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Thank you for the opportunity to submit testimony on Pew's research regarding Pennsylvania public pensions at today's Public Pension System Trends and Policy Considerations hearing. By way of background, The Pew Charitable Trusts is a non-profit research and policy organization committed to informing the public and improving public policy with non-partisan, rigorous, fact-based research. Pew supports over 40 projects in the field of government performance, covering a diverse set of issues ranging from public safety concerns to the effectiveness of state tax incentives to the fiscal health of public pensions.

The Public Sector Retirement Systems project produces 50-state research and provides technical assistance to policymakers in states and cities to make public retirement systems more sustainable and secure. We approach our work with a clear understanding that there is no one-size-fits-all solution and endeavor to provide objective, data-driven analysis tailored to the specific circumstances in each jurisdiction where we work.

Our testimony today will review the significant progress the state has made in addressing unfunded pension liabilities over the past decade; the scope and impact of recent reforms; and our assessment of further opportunities to implement best practices identified in our research around pension investment transparency and reporting.

Pennsylvania serves as both a cautionary tale as well as a turnaround story in terms of pension management. With the primary state and teacher plans fully funded in 2000, thanks partly to strong investment returns in the late 1990s, sound pension policy paired with fiscal discipline could have allowed Pennsylvania to maintain fully funded retiree pension plans at a manageable cost. Instead, policymakers approved one of the largest retroactive unfunded benefit increases underfunded promised benefits. The resulting $80 billion swing from a $20 billion surplus to a $60 billion deficit over 15 years was among the largest recorded by any state.

By 2010, it was clear that Pennsylvania was facing a substantial pension challenge, similar to other states, including Kentucky and New Jersey. Contributions towards the Pennsylvania State Employees Retirement System (SERS) and the Pennsylvania School Employees' Retirement System (PSERS) were less than half of the actuarially recommended amount, placing the state 49^{th} among states in fiscal discipline. And from 2003, the last year in which the Commonwealth reported its pensions as fully funded, to 2010, the funding gap rose to $27 billion.

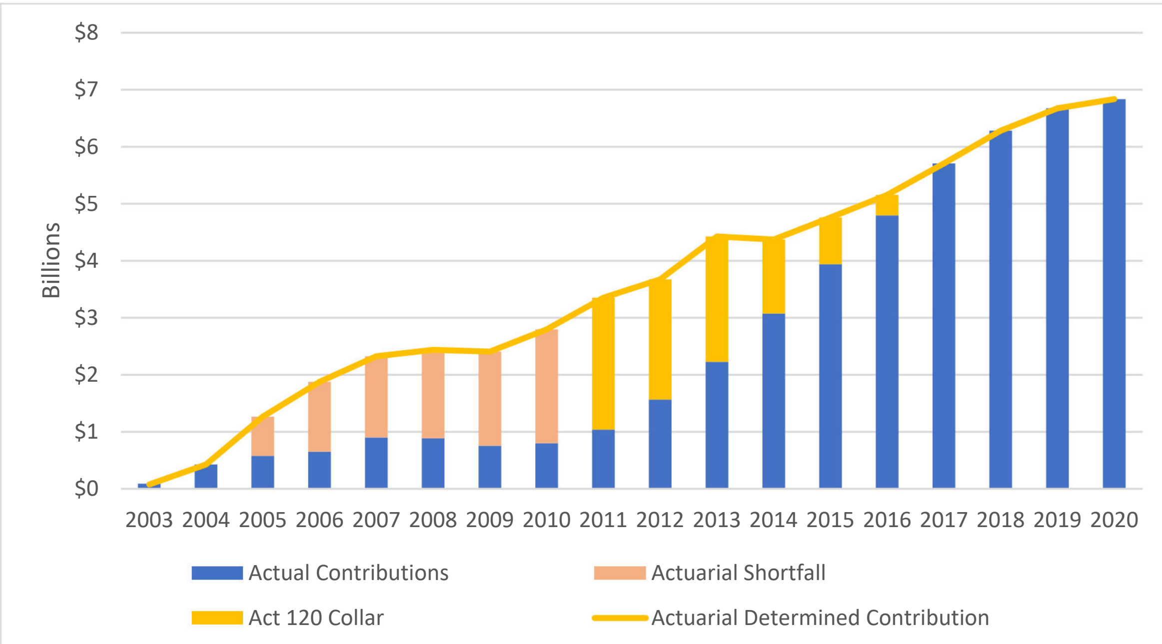
Act 120- 2010

Knowing that current funding levels were insufficient to pay for promised benefits adequately and that the previous benefit enhancements were unsustainable given existing funding levels, legislators enacted Act 120. This legislation set a slow but steady ramp-up to making the full employer pension payments and created a benefit tier for new hires only that reversed the benefit enhancements from the early 2000s.

The contribution ramp-up from 2010 to 2017 increased annual payments from less than $1 billion to over $6 billion. However, during this time, reported unfunded liabilities continued to rise to $65 billion, with funding levels falling to 58% funded. As a result, it was only starting in 2018 - when the payment reached 100% of the annual required contribution (ARC) - that we began to see progress in paying down pension debt as contributions achieved positive amortization.

Chart 1 below shows the progress in making full actuarial contributions between 2003 and 2020.

Chart 1: Historic Pension Contributions- SERS and PSERS



Source: Comprehensive annual financial reports, actuarial reports and valuations, and other public documents.

Table 1 summarizes key funding and contibution data over different periods of time reflecting the progress the state has made to ensure long-term sustainability of the pension systems.

