SPECIAL REPORT:

Funding and Reforming Public Employee Retirement Systems

Commonwealth of Pennsylvania
Public Employee Retirement Commission
Harrisburg, Pennsylvania

January 2013

PUBLIC EMPLOYEE RETIREMENT COMMISSION

Gubernatorial Appointees

Mr. Anthony W. Salomone
Chairman
Retired Executive Director of the
Public Employee Retirement Commission
Commonwealth of Pennsylvania

Mr. A. Carville Foster, Jr.
Vice Chairman
Retired Legislator

Mr. Christ J. Zervanos
Retired Director of Labor Relations
Office of Administration
Commonwealth of Pennsylvania

Mr. David F. Werner, CPA
Retired Principal
State and Local Tax Services
ParenteBeard LLC

Mr. John J. Egan, Jr.
President, J. Egan Consulting, LLC

Legislative Appointees

Senator Patrick M. Browne
District 16
Lehigh, Monroe and
Northampton Counties

Senator Daylin B. Leach
District 17
Montgomery County

Representative Mike Tobash
District 125
Berks and Schuylkill Counties

Representative R. Ted Harhai
District 58
Fayette and Westmoreland Counties

Executive Director:	James L. McAneny
Commission Office:	510 Finance Building 613 North Street P. O. Box 1429 Harrisburg, PA 17105-1429
Telephone:	(717) 783-6100
FAX:	(717) 787-9531
E-mail:	perc@pa.gov
Web Site:	www.perc.state.pa.us

COMMONWEALTH OF PENNSYLVANIA
PUBLIC EMPLOYEE RETIREMENT COMMISSION
HARRISBURG
17120

January 28, 2013

To: Members of the Pennsylvania General Assembly
and Governor Corbett

Under the Public Employee Retirement Commission Act (Act 66 of 1981), this Commission has a responsibility to study, on a continuing basis, the Commonwealth's public employee retirement systems and to report thereon to the Governor and the General Assembly. Pursuant to that mandate and the pension funding issues brought about by the recent recession and weak recovery, the Commission initiated a study of the current funding crisis, the actions available to manage that problem, and the reforms that may be undertaken to prevent a recurrence of these issues in the future. In the course of that study, Commission staff conducted an extensive review of actuarial methodologies, legal strictures, analytical publications, various plan designs, the reforms adopted in other jurisdictions, and other matters specific to the fragmented nature of Pennsylvania's local government pension plans. In addition, the Commission issued an open call for interested parties to express their ideas, and conducted a series of public hearings in the autumn of 2012 for that purpose.

On behalf of the Commission, I hereby submit the attached report for your review and consideration. The Commission hopes that you will find the material presented in the report to be beneficial in your deliberations on pension reform, and I specifically extend the services of the Commission staff to assist any member of the administration or General Assembly who seeks to develop a legislative proposal to address these vital issues.

Sincerely,

Anthony W. Salomone
Chairman

TABLE OF CONTENTS

TABLE OF CONTENTS (CONT'D)

Page

Tables **(Cont'd)**

Graphs

Appendices

TABLE OF CONTENTS (CONT'D)

Page

Appendices (Cont'd)

EXECUTIVE SUMMARY

In essence, this entire report is a summary of the multiple and complex issues involved in the problem of pension funding and reform. No single method is sufficient to resolve the current crisis of funding government pension systems, but unfunded liabilities are the most significant cost component of current and future employer contributions.

This report is intended to provide no more than an overview of possible actions that the General Assembly could consider, and identify the most likely consequences of those actions. It is not an analysis of any specific proposal, but seeks to provide a reference tool for those with the responsibility to deal with this problem.

Without making recommendations, this report does identify certain issues that should guide any proposed legislative solution.

- The amortization of the existing actuarial accrued liability is the most critical issue to be addressed.

- Avoidance of contribution volatility is another consideration for any future benefit structure.

- The closure of an underfunded defined benefit pension plan may incur additional costs.

- The fragmented nature of Pennsylvania's local government pension program makes reform difficult.

The Public Employee Retirement Commission was created to advise the administration and the legislature regarding pension issues, and the staff welcomes the opportunity to work with any interested parties in developing solutions to the problems that now confront the Commonwealth.

I. INTRODUCTION

The "Great Recession" has triggered an extraordinary increase in the required employer contributions to defined benefit pension funds, because the risk of investment loss in these traditional retirement plans is borne by the employer. Unlike the private sector, where the applicable law allows for the freezing of existing benefits and conversion to other pension structures, such as defined contribution plans where the risk of investment loss is borne solely by the employee, government plans are limited by the fact that they are created and maintained by statutory enactments (whether State statute or local ordinance) and subject to the constitutional proscription against the adoption of laws that impair the obligation of contracts. The extent of those constitutional protections vary significantly from state to state.

Under the Public Employee Retirement Commission Act (Act 66 of 1981), the Public Employee Retirement Commission has a mandated responsibility to study on a continuing basis the Commonwealth's public employee retirement systems. In accordance with that responsibility, the Commission initiated a study of the current funding crisis, its causes, and the potential reforms available under the strictures of judicial rulings. In the course of study, Commission staff reviewed existing laws, the funding status of Pennsylvania's public employee pension plans, treatises and reports of various universities and other institutions and organizations, and the nature and effect of reform efforts undertaken in other jurisdictions. The Commission further conducted a series of public hearings and invited the participation of any person or organization with an interest in this issue and solicited their suggestions for a solution.

This report is the result of that study. It does not make recommendations, but simply identifies and discusses the actions that can be undertaken. It does not provide the detail of an actuarial note on specific legislation, but does set forth a general analysis of the various reforms that are available. The only limitations are those imposed by constitutional law and budgetary realities.

II. HISTORY OF THE CRISIS

After a decade of extraordinary investment gains, the financial markets spoke of the "new paradigm:" an anticipation that double-digit growth would continue indefinitely. This was the argument that supported the benefit improvements of Act 9 of 2001, and the cost-of-living adjustment provided by Act 38 of 2002. In reality, the markets lost heavily in 2001, when technology stocks fell dramatically.

The benefit improvements of Act 9, although generous, would not have caused significant risk if those benefit improvements had been applied only to future service. Instead, that statute granted a twenty-five percent increase in the annual pension accrual rate going back throughout each active employee's entire career. (Even greater increases were provided to members of the General Assembly and judiciary, but the number of employees within those classifications is not sufficient to place the entire system at risk).

During the halcyon days of the late 1990s, the investment earnings of the State Employees' Retirement System (SERS) and the Public School Employees' Retirement System (PSERS) were such that the plan actuaries determined that employer contributions were unnecessary, resulting in the suspension of employer contributions in multiple years. With the market downturn in 2001, the actuarial calculations called for the reinstatement of employer contributions, but the funds had been committed to other uses. The Commonwealth passed Act 40 of 2003, resetting the amortization period for the increased liabilities of Act 9 of 2001; and amortizing the pre-Act 9 gains over 10 years and the post-Act 9 losses over 30 years. Employer contributions were artificially suppressed by that process. This was the genesis of the steeply increased employer contribution requirements that occupied much discussion during the first decade of this century, as failure to achieve sufficient income would trigger a substantial increase in employer pension contributions.

In fact, the retirement systems almost succeeded in generating the revenues necessary to avoid that increase. But the extreme market downturn of 2008 brought those hopes to an abrupt end. The anticipated contribution increase was not just significant, it was beyond the range of budgetary possibility.

Act 120 of 2010 was the legislative response to that situation. It repealed the Act 9 benefit improvements for future employees while retaining the higher employee contributions imposed by that act, increased normal retirement age, abolished the lump-sum distribution of accumulated employee pension contributions as a retirement option, re-amortized the unfunded actuarial accrued liabilities of the Systems, and imposed a system of limits on employer contributions until such time as the allowable contribution level equaled the actuarially required rate. While significant, the Act 120 reforms have not resolved the funding crisis.

At the local government level, the funding requirements established by Act 205 of 1984 avoided the problem of systematic underfunding of the retirement systems subject to that statute (municipalities and local authorities). Nevertheless, those retirement plans have not been immune to the investment losses of the recession and the corresponding increases in employer contribution requirements. Our cities, in particular, are faced with overwhelming budgetary challenges, but no class of municipal government has been spared.

Unlike the private sector, increased employer pension costs do not just reduce the profits of shareholders. Governments are funded by taxpayers, and every dollar spent comes from the people who live and work in this Commonwealth, and who are themselves suffering from the effects of the recession. It is imperative that effective action be taken to alleviate that burden, even though there is no painless solution. The only practical reason to consider past mistakes is to assure against their repetition in the future.

This report is focused solely upon actions that can be taken to deal with the existing unfunded liabilities of government pensions and the reforms that may prevent the recurrence of this situation.

The most difficult problem to address is the unfunded actuarial liabilities of existing pension systems. The Public School Employees' Retirement System and the State Employees' Retirement System have together accumulated over $41 billion in unfunded liabilities.[1] By fiscal year 2017-2018, the combined unfunded liabilities of the two systems are projected to approach $65 billion.[2] These liabilities represent a debt that must be paid and will result in increasing employer contribution requirements. Current projections indicate that employer contributions for the two state systems will increase from $1.2 billion, or 4.2% of appropriations, in fiscal year 2012-2013 to $3.2 billion, or 9.6% of appropriations, by fiscal year 2017-2018.[3] Based upon the Commission's most recent data, there is also another $7 billion in unfunded liabilities in local government pension plans.[4]

Past decisions of Pennsylvania courts suggest that these liabilities are subject to the Pennsylvania Constitution restrictions on the ability of the Legislature to significantly alter existing retirement benefits. **Article 1, section 17, of the Pennsylvania Constitution** provides:

> No *ex post facto* law, nor any law impairing the obligation of contracts, or making irrevocable any grant of special privileges or immunities, shall be passed.

In <u>Retirement Board of Allegheny County v. McGovern</u>, 316 Pa. 161, 174 A. 400 (1934), the Pennsylvania Supreme Court applied a strict construction to this constitutional provision as it applied to statutory retirement benefits, holding that retirement benefits are future compensation for present services, and our courts have done so ever since.

