally?
4 MS. PETRINI: I think it certainly
5 gained a lot of visibility with the activity in
6 this session. I think it's gained a lot of
7 visibility, in part, because, in a few instances
8 these plans have been adopted, and then courts have
9 come along and said, no, you can't do that, for
10 whatever reason. I think at least in some of the
11 cases there have been procedural issues in play,
12 and that's why the courts were overturning them.
13 But, in any case, I think when you have
14 that kind of litigation environment around these
15 plans, it tends to generate even more visibility.
16 So I would think that's also a piece of the
17 equation in terms of raising the visibility of the
18 cash balance model in this session and in previous
19 ones.
20 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
21 Okay. I want to dovetail a little bit
22 on the litigation side. You had referenced
23 previously in your testimony that some states were
24 looking at plan changes and had implemented some
25 for current employees. Were there lawsuits

1 associated with that?
2 MS. PETRINI: Definitely. I think the
3 instance I was citing that's most notable is Rhode
4 Island, and there was absolutely litigation in
5 Rhode Island. There are other groups that track
6 the litigation environment in a very detailed way
7 that NCSL just doesn't have the resources to do.
8 But I will relay -- I will refer you to some
9 outside groups that have done a lot of litigation
10 tracking in that area especially.
11 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
12 I was interested in that because it
13 seemed to me that, in most instances, where a --
14 there's change -- plan design changes that applies
15 to new hires in most instances, I was intrigued to
16 find out if some were attempting it for current
17 employees.
18 I think the last question I have is,
19 since Pennsylvania's PSERS and SERS are under
20 60 percent funded, there are time to time we're
21 presented with options to increase benefits to a
22 particular group here or there, to add new groups
23 to the plan.
24 Your sense of what's happening across
25 the nation in terms of how states do that because,

1 if you're, in our case, under 60 percent funded and
2 you add a new group to that either by increasing
3 your liability and your future costs. Thoughts on
4 what you're seeing out there?
5 MS. PETRINI: Oh, wow.
6 You know, I guess I don't have sort of a
7 general impression of states -- I mean, I think
8 it's the usual set of considerations that they
9 would be taking into account. But in terms of
10 where they land and how they break down, I would
11 have to do a little bit more thinking and get back
12 to you about how that particular thing is playing
13 out.
14 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
15 Okay. To Representative Keefer's
16 question about how most states have reduced COLAs,
17 or those sorts of types of benefits, seems like a
18 lot of states are looking at that and implication
19 of where they are currently, and if they increase
20 COLAs and other types of benefits, and what the
21 impact of them will be. So, I was curious what the
22 states were seeing on that. So, I'd appreciate
23 that.
24 With that, we appreciate very much your
25 testimony, taking the time to come here, your

1 information, and follow-up information you'll
2 provided for us in due time. So, thank you very
3 much.
4 MS. PETRINI: Thank you.
5 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
6 I should add that I didn't acknowledge
7 Chairman Grove who came in from another meeting to
8 this. Welcome, Chairman Grove. And, of course,
9 you've seen Chairman Conklin here who had some
10 comments earlier.
11 With that, we'll take a minute or two to
12 transition to our next testifier, and we'll get
13 started here in just a second.
14 (Pause).
15 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
16 Okay. We're going to transition to our
17 next panel. With us today, we have Keith Brainard,
18 the Research Director of National Association of
19 State Retirement Administrators, and Alex Brown,
20 the Research Manager also with the National
21 Association of State Retirement Administrators,
22 which we will be referring to as NASRA here.
23 Gentlemen, we welcome you to our hearing
24 and appreciate you being with us today. I will
25 swear you in, so if you could kindly raise your

1 right hand.
2 (Testifiers were sworn by Chairman
3 Miller).
4 Thank you. Who will be starting off
5 here today.
6 MR. BRAINARD: This is Keith. I'll
7 begin. I'll pass it on to my colleague, Alex,
8 after just a few moments.
9 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
10 All right. The floor is yours.
11 MR. BRAINARD: Mr. Chairman, members of
12 the Committee, thank you for the opportunity to be
13 here. We appreciate your interest in the subject
14 matter that we spend a lot of time with.
15 The number of our slides are relatively
16 few. Our objective, with the information we've
17 provided you, is to provide you with an overview of
18 public pensions and how Pennsylvania compares with
19 the national picture; chiefly to foster questions
20 and discussions with you.
21 We've been listening in on the prior
22 testimony, and we can respond to some of the
23 questions that came up previously, to the extent
24 that we took good notes, on remembering those, and
25 if there are others that we don't remember you wish

1 to ask us, we would be happy to take a shot at
2 responding to those.
3 It is our understanding that you have a
4 handout from us, which is a series of slides, and
5 we're going to be working from those if we might.
6 And first slide on there, this is slide number 2,
7 is just a high-level overview of public pensions in
8 your state. You can see the size of assets and
9 liabilities. That's our latest best estimate. As
10 you know, markets have been volatile in recent
11 months, so that figure might be off a little bit,
12 but we think that that's in the ballpark.
13 One of the questions that came up
14 previously was where -- if there are any areas
15 where Pennsylvania is an outlier. And I'd like to
16 identify a couple of those areas. One is reflected
17 here in the sense that Pennsylvania, as a state,
18 may be the most mature pension state in the
19 country; mature being defined as having more
20 annuitants, those receiving a regular benefit,
21 compared to active working members.
22 There's a trend, generally -- well, a
23 trend definitively for the nation as a whole with
24 regard to the ratio of active working participants
25 compared to those receiving a regular benefit has

1 been quite clear and definitive over the years.
2 And right now on a national basis, there are
3 roughly one and a quarter, maybe one and a third
4 active working members for every annuitant.
5 But, in Pennsylvania a few years ago,
6 you crossed that threshold where your pension
7 plans, as a group are now paying more benefits,
8 more annuitants compared to those who are
9 participating on an active basis; that is, working.
10 So that is one area where Pennsylvania is and --
11 it's an outlier.
12 And speaking of those benefits, as the
13 chart shows, sometimes this important fact is
14 overlooked. The -- Your retirement systems -- the
15 two big statewide retirement systems distribute
16 more than $10 billion annually in benefits. So, as
17 these plans invest their assets and manage these
18 assets and collect contributions, sometimes the
19 fact that they are regularly dispensing these
20 benefits, almost a billion dollars a month, is
21 overlooked.
22 And the fact that Pennsylvania's pension
23 plans, as a group, are so mature has ramifications
24 on those benefits and on the financial management
25 of the plans. And, in part, that is because, on a

1 relative basis, you have fewer people paying in
2 compared to those who are receiving a benefit. And
3 among other things, that requires the plans to be a
4 little bit more liquid, more the plans less mature.
5 And as the slide indicates, more than 90 percent of
6 the benefits that are paid are paid to folks who
7 live in the State of Pennsylvania.
8 Interestingly, the two big statewide
9 plans, the school employees and state employees
10 account for about three-fourths of all of the
11 assets of participants in the state. I mentioned
12 the relative maturity of the state plans. And I'll
13 look in more detail in a moment at the funding
14 condition, which did come up with some questions --
15 in some questions with the prior speaker. But,
16 relative to other states, the two big statewide
17 plans are less well-funded; meaning, they have more
18 liabilities relative to the size of their assets.
19 You may be aware of this, and it may be
20 a little bit off topic for this, but it is worth
21 mentioning, and that is, as in response to the
22 outlier question. By far, Pennsylvania has more
23 local pension plans than any state in the country.
24 The U.S. Census Bureau reports this information.
25 The last I saw it was roughly on the order of 1500,

1 but they have reported a figure much higher than
2 that before. So that's another area where
3 Pennsylvania's a bit of an outlier.
4 The fact that you've got a couple of big
5 statewides that dominate the percentage of actives
6 and -- I'm sorry. Participants and assets is not
7 unusual, but the very large number of relatively
8 small local plans is kind of unusual.
9 I'd like to move to slide 4, which is
10 what we call the bubble chart, and that chart is
11 clogging the actuarial funding level of about 120
12 public pension plans around the country. Together
13 these plans reflect roughly 80, 85 percent of all
14 public pension plan liabilities in the country, and
15 the size of the bubbles are roughly proportionate
16 to the size of the plan's liability. So bigger
17 bubbles reflect bigger pension plans; smaller
18 bubbles, smaller plans.
19 I've denoted the two statewide pension
20 plans that are funded just below 60 percent, but if
21 you lay out all of the actuarial experience and the
22 actuarial assumptions, and the methods and so on
23 for all of these plans, this is where it all lays
24 out, and it's quite a wide range, with the
25 exception of an outlier there below 20 percent,

1 they're roughly between 40 and 100 percent, but
2 they fill that gap pretty well.
3 The median, you can see the midpoint is
4 funded around 72 percent, in the aggregate
5 73 percent. This is all pre-recent market run-up.
6 Generally, I think that we can expect on a market
7 basis of a pension funding levels to be lifted by
8 about 10 percent. So if we were using a market
9 basis to measure funding levels rather than an
10 actuarial basis, these funded levels would grow by
11 about 10 percent.
12 Of course, actuarial basis phases in.
13 Investment gains and loses are typically over a
14 four- or five-year period. So assuming some
15 normalcy of market behavior going forward, we can
16 expect these funding levels to begin to rise over
17 the next few years by, perhaps, as much as
18 10 percent.
19 Point out a couple of the bubbles here
20 as you might -- just to orient you. You might
21 expect the very large bubble in the middle there is
22 CalPERS, the nation's largest public pension plan.
23 The large bubble to the lower left of CalPERS is
24 CalSTRS, the California State Teachers' Retirement
25 System, and that's just in the lower left of that

1 CalPERS' level.
2 Then some of the larger plans to the
3 upper right of the median line include the New York
4 State Teachers' Retirement System, New York State
5 and Local Retirement System, Florida Retirement
6 System, teacher retirement system in Texas,
7 Wisconsin Retirement System, some of the larger
8 bubbles that are all pretty well-funded.
9 With that, Mr. Chairman, I'd like to
10 hand it over to my colleague who will walk through
11 the next few slides.
12 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
13 Thank you very much. Go ahead. You may
14 proceed.
15 MR. BROWN: Thanks. My appreciation as
16 well to the Chairman and members of the
17 Subcommittee for the opportunity to speak with you
18 this morning.
19 I'm kicking things up on slide 5. It
20 should be page 30 on the handout. The chart on
21 this slide is plotting the employer contributions
22 received by the two largest statewide pension funds
23 in Pennsylvania, PSERS and SERS, since FY 2001 as a
24 percentage of those plans actuarially determined
25 contributions.

1 The actuarially determined contribution
2 is, very broadly speaking, the contribution level
3 required to fund newly-approved benefits and pay
4 down a portion of the plan's unfunded liability in
5 accordance with the plan's amortization schedule.
6 As you can see in the earlier years of
7 this period, both PSERS and SERS were receiving
8 100 percent or more of their actuarially determined
9 contributions beginning in FY 2005, contribution
10 adequacy for both plans defined sharply to around
11 40 percent of the actuarially determined
12 contributions received and sort of language at that
13 level until beginning to rise in FY 14.
14 Contributions in recent years to both
15 plans are now consistent with the actuarially
16 determined contribution, a development that this
17 Subcommittee and the Pennsylvania General Assembly
18 as a whole deserves to be recognized for
19 overturning that contribution to the full
20 actuarially determined level.
21 This experience was somewhat
22 representative of the public pension community as a
23 whole, although some plans consistently received
24 their full actuarially determined contribution
25 during this period, as we'll see in a moment. Many

1 others had a similar experience in Pennsylvania due
2 to market declines in the first decade of this
3 period produced significant increases in unfunded
4 liabilities for most plans, which increase their
5 costs, and those market declines were followed by
6 periods of economic recession, which, in many cases
7 challenge public employers to pay those higher
8 required costs.
9 Moving on to the next slide, slide 6.
10 We also plotted the weighted average annual
11 required contribution, or actuarially determined
12 contribution received for all 50 states during this
13 measurement -- same measurement period, and the
14 chart on this slide shows how it all falls out. As
15 I mentioned, some states received all or most of
16 their required contribution during this period,
17 despite the challenges presented by the market
18 declines and recessions. And those states are
19 found around the hundred percent line or greater on
20 this chart.
21 You'll notice that Pennsylvania is
22 labeled second from the left on this chart,
23 indicating that only one other state, your neighbor
24 to the east, New Jersey, received a lower
25 percentage of their actuarially required

1 contributions in Pennsylvania during this period.
2 The state order in this chart tells only
3 a part of the story and obscures the recent
4 restoration of funding adequacy in Pennsylvania
5 that was shown on the previous slide. When we
6 break out the Pennsylvania experience in two parts,
7 as we've done here on this chart, we can see the
8 impact of recent funding improvements in sharper
9 relief.
10 But when we cut the period of
11 measurements off at FY 13, we see that Pennsylvania
12 during that period, FY 01 to FY 13, but received
13 just over one-half of its required contributions,
14 adding the most recent six years to the measurement
15 period adds 20 percentage points to that metric at
16 just under 70 percent, and we would expect that as
17 more years of contributions at or above 100 percent
18 of the actuarially determined contribution are
19 added to this analysis, so that the percentage will
20 continue to increase.
21 Moving on to slide 7. Another way we
22 look at pension contributions is to calculate each
23 state's spending on pensions as a percentage of all
24 state and local government spending, and that's
25 what we're looking on the chart on this slide.