Table 1: Historical Funding and Contribution Data- SERS and PSERS (Billions)

	2005	**2008**	**2011**	**2014**	**2017**	**2019**
Assets	$78	$92	$87	$80	$83	$90
Liabilities	$90	$105	$128	$135	$149	$155
Funded Ratio	87%	87%	68%	60%	55%	58%
Unfunded Liability	$12	$14	$41	$54	$67	$65
Actuarial Determined Contribution	$1.26	$2.44	$3.35	$4.37	$5.71	$6.68
Actual Contribution	$0.58	$0.89	$1.04	$3.07	$5.71	$6.68
Shortfall	$0.69	$1.55	$2.31	$1.30	$0.00	$0.00

Act 5- 2017

The Act 120 changes were important stepping stones to Pennsylvania's pension turnaround. Still, they did not fully address the risk of future unfunded liabilities that would further strain the state and school districts' ability to fund pension benefits. As a result, Act 5 was passed with bipartisan support in 2017, which made additional improvements to funding policy and put in place a new benefit plan design that would share risk and some gains with employees to make costs more predictable.

Under Act 5, the default plan for newly hired employees is a hybrid plan, which combines a reduced defined benefit (DB) program- the traditional pension- with a separate defined contribution (DC) savings account, like a 401(k). In addition to sharing risk, the plan provides retirement security to career workers and improves the savings rate for employees who change jobs mid-career.

The reform also began to focus policymakers' attention on investment fees and transparency, including creation of the Public Pension Management and Investment Review Commission (PPMAIRC). Act 5 tasked the PPMAIRC with identifying opportunities to reduce investment fees by $3 billion, improve transparency, and establish a stress test requirement. This effort ultimately identified nearly $10 billion in fee savings. In addition, it led to the adoption of pension stress testing legislation. In response to Act 5 and the PPMAIRC recommendations, the plans have taken action to fulfill these recommedations by SERS producing an industry-leading stress test analysis and PSERS identifying changes that would lead to over $2 billion in fee savings.

Investment Fees and Transparency

Table 2 summarizes the asset allocation for both SERS and PSERS as of 2019 reporting. While SERS's asset allocation tracks closely to national average, investments in PSERS are more heavily concentrated in alternative investments. As a result, the ratio of investment management fees to assets, 77 basis points (bps), is among the highest for state-sponsored pension funds and roughly twice the national averages.

Table 2: 2019 Asset Allocation and Fees

	Total Equity	**Total Fixed Income**	**Total Alternatives**	**Fees in basis points**
Pennsylvania State Employees Retirement System	55%	19%	26%	54
Pennsylvania Public School Employees Retirement System	16%	35%	49%	77

Note: The Pennsylvania Public School Employees Retirement System asset allocation has been adjusted to account for leverage (12.6% as of the 2019 Annual Report).
Source: Comprehensive annual financial reports, actuarial reports and valuations, and other public documents.

The use of alternative investments is by no means a negative. Many pension funds have adopted successful private equity and real estate investment strategies to boost long-term returns and diversify investment portfolios. At the same time, the cost and complexity of these investment strategies reasonably call for ongoing attention and heightened transparency.

And, while PSERS use of private equity (11% of the total portfolio) and real estate (10%) track closer to the national average, a closer examination reveals that the fund's allocation to hedge funds and other alternative investments are something of an outlier compared to other funds. Total alternative investments -- including private equity, real estate, hedge funds and other alternative investments -- account for 49% of portfolio assets as of 2019 reporting, with management fees on alternatives of $285M or 101 bps.

In the future, the findings of the PPMAIRC point to several considerations for policymakers, including the possibility of consolidating investment functions across the two plans and more comprehensive fee disclosure. According to our research, twenty states have stand-alone investment boards that manage state and teacher pension plans assets. Furthermore, there has been significant progress in disclosing more details on performance fees and indirect costs of private equity and other alternative investments.

Emerging transparency practices include adopting comprehensive fee-reporting standards, such as those proposed by the Institutional Limited Partners Association's Fee Transparency Initiative, or currently being considered by the Global Pension Transparency Benchmark (GPTB), which CEM Benchmarking created in collaboration with the top1000funds.com.

These efforts reflect the fact that most funds only report management fees and performance fees paid (as opposed to deducted from investments' market value). However, undisclosed private equity fees, including carried interest, monitoring costs, and other portfolio company fees, are estimated to be more than $5 billion annually across state sponsored public pension funds.

In response, state pension funds that have adopted comprehensive fee reporting practices include: the South Carolina Retirement System (SCRS); Missouri State Employees Retirement System (MOSERS); California Public Employees Retirement Systems (CALPERS); New York State and Local Retirement System (NYSLRS); and the Arizona State Retirement System (ASRS). In addition, others have begun making a good faith effort to provide at least some estimate of performance and other fees that are netted against assets. For example, Ohio Public Employees Retirement System (OPERS) provides a breakdown of net management fees, fund expenses, and performance fees by asset class (not fund or manager).

The growing consencus on the need for improved transpareny on performance and fees has also been reflected in actions by both the boards of SERS and PSERS to put in place improved standard disclosures. Given the complexity and cost of public pension investments, including in Pennsylvania, transparency and disclosure is an important best practice for long term sustainability.

Conclusion

Overall, the changes made in Pennsylvania have put in place a number of the prerequisites for long-term success. Among those, a funding plan designed to pay down pension debt and the fiscal discipline to stick with it; a benefit plan design that helps to ensure costs will stay predictable for new workers while providing a path to retirement security across the workforce; and ongoing efforts to ensure that pension funds are managed transparently, with an emphasis on reducing fees.

Thank you for the opportunity to share our research and commentary. Please feel free to contact us if you have any questions.