In fact, when the Commonwealth simply raised the future employee contribution rate for SERS and PSERS members in response to significant increases in the employer contribution rate, the courts struck down that measure as it applied to each and every person employed on or before the date of the enactment: <u>Pennsylvania Federation of Teachers v. School District of Philadelphia</u>, 506 Pa. 196, 484 A.2d 751 (1984); <u>Association of Pa. State College and University Faculties v. State System of Higher Education</u>, 505 Pa. 369, 479 A.2d 962 (1984).

---

[1] SERS as of 12/31/11, PSERS as of 6/30/11. The Keystone Pension Report, Governor's Office of the Budget, November 2012, p. 7.

[2] Independent Fiscal Office, The Economic & Budget Outlook: Fiscal Years 2012-13 to 2017-18, November 2012, pp. 49-50.

[3] Independent Fiscal Office, The Economic & Budget Outlook: Fiscal Years 2012-13 to 2017-18, November 2012, p. 49.

[4] Public Employee Retirement Commission, Status Report on Local Government Pension Plans, December 2012, p. 9.

As one of the jurisdictions that applies the most literal construction to the constitutional contract clause, Pennsylvania is less able to alter the benefits of existing employees than some other states that apply the liberal interpretation adopted by the federal courts under the United States Constitution (cannot enact a law that impairs the obligation of contracts without a sound, governmental basis for doing so) or some other less restrictive interpretation. It may not even be possible for a Constitutional amendment to take away currently protected rights, except for elected officials; Shiomos v. State Employees' Retirement Board, 533 Pa. 558, 626 A. 2d 158 (1993).

Unless the Pennsylvania Supreme Court modifies its stance, the unfunded pension liabilities cannot be significantly reduced. There are, however, ways to reduce the current obligations that do not run afoul of the impairment of contracts clause. They are to reduce liabilities, increase funding, or manage liabilities over time.

III. UNFUNDED PENSION LIABILITIES

A. Reduction of Liabilities

1. The nature of the contract clause protection is the concept that retirement benefits are future compensation, presently earned. In other words, the employee undertakes to perform services for the employer in return for compensation, both present (wages and benefits) and future (to be paid after retirement). Any benefit not part of the consideration for services is not protected because it is not part of the contract.

At the State level, **post-retirement cost-of-living adjustments** are not promised. Instead, they are granted on an occasional, *ad hoc* basis. As such, the post-retirement adjustments granted to retirees are not protected contractual compensation and are subject to repeal or suspension until the retirement funds recover sufficiently to afford those supplemental benefits.

These *ad hoc* supplemental annuities are not only not contractually protected, they are not funded the same as regular retirement benefits. Normal retirement benefits are supposed to be funded, in advance, in accordance with actuarial principles. *Ad hoc* cost-of-living adjustments are not included in the actuarial calculation, and the entire cost is added to the unfunded liability and amortized after enactment.

Beginning in 1968, these cost-of-living adjustments were authorized every four or five years on average, with the amounts generally determined using a formula based on the increase in the Consumer Price Index. Although controversial, the cessation of some or all supplemental annuity payments could result in significant savings. For example, the most recent supplemental annuity enacted in 2002 was estimated to add approximately $1.2 billion in unfunded liability to PSERS and $600 million to SERS.[5]

[5]Public Employee Retirement Commission actuarial note on Document Number 1182, April 2002.

2. Another area that may be available to obtain immediate reductions in existing liabilities and corresponding contribution requirements is the **voluntary reduction** of pension benefits. A possible example would be the reduction or elimination of post-retirement medical insurance benefits unless some pension benefit modification was accepted. The legal precedents regarding the constitutional protections afforded to other post-retirement benefits (called "OPEBs"), such as health insurance, suggest that this may be tenable[6], although such a change for union members would need to be submitted to collective bargaining. The most likely target of such a move would be increased employee pension contributions, since that could be structured on an individualized basis and would provide immediate help toward paying the amortization costs.

3. Another change would be the abrogation of the so-called **"footprint rule,"** whereby persons returning from a break in service are granted the higher of the benefit available under prior service or new service. For example, a State employee who worked for ten years in the 1980s (accruing 2% per year of service) leaves and returns to State service in 2011. After three years of additional service, that employee is granted the Act 9 accrual rate of 2.5% for service before and after the break. This process was not repealed by Act 120, so it remains available to employees who return from a break in service after 2010.

4. While the Commonwealth, like all other states, cannot avail itself to the **bankruptcy** courts[7], this remains a viable option for municipal governments that find themselves unable to pay their bills. Because the bankruptcy courts are federal, and apply the federal constitutional contract clause construction, it appears that a bankruptcy judge could vacate contractual provisions going forward. This is one of the many issues being litigated in other jurisdictions (e.g., California and Rhode Island).

5. Yet another possibility is to **shift certain costs**, now part of the pension plans, to other sources of funding. An example of this was Act 51 of 2009, which eliminated the killed-in-service benefit within the police pension law governing boroughs, towns and townships, and transferred that liability to the Emergency and Law Enforcement Personnel Death Benefits Act. In a similar way, service-related disability retirement benefits could be transferred to Workers' Compensation, thereby eliminating the costs associated with this pension benefit.

---

[6] City of Pittsburgh v. Fraternal Order of Police, Fort Pitt Lodge No. 1, 911 A.2d 651 (Pa. Cmwlth. 2006), affirmed on other grounds, City of Pittsburgh v. Fraternal Order of Police, Fort Pitt Lodge No. 1, 595 Pa. 47, 938 A.2d 225 (2007); Millcreek Township Police Association v. Millcreek Township, 960 A.2d 904 (Pa. Cmwlth. 2008).

[7] In re Northern Mariana Islands Retirement Fund, Debtor.
Case No. 12-00003, Docket Nos. 24, 50, 53, 79, 81, 90
United States District Court for the Northern Mariana Islands (2012)

B. Increase Funding

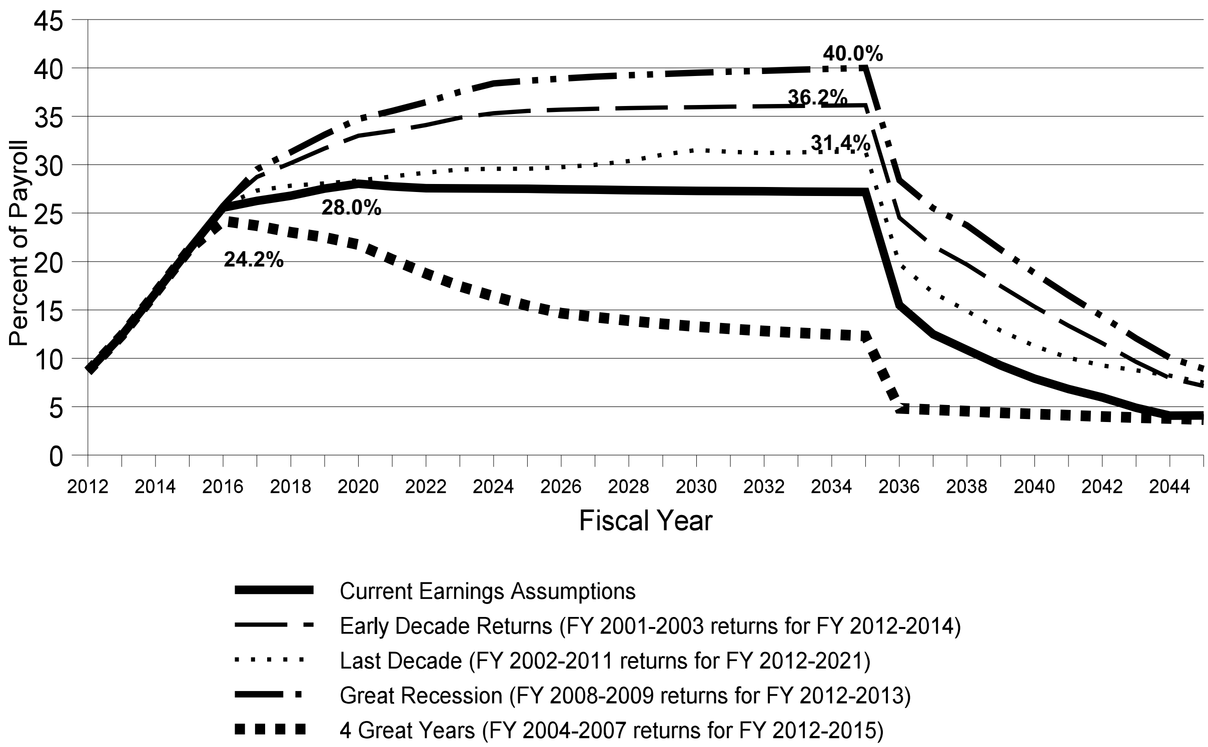
1. One obvious way in which to increase funding would be to enhance the pension systems' **investment performance**. Returns on the investment of pension plan assets represent the largest single source of income for the funding of plan benefits. Favorable investment experience, in which investment performance exceeds the investment return assumptions set by the trustees of the retirement system results in actuarial gains that can then be applied to reducing the unfunded liability of a pension plan. Conversely, the reverse is true when unfavorable investment experience occurs, meaning investment performance falls short of expectations. When investment losses occur, additional employer contributions are generally required to compensate for those losses.

Retirement systems usually employ some method of "asset smoothing," in which both gains and losses are recognized over a period of years (most commonly, three to five years) rather than immediately. This is intended to minimize the effects of large market fluctuations on contribution requirements. However, when unfavorable investment experience occurs over an extended period, or when investment losses are especially severe, additional employer contributions will be required to offset the effects of poor investment performance. Any form of benefit enhancement that does not include a corresponding increase in funding to offset the resulting additional liabilities (such as post-retirement cost-of-living adjustments or early retirement incentives) also requires corresponding increases in contributions or investment returns to ensure adequate funding.

The board of trustees of a public pension system, in consultation with the system's consulting actuary, sets the plan's investment return assumption in addition to other economic and demographic actuarial assumptions. A retirement system's investment return assumption represents that system's best estimate of the long-term investment performance of the fund. If the investment return assumption is 7.5%, as is now the case for both PSERS and SERS, the board of trustees expects that, in the long term, the fund will achieve a 7.5% return rate. This is not to say that the system expects to achieve a 7.5% return each and every year for the next thirty years. It is understood that there will be years in which investment returns greatly exceed the investment assumption and years in which investment performance is below the assumption, but that in the long run, the assumption will approximate actual experience. For this reason, it is unlikely that the retirement systems can sustain long-term investment performance that will exceed the investment return assumption by a margin sufficient to significantly improve the funded status of the plans.