1 On a national basis, state and local
2 pension contributions comprise approximately
3 5 percent of all state and local government
4 spending. The median is approximately 1 percentage
5 point lower than the aggregate figure, which
6 indicates that several large states with higher
7 levels of pension spending percentages are driving
8 that aggregate figure to be higher.
9 You can also see on this chart the range
10 of outcomes just under 2 percent to over
11 10 percent, and Pennsylvania's percentage was just
12 over 6 percent as of FY 19. This chart invites
13 comparison among states, but states differ across
14 several important factors, and some of those
15 differences contribute heavily toward the range of
16 outcomes you see on this chart. First, pension
17 plans in different states differ with regard to
18 their level of unfunded liabilities. Generally, a
19 plan higher up on the liabilities will require
20 greater contributions than a plan with a lower
21 level of unfunded liabilities.
22 Plans also differ with regard to benefit
23 levels, and employee contributions are also
24 different across plans. Social Security
25 participation, which was touched on by the previous

1 speaker, or lack thereof, is a key factor driving
2 differences in benefit levels.
3 Plans of participants are not also
4 covered by Social Security, which the previous
5 speaker mentioned, includes approximately
6 40 percent of teachers, two-thirds of public safety
7 officers, and substantially all public employees
8 are not -- a handful of states tend to receive
9 higher benefits to compensate for the lack of
10 Social Security, and the cost of those benefits
11 tends also to be higher.
12 Differences in actuarial assumptions and
13 methods can also produce differences in pension
14 costs. And as I had discussed with the previous
15 two slides, an employer fidelity to paying required
16 contribution is another factor. And, in fact, it's
17 a pretty relevant factor for Pennsylvania. If we
18 were to go back one decade earlier and produce this
19 exact same chart, Pennsylvania's percentage of
20 spending on pensions would be below 2 percent, be
21 among the lowest of any state.
22 However, as we saw earlier, annual
23 contributions of the two largest statewide plans a
24 decade ago were around 40 percent of the
25 actuarially determined contribution. So, the fact

1 that Pennsylvania's percentages much higher than
2 that today, around 6 percent, is an additional
3 reflection of the improvement in pension funding
4 discipline that I talked about earlier.
5 So, slide 8, I'd like to spend just a
6 moment discussing Pennsylvania's experience with
7 pension plan design and where that experience fits
8 into broader national terms that we observe.
9 The first point on slide 8 emphasizes
10 what was previously covered in detail, the
11 restoration of full funding following several years
12 of underfunding, and that's consistent with
13 national aggregate trends as well. Also listed on
14 this slide are a few notable legislative enactments
15 which alter the PSERS and SERS' plan designs in
16 ways that are also consistent with national trends.
17 First, the 2010 legislation which
18 created a variable employee contribution rate, at
19 which PSERS and SERS' participants could be
20 required to make additional contributions depending
21 on the plans through your investment experience.
22 And then more recently, 2017 legislation
23 which established plan choice for new school hires
24 and for most state hires. These participants have
25 access to two different hybrid plans, different

1 benefit levels, and corresponding contribution
2 rates, or defined contribution plan.
3 And notably, this legislation also
4 introduced a shared gain provision for current and
5 active participants that could see contribution
6 rates reduced following periods of investment
7 performance that exceeds the assumed rate of
8 returns so to go along with the shared risk,
9 contribution rate introduced in 2010, shared gain
10 came along in 2017.
11 As the final line indicates, so these
12 plan design changes, and the introduction of
13 variable components, shared risk and shared gain,
14 the introduction of plan choice, all of that is
15 consistent with broad national trends among states
16 and public retirement systems.
17 In the context of public pensions, when
18 we talk about risk, we're referring to the risk of
19 a financial loss compared to what was anticipated.
20 How that risk is borne depends on the plan type and
21 plan design. In most defined contribution plans,
22 for example, participants bear most of the risk of
23 a financial loss. In a defined benefit model,
24 employers have traditionally borne most of the
25 risk.

1 Recent trends have seen the balance of
2 risk distribution shift, and in some public pension
3 plans, from employers to participants, accomplished
4 by methods such as those deployed recently here in
5 Pennsylvania.
6 So, on our final slide, slide 9, we're
7 looking at a map that identifies states that
8 implemented automatic risk-sharing plan design
9 features since 2009. Although some states have
10 featured these elements in their pension fund
11 design for decades, the trend has accelerated in
12 recent years, and that's what we're attempting to
13 show using this map.
14 This map provides an indication of the
15 scope of the adoption of new risk-sharing design
16 elements, or in some cases the strengthening or
17 clarification of existing risk-sharing plan design
18 elements since 2009. Approximately one-half of
19 states, including Pennsylvania, has implemented
20 risk-sharing plan designs, and we expect more to do
21 so in the coming years.
22 So that's the conclusion of the
23 presentation of our prepared material. But before
24 we wrap up, I do want to ask Keith if he has any
25 final comments that he'd like to make?

1 MR. BRAINARD: Thank you, Alex. I do.
2 Mr. Chairman, members of the Committee,
3 we also were asked by your staff to talk about
4 governance, and I wanted to address that just
5 briefly.
6 NASRA, our organization, does not
7 recognize or endorse a best practice when it comes
8 to most facets of governance. We have a little bit
9 of a recommendation with regard to federal
10 oversight of public retirement systems. But beyond
11 that, we don't, as an organization, really take
12 that position on governance.
13 We do have a position on the role of
14 fiduciaries, and that specifically, in a nutshell,
15 says that fiduciaries should strictly follow
16 disclosure and ethics policies. That includes
17 loyalty to the plan, decision making that is open
18 and honest, due diligence in conducting pension
19 plan business, including complete transparency and
20 decision making, and eliminating conflicts of
21 interest. But, beyond that, governance really
22 should reflect the priorities of the plan sponsor,
23 the state or the city, whoever is sponsoring the
24 plan, and the plan itself as governed by the board.
25 And, of course, it's within the

1 authority of you, the legislature, and the board's
2 individual retirement systems to create a
3 governance framework that works best for your
4 unique situation.
5 And with that, we would be happy to
6 answer any questions you might have, including
7 questions that may have come up previously.
8 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
9 Thank you to both of you for your
10 testimony and the materials that you provided.
11 Our first question will be
12 Representative Schemel.
13 REPRESENTATIVE SCHEMEL: Thank you, Mr.
14 Chair. I have just a few questions. Is it okay I
15 just ask them all?
16 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
17 Yes. That's fine.
18 REPRESENTATIVE SCHEMEL: Thank you,
19 gentlemen, for your testimony today.
20 In regard to the actuarially required
21 contribution, or ARC, in Pennsylvania, isn't it
22 actually a construct of the legislature and not
23 formula that was developed by actuaries? We told
24 the actuaries what we wanted for a contribution,
25 and they came up with the rest. Isn't that

1 accurate?
2 MR. BRAINARD: Representative, the
3 actuarially required contribution, which now is a
4 -- is truly a technical term, previously the term
5 was annual required contribution, and that changed
6 in about 2014 to actuarially determined
7 contribution, although the nomenclature changed.
8 The underlying definition or methodology
9 really did not. And that is, it is a contribution
10 made by the employer that reflects the normal cost;
11 that is, the cost of benefits accrued by active
12 workers each year, plus the cost to advertise or
13 pay off the unfunded liability.
14 And so, each year the actuarial
15 consultants, the actuaries for each of the plans,
16 identifies that cost. They will tell the
17 retirement system the annually -- sorry, the
18 actuarially determined contribution for this plan
19 is X; typically, identified or characterized as a
20 percentage of pay.
21 Now, there are some states, Pennsylvania
22 may be one of them--or it has been in the past--in
23 which the contribution is set in statute and does
24 not necessarily relate to what the actuaries are
25 recommending, and that may be what you are

1 referring to.
2 But, it is true that each year the
3 actuaries do identify an actuarially determined
4 contribution. And so, the information that Alex
5 was referring to earlier was simply a comparison of
6 the actual contribution that was paid in
7 Pennsylvania compared to what the actuaries said
8 needed to be paid.
9 REPRESENTATIVE SCHEMEL: Thank you.
10 Pennsylvania is among those states, so I often sort
11 of remind my colleagues when we look at the ARC, we
12 like to pat ourselves on the back and say we've met
13 the ARC contribution rates, but those are not
14 actually necessarily actuarially, um, adequate to
15 pay off the unfunded liability.
16 Another question. You made reference to
17 private -- private plans, but in all respects, you
18 compared us with all public plans. Why don't we
19 look at how states, and particularly Pennsylvania
20 performs with respect to private plans, which I
21 understand always, or almost always, much better
22 funded? It seems to me that comparing us just with
23 other states is almost like, sort of a rogue's
24 gallery of states that tend to underfund those
25 plans.

1 Can you give us an idea as to why -- why
2 we are being compared to private plans and what
3 they would look like if we were?
4 MR. BRAINARD: Yes, sir. Thank you for
5 the question.
6 Really, to me, that's bit of an apples-
7 and-oranges comparison, primarily because private
8 sector plans are governed by ERISA, the body of
9 federal laws that oversee health care and
10 retirement plans in the private sector, and that's
11 a completely different set of rules and regulations
12 actuarially and with regard to the use of discount
13 rates and other assumptions, and it would -- In
14 order to provide that comparison would also require
15 a lot of explanation and qualification.
16 It's not always been so that private
17 sector pension plans have been better funded than
18 public sector plans, although in recent years that
19 has been the case. Federal law passed chiefly, I
20 think, in 2007, or mostly recently in '07 with the
21 Pension Protection Act, governing these private or
22 corporate plans, really required those plans to
23 become fully funded or created strong incentives
24 for the corporate plans to become fully funded, or
25 very strong disincentives to not, to be unfunded in

1 a fairly short period of time.
2 And one of the effects of that, in
3 addition to improving the funding levels of the
4 corporate plans has also been the closing of those
5 plans generally to new hires. And so, the
6 coverage, defined benefit plan coverage, pension
7 plan coverage of folks in the private sector has
8 been dropping, as you probably know, for the last
9 40 years or so; really, since the onset of the
10 original federal regulations in the mid-1970's.
11 At that time, roughly one-half of the
12 nation's private sector workforce participated in a
13 pension plan. And now the latest numbers are
14 roughly 15 percent of the nation's private sector
15 workforce is participating in a pension plan, a
16 figure that continues to decline each year,
17 certainly in no small part because of federal
18 regulations. And I'm not making a judgment on
19 those federal regulations when I'm saying that.
20 I'm just relating the facts.
21 REPRESENTATIVE SCHEMEL: And one final
22 question. If this is beyond the, kind of your
23 experience, you can just tell me.
24 Do you see what states, any difference
25 in terms of active or -- versus passive investment

1 strategies; those states that have active
2 management of their plans versus those that have
3 passive in terms of performance?
4 MR. BRAINARD: I'm not in a position to
5 identify which ones have out-performed. I can tell
6 you that we see a fairly wide range of state
7 practices with regard to active and passive.
8 Typically, our group, the group that we
9 tend to measure, have passive investments that
10 range generally between maybe one-fourth and
11 one-half, perhaps up to two-thirds of their assets.
12 That is a figure that is generally in flux.
13 Some -- Many plans will move in and out
14 of active and passive as they see different
15 opportunities. Some plans have absolute
16 commitments to be predominately passive. Others
17 exercise or use less -- relatively less passive
18 investments. But I'm not in a position to identify
19 whether those that are more active or more passive
20 necessarily outperform or under-perform.
21 We'd be happy to try to look into that
22 for you, though, and get an answer for you. I
23 think it's an interesting question.
24 REPRESENTATIVE SCHEMEL: Okay. Thank
25 you, gentlemen.

1 Thank you, Mr. Chair.
2 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
3 Representative Keefer.
4 REPRESENTATIVE KEEFER: Thank you, Mr.
5 Chairman.
6 I have a question regarding the expected
7 earnings rate. For the pension plans in
8 Pennsylvania is approximately 7 percent. Is that
9 consistent with national average, and what factor
10 should be taken into consideration when you're
11 making an expected earnings rate?
12 MR. BRAINARD: So, it is very
13 consistent. It's right in the middle there. The
14 median that we measure, we have a data set of about
15 131 public pension plans, and the median, the
16 midpoint figure, is 7 percent. The average is just
17 north of that, 7.1 percent. We have seen an
18 unprecedented movement toward lower rates of
19 assumption in recent years, and especially in
20 recent months.
21 The actuarial determine -- I'm sorry.
22 The actuarial assumption for the investment return
23 is prescribed. There are rules that prescribe how
24 actuaries should arrive at that and what factors
25 they should consider, including, as you might

1 expect, rates of inflation, projected rates of
2 return on individual asset classes, the historic
3 returns of the portfolio, and so forth.
4 But, in a nutshell, I would say that
5 Pennsylvania's return assumptions are right sort of
6 in the middle of the pack with regard to the rest
7 of the country.
8 REPRESENTATIVE KEEFER: Thank you.
9 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
10 Representative Ryan.
11 REPRESENTATIVE RYAN: Thank you so much.
12 Again, this has been very useful.
13 Mr. Brown, I'm certain you get questions
14 that you were pre-ordained as you go into this line
15 of work with a name like Alex Brown, I'd presume.
16 You probably had that coming. For those who aren't
17 familiar with who Alex Brown is, is a major
18 investment banking firm, so welcome to this group.
19 On page 3, which is slide 5, the comment
20 there's a 100 percent funding since 2016 for the
21 pension systems, and it was interesting that you
22 made, Keith, a comment that I thought was very
23 appropriate that that was the full funding
24 reflected the underfunding in the prior years.
25 Have you ever gone back and tried to

1 break out what incremental funding was taking place
2 because of the underfunding in the prior years? In
3 other words, if you were to take a look, as an
4 example, the pension funding for the Public School
5 Employee Retirement System, a substantial portion
6 of that actuarially required contribution is a
7 repayment of the underfunding for that 10-year
8 period where it was underfunded.
9 Do you ever break that out as to what is
10 a repayment of the underfunding versus the actual
11 required contribution for that period?
12 MR. BRAINARD: Typically, retirement
13 systems will have their actuaries conduct what's
14 called attribution analysis.
15 REPRESENTATIVE RYAN: Okay.
16 MR. BRAINARD: They'll go back and
17 they'll identify the unfunded liability, or
18 surplus; typically, the underfunded liability in
19 recent years, and attribute that unfunded liability
20 to the various factors. And the primary factors
21 are the ones you allude to, the contribution
22 experience, also investment performance, and the
23 actuarial experience of the plan; that is, are
24 people living longer, are they retiring sooner,
25 things like that.

1 The answer with regard to Pennsylvania
2 and the effect of the under-contributions during
3 that period, but by the look (video difficulty),
4 I'm certain that the under-contributions that
5 (video difficulty) under-contributions combined
6 with the length of time that those were in place,
7 I'm certain had a material effect on the unfunded
8 liabilities of the two big statewide plans.
9 REPRESENTATIVE RYAN: Yeah. It's
10 interesting that both -- I'm sorry.
11 MR. BRAINARD: One other thought. It's
12 possible that the retirement systems would have
13 that information. It's not unusual for actuaries
14 to prepare those attribution analysis.
15 REPRESENTATIVE RYAN: They actually do.
16 I would encourage all the members to take a look at
17 that, because it's very useful to see what happens
18 when the legislature and the executive branch don't
19 fund the actuarial required contribution, the
20 impact that that's got in future years, and how
21 that impacts the allocation of budgets going
22 forward.
23 The same thing is true then on page --
24 or slide number 7 in terms of that impact you have
25 there as well.

1 In terms of the actuarial earnings rate,
2 I want to dovetail on a question both
3 Representative Schemel and Representative Keefer
4 asked.
5 When you mentioned the 7 percent
6 expected earnings rate is kind of the norm for
7 that, and there were differences with the private
8 sector plans, and you mentioned that there are
9 differences with private versus public sector
10 plans, the question I've always had is, should
11 there be? Should there be a difference? I realize
12 the risk or rules are different, but that's
13 legislative in nature.
14 But, from a policy perspective and from
15 a managerial perspective or management of the
16 funds, should those be different, or should they be
17 viewed in the fact that they're retirement funds,
18 that we should look at them differently?
19 MR. BRAINARD: Well, in my view they
20 should be different. And the underlying reason is
21 this: On the corporate side, the federal
22 regulations I was referring to, one of those
23 federal regulations prescribes what the corporation
24 can assume or discount its assets at, and that it's
25 tied to current interest rates. And the underlying

1 idea there is that, at least in theory, if not in
2 practice, at any given point a corporation could
3 either declare bankruptcy, go out of business, be
4 acquired, somehow go away.
5 The federal government, through years of
6 experience, particularly preceding the onset of
7 ERISA in the mid-1970's has decided that it is in
8 the best interest, as a matter of public policy,
9 that these corporations essentially maintain a
10 certain level of funding for their plans, less we
11 experience a corporation going out of business or
12 going bankrupt or being acquired and not being able
13 to pay its pension promises.
14 By contrast, the idea behind the
15 difference in policy is that, with regard to the
16 public sector, states and cities, essentially they
17 are permanent entities; not going away, not going
18 to declare bankruptcy, or go out of business, and
19 that it's more reasonable to allow them to take a
20 longer view of their investment horizon, and also
21 to provide some level of budget stability and
22 predictability, which is what a long-term
23 investment return assumption does.
24 And so, studies have shown that one of
25 the leading factors encouraging corporations to

1 basically get out of the business of providing a
2 traditional pension plan was the uncertainty or
3 volatility of cost. As interest rates fluctuated,
4 so did the cost of the plan to those corporations.
5 And as a group, they threw up their hands and said,
6 we just can't. This volatility is untenable, and
7 we're gonna switch over to a defined contribution
8 plan.
9 And, by contrast, state and local
10 governments with these pension plans that are able
11 to maintain longer-term investment return
12 assumptions that are not necessarily subject to the
13 fluctuation of current interest rates have had a
14 more stable experience with regard to the cost of
15 the plans.
16 I think those are the driving factors
17 behind the differences between those two sectors,
18 sir.
19 REPRESENTATIVE RYAN: Again, thank you
20 very much. Just one last kind of comment/question
21 simultaneously.
22 Obviously, Puerto Rico filed bankruptcy
23 and it's still in the various stage of bankruptcy,
24 and some other areas filed bankruptcy. And so, the
25 question I would ask you is, in light of the fact

1 there's been a fairly significant market run-up
2 since 2009, which has reduced somewhat
3 significantly the unfunded liability, do you see
4 any tail-risk exposure to the states and to the
5 funding abilities of other states in the event of a
6 tail-risk event with world equity markets or world,
7 for lack of a better term, fixed rate bond markets
8 that could have an implication from a policy
9 perspective that legislatures around the nation
10 should start considering, or Pennsylvania as a
11 minimum should consider?
12 MR. BRAINARD: Well, I'm not an
13 investment expert. The ones that we look at have
14 been, for a few years, suggesting or
15 prognosticating lower expected returns from major
16 asset classes, equities, private equities, even
17 fixed income and so on in the coming years.
18 Interestingly, we have seen, Alex and I,
19 my colleague here, have seen in recent months some
20 (video difficulty).
21 REPRESENTATIVE RYAN: No.
22 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
23 Your system has frozen. Hold on until
24 we can get this figured out. We'll go with these
25 until we can get this ironed out.

1 REPRESENTATIVE RYAN: I'm sorry I caused
2 that. It was a fascinating answer you had too, by
3 the way. We were so close, yet so far away.
4 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
5 I notice that didn't happen with any
6 other questions.
7 A VOICE: Mr. Brainard, if you want to
8 log out and then log back in and see if that works,
9 we'll with these until you're able to come back.
10 Mr. Brown, he might not be able to hear
11 us. Would you mind letting him know that he's
12 frozen?
13 MR. BROWN: Yes. I'll have to make
14 contact.
15 A VOICE: Thank you.
16 (Off the record during video
17 difficulty).
18 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
19 Continue with your answer for
20 Representative Ryan, we'd appreciate it.
21 MR. BRAINARD: Okay. I'm sorry. I got
22 completely distracted and I'm not sure where I was,
23 where I left off.
24 REPRESENTATIVE RYAN: About personal
25 pension plan and the asset allocation that looks at

1 monetary policy, and I won't use the word
2 quantitative easy, but monetary policy, the impact
3 on fixed income. Are you concerned and what
4 recommendations might you have relative to
5 tail-risk exposure for pension assets and
6 future-funding obligations of these states?
7 MR. BRAINARD: All right, the tail-risk
8 question. Thank you for the reminder.
9 Well, obviously, the pension funds have
10 enjoyed a significant run-up in returns and asset
11 values in recent months. And I would say that for
12 a number of years, certainly the last four or five
13 years at least, the major investment consulting
14 outfits have been projecting lower returns on the
15 major asset classes, equities, private equities,
16 and even fixed income, and so forth, in the coming
17 years.
18 And so, recent events have sort of belie
19 what the prognostications have been. However,
20 particularly given the strong run-up in equity
21 markets, I think that pension plans as a group are
22 on much greater notice than they had been
23 previously and much more cautious than they had
24 been previously with regard to future expected
25 returns.

1 My colleague Alex and I have seen just
2 in recent months after news of the investment
3 returns for the period ended June 30th of this year
4 have been reported. We've seen a number of funds
5 announce they were reducing their investment
6 returns assumption, attempting to sort of lower,
7 ratchet down their overall level of investment risk
8 and to take advantage of the recent investment
9 gains.
10 I think that tail risk is always out
11 there. But, perhaps, it's a little bit more
12 pronounced right now given what's happened in
13 recent months.
14 REPRESENTATIVE RYAN: Thank you so much.
15 Mr. Chairman, thank you.
16 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
17 Before I turn over to Representative
18 Grove, a quick follow-up question.
19 You had mentioned regarding the
20 discussion on ERISA and the comparison between
21 public and private pension funds, the concept of
22 standards that the federal government had. Just a
23 quick question.
24 Are there any states that you're seeing
25 from your NASRA standpoint that are adopting

1 similar type of standards as a fixed state of law
2 of what minimum funding level should be, et cetera,
3 et cetera?
4 MR. BRAINARD: Is the question, are we
5 seeing states adopt laws that are consistent with
6 federal regulation corporate plans?
7 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
8 Not necessarily consistent with, but
9 standards similar to.
10 In other words, ERISA and the federal
11 government have certain standards that the private
12 funding -- private pensions must adhere to, so
13 states would adopt similar standards that their
14 particular state must adhere to.
15 MR. BRAINARD: Yes. Those are out
16 there. In some cases those are embodied in state
17 constitutions, and in other cases they will be in
18 state laws. They take the form of funding
19 policies, and funding policies run a range. Some
20 of the funding policies are very specific and
21 prescriptive and inflexible, and as I mentioned, in
22 some cases specific articulated in the
23 Constitution.
24 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
25 Okay. Thank you very much.

1 Representative Grove.
2 MR. BRAINARD: And we would be happy to
3 provide you with some examples of those if you'd
4 like.
5 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
6 Yes, that would be helpful.
7 Representative Grove.
8 REPRESENTATIVE GROVE: To follow up on
9 that, have any states actually adopted ERISA
10 standards for their public -- for their public
11 pension plans?
12 MR. BRAINARD: Not that I'm aware of.
13 I should mention that right now the
14 professional actuarial governing body is in the
15 process of passing a new actuarial standard that
16 would require actuaries to calculate funding
17 conditions -- the funding cost and funding
18 conditions for public pension plans that is pretty
19 similar to, if not almost identical to, the
20 discount rate for vision that is in ERISA.
21 So, in other words, if and when this
22 passes, and I think it's just a matter of when,
23 probably take effect in the next couple of years,
24 actuaries of public pension plans will need to
25 identify, in addition to the common conventional

1 funding method that we are accustomed to seeing,
2 actuaries will also be required to calculate, and
3 retirement systems will, presumably, report a
4 funding condition of the plan based on a very low
5 risk interest rate as well. And that, as you would
6 expect, would identify or be calculated as a much
7 lower funding level and much higher cost of the
8 plan.
9 REPRESENTATIVE GROVE: Let's assume the
10 federal government decided we are now going to
11 apply ERISA standards to all public pension plans
12 across the United States. How many would be out of
13 compliance?
14 MR. BRAINARD: Almost all.
15 REPRESENTATIVE GROVE: Okay.
16 How about global investment performance
17 standards, or GIPS? How many states have applied
18 those standards or start utilizing those standards?
19 MR. BRAINARD: I'm not familiar with
20 those, but I believe not many.
21 REPRESENTATIVE GROVE: Okay.
22 And then, Sarbanes-Oxley standards on
23 governments, has any states adopted SOX standards
24 for their kind of governance structure?
25 MR. BRAINARD: I can only speak to sort

1 of this stress-testing concept associated with
2 Sarbanes-Oxley, and some states had moved in that
3 direction. But I'm not aware of any state that has
4 really embraced some of the more specific and
5 strict requirements of Sarbanes-Oxley.
6 REPRESENTATIVE GROVE: Okay. That's it.
7 Thank you, gentlemen. Really appreciate it. Thank
8 you.
9 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
10 I have a couple questions. What are you
11 seeing by way of what states are doing in regard to
12 collars? The problems that we had several years
13 ago with the market downturn, and states
14 implemented collars to help with the smoothing
15 process and all of that. Tell me, what are you
16 seeing as far as national trends related to that?
17 MR. BRAINARD: Personally, I don't
18 recall seeing much change with regard to collars in
19 recent years. I do recall following the Great
20 Recession movement toward, perhaps, a little bit of
21 a relaxation of those collars, because they were
22 found to be not particularly helpful; that they
23 worked well on paper, but in practice they created
24 some havoc with plans. But I've not seen a lot of
25 discussion or change with regard to collars

1 recently.
2 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
3 Okay. Another question related to
4 alternative investments. Can you tell me what
5 you're seeing nationally in terms of the percentage
6 of total investments of various states in
7 alternative investments? Do you have any insight
8 in that question?
9 MR. BRAINARD: Yeah. We have seen that
10 the group of alternative investments being
11 predominately private equity, hedge funds, and
12 commodities. There are others, but those are the
13 three major areas.
14 And we have seen a general movement and
15 some people consider real estate to be
16 alternatives. So whether or not you consider that
17 would affect the answer.
18 Right now, on a national basis, roughly
19 20 percent of public pension fund assets are
20 invested in alternatives. And that is up probably
21 by double or so compared to 15, 20 years ago. The
22 movement toward alternatives has been incremental,
23 but the trend has been very clear.
24 And, in addition to that, if you want to
25 plug -- count real estate, roughly 7 percent of

1 public pension assets are invested in real estate.
2 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
3 Would that 20 percent that you're
4 considering a national average of alternative
5 investments include the 7 percent real estate?
6 MR. BRAINARD: No, I don't think that
7 does.
8 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
9 Okay. If real estate is included, then
10 roughly the national average, you would say, would
11 be approximately 27 percent of investments in the
12 nation being in alternative investments?
13 MR. BRAINARD: Yes, I agree with that.
14 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
15 Okay. All right. I think that's all.
16 Any other questions here from the
17 members?
18 (No response).
19 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
20 Very good.
21 Well, gentlemen, thank you so much for
22 your time today and working with us, and the
23 technological problems that we've had. We
24 appreciate that.
25 We're going to go into recess at this

1 point, but I want to announce that our presenter
2 when we get back will be Jean-Pierre Aubry, the
3 Director of State and Local Research, the Center
4 for Retirement Research at Boston College, who will
5 be followed by the Honorable Secretary Richard
6 Vague, Pennsylvania Department of Banking and
7 Securities.
8 So we will recess at this point until
9 approximately 1 p.m.
10 Thank you again, gentlemen. We
11 appreciate it. We are now in recess.
12 (Whereupon, the Committee recessed for
13 lunch; then reconvened).
14 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
15 Welcome back, everyone, to the House
16 State Government Committee Subcommittee on public
17 pensions, benefits and risk management. The
18 hearing on the topic public pension system trends
19 and state policy considerations for our afternoon
20 session on August 18th.
21 We're now coming out of recess and are
22 ready to begin with our next testifier. With us
23 today we have Jean-Pierre Aubry, Director of State
24 and Local Research, the Center for Retirement
25 Research at Boston College.

1 Mr. Aubry, welcome. We are glad to have
2 you here today. And to begin things, I would like
3 to swear you in, so if you would kindly raise your
4 right hand.
5 (Testifier was sworn by Majority
6 Subcommittee Chairman Miller).
7 Mr. Aubry, I don't believe your
8 microphone is on, or at least we're not picking it
9 up here.
10 MR. AUBRY: I do.
11 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
12 Okay. Well, thank you. We're glad we
13 got those technological things worked out. And the
14 floor is yours. We look forward to hearing your
15 testimony. Thank you so much.
16 MR. AUBRY: I want to thank the Chairman
17 and the Committee for giving me the opportunity to
18 speak on a contest or an idea that we've both been
19 kind of kicking around at the center. I know the
20 past two presentations have done, proceeded me, a
21 thorough and comprehensive job at looking at the
22 landscape of public plans, which is
23 (indiscernible). I'm trying -- putting
24 Pennsylvania kind of within that context.
25 But, this presentation, ah, will do is

1 look a little more deeply at Pennsylvania
2 specifically and its history to try to unpack why
3 it is one of the lower-funded plans in the nation
4 today. Specifically, we're going to look at the
5 focus on the impact of what we call at the center
6 legacy debt. This is an idea that, at the center
7 we've been kind of working through as a way to help
8 understand what may be driving a part of the large
9 unfunded liabilities within federal, state, and
10 local plans and how the context of legacy debt
11 might help inform options for going forward that
12 haven't been considered in the past.
13 And so, because this idea, again, is
14 part of a larger analysis that you're doing for
15 many of the worst public plans in the nation to see
16 to what extent legacy debt will play a role. So
17 with that, I'm going to begin with my PowerPoint
18 presentation. I believe that all the Committee
19 members have been given a hard copy at this point.
20 I did send it kind of late yesterday, so...
21 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
22 Yeah, we do have a copy of that. Thank you.
23 MR. AUBRY: Okay. Great.
24 So I'll just start with the very first
25 slide. The name of this presentation is Legacy

1 Pension Liabilities for Pennsylvania SERS.
2 Looking back, slide 2. Sorry. I'm
3 rolling off my numbers.
4 The third slide, third paper you have,
5 SERS was established in 1923. That's an old
6 system. Long before most retirement systems had
7 been established.
8 Here we have a bar chart that shows when
9 many of the major state and local pension plans
10 were established or significantly restructured by
11 date. You can see here that PA -- Pennsylvania
12 SERS also left that distribution, you know, being
13 formed much sooner than more than half of the plans
14 in our sample.
15 I should also at this point say that
16 whenever I make comparisons between Pennsylvania
17 SERS and other plans, I'm doing so within a
18 database called public plans database that is a
19 database that is maintained in partnership with the
20 Centre for Time Use Research, as well as NASRA and
21 the -- what was once a state -- the Center for
22 State and Local Government Excellence, which has
23 been labeled now MissionSquare Research Institute.
24 We maintain the database of roughly 200 state and
25 local pension plans -- major state and local

1 pension plans across the nation that covers about
2 95 percent of all the assets and 95 percent of all
3 the state and local workers in the U.S.
4 So, it may sound like a small number of
5 plans considering the number of cities and towns
6 that are in the United States, but these 200 plans
7 cover the vast majority of state and local
8 employees that hold a vast majority of public
9 pension assets. So, given that sample, SERS is
10 still one of the oldest plans in the country,
11 essentially.
12 Next slide. Even though SERS was
13 established in 1923, it didn't start actuarially
14 pre-funding benefits until the mid-1970's. (Video
15 difficulty). Fifty plus years of benefits being
16 paid through what we call pay-as-you-go financing.
17 So, revenue comes in. It may be held in a trust
18 for a short period of time, but that's gonna pay
19 out almost immediately to beneficiaries. So
20 there's no actuarial pre-funding, putting money
21 aside for it to build up a pile of assets that
22 would then pay people in retirement. It was really
23 just a pay-as-you-go system.
24 I should make the point that this was
25 not uncommon even for plans that started later.