GRAPH 1

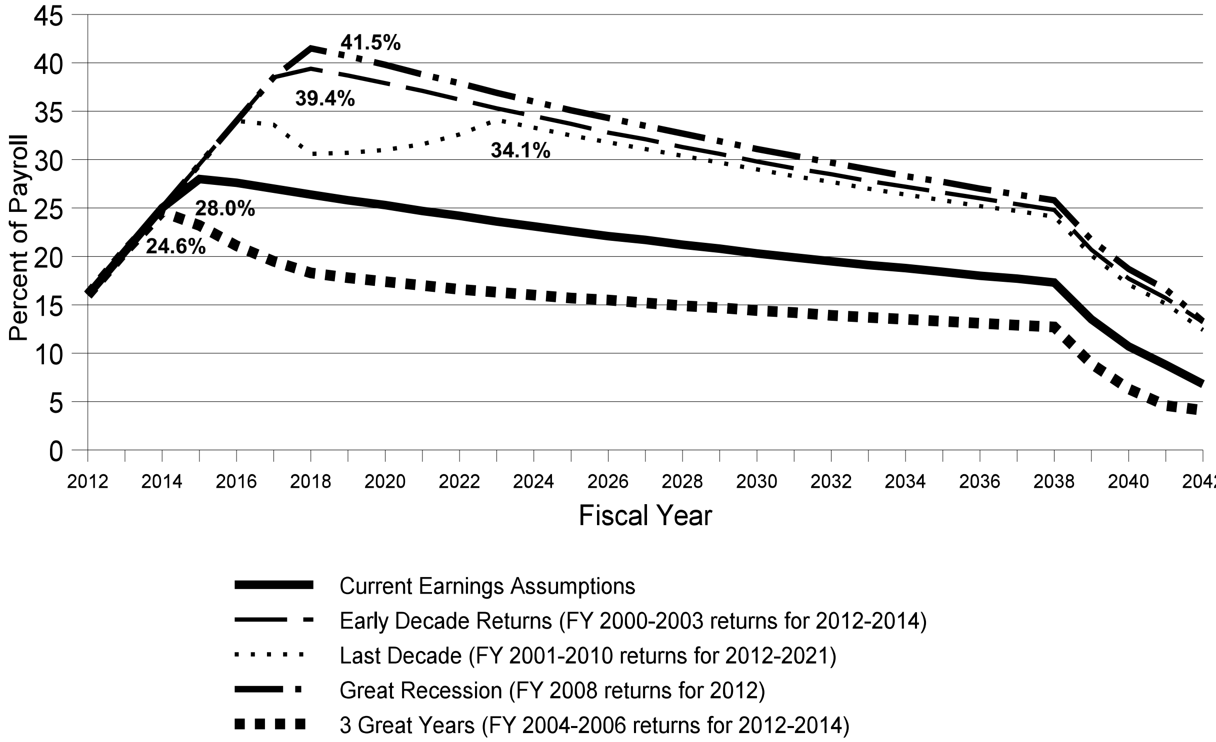
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM
EMPLOYER CONTRIBUTION RATE PROJECTIONS
BY INVESTMENT RETURN SCENARIO
(as a percentage of payroll)



Source: Public School Employees' Retirement System

GRAPH 2

STATE EMPLOYEES' RETIREMENT SYSTEM
EMPLOYER CONTRIBUTION RATE PROJECTIONS
BY INVESTMENT RETURN SCENARIO
(as a percentage of payroll)



Source: State Employees' Retirement System

2. A major issue raised in testimony during the Commission's public hearings was the apparent need for additional revenue. **Tax increases** are often controversial and rarely popular. Nevertheless, it is clear that significant additional revenue could be raised through increases in taxes and/or fees. All or a portion of these additional revenues could be applied to the unfunded liabilities of PSERS and SERS. The state personal income tax, for example, is a major source of revenue. Based upon data obtained from the Department of Revenue, the state personal income tax of 3.07% raised approximately $10.4 billion dollars in the fiscal year ended 2011 (year-to-date, approximately $10.8 billion has been raised in 2012). Table 1 below shows the amount of additional revenue that could be raised by increasing the tax rate by the increments shown. The table also includes a rough estimate of the increased tax burden that would be borne by a hypothetical taxpayer with an annual gross income of $45,000.

TABLE 1

PERSONAL INCOME TAX, ADDITIONAL REVENUE ESTIMATES

Tax Rate %	% Increase	Revenue Generated	Additional Revenue	Additional Cost Per Year for Taxpayer
3.07[8]	--	$10,435,706,000[9]	--	--
3.17	3.25%	$10,775,631,277	$339,925,277	$45
3.20	4.23%	$10,877,608,860	$441,902,860	$59
3.30	7.49%	$11,217,534,137	$781,828,137	$104
3.40	10.75%	$11,557,459,414	$1, 121,753,414	$149
3.50	14.00%	$11,897,384,691	$1, 461,678,691	$194
3.60	17.26%	$12,237,309,967	$1, 801,603,967	$239
3.70	20.00%	$12,577,235,244	$2, 141,529,244	$284

Likewise, increases in the state sales tax could also produce significant additional revenue. Table 2 displays an estimate of the effect of increasing the state sales tax in ¼ percent increments, again based upon data supplied by the Department of Revenue.

TABLE 2

SALES TAX, ADDITIONAL REVENUE ESTIMATES

Tax Rate %	% Increase	Revenue Generated	Additional Revenue
6.00%[8]	--	$8,590,217,000[9]	--
6.25%	4%	$8,948,142,708	$357,925,708
6.50%	8%	$9,306,068,417	$715,851,417
6.75%	13%	$9,663,994,125	$1,073,777,125
7.00%	17%	$10,021,919,833	$1,431,702,833

[8]Actual tax rate for Fiscal Year 2010-2011, Monthly Revenue Report June 2012 Department of Revenue, p. 4.

[9]Total Tax Revenues for Fiscal Year 2010-2011, Monthly Revenue Report June 2012, Department of Revenue, p. 4.

Tables 3 and 4 show the one-time contributions that would be required to reduce annual contributions below certain payroll percentages.

TABLE 3

CASH INFUSION PROJECTIONS
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM
Additional Infusion Required as of July 1, 2012, to Reduce Contributions Below Target
($ in billions)

	Amount Needed (30-Yr. Amortization)	Amount Needed (10-Yr. Amortization)
Target Percent of Payroll	To Keep All Future contribution Rates Below Target	To Keep all Future Contribution Rates Below Target
< 20%	$18.18	$30.19
< 15%*	$29.81	$37.05
< 10%*	$41.16	$43.91

*The FY 2014 contribution rate would remain at 16.75% as a payment made on July 1, 2012, would not impact contribution rates until FY 2015.

NOTE: Rates assume a 3% collar on FY 12, 3.5% on FY 13, and 4.5% on FY 14 and above until collars are no longer needed. (Act 120 collars)

Rates projected based upon PSERS June 30, 2011, actuarial valuation.

TABLE 4

CASH INFUSION PROJECTIONS
STATE EMPLOYEES' RETIREMENT SYSTEM
Additional Infusion Required in 2012 to Reduce Contributions Below Target
($ in billions)

	Amount Needed (30-Yr. Amortization)	Amount Needed (10-Yr. Amortization)
Target Percent of Payroll	To Keep All Future Contribution Rates Below Target	To Keep all Future Contribution Rates Below Target
< 20%	$4.9	$11.3
< 15%	$8.3	$13.7
< 10%	$12.3	$16.1

NOTE: Per current law, rates assume collars of 3% in FY 12, 3.5% in FY 13 and 4.5% in FY 14+ until no longer needed.

SERS 03-28-12

3. If raising new revenue is not a viable option, one alternative may be to **redirect all or some portion of one or more existing revenue streams** to pension funding. For example, recently the City of Pittsburgh elected to commit future parking revenues to fund the City's municipal pension liabilities by transferring actual ownership of those future revenues (valued at approximately $284 million) to the trustees of the City's pension funds, which increased the funded ratio of the City's pension plans from approximately 34 percent to 62 percent. Similarly, Kansas, Louisiana, and Washington states have dedicated various revenue sources for the amortization of pension liabilities.

a. While the courts of the Commonwealth have consistently defended the inviolability of pension benefit promises, that protection has not been extended to other post-retirement employee benefits (**OPEBs**) such as post-retirement medical insurance coverage: City of Pittsburgh v. Fraternal Order of Police, Fort Pitt Lodge No. 1, 911 A.2d 651 (Pa. Cmwlth. 2006), affirmed on other grounds, City of Pittsburgh v. Fraternal Order of Police, Fort Pitt Lodge No. 1, 595 Pa. 47, 938 A.2d 225 (2007); Millcreek Township Police Association v. Millcreek Township, 960 A.2d 904 (Pa. Cmwlth. 2008).