1 Most pension funds in the U.S., state and local
2 pension funds, have a period in their history where
3 they were financing benefits on a pay-as-you-go
4 basis. It really wasn't until the mid-1970's, for
5 some plans the 1980's, that actuarial pre-funding,
6 as you think about it today, really took hold.
7 At this point in Massachusetts, our own
8 state, in the spirit of pick on home. So, you
9 know, Massachusetts, I think its first pension plan
10 was also started in 1920. We didn't start
11 pre-funding, really, until 1995. So that's
12 generation after generation after generation of
13 benefit promises that weren't pre-funded. What I'm
14 going to argue in this presentation is that, that
15 has some role in state unfunded liability for many
16 plans.
17 Next slide. So, for SERS, as a result
18 of this additional period of pay-as-you-go
19 financing, over a third of the current unfunded
20 liabilities stem from this legacy period, what
21 we'll call going forward, legacy liability.
22 Now, I want to be clear what I mean by
23 today's unfunded liabilities being partially --
24 stemming partially from legacy liability. It
25 doesn't mean that we're still paying benefits for

1 people who were hired in 1923, right? Because,
2 obviously, many of them have past away. So you
3 might ask, how are those benefits still burdening
4 the plan today?
5 The reason that they're still playing a
6 role in the finances of the Pension Fund today is
7 that, when you have benefits that are being paid
8 without being pre-funded, that money has to come
9 from somewhere, right? And so, once you start
10 pre-funding the plan -- pre-funding for people
11 going forward, some of that money you're putting
12 aside for those individuals has to be used to pay
13 the people that you didn't pre-fund before.
14 And so, every time that happens, you pay
15 them some of the money you put aside to pre-fund a
16 new generation to pay a generation before. And in
17 that way the gap from before moves forward, because
18 now that new generation has a little less money
19 than it would have had because they had to use it
20 to pay the older generation who was not pre-funded.
21 And, therefore, that kind of the hole created that,
22 with that initial generation rolls forward with
23 time.
24 So it's not really the benefit of the
25 19 -- people that were hired in the 1930s, 1940s,

1 and 1950s are still being paid. And it won't be
2 that, once those benefits are paid, this hole goes
3 away. It's really the fact that this hole kind of
4 rolls forward over time because of the initial gap.
5 And so, what our data show and our
6 estimate shows that for SERS specifically, and
7 other plans have different kind of ratios, but for
8 SERS we estimate that to be about a third of -- be
9 over $20 billion in unfunded liability is related
10 to this initial legacy liabilities that stems from
11 that.
12 Now, I want to be clear. Of course,
13 there are many other factors that played a role.
14 Like, legacy liabilities aren't everything. We
15 only see that there's a third. So, there are other
16 issues, there are other challenges that SERS has
17 had along the way. Benefit increases in two
18 thousand, um -- sorry. That 2009-01 is not quite
19 right.
20 As the benefit increases in the early
21 2000's, that increased the accrual rate from 2 to
22 2.5 percent for most plan members. That caused
23 increased each month unfunded liabilities. At the
24 same time, the Pension Fund offset the cost that
25 came with that benefit increase. They selectively

1 advertised certain things over shorter periods to
2 things over longer periods; mainly that the
3 overfundedness in the early 2000's, they advertised
4 that over short periods; meaning that, each year a
5 bigger chunk of that overfundedness would apply
6 against the benefits.
7 At the same time they back-loaded costs,
8 stretching those -- the imposition of the cost over
9 a longer period, so the cost was smaller pieces
10 each year. And so, you had kind of a big chunk of
11 overfundedness against small chunks of cost. And
12 so, what that does, really, at least in the near
13 term, reduced the cost to the Pension Fund. So
14 that also created some issues. I'm sorry. It
15 created some unfunded liabilities.
16 And finally, the big one is investment
17 returns, and like most other pension plans does not
18 particularly specific to SERS alone, although
19 severity may be different. SERS outperformed
20 expectations up until 2000. Our data shows that
21 the assumed return from 1974 when plans started
22 pre-funding to 2000. If they had hit their assumed
23 returns, they would have expected to get about
24 7 percent a year over that period. They actually
25 got 11 percent.

1 So, from 1974 to 2000, they really
2 outperformed expectations, which maybe led to
3 assess those when I kind of approaches in terms of
4 the outlook going forward from there, they may have
5 spurred benefit increases from other practices.
6 But, like most other pension plans since 2000,
7 they've been bucketed by the dot com bust, and the
8 financial crisis since basically COVID, the COVID
9 financial downturn.
10 So, what we see is that, they
11 underperformed their assumed returns since 2000.
12 If they had hit their assumed return, they'd be
13 closer to 8 percent in 2000, but they actually
14 achieved about 6, so a 2 percent gap in their
15 respective return since 2000.
16 So, benefit increases, inadequate
17 contributions, and kind of pay-as-you-go benefit
18 increase so that there is funding in general, as
19 well as poor investment trends since 2000, those
20 all have combined added to the unfunded liability.
21 What I really want to focus on -- I
22 think these other issues have been touched on by
23 many other researchers, us included, but I think
24 what has not been presented as part of the PSERS
25 unfunded legacy liability, which I'm going to

1 discuss today.
2 So as we look forward for SERS and many
3 other pension plans, what are the options in this
4 unfunded legacy liability? The key question is how
5 they're gonna deal with the unfunded UAAL, they
6 promote most pension funds. The unfunded liability
7 is the majority of their costs.
8 I'm sorry. That slide -- I slide
9 without turning the page so you can do that with
10 me. I'm so used to doing that. Forgive me. I am
11 on page 8, and the key question as we're going
12 forward, you know they just did UAAL. I'll give
13 you one moment to catch up. I apologize moving
14 forward without telling people.
15 Okay. So, on page 8, the key question
16 going forward is how to deal with existing unfunded
17 liability. And what we see is that for
18 Pennsylvania SERS, the majority of the costs are
19 due to unfunded liabilities, more so actually than
20 the average plan. While their normal cost, which
21 is the cost of benefits being earned by employees
22 each year, is actually quite small relative to
23 other funds. So, the benefits that are being
24 promised year after year are not as much the issue
25 as how to deal with existing liability from past

1 promises.
2 Next page. So one way forward is the
3 statement with the current actuarial basis to
4 either fund by advertising unfunded liability over
5 a set period of time, 20 to 30 years, maybe to use
6 something like a level-dollar amortization rather
7 than a level percent of pay.
8 Here what we show is kind of two
9 projections of the standard actuarial framework for
10 Pennsylvania SERS. If they do attach a level
11 percent of pay, which is the current agreement, 12
12 percent of pay amortization, or a level-dollar
13 percent -- a level-dollar amortization.
14 What you see on the left, for the first
15 ratio, because they have a fixed funding date, they
16 get the full funding in both scenarios. The
17 level-dollar approach gets there a little more --
18 the number quickly, but then increases the funded
19 ratio more quickly, by not back-loading costs.
20 But, the current agreement, level dollar --
21 level-percent approach also gets you there, with
22 only a slightly slower pace in terms of how quickly
23 the funded ratio is increased before it hits its
24 full funding point.
25 I think there might have been a typo in

1 my -- in the funded ratio chart that I copied in
2 there. The funded ratio starts a little bit lower
3 at 40 percent. So I think I copied maybe the wrong
4 plan on your chart. But in the testimony the
5 figure is actually the right one.
6 And also, the basic trend and the basic
7 pattern that we see here are the same. They look
8 roughly the same, whether you're doing level dollar
9 percent, the funded ratio is rising and may change
10 full funding at your funding goal.
11 The bigger difference in the actuarial
12 framework is whether its on the contribution side
13 whether you're doing level dollar, a level percent
14 amortization. Level percent starts low. Over time
15 as payrolls increase, the level dollar stays
16 roughly flat over time even though it starts higher
17 than the level percent. That's kind of what you
18 expect to see under the traditional framework.
19 Those are kind of your basic options for trying to
20 fund and how to deal with the unfunded liability.
21 Next page. SERS' recent history raises
22 doubt about the likelihood for future success. So
23 the figures I showed you in the last slide were
24 projections, actuarial projections, the kind of
25 projections that you would get in an actuarial

1 valuation or actuarial analysis. You kind of
2 generally presume that your interest assumed return
3 over time; that contributions are made. All
4 expectations for mortality is (indiscernible),
5 everything works out exactly as predicted. And in
6 those scenarios, the world looks pretty duped.
7 And in the past the full funding looks
8 relatively smooth. But, this chart here shows you
9 how easy or how much reality can diverge from
10 expectation. So what we're looking at here, the
11 projected contributions as of 2001 for the Pension
12 Fund versus what actually transpired over the
13 course of those last 20 years, roughly. And you
14 can see there's a dramatic difference.
15 So, the projections within the actuarial
16 framework, there are doubts whether those
17 projections can really be a useful model for
18 looking forward than what we've seen in the recent
19 past. And, most importantly, this actuarial
20 framework, I argue is not that well-suited for
21 managing the legacy unfunded liability.
22 So, legacy liability, it stems from an
23 earlier era that starts at the next slide. Legacy
24 liability stems from an earlier era of pay-go
25 financing for -- stems this period, 1923 to 1974,

1 and their costs cannot really be allocated to those
2 unfunded benefits. So the actuarial kind of
3 rational generally hurt, wanting to amortize those
4 unfunded liabilities in 20 to 30 years.
5 You don't want any spillover. You don't
6 want one generation -- the cost of one generation
7 to pay for the next. So, using the 20-to-30-year
8 valve as kind of a generational cutoff or, you know
9 -- yeah, generational cutoff. That's kind of the
10 limit. You really want to pay things off within
11 that time valve. Not the next generation pay for
12 another generation's cost.
13 The issue with legacy liabilities, the
14 spillover has already happened. There's no way to
15 get those who kind of promise the benefits in 1923
16 to 1974 to pre-fund now; to make up for that
17 difference now. So the milk is essentially already
18 spilt. And so, because of that, the actuarial
19 standards for amortizing this portion of the
20 liability for 20 to 30 years is less compelling.
21 There's no really way to put those costs back with
22 the right cohort, the right generation.
23 So, at this point, choosing any single
24 generation to bear the cost of the legacy
25 liabilities is somewhat arbitrary and potentially

1 unfair. It can be done, but it's not -- it's
2 really a policy decision and a social decision, and
3 not so much as one that is compelled by actuarial
4 best practices and future generation equity.
5 And, importantly, the high cost of
6 dealing with legacy liabilities in a single
7 generation it may be promoting other undesirable
8 pension practices, such as using artificially high
9 assumed returns or using assumptions for salary
10 growth or mortality to help mitigate some of the
11 costs of trying to pay down originally large legacy
12 liability in 20 to 30 years.
13 Next page. So another option we've been
14 -- we've been thinking about it at the center is
15 separating legacy liability from more recent
16 pension liabilities. One -- I think one benefit of
17 this approach is that when you separate the legacy
18 liabilities from the rest of the pension system, it
19 may give the pension system more room to think
20 about dividing liabilities appropriately and
21 funding in a more responsible manner because the
22 burden of those costs have now been lifted.
23 So, in our analysis what we look at is
24 what happened to the plan, applies the market
25 interest rate, the market tightly to value its

1 liabilities. It then separates the legacy portion
2 from other liabilities and spreads the cost of that
3 legacy over multiple generations rather than 20 to
4 30 years.
5 And then for the remaining, the
6 non-legacy liability, it looks to the private
7 methods of funding. It doesn't have to copy the
8 private sector, but it looks towards it for maybe
9 ways to tighten the practice -- funding practice to
10 the public fund.
11 So how would -- Well, first, to make a
12 clear break between the legacy liability and other
13 liabilities, it's our sense that a separate account
14 trust needs to be established. The government
15 could essentially create two systems, a legacy
16 system and the pension system, each with its own
17 trust.
18 The legacy system would require a new
19 trust with no assets and a liability, legacy
20 liability. The pension system would utilize the
21 existing trust with all SERS' current assets and
22 all the liability for SERS, net of legacy
23 liability, which has been already removed. So what
24 you essentially get is a zero-funded system, the
25 legacy system, and a better funded system for SERS

1 that (indiscernible) all it's assets and the
2 non-legacy liability.
3 Next page. So then, how would the plan
4 proceed after creating these two different systems?
5 Well, the increment will reduce the legacy
6 liability over time. Remember, we're trying to
7 amortize legacy liability over many years; not just
8 20 to 30. The government would make annual
9 payments into the trust fund, but only slightly
10 above the liability interest rate. So we're really
11 trying to stretch out these costs. The notion here
12 is that they are a societal burden from many, many
13 generations in the past.
14 So they do pay off, basically, the cost
15 over many generations going forward, so that no
16 single generation is, quote unquote, responsible
17 for the cost. And given that, potentially, the
18 most equitable way to do it is to spread the cost
19 basically across all generations. And to do that
20 will still, you know, incrementally reducing the
21 legacy liability, we argue that paying something
22 only slightly above the interest on that would
23 maintain -- would help ensure that the legacy
24 liability does increase over time, but very slowly.
25 The government would also contribute to

1 the Pension Trust Fund just like it would to SERS
2 currently. It could plan (indiscernible) to normal
3 cost, and it'd be planning an amount to amortize
4 the more recent unfunded liabilities, the
5 liabilities of legacy.
6 Importantly, all the contributions being
7 made are based on a market-based interest rate, not
8 the long-term expected return. Now, I'll come back
9 to what that means.
10 And for the benefit payment, the idea is
11 that the benefits would be first paid through the
12 Legacy Fund. So, the contributions into the Legacy
13 Fund basically are paid out are equally invested.
14 And any amount that's not -- any amount of benefits
15 that exceed what would contribute to Legacy Fund
16 can be paid out from the Pension Trust. What this
17 means is that the Legacy Fund assets are held in
18 cash or short-term liquidity in order to
19 immediately pay benefits, while the Pension Fund
20 assets can be invested like those in a large
21 private sector plan.
22 I think it's a very important point
23 there. So when I say the pension plans are
24 invested like a private sector plan, it doesn't
25 mean a hundred percent that's been drawn. It

1 doesn't mean COLA cash matching and LDI.
2 As it turns out, most large public --
3 large private sector plans that are also open to
4 new employees and are remaining a going concern.
5 These are plans that are continuing to run their
6 DB, continuing to bring in new employees. They're
7 not plans that are shutting down or winding down.
8 Those pension funds invest in equities.
9 They are roughly 50/50 equities involved. They
10 don't invest in alternatives. They only invest in
11 a lot of the alternative public plan investing, but
12 they do invest in risky assets. They're not
13 totally fixed income or LDI. And so, we argue
14 that, potentially, without the incentive of
15 reducing the cost of the Legacy Fund -- legacy
16 liability, the public pension fund maybe ought to
17 move more towards that model of taking on some
18 risk, but not as much as they are now in order to
19 fund their pension.
20 Next slide. So, to be clear, properly
21 valuing benefit promises using something closer to
22 a market value rate would increase reported
23 liabilities. There's no way about that. So we
24 show here what reported liabilities are currently
25 under the kind of actuarial approach that uses the

1 assumed return compared to what it might look like
2 under a new approach where liabilities are valued
3 closer to something like 4 and a half percent, um,
4 and there is an increase.
5 Now, this increase is somewhat an
6 increase on paper. Like the actual benefit
7 promises, the money needs to be paid out to
8 beneficiaries has not changed. You don't owe more
9 money, really. It changes how you value those
10 future promises. So this is kind of more of an
11 academic valuation exercise than an actual cash
12 flow per se, exercise. But, it's important to kind
13 of make a point. This is what would happen on
14 paper if you were to value benefit promises
15 correctly. Not correctly. With a market value
16 rate.
17 But, lengthening the amortization of the
18 legacy liabilities would mitigate much of that
19 impact. And so, what we see here is kind of a
20 comparison between the current schedule of payments
21 for SERS on the printed black line, which is,
22 potentially a level percent of pay amortization
23 where amortizations will grow with payroll over
24 time, and fully funded by roughly 2040 versus the
25 new approach where legacy costs, the lowest bar, go

1 on virtually infinitely; normal cost, the next bar,
2 and then amortization of the additional non-legacy
3 liabilities is paid out over 20, 30 years.
4 So what you see is that the current
5 method is under the cost, and some periods it's
6 higher than the new approach than other periods.
7 And so, it's not clear that there is a better --
8 which one is better in terms of the structure. I
9 will say that the new approach has much more
10 consistent and level cost over time.
11 Additionally, under the new approach the
12 pension funds are using a more safer investment
13 strategy. They're funding according to the market
14 interest rate. And so, the -- what you're seeing
15 here is kind of a system with little less risk in
16 it over time as well.
17 Next slide. I think kind of, most
18 importantly, under the new approach, liabilities --
19 liabilities would be truly reduced. So, what we
20 have here is the path of unfunded liabilities under
21 the current agreement and the new approach. So
22 here we value all liabilities at a market rate to
23 get a sense of how the actual unfunded liability
24 valued at a market rate is changing over time under
25 the current agreement and the new approach.

1 You can see under the current agreement,
2 there actually isn't that much of a decline in the
3 market interest rate value of unfunded liability.
4 It's quite similar to what you see under the new
5 approach.
6 Next slide. And finally, in this new
7 model where those legacy liabilities are separated
8 from the system, we also argue that both legacy and
9 pension unfunded liabilities would no longer be
10 part of the employee fringe rate. So, currently,
11 from many states, the whole ARC, the whole
12 actuarially required contribution, is billed at the
13 fringe rate on employee wages.
14 However, that's shown based on legacy
15 costs and these other unfunded liabilities, much of
16 this cost is not related to current workers.
17 Really, it's the normal costs that are related to
18 the cost of benefits for the current year of work.
19 And so, by tacking on the unfunded liability cost
20 into that, you're potentially distorting hiring
21 decisions.
22 It's not that the cost isn't there.
23 It's not your unfunded liability cost isn't a real
24 cost, and it should be borne by, um, in some way.
25 It's just not clear the purity, an ongoing labor

1 cost, which is how it is being billed both as a
2 cost to hiring a new worker to (video difficulty)
3 percent because of the fringe rate on the
4 employee's salary. My point is, whether you hire a
5 new worker or not will not change the unfunded
6 liability.
7 And so, once you start separating legacy
8 liability from the pension system it opens the door
9 to start thinking about how do you really want to
10 build from unfunded liabilities versus normal cost,
11 which may also (indiscernible) how to think about
12 what is really the cost of hiring an additional
13 employee.
14 And so, we show under the current
15 agreement, you know, the fringe rate would be
16 something close to 30 percent for a worker. Under
17 the new approach where you just kind of think about
18 the normal cost as what the current costs for
19 workers valued at a market -- closer to a market
20 rate, you see something like 6 percent for
21 benefits.
22 The other portion, this other kind of
23 30 percent that comes from unfunded liability will
24 still be a cost, but it will be presented
25 differently, via kind of fixed cost or some other

1 cost on budget, but not a -- particularly a kind of
2 per unit ongoing worker cost.
3 Next slide. So, to conclude, as we
4 think about unfunded pension systems across the
5 U.S. and we look forward, we really see the biggest
6 issue is how to manage their existing unfunded
7 liability. Importantly, for SERS and for any other
8 poorly funded system, a large portion of the
9 current unfunded liabilities stems from legacy
10 liabilities; stem from benefits that were earned
11 prior to when the system really shifted to
12 actuarial pre-funding.
13 So these plans could continue their
14 current actuarial approach and hope for the best.
15 But for many of them, the recent history raises
16 doubt that this approach would serve them well
17 going forward.
18 Importantly, the actuarial approach is
19 not well-suited for the specific problem of legacy
20 costs. So another option might be to separate that
21 from the current pension system and pay those out
22 over a longer period. And without the legacy
23 burden, kind of within the pension system, they
24 could shift the funding method that might better
25 align with current funding practices -- I'm sorry

1 -- with current best practices for their non-legacy
2 liabilities and the ongoing liabilities being
3 accrued back to the employees.
4 Next slide is my conclusion, so my
5 (indiscernible). And the public plan database,
6 which, like I said, both NASRA and the center
7 worked together to maintain, just got data on
8 Pennsylvania SERS as well as teachers, as well as
9 school employees, and 198 other public plans across
10 the U.S.
11 I'll now open it up to any questions. I
12 know this is lobbying a new ball, I guess, into the
13 -- into the playing field. Something that we think
14 is kind of -- We've been kicking it around the
15 center and starting to explore more among
16 worst-funded plans. So, I appreciate the comment
17 and questions as we kind of work through this, this
18 idea.
19 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
20 Mr. Aubry, thank you very much for your packet of
21 information and your detailed report. This legacy
22 liability issue is, obviously, a big impact on our
23 systems. Thank you for your presentation.
24 We'll open it up for questions.
25 Chairman Sanchez.

1 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
2 Thank you, Chairman Miller.
3 And thank you, Mr. Aubry.
4 I just had a question. Really an eye
5 opening about how much was due to that legacy
6 funding, so thank you for bringing that -- or the
7 legacy underfunding. As we all know, the sins of
8 the past really drive a lot of the unfunded
9 liability altogether.
10 The question on your chart on page 9 of
11 the -- where the tracking -- And I'm just trying to
12 wrap my mind around it, the comparison of the, I'll
13 call it the ARC, Actuarially Required Contribution
14 --
15 MR. AUBRY: Yep.
16 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
17 So the tracking there, how much of that in your
18 opinion is -- And, obviously, it doesn't track with
19 the projection. But, was the projection taking
20 into account the underfunding at that time? So, I
21 guess if you start and you're looking out 10 years,
22 and you're gonna put that underfunding in the big
23 calculation, it's going to change the projection.
24 So, if there's --
25 MR. AUBRY: Right.

1 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
2 So if there's, you know --
3 Have you run any models where it's
4 compared, like, without the underfunding, or is
5 that something you've looked at that obviously
6 compounds where that, you know, at least maybe not
7 the next year, but the year after, the year after
8 it keeps building a bigger required contribution.
9 So, have you looked at any of that data?
10 MR. AUBRY: Right, no. That's kind of
11 the point we make. At any given point in time,
12 when an actuary makes a projection, we have not.
13 The point I think we're trying to make, at any
14 given point in time an actuary makes a projection,
15 the intention is presumed there may be no other
16 unfunded liabilities going forward, but in the
17 cases where they are and have given any kind of
18 move forward.
19 I think the point this chart makes is
20 that, there's lots of shocks along the way that
21 throw you off course. I think if you practice the
22 system, the cost of adjusting charge over time
23 (video difficulty) for the entire payment.
24 In terms of the legacy unfunded
25 liability how they'll be incorporated, we have not

1 -- we have not kind of thought about if the actuary
2 in 2001 had kind of separated out the legacy cost
3 at that point. What essentially it would have
4 created is a system where the legacy cost is still
5 underfunded, and the current system is kind of
6 partially over- funded, you know, given that the
7 system was basically a hundred percent funding in
8 2001.
9 And what, looking at the plan in that
10 way is how the two systems was; had a legacy
11 liability and zero assets and essentially a little
12 bit over-funded, and moving most important at the
13 time what your contribution projection would look
14 like versus what the system is currently
15 suggesting, putting everything together kind of
16 looking at the net value of putting everything
17 together and then running the projection.
18 And so, the long and short of it is, no,
19 we've not been there. That would kind of be an
20 interesting model. So, for our report, we're
21 separating the two and will not be able to say
22 assets in this pile can go towards legacy and vice
23 versa, and really trying to kind of separate the
24 two as much as possible as you kind of think about
25 the funding going forward.

1 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
2 And that's, you know, definitely a, ah,
3 you know, an interesting policy consideration, of
4 course. I mean, I guess I'm just driving at -- It
5 seems like there's no -- no other overarching
6 policy other than you should fund -- the safest
7 play would be to fund each year's actuarially
8 required contribution because that's the best
9 information at that point in time, you know,
10 notwithstanding any shocks or bumps in the road
11 which, hopefully, those would be adjusted for
12 within the calculation and information at that
13 time.
14 MR. AUBRY: Yeah. So I'm not arguing.
15 That's a very good point. NASRA's presentation, at
16 this point, made it very clear. We also make the
17 same point that underneath the current framework,
18 the most important thing a plan can do is fund the
19 annual required contribution that's presented. And
20 so, there may be shocks down the road, but you kind
21 of keep paying.
22 I think one thing that we've noticed is
23 that, in plans that have paid the full ARC, that
24 number has continued to rise over time. And it is
25 kind of a confounding issue when you're doing the

1 right thing every period and, yet, costs keep going
2 up and keep crowding out other elements of your
3 budget, and it's hard to kind of describe to the
4 public or to anyone else why that's happening.
5 I think one argument that we are trying
6 to make here is that, there may be another -- Part
7 of the rise is the cost is basically the fact that
8 we are forcing ourselves to pay down unfunded
9 liabilities over a very short horizon, when there's
10 a portion of those costs that, maybe, could be
11 stretched out further.
12 Now, the issue with that, you know, that
13 can be seen as kicking the can down the road to
14 some. Our sense is that you can do two things at
15 once. You can stretch out the payment, but then
16 also realize that some of the assumptions made in
17 the past have been part of the problem and, if
18 we're going to relax how we pay for this legacy
19 liability, which I think had decent rational. Not
20 keep kicking the can down the road, but saying that
21 this is different types -- this is a different type
22 of liability and maybe deserves to be treated
23 differently. But it is going to kind of remove
24 some of the burden by being able to stretch it out.
25 And so, in that context, we maybe have

1 some opportunity here to also kind of tighten up
2 what we're doing on the more modern actuarial
3 funding pension liability side as well. Whether
4 that's gonna go over marketing straits or private
5 sector, it's not clear, we kind of use those for
6 our analysis of kind of one way forward to show
7 that maybe you can -- So there you don't have
8 shocks going forward where you're paying all the
9 ARC and things still get worse.
10 If you tighten up the system, you have
11 less of those kind of situations. At the same
12 time, you have a legacy liability that is kind of
13 separately off the books and being paid over a
14 longer period of time to help to get some of the
15 cost increase.
16 MINORITY SUBCOMMITTEE CHAIRMAN SANCHEZ:
17 Thank you very much.
18 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
19 Representative Ryan.
20 REPRESENTATIVE RYAN: Mr. Aubry, I want
21 to congratulate you for taking a different approach
22 to this. Like Chairman Sanchez, I'm a CPA as well.
23 And this concept of legacy cost is something that
24 we had to face in the automotive industry, the
25 steel industry, and other areas, and we did not do

1 it particularly well, which led to the bankruptcy
2 of those industries -- partially led to the
3 bankruptcy of those industries.
4 The approach you're doing is fine along
5 the lines of an activity-based costing approach to
6 where you're taking a look at those kinds of
7 methodologies. Will the Governmental Accounting
8 Standards Board give us any difficulty if we were
9 to consider such an approach, which I think is a
10 very rational approach to solving this problem?
11 MR. AUBRY: That is a very good
12 question. Of course, I'm not an expert on their --
13 on their opinion. They are -- So I really can't
14 speak to that, unfortunately.
15 I don't know if there's any examples of
16 plans of something similar with legacy costs.
17 There have been some small plans that closed down
18 and issued types of obligation bonds to pay down
19 remaining unfunded liabilities, those might provide
20 some guidance.
21 REPRESENTATIVE RYAN: The Financial
22 Accounting Standards Board addresses the issue, but
23 I don't think that the Governmental Accounting
24 Board does. If they do, I'll try to get you the
25 information on that as well.

1 Do you have similar information as
2 you've done for SERS on PSERS?
3 MR. AUBRY: Yes, actually we do. We --
4 But, yeah. (Video difficulty) -- are the same.
5 The numbers are slightly different, but the
6 narrative of the legacy liability kind of --
7 roughly the portion that makes up the unfunded
8 liabilities are similar.
9 REPRESENTATIVE RYAN: If you could get
10 that for us, I would really appreciate it. It
11 would be tremendous. Mr. Chairman, if we can get a
12 copy of that to the members, I would welcome it
13 tremendously.
14 You mentioned that approximately -- of
15 the 35 percent or so reported contribution rate,
16 about 6 percent of that reflects normal cost of the
17 current pension. 29 to 30 percent represents the
18 unfunded obligation, and your approach is smoothing
19 it out over a longer period of time, which includes
20 a market interest rate as opposed to expected
21 earnings rate.
22 In today's market of monetary policy,
23 what market rates -- So we have some perspective
24 for comparison purposes. I've seen some as low as
25 a percent and a half, some as high as 3 and a half.

1 And I'm curious as to what rate you would see that
2 is, and is there a benchmark rate that we would be
3 looking at?
4 MR. AUBRY: Yeah. I don't have any
5 specific projections, but I think what GASI has
6 recently proposed, for example, about the municipal
7 bond rate that could be used for the cross-over
8 dates.
9 REPRESENTATIVE RYAN: Okay.
10 MR. AUBRY: I think that that sets a
11 pretty decent model. It has the benefit of being
12 something that's already been kind of tested in the
13 field, and that public plan they've become
14 comfortable using as one rate for -- for valuing
15 the liability. That might be one fund where I
16 would look first trying to think about a rate.
17 REPRESENTATIVE RYAN: For your analysis,
18 the one you did for us for SERS, what rate did you
19 use there?
20 MR. AUBRY: So we used at that point, we
21 used something again, it's kind of preliminarily, 4
22 and a half.
23 REPRESENTATIVE RYAN: Okay. And that's
24 compared to the 7 percent that the SERS system is
25 currently using.