According to the Governor's Office of Administration, the cost of providing health benefits for both active employees and retired members totals roughly $1.5 billion annually, with approximately one-third of that amount allocated to the retired employee health program and the remainder to active employee healthcare. Additional efficiencies could be obtained through modifications to the active employee health program, though the healthcare benefits provided through that program, managed and funded through the Pennsylvania Employees' Benefit Trust Fund (PEBTF), is subject to collective bargaining. Although such a move would be controversial, revenue saved by modifying the active employee health plan, or by reducing or eliminating retiree healthcare, could be applied to pay for pension obligations. Alternatively, the continuation of these healthcare programs could be bargained in exchange for reductions in future pension benefits of active employees (although the retirement code provisions that preclude bargaining over pensions may need to be amended).

b. A more conservative approach could involve the consolidation of healthcare programs under a single healthcare trust fund. The resulting economies of scale would provide significant savings. A 2004 report by the Legislative Budget and Finance Committee addressed this very issue. The report entitled *The Feasibility of Placing Public School Employees Under the Commonwealth's Jurisdiction for the Purpose of Providing Healthcare Benefits* (which can be accessed via the link) stated that $585 million dollars could initially have been saved through consolidation of public school employee healthcare plans in a single trust, with an eventual saving of as much as $835 million with full implementation. Although not well-studied, a similar saving may be obtained through a similar consolidation of health plans currently provided to local government employees, providing a measure of fiscal relief to local governments.

c. Another option would be to **reallocate some or all of the annual General Municipal Pension System State Aid allotment** (State aid) to SERS and PSERS for all future years or until a certain funding threshold is attained. Over the past 27 years since the passage of Act 205 of 1984, State aid revenue has increased from the initial allocation of $62.3 million in 1985 to $232.8 million in 2012, and will most likely continue that trend into the future.[10] Such a major reallocation would shift the burden from state to local resources requiring those local governments to compensate for the funding lost from the State aid program. One method of easing the financial burden on municipalities from such a substantial change in pension funding would be to gradually diminish the funding available from the State aid program over a five or ten-year period until the municipal pension plans are solely funded by the municipal governments.

d. Additional revenue could be generated through the outright sale, long-term lease or other forms of **privatization of certain governmental assets**. Such assets could include actual physical assets or infrastructure, or revenue generated from certain governmental functions. All or a portion of these proceeds could be dedicated to pension funding. In the recent past, the Commonwealth explored the possibility of leasing Pennsylvania Turnpike operations to the private sector. More recently, the sale of the state-owned liquor stores has been seriously considered as well as the privatization of the Pennsylvania lottery system. The City of Philadelphia has considered the sale of the Philadelphia Gas Works in order to provide additional revenue to fund the City's unfunded pension liabilities. Although somewhat drastic, the liquidation of certain assets, particularly those that do not constitute core governmental functions, may be considered justifiable.

e. **Pension obligation bonds** (POBs) are a form of taxable general obligation bond that governments issue to finance pension obligations. POBs may be employed to transform a current pension obligation into a long-term, fixed obligation of the government. While POBs may provide an avenue to alleviate fiscal distress and reduce pension liabilities, they also pose certain risks. Despite the risks, POBs have the potential to be useful tools under certain conditions. POBs can offer budgetary relief during periods of economic stress. For this strategy to be successful, pension fund investment returns must exceed the taxable borrowing rate on the bond issue, resulting in a net gain over time. The timing of the bond issuance is another area of concern. In order to obtain the best possible gains, the debt must be incurred when the borrowing costs are low. There is also a greater risk that investment returns will prove insufficient during periods of restrictive monetary policy (i.e., quantitative easing).

The retirement codes governing both PSERS and SERS currently bar those systems from utilizing the proceeds of POBs. If the issuance of such bonds is to occur, the statutes governing the systems would need to be amended.

---

[10] 2012 Status Report on Local Government Pension Plans, Public Employee Retirement Commission, December 2012, pp. 24-25.

4. It has been suggested that **early retirement incentive programs** (ERIPs) could be employed as a means of reducing pension system liabilities. The short-term cost-saving potential of early retirement incentives is often cited by proponents. However, in evaluating the potential merits of any ERIP, it is important to disentangle the issue of pension plan liabilities from employer payroll savings. Because the incentive constitutes a liberalization of benefits, any ERIP will increase the liability to the pension plan, regardless of any payroll savings that may be realized by the employer. Under actuarial methods commonly used by public employee retirement systems, an actuarial accrued liability is developed. The actuarial accrued liability represents the present value of benefits payable at a given date. When the ERIP is enacted and the unfunded accrued liability is increased without a corresponding increase in assets, the fund ratio of the plan is reduced. The additional liability associated with the ERIP must be amortized with appropriate interest charges, much like mortgage payments. Amortization has the effect of spreading the costs of an ERIP over a period of time.

The issue of early retirement incentives has also been studied extensively by the Commission. In March 1995, the Commission issued its first report on early retirement incentives which can be accessed on-line via the following link: *Feasibility of Early Retirement Incentives in the Public Sector*, and in March 1996, the Commission issued its second report, which can be accessed on-line via the following link: *Fiscal Impact of the Early Retirement Incentive for Public School Employees Provided by Act 186 of 1992 and Act 29 of 1994*.

C. Management of Liabilities

The unfunded liabilities of PSERS and SERS are the most significant cost component driving projected employer contribution rate increases. No future benefit modifications are likely to significantly impact these unfunded liabilities unless the courts allow changes to the benefits of existing employees.

The unfunded liability represents a long-term debt, not unlike a home mortgage, that must be paid-off, or amortized, over time through installment payments. However, unlike a home mortgage, the unfunded liability is not a fixed dollar amount. Instead, the liability varies in response to plan experience. Favorable plan experience, resulting from an event such as an extended period of investment returns that exceed the pension fund's assumed rate of return, would result in an actuarial gain, causing the unfunded liability to decline and improving the funded condition of the plan. The reverse is also true; a period of unfavorable plan experience would result in an actuarial loss, causing the unfunded liability to grow and ultimately resulting in the need for additional funding to offset those losses. Also, unlike the home mortgage, the time period over which the unfunded liability is amortized need not be fixed.

Methods for amortizing the unfunded accrued liabilities include level-dollar amortization and level-percentage-of-projected-payroll amortization. Under level-dollar amortization, the amount to be amortized is divided into equal dollar amounts to be paid over a given number of years. Part of each payment is interest on the outstanding balance and part of each payment is principal. Because annual covered payroll of active members can be expected to increase in future years as a result of inflation, level-dollar payments generally represent a decreasing percentage of annual payroll.

Under level-percentage-of-projected-payroll amortization, amortization payments are calculated so that they increase by a constant percentage each year over the amortization period. If the increases in annual amortization payments are at the same rate as the increases in annual covered payroll of active members, they generally represent a level percentage of payroll each year even though the dollar amounts of annual payments increase over time.

The method for amortizing the unfunded accrued liabilities can also be based upon a closed amortization period or an open amortization period. Under a closed amortization period, a specific number of years is utilized in the calculation of the initial amortization amount and the number of years remaining in the amortization period declines by one each year until the period expires. Under an open amortization period, the amortization period chosen to determine the initial amortization amount (i.e., 30 years) is used at each subsequent actuarial valuation date.

In the absence of significant additional funding or the ability to meaningfully reduce unfunded liabilities through benefit reductions or other means, a strategy for responsibly managing these liabilities will need to be developed. In light of the projected increases in employer contributions to PSERS and SERS required by current law, and the resulting pressures on the Commonwealth budget, a more gradual approach to amortizing the unfunded accrued liabilities may need to be considered. In Pennsylvania there is clear precedent for such an approach to the management of long-term pension liabilities. At various times, PSERS, SERS and the Commonwealth's many local government pension systems have all employed various strategies for amortizing unfunded liabilities over differing time frames depending upon the source of the liability. Both PSERS and SERS have employed amortization strategies that included both level-dollar and level-percentage-of-payroll amortization over periods ranging from as little as 10 years to 30 years, and the liabilities of both systems have been repeatedly re-amortized as part of benefit modifications and other plan changes that have been enacted.

For local government pension plans, there are similar precedents. Act 205 of 1984 mandated actuarial funding standards for municipal pension plans and implemented a recovery program for distressed plans. As part of the original recovery program for distressed municipal pension systems, existing unfunded actuarial accrued liabilities were permitted to be amortized by municipalities over a period of 40 years. The extended amortization period provided the affected municipalities with a measure of short-term relief.

In order to illustrate the impact of different amortization methods and periods, one of the Commission's consulting actuaries (Conrad Siegel Actuaries) was asked to develop a number of different amortization scenarios. (For more detail, the complete work of the Commission's consulting actuary can be found in Appendix 2 of this report). The **following two tables** illustrate the projected employer contribution rates under current law for both SERS and PSERS compared with projected employer contribution rates under **eight optional amortization methods** developed by the Commission's consulting actuary. It should be noted that for PSERS, the employer contribution rates shown are for pension benefits only and do not include the health care contribution rate. Any of these amortization methods would fully pay the existing unfunded actuarial accrued liabilities of the systems, provided that the actuarial assumptions are met.

Under current law, the total employer contributions for SERS and PSERS are limited by artificial contribution limits pursuant to Act 120. The reduced employer contributions, compared to the actuarially determined employer contribution rates, result in increased employer contributions in succeeding years. Under the optional amortization methods illustrated in the tables, there are no contribution collars used in the calculation of the employer contribution rates. Instead, these contribution rates are actuarially determined based upon the amortization method employed.

TABLE 5

PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM PROJECTED EMPLOYER CONTRIBUTION RATES BASED UPON OPTIONAL AMORTIZATION METHODS

		AMORTIZATION METHOD							
		30-Yr Level % (5%)	30-Yr Level % (4.0%)	30-Yr Level % (3.0%)	30-Yr Level $	40-Yr Level % (5.0%)	40-Yr Level % (4.0%)	40-Yr Level % (3.0%)	40-Yr Level $
Fiscal Year	Current Law Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution
2012/2013	11.50%	17.17%	18.25%	19.39%	23.26%	15.73%	16.88%	18.13%	22.35%
2013/2014	16.00%	17.25%	18.25%	19.30%	22.74%	15.78%	16.87%	18.04%	21.86%
2014/2015	20.50%	17.12%	18.04%	19.00%	22.03%	15.62%	16.65%	17.74%	21.17%
2015/2016	25.00%	17.03%	17.88%	18.74%	21.37%	15.50%	16.47%	17.48%	20.54%
2016/2017	27.51%	16.96%	17.73%	18.50%	20.74%	15.40%	16.32%	17.24%	19.93%
2017/2018	28.38%	16.91%	17.60%	18.27%	20.13%	15.32%	16.17%	17.01%	19.35%
2018/2019	29.38%	16.89%	17.50%	18.07%	19.57%	15.27%	16.05%	16.81%	18.81%
2019/2020	30.13%	16.88%	17.40%	17.87%	19.01%	15.23%	15.94%	16.61%	18.27%
2020/2021	30.06%	16.88%	17.31%	17.68%	18.47%	15.19%	15.83%	16.42%	17.76%
2021/2022	30.05%	16.88%	17.22%	17.49%	17.95%	15.16%	15.73%	16.23%	17.25%
2022/2023	30.24%	16.90%	17.14%	17.31%	17.44%	15.15%	15.64%	16.05%	16.77%
2023/2024	30.30%	16.92%	17.06%	17.13%	16.95%	15.13%	15.54%	15.87%	16.29%
2024/2025	30.35%	16.95%	16.99%	16.96%	16.47%	15.13%	15.46%	15.70%	15.83%
2025/2026	30.38%	16.98%	16.92%	16.78%	15.99%	15.13%	15.37%	15.52%	15.37%
2026/2027	30.43%	17.02%	16.85%	16.61%	15.53%	15.13%	15.29%	15.35%	14.93%
2027/2028	30.47%	17.07%	16.79%	16.44%	15.08%	15.14%	15.21%	15.18%	14.50%
2028/2029	30.48%	17.10%	16.71%	16.25%	14.62%	15.13%	15.12%	14.99%	14.05%
2029/2030	30.52%	17.14%	16.64%	16.07%	14.17%	15.14%	15.03%	14.81%	13.62%
2030/2031	30.56%	17.19%	16.57%	15.89%	13.74%	15.15%	14.94%	14.63%	13.20%
2031/2032	30.60%	17.25%	16.50%	15.71%	13.31%	15.17%	14.86%	14.45%	12.79%
2032/2033	30.65%	17.31%	16.43%	15.53%	12.88%	15.18%	14.78%	14.27%	12.38%
2033/2034	30.71%	17.38%	16.37%	15.36%	12.48%	15.22%	14.70%	14.10%	11.99%
2034/2035	30.76%	17.45%	16.31%	15.18%	12.07%	15.24%	14.62%	13.92%	11.59%
2035/2036	17.85%	17.52%	16.24%	15.00%	11.67%	15.27%	14.54%	13.74%	11.21%
2036/2037	14.54%	17.61%	16.19%	14.83%	11.28%	15.31%	14.47%	13.57%	10.83%
2037/2038	12.99%	17.70%	16.13%	14.66%	10.90%	15.36%	14.40%	13.40%	10.47%
2038/2039	11.05%	17.80%	16.08%	14.49%	10.53%	15.41%	14.33%	13.23%	10.11%
2039/2040	9.42%	17.91%	16.04%	14.33%	10.17%	15.48%	14.27%	13.07%	9.76%
2040/2041	7.87%	18.03%	16.00%	14.17%	9.82%	15.55%	14.22%	12.91%	9.42%
2041/2042	6.62%	18.17%	15.99%	14.03%	9.49%	15.65%	14.18%	12.77%	9.11%
2042/2043	5.23%					15.76%	14.16%	12.64%	8.81%
2043/2044	4.14%					15.89%	14.15%	12.53%	8.54%
2044/2045	4.02%					16.03%	14.15%	12.42%	8.27%
2045/2046	3.82%					16.17%	14.15%	12.31%	8.00%
2046/2047	3.00%					13.59%	11.42%	9.47%	5.01%
2047/2048	3.00%					13.86%	11.53%	9.47%	4.87%
2048/2049	3.00%					14.12%	11.64%	9.47%	4.72%
2049/2050	3.00%					14.40%	11.76%	9.47%	4.59%
2050/2051	3.00%					14.68%	11.87%	9.47%	4.45%
2051/2052	3.00%					14.96%	11.99%	9.47%	4.32%

TABLE 6

STATE EMPLOYEES' RETIREMENT SYSTEM PROJECTED EMPLOYER CONTRIBUTION RATES BASED UPON OPTIONAL AMORTIZATION METHODS

		AMORTIZATION METHOD							
		30-Yr Level % (5%)	30-Yr Level % (4.0%)	30-Yr Level % (3.0%)	30-Yr Level $	40-Yr Level % (5.0%)	40-Yr Level % (4.0%)	40-Yr Level % (3.0%)	40-Yr Level $
Fiscal Year	Current Law Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution
2012/2013	11.50%	16.53%	17.97%	19.52%	24.71%	14.59%	16.14%	17.82%	23.49%
2013/2014	16.00%	16.75%	18.10%	19.52%	24.14%	14.78%	16.25%	17.82%	22.95%
2014/2015	20.50%	16.98%	18.22%	19.52%	23.58%	14.96%	16.36%	17.82%	22.43%
2015/2016	25.00%	17.21%	18.35%	19.52%	23.04%	15.16%	16.47%	17.82%	21.93%
2016/2017	29.50%	17.45%	18.48%	19.52%	22.52%	15.35%	16.58%	17.82%	21.44%
2017/2018	32.49%	17.69%	18.61%	19.52%	22.01%	15.55%	16.69%	17.82%	20.96%
2018/2019	31.92%	17.93%	18.74%	19.52%	21.52%	15.75%	16.80%	17.82%	20.50%
2019/2020	31.22%	18.18%	18.87%	19.52%	21.04%	15.96%	16.92%	17.82%	20.05%
2020/2021	30.53%	18.43%	19.01%	19.52%	20.58%	16.17%	17.03%	17.82%	19.61%
2021/2022	29.84%	18.69%	19.14%	19.52%	20.13%	16.39%	17.15%	17.82%	19.19%
2022/2023	29.18%	18.96%	19.28%	19.52%	19.69%	16.61%	17.26%	17.82%	18.78%
2023/2024	28.54%	19.23%	19.42%	19.52%	19.26%	16.83%	17.38%	17.82%	18.38%
2024/2025	27.91%	19.50%	19.56%	19.52%	18.85%	17.06%	17.50%	17.82%	18.00%
2025/2026	27.30%	19.78%	19.70%	19.52%	18.45%	17.29%	17.62%	17.82%	17.62%
2026/2027	26.71%	20.07%	19.84%	19.52%	18.06%	17.53%	17.74%	17.82%	17.26%
2027/2028	26.14%	20.36%	19.98%	19.52%	17.68%	17.77%	17.86%	17.82%	16.90%
2028/2029	25.59%	20.65%	20.13%	19.52%	17.32%	18.01%	17.99%	17.82%	16.56%
2029/2030	25.05%	20.95%	20.27%	19.52%	16.96%	18.26%	18.11%	17.82%	16.22%
2030/2031	24.53%	21.26%	20.42%	19.52%	16.62%	18.52%	18.24%	17.82%	15.90%
2031/2032	24.02%	21.58%	20.57%	19.52%	16.28%	18.78%	18.37%	17.82%	15.59%
2032/2033	23.53%	21.90%	20.72%	19.52%	15.96%	19.05%	18.50%	17.82%	15.28%
2033/2034	23.05%	22.22%	20.87%	19.52%	15.64%	19.32%	18.63%	17.82%	14.98%
2034/2035	22.59%	22.55%	21.02%	19.52%	15.33%	19.59%	18.76%	17.82%	14.70%
2035/2036	22.14%	22.89%	21.18%	19.52%	15.03%	19.87%	18.89%	17.82%	14.42%
2036/2037	21.71%	23.24%	21.33%	19.52%	14.74%	20.16%	19.02%	17.82%	14.14%
2037/2038	21.28%	23.59%	21.49%	19.52%	14.46%	20.45%	19.16%	17.82%	13.88%
2038/2039	20.87%	23.95%	21.65%	19.52%	14.19%	20.75%	19.30%	17.82%	13.63%
2039/2040	20.48%	24.32%	21.81%	19.52%	13.93%	21.05%	19.43%	17.82%	13.38%
2040/2041	16.62%	24.69%	21.97%	19.52%	13.67%	21.36%	19.57%	17.82%	13.14%
2041/2042	13.82%	25.07%	22.14%	19.52%	13.42%	21.68%	19.71%	17.82%	12.90%
2042/2043	10.71%					22.00%	19.86%	17.82%	12.67%
2043/2044	8.59%					22.33%	20.00%	17.82%	12.45%
2044/2045	8.00%					22.66%	20.14%	17.82%	12.24%
2045/2046	7.36%					23.01%	20.29%	17.82%	12.03%
2046/2047	6.81%					23.35%	20.44%	17.82%	11.83%
2047/2048	6.58%					23.71%	20.59%	17.82%	11.63%
2048/2049	6.51%					24.07%	20.74%	17.82%	11.44%
2049/2050	6.50%					24.44%	20.89%	17.82%	11.26%
2050/2051	6.50%					24.81%	21.04%	17.82%	11.08%
2051/2052	6.50%					25.20%	21.20%	17.82%	10.91%

As the tables show, the extended amortization methods would provide immediate fiscal relief. These projections are actuarially determined and do not employ artificial contribution limits as is the case under current law. It is also true that some of the amortization methods shown would not be in compliance with current standards of the Governmental Accounting Standards Board (GASB). However, adoption of one of these amortization methods may provide a payment plan for addressing funding shortfalls which is more manageable than that provided for under current law.

The Keystone Pension Report, released in November 2012 by the Governor's Office of the Budget, clearly illustrates the growing costs of employer contribution for PSERS and SERS over the next several fiscal years (That report only addresses the remainder of this decade, and does not extend through the full amortization or discuss the ultimate contribution peaks). In fiscal year 2009-2010, the employer contribution rate for SERS was just 5 percent. For the fiscal year 2011-2012, the rate is at 11.5 percent and will continue to grow every year until peaking at 32.5 percent in 2017-2018. For PSERS, the employer contribution rate was 5.64 percent of payroll in fiscal year 2010-2011 and is at 12.36 for the current fiscal year. It is expected to increase every year until peaking at 30.76 percent in fiscal year 2034-35 (at the end of a sixteen-year period of 30%+ contribution levels). These contribution rates are clearly not tenable.

IV. NEED FOR A PENSION POLICY

It is essential that the goal be established before we choose the road to get there. Whatever we do, there will be both positive and negative consequences, depending upon the perspective of the individual involved. Without a coherent statewide pension policy with an identifiable objective, there is no adequate way to measure the various pros and cons of different methodologies.

Let us begin with the recognition that there is no constitutional requirement that governments provide their employees with <u>any</u> retirement benefit for future hires. Nor is there any constitutional mandate regarding the type of pension to be provided, if any. This is the first consideration in the development of any pension policy: should we have one? Statutory amendment would be sufficient to close existing defined benefit plans, and replace with defined contribution plans, or nothing at all.