1 If I understand the legacy amortization,
2 it's a little bit more enhanced than the
3 pay-as-you-go model, and it's doing -- It's a much
4 smoother paydown.
5 From a public policy perspective, that
6 does seem like it makes much more sense to avoid a
7 shock on one particular generation versus another.
8 Do you see any secondary tertiary public
9 policy effects by doing it over a longer period of
10 time versus a shorter period of time, as we're
11 currently doing in Pennsylvania, for a state that's
12 got the demographics as Pennsylvania, being an
13 older state, and more of a rust-belt state in some
14 respects relative to our industries from the rail,
15 coal, and steel industry?
16 MR. AUBRY: Yeah. Right. So I think
17 they're actually two benefits. So you've mentioned
18 one, which is the stretching out of the payment and
19 structuring the payments such as they are kind of
20 the 6 percent of the remaining liability based on
21 the current interest rate in the marketplace. So
22 those are ideally relatively slow moving and making
23 the payments much more smoother.
24 And the other benefit I think that is of
25 separating the legacy debt, fund the pension system

1 in a very kind of clear and salient and visible way
2 is that, you can start thinking about the pension
3 system differently.
4 You could start really focusing on the
5 problems with actuarial funding, and thinking about
6 the ways you want to really incorporate the notion
7 of intergenerational risk and amortizing unfunded
8 liabilities. You can do that with kind of the
9 right portion of the unfunded liability. You can
10 really start thinking about the cost of the modern
11 pension system more clearly; specifically, the
12 benefits of current employees.
13 I think currently the way it's been
14 built, all the costs are put together and kind of
15 presented to the public as kind of a single rate.
16 And in Massachusetts, for example, you go down to
17 our financial district, we have really smart people
18 who are very knowledgeable in finance and business,
19 and they'll tell you that Massachusetts has the
20 most expensive benefits in the country. You know,
21 we have the most generous benefits in the country
22 because we have a really large unfunded liability.
23 We're point in fact.
24 The benefits our employees get are -- We
25 don't get them in COLAs. They're not covered by

1 Social Security, and their employee contributions
2 make up, like, you know, 50 percent or more of the
3 actual benefits that they're earning every period.
4 So it's actually significantly not generous, but
5 the government pays huge unfunded liability costs
6 because they're trying to pay down this 1923 to
7 1995 legacy in 20 years. And so, everyone thinks
8 that matches the employee and they're living like
9 fat cats.
10 And so, I think that's another really
11 important part of the separation. It needs to be
12 kind of very visible and salient to policymakers
13 and the public alike, in addition to kind of
14 stretching out to really have a separation.
15 REPRESENTATIVE RYAN: Mr. Aubry, thank
16 you so much. This has been so enlightening.
17 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
18 Yes. Thank you. And if you could get that
19 information on PSERS as well, we'll have staff
20 distribute that to members of the Committee.
21 Representative Schemel.
22 REPRESENTATIVE SCHEMEL: Thank you, Mr.
23 Chair.
24 So every year the state legislature,
25 when we do our budgeting, we pat ourselves on the

1 back for having met the ARC. But I'm also looking,
2 just as Representative Sanchez, at your page number
3 9 in your tutorial there which demon -- which
4 illustrates that the ARC, as we calculate it for
5 our budget allocation purposes, this is not the
6 actual cost.
7 So if we stay the course as I read this
8 and as I understand the system, we really are on a
9 collision course with just pay as you go again,
10 because we're going to run out of money even though
11 we're paying the ARC every year; is that correct.
12 MR. AUBRY: No. So, if you got that
13 impression, that's -- that's my mistake.
14 I don't think there's any system in the
15 U.S. essentially, in effect, in danger of running
16 out of money; that they continue to do the Peter
17 pay Paul thing infinitely. As long as
18 contributions are coming in, plus a modest
19 investment return, they have enough to pay benefits
20 going out. They may not better funded, but
21 (indiscernible) but growing very fast, but the risk
22 of actually exhausting assets is quite small, as
23 long as there's new active employees coming in
24 paying contributions, as well as the government
25 paying some basic level of contributions.

1 REPRESENTATIVE SCHEMEL: But, doesn't
2 that require the government's basic level of
3 contribution to increase? We know the number of
4 state employees is decreasing --
5 MR. AUBRY: No.
6 REPRESENTATIVE SCHEMEL: -- in
7 Pennsylvania, and here we have a system that's not
8 -- that's not meeting its burden in terms of the
9 unfunded liability. Our unfunded liability is
10 growing.
11 MR. AUBRY: So the rising ARC, what's
12 that -- What the rising ARC is telling you, the
13 amount of money you need to pay in order that
14 20 years from now you basically shut down the
15 system, and say, we have all the assets we need to
16 pay all the benefits we promised, so we can stop
17 now, right? That's what the ARC is telling you.
18 REPRESENTATIVE SCHEMEL: That's right.
19 MR. AUBRY: Yeah. In reality, the
20 Pension Fund is never -- I mean, for the most part,
21 they're not shutting down. There are ongoing
22 concerns. So, there's always more money coming in
23 the door to pay benefits, so you never have to
24 worry about that point where, if we're gonna shut
25 down tomorrow, will we have enough money?

1 So, the ARC is intended to eventually
2 get you to the point where, if you were to have to
3 shut down the plan tomorrow, you'd have all the
4 money you need to pay benefits, it's kind -- kind
5 of a different goal. It's a perfectly reasonable
6 goal. But what it means is that, if you don't pay
7 the ARC, it doesn't mean you're not going to have
8 enough money. It means you're not gonna have the
9 money to shut down one day, so it's very two
10 different things.
11 REPRESENTATIVE SCHEMEL: Okay. So our
12 current ARC, you calculate -- Well, you demonstrate
13 two different ARCs--the actual ARC, and the ARC as
14 calculated in 2001. We are basing our allocations
15 on the ARC as calculated in 2001. If I'm correct
16 from your testimony, that's not --
17 MR. AUBRY: Oh, oh, oh, oh, that's
18 right. That's where maybe we're getting confused.
19 REPRESENTATIVE SCHEMEL: Yeah.
20 MR. AUBRY: No. What we've done here,
21 in 2001, if you're -- what the actuary was
22 projecting at that point. So if you go back in
23 time, if you ask the actuary in the year 2001, hey,
24 what do you think the payments are going to be for
25 the next 30 years that are needed, that's what they

1 would have shown you.
2 REPRESENTATIVE SCHEMEL: Yes.
3 MR. AUBRY: So we're saying, over time,
4 each year they have to actually re-calculate to see
5 what happened, and that's the black line. And the
6 black line is kind of what is needed. That's more
7 closely to what the state did referencing when
8 thinking about what payments to make each year.
9 Of course, some of these periods didn't
10 make that payment. But my point is that, the
11 actual ARC that's required each year, that's what
12 the state is looking towards, generally, as a
13 benchmark for what it should be putting in each
14 year. My point is, that that -- that number is
15 much different each year than what an actuary would
16 have told you it would have been in 2001.
17 REPRESENTATIVE SCHEMEL: Yes, exactly.
18 Thank you, Mr. Chairman.
19 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
20 Chairman Grove.
21 REPRESENTATIVE GROVE: Thank you.
22 Since fees have been an enormous impact
23 on fund returns, in your view what are the optimum
24 fee-reporting criteria that you would advise for
25 all investors, but, in particular, for alternative

1 investments?
2 MR. AUBRY: Yeah. I don't really have
3 too much insight on the best feedback. I think
4 there are organizations that are working very hard
5 on that. I'm trying to think of 'em. Gosh.
6 And then formulas specifically focuses
7 on this for private assets. I can maybe send it to
8 the Committee afterwards if you're thinking very
9 hard about how to be more transparent about the
10 fees --
11 REPRESENTATIVE GROVE: That would be
12 great.
13 MR. AUBRY: -- for the private sector,
14 yes.
15 REPRESENTATIVE GROVE: In your
16 discussion of shifting all the unfunded legacy
17 liability to a trust fund, history -- history tends
18 to repeat itself, right?
19 MR. AUBRY: Um-hm.
20 REPRESENTATIVE GROVE: So at some point,
21 the General Assembly in the future, let's say we
22 establish -- At some point in the future the
23 General Assembly may say we're going to give a
24 benefit increase, but not necessarily fund it.
25 We've done that in the past, I think --

1 MR. AUBRY: Yeah.
2 REPRESENTATIVE GROVE: -- 2000 odd some,
3 2001 that transpired, right? So, you're basically
4 creating a new legacy liability, so to speak.
5 Would that be then shifted over, or would this
6 envision us not making those bad financial
7 decisions anymore?
8 MR. AUBRY: Yeah. Good question.
9 I think part of the -- part of what we
10 hope is kind of -- benefit against separating
11 legacy debt is that, it comes with -- you know, at
12 the center we work in (indiscernible) and we always
13 think that, you know, loosening of something should
14 come with tightening something else.
15 So, if you loosen the payment time
16 horizon for legacy liabilities from what it is
17 currently, that it should come with some other
18 things that tighten the system up, right? In our
19 mind that is kind of valuing liabilities as
20 appropriate and coming closer to the market rate,
21 that contributions should be, perhaps, based on
22 coming closer to the market interest rate. In the
23 end, investments can probably be a little more
24 risky than the market rate.
25 If you look at private sector plans

1 again, they contribute on the market rate. They
2 value on the market rate. They invest with a
3 little bit of risk, right? So they kind of -- so
4 they don't bake in the risk before they contribute.
5 But if they take on a little risk and
6 make a little more money than they've got, then
7 they can lower their cost. But they can't do it
8 before, which is what public funds do. They kind
9 of bake in the risk in their long term or assumed
10 returns, but they can low cost now. But private
11 plans basically pay, based on market rates, take a
12 little risk with the contributions. And if the
13 risk pans out, in the next period they have to pay
14 a little less. So it's kind of, they work it the
15 other way around.
16 So we envision that if you were to kind
17 of separate the legacy debt that if you would
18 tighten up the public system so that, if you were
19 to do retroactive benefit increases, that would
20 look a lot different on the balance sheet when
21 you're valuing liabilities correctly. It would
22 look a lot different on the part of the
23 contributions when you're valuing benefits
24 correctly.
25 So, those kind of practices just take a

1 little bit more thought, I think, from most policy
2 makers before they went and did 'em, just because
3 of the way the system is now valued using kind of
4 more appropriate interest rates.
5 REPRESENTATIVE GROVE: Gotcha. So your
6 legacy debt would be a harden debt, basically, and
7 you would then use basically whatever the market
8 rate is to put into that for investments. You
9 would use -- kind of current investing.
10 So you take your investment pot of
11 money. Whatever that legacy is, you put that money
12 in there. It stays in that trust fund, and then
13 for your actual payments to employees moving
14 forward, you can get a little more riskier in that
15 for higher rates and have probably less risk
16 exposure, because it's a smaller kind of portion of
17 money you're putting out there?
18 MR. AUBRY: Yeah, that's one way to do
19 it. The other -- the other -- the way we had
20 thought about it was really that the legacy --
21 paying down the legacy portion would kind of be
22 pay-as-you-go practice. It's not perfect; not
23 quite that. You have to keep all the assets.
24 We kind of discussed this with other
25 pension funds kind of informally and really taking

1 half of this out of a trust is very difficult. It
2 often creates a lot of anxiety for, rightly so, I
3 think for plan members, right?
4 REPRESENTATIVE GROVE: Right.
5 MR. AUBRY: So the notion would be that
6 the legacy trust fund would start out with zero
7 assets, and that the states would be required --
8 Since we have a liability, the state would be
9 required to basically put a nominal amount of money
10 into that trust fund that is equal to the interest
11 on the liability, essentially, and that money would
12 immediately go to pay benefits to people.
13 REPRESENTATIVE GROVE: Okay.
14 MR. AUBRY: The existing trust fund --
15 Everything is valued at market rate. Liability --
16 Legacy Trust Fund, market rate, the liability
17 Pension Trust Fund market rates. The contribution
18 of the Legacy Fund is, again, market interest rate
19 on the market value liability. The contribution of
20 the Pension Fund is the normal cost on market
21 interest rates and amortization based on market
22 interest rates of the pension system.
23 The real mitigation comes from the fact
24 that you are stretching out payments for the
25 legacy. Also the fact that everything is now at

1 higher levels to value the market interest rate.
2 REPRESENTATIVE GROVE: Gotcha. Thank
3 you.
4 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
5 Representative Keefer.
6 REPRESENTATIVE KEEFER: Thank you, Mr.
7 Chairman.
8 I'm trying to understand how -- So the
9 ARCs that you have, we had a statutory language
10 where we had -- that expired, but it actually -- in
11 practice it expires, but it's still there in the
12 code is for the contribution collars. Is that
13 factored into all of your graphs and charts you
14 have because, technically, those are artifically
15 suppressed ARCs that we have had for at least five
16 years?
17 MR. AUBRY: Yeah. That's a good
18 question. I don't think we have incorporated the
19 collars. I think we have the kind of full,
20 pre-collared required contribution from the
21 actuary.
22 REPRESENTATIVE KEEFER: Okay. And the
23 practice of having -- Does any other states have
24 something like that in place that you're aware of?
25 MR. AUBRY: Not -- Not that I'm aware

1 of. I kind of remember, again, historically,
2 Maryland having something like this, but I think
3 they kind of did away with it. That's the one that
4 comes to mind, but I don't --
5 Again, I know -- I think somebody
6 brought this up during NASRA's presentation. I
7 think they are kind of the gold standards for
8 tracking provisions like this. So, I would turn to
9 them to see if they might have something in the
10 past where they have done something on collars.
11 REPRESENTATIVE KEEFER: Okay. But what
12 you have drafted out for us is taking the true, the
13 actual ARC; not the --
14 MR. AUBRY: You're right.
15 REPRESENTATIVE KEEFER: Okay.
16 (Cross-talk).
17 REPRESENTATIVE KEEFER: Thank you.
18 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
19 Mr. Aubry, just a question to follow up in closing.
20 Your presentation on legacy debt
21 basically, you know, detailing the one-third of the
22 liability is essentially a legacy debt of people
23 who are no longer there that the current folks are
24 paying for is a substantial issue that we need to
25 factor and I think the public needs to understand.

1 Are there any states right now that are
2 doing something like what you described, of
3 addressing the legacy trust and a pension trust
4 situation like you've outlined?
5 MR. AUBRY: No. We're kind of -- We --
6 Again, this is an idea that we are working through
7 at the CR in kind of real time. We have a kind of
8 series that we are doing for six states that are
9 some of the worst funded in the country.
10 Pennsylvania is among them. I think also
11 Massachusetts, our home state, Ohio, Rhode Island.
12 Most of them are actually in the
13 northeast because that's where many of the oldest
14 pension systems are. So we are trying to look at
15 each of these states to get a sense of how the
16 unfunded liability -- how affected the unfunded
17 liability is and legacy liability is.
18 And so, I think once we release all
19 these reports, that may change. I'm presuming
20 we'll probably get a few calls to learn more. But
21 as of right now, this idea is not really out there.
22 Your group is, you know, one of the very first to
23 see some of our preliminary work.
24 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
25 I think I know the answer to this question, but I'm

1 going to ask it anyway.
2 We, from time to time, get requests for
3 benefit enhancements. And that, of course, in
4 light of the fact that Pennsylvania is under
5 60 percent funded and the cost that go with that,
6 what would your thoughts be on Pennsylvania
7 prepaying -- requiring a prepayment of whatever
8 future enhancements are requested? What would your
9 thoughts be on that?
10 MR. AUBRY: Yes, this is tricky, because
11 that -- That's essentially what a lot of states did
12 in 2001, and late the '90s and early 2000s. Not
13 just SERS, they were over-funded so they provided
14 benefit enhancements which were essentially prepaid
15 with the assets that were in the trust. So, they
16 are 120 percent funded. They get benefit
17 enhancements. Now they're just 100 percent funded,
18 and we still ended up where we are today.
19 So, I think a lot of it has to do,
20 again, with the predicted cost of enhancements and
21 trying to bake that in beforehand is risky in the
22 sense that there's incentives to under represent
23 the cost. I think that's what's been a challenge
24 for public pensions.
25 So, again, I think one -- one aspect of

1 this approach that I think is important is that,
2 we're not saying that pension funds can't invest in
3 risky assets, can't take risk in their present
4 portfolio, but they can't bake those gains into
5 their -- before they occur.
6 The private sector, again, they use
7 something closer to market rates to calculate
8 contributions. And then they say, okay, we're
9 gonna take those contributions out, put in and
10 invest them in some risky assets, and any gains
11 that we get will offset our subsequent
12 contributions after we've realized those gains; not
13 beforehand.
14 So, I would think the challenge benefit
15 enhancement, again, I would be -- I would think
16 they'd have to be prepaid, but I would also have
17 them prepaid in an environment for the interest
18 rates being used is much closer to a market
19 interest rate.
20 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
21 Yeah. I would add, too, you said after we achieve
22 those investment expectations is, if we achieve
23 those investment expectations as well --
24 MR. AUBRY: Right.
25 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:

1 -- which is one of the uncontrollable factors that
2 we need to consider which is why using, in your
3 example, 4.5 percent, something like that is much
4 more reasonable in that regard.
5 MR. AUBRY: Yeah.
6 So in talking about private sector
7 plans, I kind of thought about -- we asked private
8 sector plans about fishy (phonetic) legacy cost,
9 and they don't have much of a legacy debt because
10 most plans were started much later when actuarial
11 pre-funding -- in the private sector when actuarial
12 pre-funding was already kind of in vogue. They
13 were also incentivized by the pre-fund because of
14 tax advantages.
15 If they put their money in the Pension
16 Fund they were not taxed by the government. So,
17 lots of private sector pension funds were better
18 off, better funded even at the outset than public
19 plans. So, they don't only have a legacy debt
20 issue.
21 But when we talked to them about
22 investments, because they use such a low interest
23 rate for value liabilities, for calculating
24 contributions, the kind of threshold they have to
25 overcome in terms of having gains is much easier to

1 hit. So they argue that, you know, um -- There's
2 not much concern from their end from the investment
3 professionals that they can't get gains above their
4 market interest rate that will subsequently lower
5 the contributions going forward in future periods.
6 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
7 Well, Mr. Aubry, I want to thank you so
8 much for being with us here today. You have given
9 us a lot to think about. This is very, very
10 valuable information.
11 We look forward to getting -- I think
12 the one thing you'll provide is the PSERS analysis
13 as well. We look forward getting that, too,
14 because we want to see our pension system as strong
15 as possible. We'll take this legacy liability
16 information you've given us to heart.
17 So, thank you very much for your time
18 and presentation today.
19 MR. AUBRY: Sounds great. I'll be happy
20 to send along the PSERS information along to whom,
21 I guess is the question.
22 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
23 Michaele Totino will be in contact. We have your
24 contact information as well. If we have further
25 questions, we'll be in contact.

1 MR. AUBRY: Absolutely. Sounds great.
2 Thank you again.
3 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
4 Thank you so much.
5 Okay. At this point we will transition
6 to our next panelist.
7 Before we do that, I would like to
8 recognize that in the room here today we have
9 Senator Katie Muth of the 44th Senatorial District
10 representing Berks, Chester, and Montgomery County.
11 We appreciate you coming along. As far as the
12 people up here are concerned, this is the most
13 exciting place to be in Harrisburg right now. So
14 we're glad you're here.
15 With that, we'll transition to our next
16 panelist, which is the Honorable Secretary Richard
17 Vague, Pennsylvania Department of Banking and
18 Securities. I'll give you a minute here to get
19 situated before we have you sworn in.
20 (Pause).
21 SECRETARY VAGUE: Greetings, everyone.
22 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
23 Okay. Secretary Vague, thank you so much for being
24 here today. I'll swear you in.
25 (Testifier was sworn in by Majority

1 Chairman Miller).
2 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
3 Thank you, sir. The floor is yours.
4 SECRETARY VAGUE: Thank you. And good
5 afternoon, Chairmen Miller and Sanchez, and the
6 members of the Subcommittee on Public Pensions,
7 Benefits, and Risk Management.
8 I'd like to say a special thanks to
9 Representative Ryan for all of the leadership he
10 has provided on pension matters. And I would also
11 like to give a special thanks to Chairman of the
12 State Government Committee, Seth Grove. Thank you,
13 sir.
14 I'm grateful for the opportunity to
15 appear before you today. With my service as
16 Secretary of Banking and Securities for
17 Pennsylvania, I have, frankly, the privilege of
18 serving on the board of directors for the
19 Commonwealth's two largest pension funds known as
20 SERS and PSERS. To me these two funds are sacred
21 promises and trusts to school teachers, police and
22 other employees of the Commonwealth, the very
23 people I consider to be among our most cherished
24 citizens.
25 My hope is that my background has

1 prepared me to be worthy of the responsibility that
2 I have been entrusted with. I served for over
3 30 years as a founder, executive, and CEO of two
4 large banks whose reach extended to the four
5 corners of our nation. After my departure in 2008
6 from the banking industry, I had the privilege of
7 founding and serving as CEO of an energy company
8 and also as managing partner of a venture capital
9 firm investing in Pennsylvania's entrepreneurs.
10 Beyond these, I have dedicated almost
11 15 years to the systematic analysis of private and
12 public sector debt, both in the United States and
13 globally, and have published a book on the subject
14 of predicting and preventing financial crises, a
15 second book on the 200-year history of global
16 financial crises, and more recently, a general
17 business history of the United States.
18 I have served on a number of corporate
19 institutional and nonprofit boards, including the
20 board of the University of Pennsylvania, and have
21 extensive experience in the fiduciary
22 responsibilities and issues that face boards.
23 On the matter of public pensions, the
24 management of our Commonwealth's pension funds has
25 consequence for all of its citizens, as you well

1 know. Should the performance of these funds be
2 lacking, it can then fall to all citizens of the
3 Commonwealth to make up the difference; and thus,
4 can divert funds that could otherwise be spent on
5 schools, roads, and our Commonwealth's other key
6 needs. Because of this, in my public pension board
7 service, I have paid particular attention to the
8 issues of transparency and costs, along with the
9 all important issues of performance and an
10 appropriately-balanced investment asset allocation,
11 an appropriate balance of complexity versus risk,
12 and a concern regarding the overall risk inherit in
13 the national and global investment environment.
14 So again, let me thank you for giving me
15 the opportunity to appear here today and for the
16 privilege of serving the Commonwealth.
17 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
18 Thank you, Secretary. We appreciate you taking the
19 time to be here with us today to share your
20 professional experience and knowledge to help us as
21 we look at our state's pension funds.
22 I would like to begin, if I could. In
23 doing my preparation for this meeting, I took a
24 look at the Pennsylvania banking website and noted
25 the various things that your staff offers, and I

1 encourage folks who are tuning in to take a look at
2 that website.
3 One of the things I noticed was that you
4 offer various -- your staff offers various
5 educational seminars, and two of those caught my
6 attention; how to hire an investment professional
7 and how to choose an investment fund.
8 As you know, essentially, that's what
9 the pension system is all about, hiring
10 professional managers and how to choose investment
11 funds. I'd like your take on one of the key
12 elements that you think are important when
13 Pennsylvania -- when we look at hiring investment
14 fund managers and investment professionals?
15 SECRETARY VAGUE: Well, that's a great
16 question, and thank you. And thank you for
17 acknowledging the services offered by the
18 department.
19 If I may, we offer a set of educational
20 services to military and retired military
21 personnel, to incarcerated individuals as they're
22 emerging from those institutions, to students, to
23 senior citizens, and it's one of the great
24 privileges and great joys that I have in the
25 department to see that kind of training, because it

1 is truly changing lives for folks that have those
2 sorts of needs.
3 Now, relative to the issue of the 60 to
4 70 billion dollar PSERS and 30 to 40 million dollar
5 SERS funds, selecting an investment manager is of
6 incredible importance. And I think because of our
7 size, we have the luxury of choosing from among the
8 best managers out there.
9 I would say something that you already
10 know well, but at the risk of being repetitive, I
11 would say that there's a couple decisions that
12 stand in front of the line ahead of selecting
13 managers, and one of those is deciding on the
14 allocation to begin with. How much should we put
15 in public equities? How much should we put in
16 government bonds? How much should we put in other
17 types of investments?
18 And I would say to you something that
19 this Committee, with its sophistication knows well,
20 and that is, the decision that you make about the
21 allocation has the biggest impact on the ultimate
22 results of the fund, much more significant, I
23 believe, than the selection of managers.
24 The next thing that I would say to you,
25 and again, this Committee with the incredible job

1 that it does already knows this, is that, there's a
2 decision to be made about how much of the fund
3 after that allocation has been made to be in effect
4 passively managed, where there aren't managers
5 actively managing the investment assets and
6 charging the fees that this Committee knows well
7 come along with that active management.
8 So, a lot of funds will put a
9 substantial amount of their pension investments in
10 that sort of a passive structure, if I might use
11 that language, where fees are very low.
12 Then you come to the question that you
13 asked, and that is, for that portion that you
14 decided to have an active manager, how do you go
15 about that? And it is things like the size and
16 strength of that manager, the track record of that
17 manager, the reputation of that manager, an
18 examination of the type of assets that -- the
19 investments that manager has made. I think in our
20 situation, because of our size, we get to pick from
21 among the very best, and are in a position to have
22 the best of the "bestest" of the Commonwealth's
23 managers.
24 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
25 I'll hold my questions for later. I know

1 Representative Ryan is waiting to grill you, sir.
2 SECRETARY VAGUE: If he gets out of
3 control, can you --
4 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
5 I've got the gavel. I can take care of that.
6 REPRESENTATIVE RYAN: Mr. Secretary, I
7 have to say, we're honored in Pennsylvania to have
8 someone of your stature, character, and integrity
9 as Secretary of Banking. And I'm honored to call
10 you a friend. To be honest with you, I've had
11 tremendous respect and have served with you now on
12 the PSERS board for a while. So thank you very
13 much.
14 And I'm always saying this by way of
15 full disclosure, I have to say that I'm speaking
16 here as a legislator and not as a member of the
17 PSERS board, as I know you're speaking as Secretary
18 of Banking.
19 When you look at the overall fund
20 management and asset allocations, and the fact that
21 we're kind of in an unusual period of time relative
22 to monetary policy and monetary history in the
23 United States and, candidly, globally, are you
24 concerned, as you would to an extent, to a number
25 of issues on debt -- And I've got your book here,

1 it's absolutely tremendous.
2 Are you concerned about the debt levels
3 that exist? Are you seeing any risk factors, let's
4 say, for us in the legislature, we ought to be
5 particularly concerned about relative to tail risk
6 and things of that nature?
7 SECRETARY VAGUE: Yes, and thank you for
8 that question. And thank you for the gracious and
9 undesired compliment that you gave me. It's really
10 my privilege to serve the Commonwealth and an
11 honor.
12 Yes, I look personally, and I have many
13 colleagues that look, as I do, at the amount of
14 debt in the system. I think there's two things you
15 can look for when you look at debt. One is just
16 all the debt across all of the categories; so
17 mortgage debt, commercial real estate debt, private
18 equity debt, commercial real estate debt. All that
19 debt added together, and then add on top of that
20 government debt.
21 And we are, indeed, at relatively high
22 level -- very high levels relative to history. So,
23 kind of being at the top of the range would cause
24 you to be more vigilant than you would otherwise.
25 And that's something that I personally track very,

1 very carefully.
2 But, within that there's debt that's
3 specifically related to equities and, in
4 particular, I would look at margin debt. And I
5 would also look at something that I, frankly,
6 equate to debt, and that's derivatives based off
7 debt and other derivatives. And we see that
8 equity-linked derivatives right now are at
9 absolutely the highest level they have ever been,
10 and not just by a little bit.
11 So, there two things, coupled with kind
12 of a more straightforward analysis, which is stock
13 market capitalization divided by GDP is this kind
14 of an ordinary way of looking at evaluations. If I
15 look at those three things, it would cause me to be
16 more prudent than I would be otherwise.
17 REPRESENTATIVE RYAN: Should someone
18 take from that that you would say that alternative
19 investments and a longer-term investment might be a
20 challenge or equities would be or real estate?
21 What's your perspective to take-away from those
22 fact patterns, which I happen to agree with you on,
23 by the way?
24 SECRETARY VAGUE: I frankly think it
25 means that you should be cautious relative to all

1 of them.
2 The private investments, ones that are
3 more illiquid and have greater fees associated with
4 them, I personally would be even a little more
5 cautious around those at a time like this, but I
6 think it's a period to be vigilant, really period.
7 REPRESENTATIVE RYAN: We've heard
8 studies throughout the history that, if you go back
9 to the 1950s and 1960s, that a normal asset
10 allocation, 60 percent equity, 40 percent bond to
11 (indiscernible) was a prudent investment.
12 Is that something that we should be
13 concerned about in light of what you just said
14 relative to debt levels and overall monetary policy
15 and implications that could have to an investment
16 portfolio allocation?
17 SECRETARY VAGUE: Well, you've gone
18 right to the heart of the matter. There's no
19 debate that's more animated about which there is
20 greater differences in opinion as asset allocation.
21 I think there's still a lot of merit in
22 the old 60/40. There has been a lot of new
23 innovations in investing that allow you to
24 diversify beyond just those two categories. I
25 think a lot of them have merit, real estate being a