The answer to this question does not involve legal impediments (other than collective bargaining laws), but turns on fiscal affordability. Once a defined benefit pension plan is closed to new members, GASB suggests that the existing unfunded actuarial accrued liability be amortized within the remaining average working life of its active members (around 15 ½ years). GASB funding standards are recommendations, but its reporting standards are mandatory and must be reflected in Commonwealth financial statements.

The closure of a defined benefit pension plan with significant unfunded liabilities may result in increased employer costs, at least in the short term (10-15 years). Neither simple closure nor replacement with a defined contribution plan does anything to address the existing unfunded actuarial accrued liabilities. An employer contribution increase can result whether the defined benefit plan is replaced with a defined contribution plan or no plan at all.

Unlike the benefits of current employees and retirees, new benefit tiers applicable to future employees are not constitutionally protected and can take many forms. Benefit reductions applicable to newly hired employees can serve to reduce the cost of future benefit accruals, but will do nothing to address the problem of current unfunded liabilities. A transition to an alternative plan could provide some form of cost savings over the long term due to the reduction in benefit levels and corresponding normal cost rates.

It has been suggested that a new benefit tier that reduces the benefit accrual rate, increases the normal retirement age, increases employee contributions, and extends vesting requirements would result in significant savings. Act 120 of 2010, as detailed elsewhere in this report, implemented all of these changes and more, reducing the basic benefit accrual rate to 2.0%, increasing the retirement age to 65, increasing to 10 years the service required for vesting, and increasing employee contribution requirements. These benefit modifications resulted in a significant reduction in employer normal cost rates associated with members subject to Act 120; 5.10% of payroll for members of SERS and 3.0% for PSERS. These employer normal cost rates are among the lowest of statewide plans nationally. Although it may be possible to achieve more cost savings through implementation of yet another reduced benefit tier, significant additional savings may be difficult to achieve.

A. Types of Pension Plans

Although traditional defined benefit retirement plans remain the standard retirement design in the public sector, some states have moved toward alternative plans[11], including:

1. Closing the defined benefit plan in favor of defined contribution plan.
2. Developing a "hybrid" plan that includes both defined benefit and defined contribution components.
3. Creating a "cash balance" benefit plan.

While all three approaches have merit and could potentially provide long-term savings, in the short term, there may be an increase in employer cost depending upon the specifics of the plan design. In the case of a defined contribution plan for future employees, it could, in fact, mean an increased burden on employer contributions for the closed defined benefit plans, as well as additional costs for the creation and administration of new defined contribution plans. Under a cash balance plan, SERS would experience an immediate increase in its unfunded liability, due to that system's

[11]For more detailed information, you may access the National Conference of State Legislatures' Pensions and Retirement State Legislation Database (made possible by the Pew Center on the States) via the following link: http://www.ncsl.org/issues-research/labor/pension-legislation-database.aspx

A report entitled *Laura and John Arnold Foundation Policy Perspective, Pension Litigation Summary*, Stuart Buck, PH.D., J.D., LJAF Strategic Litigation Counsel and Director of Research, January 2013, is provided in Appendix 4 of this report.

nontraditional method of calculating normal cost[12]. A move to a mixed defined benefit/defined contribution plan could also provide some cost savings over the long term.

The following table, provided by the Teachers' Insurance Annuity Association – College Retirement Equity Fund (TIAA-CREF), is a comparison of the major design features for traditional defined benefit, cash balance and defined contribution retirement plans. It is important to note that plan type is not the most important factor in determining the cost of a pension plan, rather, benefit levels are the determining cost factor. Cost determinations cannot be made in the absence of a specific benefit proposal.

---

[12]Both the PSERS and SERS Codes require the normal cost to be determined using "... a level percentage of the compensation of the average new active member...." However, the Systems apply different interpretations to the language, resulting in different funding effects. Using the SERS interpretation, under prior law, the average new member (Class AA) to the System earned a benefit at the 2.5% annual accrual rate and age 60 normal retirement. However, under Act 120, the average new member of SERS is a member of Class A-3, with a 2.0% annual accrual rate and normal retirement age of 65. This interpretation results in a diminished normal cost calculation that tends to understate the true cost of SERS benefits, because in the early years of the reduced benefit tier, the majority of members will remain in a benefit class entitling them to an annual benefit accrual of 2.5%. The result was an increase in the unfunded actuarial accrued liability of $2.7 billion. The change in unfunded liability occurred because reducing the benefit accrual rate for only new members does not affect the present value of benefits for current members, but does reduce the future normal costs payable on account of current members. Since the actuarial accrued liability is the difference between the total present value of benefits for all members and the present value of future normal costs, decreasing the normal cost for current members generates an offsetting increase in the actuarial accrued liability. Because Act 120 amended the SERS Code to require that any resulting unfunded liabilities be amortized over 30 years, the effect of the change in unfunded liability does not immediately impact the employer contribution rate.

The traditional method employed by PSERS is to develop the normal cost rate based upon current active members and the benefits to which each member is entitled. This method blends the normal cost rates attributable to all active members, rather than new entrants only, resulting in a normal cost calculation that more closely approximates the normal cost of PSERS. Although the employer normal cost rate for new members of PSERS (Class T-E age 65) is 3.0%, the blended employer normal cost calculation results in an aggregate employer normal cost of 8.66%. In the past, the Commission's consulting actuary has strongly advised the use of the more traditional normal cost method employed by PSERS and has urged the adoption of this method by SERS.

TABLE 7

PLAN DESIGN FEATURES
A COMPARISON OF DEFINED BENEFIT (DB), CASH BALANCE AND DEFINED CONTRIBUTION (DC) PLANS

Design Feature	Traditional Defined Benefit	Cash Balance	Defined Contribution
DB or DC Plan	DB	DB	DC
Benefit Accrual Method	Defined formula For example: 2% x years of service x 3-year final average salary	Employer and employee contributions plus guaranteed interest	Employer and employee contributions plus investment gains or losses
Guaranteed Benefit?	Yes - 100% guarantee of accrued benefit	Yes - Usually principal and interest	No[13] (although guaranteed products can be included)
Investment Risk	Plan Sponsor	Plan Sponsor	Employee[13]
Possibility of unfunded liabilities?	Yes	Yes	No
Helps reduce future pension funding risk?	No	Somewhat	Yes
Higher employer contributions possible in the future?	Yes	Yes	No
Historical long-term investment returns[14]	6 to 8%	5%	6 to 7%
Probability of achieving benefit target for long-term employees	Higher	Lower	Higher
Probability of achieving benefit target for shorter-term employees	Lower	Higher	Higher
Able to provide retirement income for life	Yes	Yes	Yes

[13]Investment risk for participants can be reduced by the appropriate use of guaranteed investment products.

[14]5% floor based on 2010 Final IRS and Proposed Cash Balance Regulations. 6-7% returns based on current interest rate environment. Past performance is no guarantee of future results.

Converting to a defined contribution plan for new hires shifts two risks now assumed by the employer in defined benefit plans to the individual employee: investment risk and longevity risk. Investment risk is the primary reason for the current pension funding crisis, because the employer is responsible to ensure that the pension fund has sufficient assets to pay promised benefits in spite of the market losses incurred. Under a **defined contribution plan**, the fund is individually owned and the employee's retirement savings are reduced by any market losses. Longevity risk refers to the chance that a retiree might live longer than actuarially expected. If that happens in a defined benefit plan, the plan must still continue the pension payments. In a defined contribution plan, the employee simply outlives his or her savings. (Note that the American Academy of Actuaries has recently adopted new actuarial standards of practice that require the updating of mortality tables. This should alleviate a substantial element of longevity risk in defined benefit plans, while requiring commensurate increases in current employer contributions). If a defined contribution plan is adopted, centralized management and governance is necessary to control administrative and investment costs.

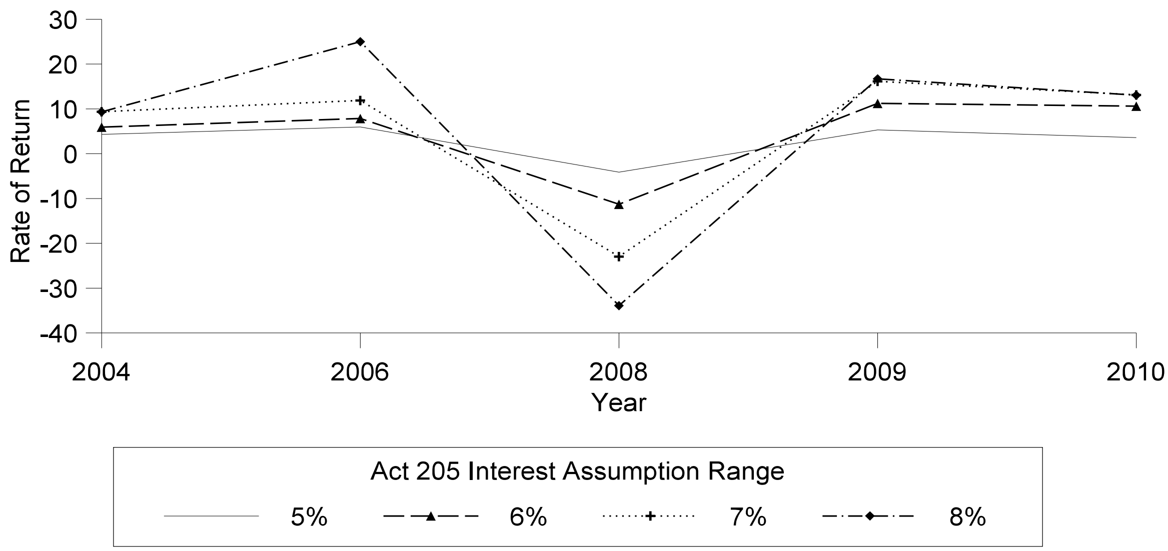
On September 9, 2010, the Commission issued an actuarial note on a bill that would have established a new mandatory retirement system applicable to all public employees hired by school or State employers within the Commonwealth after July 1, 2011, replacing the defined benefit plans provided by PSERS and SERS with a defined contribution retirement plan providing a dollar-for-dollar employer-matching contribution of up to 6% of the member's earnings. That note analyzed the funding costs, other consequences, and policy considerations involved and can be accessed via the following link: Defined Contribution Plan - Senate Bill Number 566, Printer's Number 577, as amended by Amendment Number 08034.

If we seek to avoid employer contribution volatility, this can be assured by establishing a defined contribution plan. The contribution rate is fixed and invariable. It is difficult to achieve similar contribution stability in defined benefit plans.

Graph 3 demonstrates the effect of using conservative earnings assumptions on investment earnings. The graph shows the average rate of return, by interest assumption range, for all municipal pension plans from 2004 to 2010, excluding the City of Philadelphia. In general, a higher assumed interest rate requires a higher level of risk in order to achieve a higher rate of return. The greater the investment risk, however, the more volatility a plan will experience during market fluctuations. A lower assumed interest rate decreases the investment risk and provides for lower, but more stable, investment returns.

GRAPH 3

AVERAGE RATE OF RETURN BY INTEREST ASSUMPTION RANGE



In a **defined benefit pension plan**, the employer alone typically assumes the investment risk and investment reward. No loss means no contribution increase, but no gain means no contribution decrease. Regardless of the investment performance, the employee's benefits are guaranteed and are not affected by market fluctuations. In the past, the assets of public employee retirement systems were invested conservatively. Beginning in the 1990s, many public pension plans began to diversify into higher yield, higher risk investments. The more diversified universe of investment options provided these systems with substantial investment earnings through the latter portion of the 1990s, but the higher risk has resulted more recently in significant losses (from 2001-2003 and again in 2008).

The City of Philadelphia, and a number of other states, have established **hybrid pension plans** in the attempt to bring retirement costs under control. Most of these consist of a reduced defined benefit (e.g., 1% per year of service, capped at 25 years) plus a defined contribution plan (with or without matching contribution requirements). The problem with these hybrid plans is that the employer continues to bear the investment and longevity risks, just at a lower rate than before. Pennsylvania's County Pension Law, Act 96 of 1971) has provided a hybrid system for over 40 years, with the employer funding the defined benefit portion and the employee contributions going toward a defined contribution plan. The existence of this hybrid has not spared county governments from the contribution increases triggered by the recession. Another form of hybrid would establish a defined benefit plan applicable to a fixed salary amount, with a defined contribution plan applicable to higher compensation.

On May 27, 2010, the Commission issued an actuarial note on a bill that would have established a new retirement benefit plan applicable to all members of PSERS who become members of the System after June 30, 2010. The new benefit tier established by the bill was to be a hybrid benefit plan, combining elements of both a defined benefit plan and a defined contribution plan. That note analyzed the funding costs, other consequences, and policy considerations involved and can be accessed via the following link: Hybrid Plan - Senate Bill Number 1185, Printer's Number 1672.

Yet another form of pension is the **cash balance plan**. Technically a defined benefit plan under the law, the failure of the Department of Labor to adopt regulations for over twenty years led to substantial litigation as to the rights and duties of the employers and employees, and resulted in these plans falling into disfavor. The 2010 adoption of final regulations has resolved most of the issues concerning cash balance plans, and they are again growing in popularity in both the public and private sectors.

Essentially, a cash balance plan provides for defined annual contributions from the employer and the employee into a pension fund. Unlike a defined contribution plan, ownership of the employer contribution and earning thereon does not transfer immediately to the employee. Instead, like a traditional defined benefit plan, the cash balance arrangement holds ownership in the pension fund and can utilize contributions and earnings to help defray pre-existing unfunded liabilities. At the time of retirement, which can have age and service conditions like any other defined benefit plan, the accumulated contributions and earnings are utilized to provide a lifetime annuity benefit. The amount of the benefit is based upon the balance in the cash account and is not guaranteed by the employer. The employer does guarantee an interest rate on the accumulating contributions, so there is an investment risk. This can be alleviated by the selection of a "risk-free" interest rate, such as the 10-year Treasury rate averaged over the employee's career. The employer also assumes the longevity risk, which can be ameliorated by utilizing conservative life expectancy assumptions. Commercial insurers use the age of 125 years when calculating annuities (if the annuitant dies before attaining age 125, the insurer makes a profit). In Pennsylvania State government, the Pennsylvania Municipal Retirement System provides a cash balance annuity based upon earnings in excess of the assumed rate as a supplement to its normal retirement benefit.

On August 4, 2011, the Commission issued actuarial notes on two bills that would have established a mandatory cash balance benefit tier applicable to most new members of SERS, beginning January 1, 2012, and most new members of PSERS, beginning July 1, 2012. The bills sought to create a cash balance pension plan under which members would be eligible for an annuity with a present value equal to the balance of the member's cash balance account upon superannuation (age 55). These notes analyzed the funding costs, other consequences, and policy considerations involved and can be accessed via the following links: Cash Balance Plan - House Bill Number 1676, Printer's Number 2123, and House Bill Number 1677, Printer's Number 2124.

Changing the type of retirement system does not necessarily mean a cost savings. The net effect of the benefit modifications imposed by Act 120 was to reduce significantly the normal cost of benefits earned by new employees of both Systems, resulting in a reduction in the employer normal contribution rate. As of June 30, 2009, the employer normal cost rate for PSERS was 8.08%. As of December 31, 2009, the employer normal cost rate for SERS was 9.53% of payroll.[15] According to the data supplied by the Systems, as of January 1, 2012, the employer normal cost rate for new members was 3.0% of payroll for PSERS and 5.1% of payroll for SERS. This change constitutes a reduction in employer normal cost rates compared with prior law. In order for a defined contribution plan to provide cost savings, the employer contribution to that defined contribution plan would need to be less than the prospective normal cost rate to the existing plan (conditioned upon the existing defined benefit plan achieving its actuarial assumptions), even without reference to the amortization of unfunded liabilities. The Commonwealth's only existing defined contribution plan, offered as a SERS alternative to certain employees in the higher education system, has an employer contribution rate of 9.29%[16]. That is substantially greater than the employer normal cost for new hires under Act 120.

But these are all paths to a goal, not the goal itself. Pennsylvania has never articulated its intent with regard to public employee retirement. Our statutes provide benefit ranges from substantially less than 50% of compensation to more than 100% of compensation.

B. What is an adequate retirement benefit?

Assuming one accepts that public employers should make available to their employees some type of retirement benefit plan, the most obvious question becomes the level of benefit that should be provided. A policy which sets forth a certain income replacement ratio as that policy's stated objective would be one reasonable approach. Although there are various ways to measure retirement benefit adequacy, one method, long established as a benchmark in the financial planning field, has been a post-employment income that is roughly 70% to 80% of pre-retirement income. Historically, the three primary sources of retirement income have been: 1)Social Security, 2) an employer-sponsored retirement benefit, and 3) personal savings, together, constituting the oft-cited "three legged stool." As other sources of retirement income have declined, Social Security has become an increasingly important "leg" of the stool. Nationally, for a typical retiree, Social Security currently replaces 30% to 40% of pre-retirement income. For members of SERS, the average income replacement ratio is roughly 34.5% and 35.8% for PSERS members.[17]

Many public safety employees and certain educational employees do not participate in Social Security, however. At the state level, Pennsylvania State Police Officers do not participate in Social Security, and at the local level, more than two-thirds of public safety employees do not participate in Social Security. Because Social Security participation

---

[15]From PSERS and SERS 2009 Annual Actuarial Valuations.

[16]71 Pa.C.S. §5301(a)(12).

[17]Estimates based on compensation data from the State Employees' Retirement System CAFR, 12/31/2011 and the Public School Employees' Retirement System CAFR, 6/30/2012, and calculated using Social Security Administration Methods and Assumptions (http://www.socialsecurity.gov/OACT/quickcalc/index.html).

is a matter of management prerogative, and not employee choice, policymakers may wish to consider offering additional retirement benefits to public safety employees not covered by Social Security.

The literature on personal savings in the United States shows a persistent and disturbing trend; personal savings are in decline. The trend of insufficient saving is occurring at the same time that both the access to and value of employer-sponsored retirement plans are also in decline.

In October of 2012, the Center for Retirement Research (CRR) at Boston College released an update on its National Retirement Risk Index (NRRI).[18] The NRRI was developed to show the share of working households that are at risk of being unable to maintain a pre-retirement standard of living in retirement. The Index compares projected replacement rates – retirement income as a percentage of pre-retirement income – for today's working households with target rates that would allow these households to maintain pre-retirement living standards, and calculates the percentage of households at risk of falling short. Some key findings of the NRRI were:

1. The duration of retirement is increasing as the average retirement age hovers at 63 and life expectancy continues to rise.

2. At the same time, income replacement rates are falling because of increases in the Social Security's Full Retirement Age and modest 401(k)/IRA balances.

3. Median 401(k)/IRA balances for households approaching retirement were only $120,000.

4. Asset returns in general, and bond yields in particular, have declined over the past two decades so a given accumulation of retirement assets will yield less income. In addition to the contracting retirement income systems, households have been hit by the financial crisis and ensuing recession.

5. 53% of today's households will not have enough retirement income to maintain their pre-retirement standard of living, even if they work to age 65 – which is above the current average retirement age – and annuitize all financial assets, including the receipts from a reverse mortgage on their homes.

Given the current environment, the need to address the issue of retirement benefit adequacy seems clear.

C. What is an appropriate retirement age?

Prior to Act 120 of 2010, normal retirement age for most members of PSERS and SERS was age 62 with at least one year of service, and age 60 with three years of service, respectively. For members of the General Assembly and certain public safety employees, normal retirement age was age 50. Under Act 120, normal retirement age for most new members of PSERS and SERS was increased to age 65 with a minimum of three years of

---

[18] Center for Retirement Research, National Retirement Research Index. http://crr.bc.edu/special-projects/national-retirement-risk-index/

service. Members of the General Assembly and certain public safety employees hired after Act 120 now have a normal retirement age of 55.

For public employees generally, the trend has been toward gradual increases in normal retirement ages. Increases in the retirement age in the governmental plans of other states have followed a trajectory similar to that seen with the incremental increases in full retirement age for Social Security benefit eligibility (currently, those born after 1960 are entitled to receive full Social Security benefits starting at age 67). Since 2009, 38 states have enacted higher age and service requirements for pension benefits, mainly for new hires.[19] Policymakers may wish to determine what constitutes an appropriate retirement age. Does the Commonwealth wish to retain employees until the age of full Social Security eligibility? What are the advantages and disadvantages of an older workforce? How does this affect the future recruitment and retention of well-qualified candidates in government service?