1 great example of one that you and I have discussed.
2 So, I think there's more diversification
3 than 60/40 that's appropriate today relative to
4 simpler times than several decades ago, and I think
5 we ought to take them seriously. Again, I would
6 say it's a time -- unfortunately, it's a time when,
7 in my view, that we ought to be more cautious
8 across the board and where we're facing, I think, a
9 general consensus that returns are going to be
10 somewhat lower going forward. So, caution is not a
11 bad thing.
12 And, by the way, one other thing I'd
13 say, and this is really interesting here. A lot of
14 the folks that stand the ongoing investment
15 inequities say you shouldn't -- you can focus too
16 much on timing; that the folks that really win are
17 the folks that get just in and stay in over time.
18 And we have actually saw that after the great
19 financial crisis, which folks saw the big dip in
20 equities and rushed to get into alternative
21 investments when, in reality, if you go back and
22 reconstruct it, staying in equities would have been
23 the right decision and, in fact, was the right
24 decision.
25 REPRESENTATIVE RYAN: Does some of that

1 decision based upon the financial strength of the
2 Commonwealth's ability to continue making payments
3 during an economic downturn, though?
4 SECRETARY VAGUE: There is no question
5 and you've hit the nail on head, that understanding
6 the liquidity of the portfolio relative to the
7 annual ongoing pay-out needs has to be very central
8 to the way we structure the asset allocation.
9 REPRESENTATIVE RYAN: Mr. Chairman,
10 that's my last question. I have to say, I'm so
11 thankful you're on our team.
12 SECRETARY VAGUE: Well, thank you. I
13 feel likewise.
14 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
15 Representative Keefer.
16 REPRESENTATIVE KEEFER: Thank you,
17 Mr. Chairman.
18 Mr. Secretary, two questions here. One
19 is, could you quantify what the true financial
20 impacts of that Act 120, the contribution collars,
21 what they had on the SERS and PSERS funds?
22 SECRETARY VAGUE: Well, I apologize to
23 you, but I do not have that data with me and can't
24 quantify it for you. I would be happy to get that
25 information for you and bring it to you after the

1 fact.
2 REPRESENTATIVE KEEFER: Your opinion of
3 that kind of a policy?
4 SECRETARY VAGUE: The synthetic policies
5 that have high fees associated with them are ones
6 I'm a little cautious about. I think a lot of
7 times things, like, you know -- I hate to --
8 perhaps, I shouldn't phrase it this way, but I
9 think Wall Street makes its money from complexity.
10 You know, over the course of my 40 years
11 in this business, I've seen Wall Street regularly
12 come forward with complexity and fees associated
13 with that. Sometimes it's helpful, sometimes it's
14 not as helpful. I always bring a touch of cynicism
15 to those kind of strategies and like to think
16 through very carefully, and only do the amount that
17 I think is prudent.
18 REPRESENTATIVE KEEFER: So, on that same
19 thought process as far as synthetic collars, and
20 things like that, just for matter of public record,
21 could you speak to the direct financial impact of
22 lowering the rate of return assumptions?
23 SECRETARY VAGUE: Well, this I know is
24 one of the most visible things that happens in the
25 Commonwealth, is, if you lower the return

1 assumption, that means that the state has to
2 increase its contribution. And it gets back to the
3 very dilemma that I referenced briefly in my
4 opening comments, which is that, to the extent
5 returns go down and we have to pay more from the
6 state, that effectively it means we have less
7 resources to spend on other important things.
8 REPRESENTATIVE KEEFER: Thank you.
9 Thank you, Mr. Chairman.
10 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
11 Representative Grove.
12 REPRESENTATIVE GROVE: Thank you.
13 Thank you, Sec, yeah, Secretary Vague.
14 Thank you so much for coming here.
15 I asked the previous testifier about
16 ERISA. And you having some private sector
17 experience, I assume that you probably had to
18 manage or discuss private pensions for employees
19 underneath your purview at that.
20 How would you say your ERISA plans under
21 the private sector compared to public sector, do
22 you think there's possibility of driving more
23 policy at the state level and applying those ERISA
24 policies? What do you think the impact of that
25 would be for the Commonwealth?

1 SECRETARY VAGUE: You know, you bring up
2 a very important point. ERISA effectively
3 increased the flexibility that corporations had in,
4 perhaps, not making as much of a contribution in
5 the years they should have and computations around
6 that. To me that was a very healthy thing. And
7 states and local governments have more flexibility,
8 and I think in some cases the result has been that
9 they haven't -- they've been available to avoid
10 stepping up from time to time in a way that would
11 be required under ERISA.
12 So, I like having more stringent
13 requirements, and I do think that there's anything
14 we can do at the state and local government level,
15 not just in the Commonwealth, but broadly, that
16 make sure we step up as we should for our
17 pensioners I think is a healthy thing.
18 REPRESENTATIVE GROVE: And then, I also
19 asked about Sarbanes-Oxley and those governance
20 requirements from the federal and corporate boards.
21 Do you think some of those -- When I asked that,
22 Frank looked over, we have some of those on PSERS.
23 But how much of those structures on
24 governance has been implemented within the pension
25 systems? What more could we do, and from your --

1 And I don't know if it's your -- In the private
2 sector when that came in it had to do with those
3 requirements, what more could we do aligning with
4 those requirements to bring more governance
5 structure to the pension funds?
6 SECRETARY VAGUE: I was absolutely in
7 the private sector when Sarbanes-Oxley came about.
8 That was pursuant, I believe, to Enron and Worldcom
9 and '02, '03. I think I still have a lot of scars
10 on my back for implementing Sarbanes-Oxley after it
11 came into play, because Sarbanes-Oxley was a really
12 comprehensive, really in-depth set of requirements
13 on the institution I was at and others.
14 And I, frankly, felt like there was some
15 components of Sarbanes-Oxley that weren't that
16 necessary. But I think there was a lot of
17 Sarbanes-Oxley that was absolutely necessary. And
18 I am personally a believer in very high stringent
19 standards on internal audit; on audit generally. I
20 felt that way as a CEO because I wanted to stay out
21 of trouble, you know. I felt like the more we
22 tried to do as a company, the more important it was
23 to have really stringent comprehensive audit
24 standards. That helped me sleep at night.
25 My only observation is that, in the

1 parts of the state I'm involved in, there's
2 progress being made on those measures.
3 Representative Ryan is the champion of those. We
4 have a little contest in our meetings. We get --
5 We score points the more times we take a tally of
6 when Frank mentions Sarbanes-Oxley, so -- But I
7 think -- I tease him. That's a very -- actually, a
8 very healthy thing.
9 So, I think there's a lot of progress
10 that needs to be made. And I think it's
11 fundamentally and a very, very healthy thing.
12 REPRESENTATIVE GROVE: And kind of last
13 question. You know, we implemented an optional DC
14 plan several years ago. How does the benefit
15 structure of that compared to private sector? I
16 think our employer rate is 3.5 percent. Is it
17 attracting individuals? Is it too low? What's
18 your kind of thought process with that?
19 SECRETARY VAGUE: Yeah, the -- I think
20 providing more options to pensioners is a positive.
21 I was pleased to see a modest introduction of
22 defined contribution plans. I think, as I
23 understand it, and I happen to be involved in the
24 direct Defined Contribution Committee within one of
25 the pension funds that I serve on the board of,

1 it's almost like there's an element of getting to
2 know it, becoming familiar with it that's going on.
3 Not just among the pensioners, but among the staff
4 of the pension.
5 So, if I were to speculate, I would say
6 that more of that will come, and that there's
7 opportunity, perhaps, to do some element more. So
8 I'll like seeing it there.
9 REPRESENTATIVE GROVE: Thank you so
10 much.
11 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
12 Representative Schemel.
13 REPRESENTATION SCHEMEL: Thank you,
14 Mr. Chair.
15 It's good to see you in person,
16 Secretary Vague. I served on the SERS board for a
17 very short period of time, but our interactions
18 have all been virtual, so... As you can see, I look
19 much better in person.
20 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
21 Seems to me you're out of order.
22 REPRESENTATIVE SCHEMEL: Way, way out of
23 order.
24 With regard to the assumed rate of
25 return, so I think -- I think those of us in the

1 legislature are probably the most optimistic people
2 in the state when it comes to allocations and
3 making our pension contributions every year to the
4 ARC.
5 We always have an optimistic view of how
6 the market will perform and don't want to see --
7 I'm talking about collectively as a legislature;
8 not individually, changes the assumed rate of
9 return because that could increase the amount that
10 we have to allocate.
11 However, don't you also believe, though,
12 by not making adjustments, the assumed rate of
13 return, when the data would support that, that it
14 forces our pension systems to make increasingly
15 riskier for investments, especially in the
16 alternative investment market?
17 SECRETARY VAGUE: First of all, I'd like
18 to say, Representative, that you represent the
19 sartorial high bar for our Committee and we're
20 grateful to you. That's a compliment, by the way.
21 But, and it is great to see you in person. And I
22 would also like to say how much I value your
23 leadership on the SERS board and how grateful I am
24 for your participation there.
25 Yes, there is absolutely no question.

1 If you -- If you look, if you step back and look at
2 the entire nation, not just the Commonwealth of
3 Pennsylvania, but all states and cities, we have an
4 intense pressure that involves being underfunded to
5 begin with, and that's not just here. That's
6 everywhere. And the macro environment for all
7 investments globally, return rates coming down.
8 When I got into banking, the interest
9 rates were 21 percent, and now they're near zero.
10 Well, it's by definition harder to achieve a 6 or 7
11 or 8 percent return. And the thing pulling that
12 down, if you want to be more reflective of what a
13 more realistic return ought to be, without question
14 it causes you to examine more investments that have
15 bigger complexity and risk. That's a pressure I
16 don't see going away. And it's about as difficult
17 to navigate a thing as I can imagine.
18 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
19 Mr. Secretary, you have been involved a
20 lot in the private sector, as you've outlined.
21 What is your view about nondisclosure agreements,
22 particularly as it relates to our public pensions?
23 SECRETARY VAGUE: Well, I'm a huge
24 believer in transparency. You know, I can't speak
25 to a specific non-disclosure agreement that you

1 might be thinking of in this question.
2 But I would say, generally, to use a
3 word I've already used a few times here this
4 afternoon, it's a fundamentally healthier thing to
5 have more disclosure and have more transparency.
6 And we see that relative to fees around alternative
7 investments.
8 I've been on both sides of the table
9 there. I know that part and parcel of what's done
10 in those kinds of investments is a lot of fees at a
11 lot of levels that might or might not be that easy
12 to get your arms around.
13 So, I feel transparency is great.
14 Disclosure is important. And I don't just feel
15 that way about the Commonwealth of Pennsylvania,
16 our pension funds. I feel that way about all
17 financial -- the entire financial world, more
18 disclosure from banks and insurance companies. The
19 more we know, the better we're going to be able to
20 predict our economic future, and the better we're
21 going to be able to manage our existing assets.
22 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
23 Okay. You had referenced this a little
24 bit earlier in your conversation with
25 Representative Ryan about active versus passive.

1 And then you referenced about 60/40, the good old
2 standard 60/40 percent investment levels.
3 Do you have a thought or opinion of what
4 percentage of the funds should be actively invested
5 versus passive?
6 SECRETARY VAGUE: I can't give you a
7 number, because it depends on a lot on the specific
8 circumstances of a pension fund. But I would say,
9 generally, my view is, it ought to be on the low
10 end of what's done across the public pension
11 industry.
12 We have a peer group of, I would say,
13 almost 30 pension funds that are similar to our
14 largest pension funds that we kind of get to check
15 ourselves against. And some of those funds are at
16 the very high end of what's done that is what some
17 call alternative investments or more liquid
18 investments.
19 My own personal belief is, somewhere in
20 the middle to lower end of the range is more
21 appropriate.
22 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
23 Okay. There's been a lot of discussion
24 through the past couple years, particularly with
25 the Public Pension Management and Asset Investment

1 Review Commission talking about alternative
2 investments and the fees associated with them.
3 Percentage of portfolio, I think prior
4 to you arriving, one individual referenced that
5 across the nation approximate alternative
6 investment portfolio was around 20 percent. Do you
7 have a sense about what would be a good number for
8 the Pennsylvania's systems and alternative
9 investments, given the fact that they're obviously
10 much riskier?
11 SECRETARY VAGUE: I don't have a number
12 for you. I can tell you that that's something that
13 is very actively discussed within the two pensions
14 that I'm involved in. And you wouldn't come to the
15 exact same conclusion in different funds because of
16 different liquidity profiles and the like.
17 But, you know, I would repeat what I
18 said earlier, which is, I believe that we ought to
19 be towards the middle or lower end of that range.
20 And I think that investment managers that charge
21 those kinds of fees, you know, ought to be
22 exceptional for us to be willing to pay those kinds
23 of fees.
24 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
25 I did appreciate your comments about

1 having a lot of transparency, and one of the -- the
2 very first question I asked was relative to, how do
3 you choose an investment manager. One of the
4 things you referenced there was about looking at
5 the track record of that person before you would
6 invest, or that institution rather.
7 For me, transparency is a key component
8 of what we, as policy makers, should be looking at
9 because these are, after all, public dollars. So,
10 if you could expound a little bit more about your
11 thoughts about transparency related to fees,
12 transparency related to any issues related to that?
13 SECRETARY VAGUE: Yeah. Well, I hear
14 you make a terrific point, and I should have
15 mentioned that when I was answering earlier.
16 Yeah, I think part of our view of a
17 manager should be around the willingness of that
18 manager to be transparent. They should be
19 confident enough in what they're doing in their fee
20 structure to do that, and they ought to be willing
21 to give us a complete look so that we can make a
22 determination as to whether we agree with their
23 philosophy in investing, the kind of investments
24 they make. So I think it's well said, and I fully
25 agree.

1 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
2 We are, obviously, looking at developing
3 the best possible policies and legislation moving
4 forward and are very much appreciative of your time
5 and expertise. We have your phone number. Frank
6 is distributing that to everyone to make sure that
7 we contact you at all hours of the day and night,
8 if necessary.
9 SECRETARY VAGUE: Well, please let me
10 say that I'm grateful to each and every one of you
11 for your service. And it's an honor to be here and
12 an honor to be associated with you. And I would be
13 delighted to take any call at any time. If the
14 question is too tough, I'm just going to refer it
15 to Frank anyway.
16 MAJORITY SUBCOMMITTEE CHAIRMAN MILLER:
17 As you should, right? Very much so.
18 Well, thank you again for your
19 testimony. And I'd like to thank all the members
20 for their participation today, and good questions.
21 We will have a follow-up hearing tomorrow, our
22 second day of hearing.
23 And I will note that one of the issues
24 related to all of our testifiers is, they provided
25 testimony. Two groups that have not provided

1 testimony -- or have provided testimony that are
2 not testifying are, PSERS will be providing
3 testimony as well as the Pennsylvania American
4 Federation of Teachers. They have provided
5 testimony as well, and all of that is available to
6 anyone who would like to see it.
7 So, with that, we will begin tomorrow at
8 10 a.m., for a second day of hearing, and this
9 meeting is now adjourned. Thank you.
10 (At 3:48 p.m., the hearing concluded).
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1 C E R T I F I C A T E

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