With respect to public safety employees, at what age should police officers, firefighters and other public safety professionals continue performing hazardous, physically demanding duties? Traditionally, reduced retirement age and service requirements for public safety employees were predicated on the need to retain a vigorous workforce up to the physical challenges and hazards of the profession.

D. What are the long-term personnel management goals of the Commonwealth?

Historically, public employees have generally earned less over the course of their working careers than counterparts of similar education and age working in the private sector, although there is significant question as to whether that still holds true. The traditional bargain was that public employees would receive secure retirement benefits as compensation for lower wages. As many states around the nation have faced the funding pressures resulting from the recession of 2008, many governments have attempted to reduce the costs of public employee retirement systems and, in a few cases, have turned to alternative retirement plans for public employees, such as "401(k)-like" defined contribution plans. In the private sector, only 18% of employees still retain access to a defined benefit pension plan as of 2011.[20]

Traditional defined benefit pension plans are designed to encourage long-term employment. They are not attractive to, or beneficial for, a transient workforce. Since many public sector job skills are not readily transferable to the private sector, the pension benefit served as an incentive to making the necessary commitment. Switching to an alternative plan would attract a different type of labor force. Policymakers may wish to consider the long-term personnel management goals of the Commonwealth before contemplating major changes to the retirement benefit structure.

Along with considering the type of employees the Commonwealth wishes to attract to public employment, policymakers may wish to consider the appropriate size and nature of a future workforce. A May 2010 report released by the Center for Economic and Policy

---

[19] Ron Snell, *State Pension Reform, 2009-11*, National Conference of State Legislatures, March 2012. Also, Ron Snell, *Pensions and Retirement Plan Enactments in 2012 State Legislatures*, National Conference of State Legislatures, August 31, 2012.

[20] Bureau of Labor Statistics, U. S. Department of Labor, *The Editor's Desk*.

Research indicated that, nationwide, Pennsylvania ranks last in terms of the number of state employees per capita.[21] Policymakers should consider whether current staffing levels are appropriate when compared with other similarly-sized states, and if not, what functions that are currently performed by state employees would be better suited to the private sector.

V. LOCAL GOVERNMENT PENSIONS

Pennsylvania's local government pension structure is quite diverse and highly fragmented. For local governments, pension benefits vary widely depending on the many governing statutes and accompanying local ordinances that have been enacted over the years. For example, while most municipal police pension plans have a benefit structure with a basic benefit of 50 percent of final average salary, the level of benefit disparity among municipal pension plans can be quite drastic, with some plans providing benefits as low as a $100 annual defined contribution payment and some as high as 100 percent of final salary.

Pennsylvania's local government pension plans comprise more than 25 percent of the public employee pension plans in the United States. There are now more than 3,200 local government pension plans in Pennsylvania, and the number is continuing to grow. Membership and benefit provisions of these 3,200 pension plans vary dramatically. The following table summarizes the major membership and benefit provisions of Pennsylvania's local government retirement systems.

TABLE 8

MAJOR MUNICIPAL MEMBERSHIP BENEFIT PROVISIONS

Municipal Code	Type of Employee	Superannuation Age & Service	Normal Retirement Benefit	Vesting Period	Member Contribution
First Class City Code (Philadelphia)	Police Officers	Age 50 with 10 years of service	2.2% of pay times years of service up to 20 years, 2.0% of pay in excess of 20 years. For members hired after January 1, 2010, 1.75% of pay times years of service up to 20 years.	10 years; 5 years for members hired after January 1, 1999. Other members may elect 5 year vesting w/ additional contributions	5% of pay. For members hired after January 1, 2010, 6% of pay.
	Firefighters	Age 50 with 10 years of service	2.2% of pay times years of service up to 20 years, 2.0% of pay in excess of 20 years. For members hired after January 1, 2010, 1.75% of pay times years of service up to 20 years.	10 years; 5 years for members hired after January 1, 1999. Other members may elect 5 year vesting w/ additional contributions	5% of pay. For members hired after January 1, 2010, 6% of pay.

Table 8 continued on next page.

[21] John Schmitt, *The Wage Penalty for State and Local Government Employees*, Center for Economic and Policy Research, May 2010.

Municipal Code	Type of Employee	Superannuation Age & Service	Normal Retirement Benefit	Vesting Period	Member Contribution
	General Employees	Age 60 with 10 years of service	2.2% of pay times years of service up to 10 years, 2.0% of pay in excess of 10 years	10 years; 5 years for members hired after January 1, 1999. Other members may elect 5 year vesting w/ additional contributions	30% of gross normal costs (2.77% as of July 1, 2011)
Second Class City Code (Pittsburgh)	Police Officers	Age 50 or 20 years of service	50% of monthly average pay during final 3 years of service	10 years	6% of pay plus $1 per month
	Firefighters	Age 50 or 20 years of service	50% of monthly average pay during final 3 years of service	10 years	6.5% of pay plus $1 per month
	General Employees	Age 55 or 8 years of service	50% of monthly average pay during final 4 years of service	8 years and minimum age of 40	4% of pay
Second Class A City Code (Scranton	Police Officers	Age 55 and 25 years of service	50% of monthly average pay during final 3 years of service	25 years	3.5% of pay
	Firefighters	Age 55 and 25 years of service	50% of monthly average pay during final 3 years of service	25 years	3.5% of pay
	General Employees	Age 55 with 15 years of service and 20 years of contributions	75% of monthly average pay during final 5 years of service	10 years	3% of pay or no more than $22 a month (1% as of January 1, 2011
Third Class City Code (Act 317 of 1931)	Police Officers	20 years of service, and age 50, if a minimum age is required	50% final rate of pay or 50% of monthly average pay during high 5 years, whichever is greater	12 years	5% of pay. Additional contributions may be permitted.
	Firefighters	20 years of service, and age 50, if a minimum age is required	50% final rate of pay or 50% of monthly average pay during high 5 years, whichever is greater	12 years	5% of pay. Additional contributions may be permitted.
	General employees	Age 60 with 20 years of service	50% of high 5-year Final Average Salary	12 years	3% of pay for joint coverage member, or 2.0% for single coverage member
Pennsylvania Municipal Retirement Law (Act 15 of 1974)	Police Officers and Firefighters	Age 55	Varies; based on contract plan provisions	12 years	Varies; based on contract plan provisions
	General Employees	Age 65	Varies; based on contract plan provisions	12 years	Varies; based on contract plan provisions

Table 8 continued on next page.

Municipal Code	Type of Employee	Superannuation Age & Service	Normal Retirement Benefit	Vesting Period	Member Contribution
Municipal Police Pension Law (Act 600 of 1955)	Police officers in boroughs and townships with 3 or more officers, or regional police departments	Age 55 with 25 of years of service	50% of the monthly average pay during final 36 to 60 months of employment	12 years	Varies; ranges from 5 to 8% of pay, with possible annual reduction
The First Class Township Code	Police Officers (*Less than 3 members*)	Varies	Varies	Varies	Up to 4% of pay
	General employees	Varies	Varies	Varies	Varies
The Second Class Township Code	Police Officers (*Less than 3 members*)	Varies	Varies	Varies	Up to 3% of pay
	General employees	Varies	Varies	Varies	Varies
The Borough Code	Police Officers (*Less than 3 members*)	Varies	Varies	Varies	Varies
	General employees	Age 60 with 10 years of service	Maximum 50% of pay	Varies	Varies
County Pension Law (Act 96 of 1971)	General employees	Age 60, or age 55 with 20 years of service	Varies. Includes a DC portion for member's annuity and DB portion for county annuity	5 years	Varies; ranges from 5 to 9% of salary
Municipality Authorities Act of 1945	General employees	Varies	Varies	Varies	Varies

Another characteristic of Pennsylvania's fragmented local government pension structure is a lack of benefit portability. In most cases, years of service accumulated in one pension plan cannot be readily transferred to another local government pension plan, making it difficult for employees who have substantial service with one employer to make a career change. This situation can negatively affect local government employees' ability to achieve their full career potential.

By establishing a uniform retirement plan across the Commonwealth for all local governments, the current level of benefit disparity and lack of portability amongst local retirement plans could be remedied. Additionally, the high per-member costs associated with administering small municipal plans would result in savings through the consolidation of administrative functions into a statewide retirement plan.

TABLE 9

PER-MEMBER ADMINISTRATIVE COST FOR SELECTED MUNICIPAL PENSION PLANS BASED ON PENSION PLAN SIZE

Pension Plan Size	Per-Member Administrative Cost	
	2011	2009
10 or fewer Active Members	$1,567.84	$1,440.62
11 to 100 Active Members	$1,063.78	$1,008.63
More than 100 Active Members	$382.86	$445.38
More than 500 Active Members	$333.55	$403.73

Through the years, the Commission has recommended the consolidation of local government pensions into a single, pooled entity that could obtain the economy of scale and reduce the per member administrative costs incurred by the current conglomeration. Each municipality would continue to be credited with its own fund, not unlike the Pennsylvania Municipal Retirement System today.

Under the Municipal Pension Plan Funding Standard and Recovery Act (Act 205 of 1984), the Commonwealth imposes a tax on the premiums of casualty and fire insurance policies sold in Pennsylvania. Act 205 establishes a **General Municipal Pension System State Aid Program** financed from the proceeds of a portion of the casualty insurance premium tax and a portion of the fire insurance premium tax assessed against out-of-state ("foreign") insurance companies. As of 2012, the total allocation available through the State aid program was $232.8 million. General Municipal Pension System State Aid (State aid) is allocated annually to all municipalities (excluding municipal authorities) to defray the costs of providing employee pension benefits. Stated in a simplified manner, the Act 205 allocation formula first determines a "unit value" by dividing the total amount of money available for distribution by the total number of employee "units" reported by the individual municipalities. The unit value is then multiplied times the number of employee units reported by each eligible municipality to determine the individual municipal allocation amounts.

The Act 205 allocation formula also limits all individual State aid allocations to 100 percent of the annual pension costs payable by the recipient municipality (except in the case of the City of Philadelphia, which is capped at 25 percent of the total State aid monies available). This limit or "cost cap" on the annual allocations was included in the Act 205 formula because of the wide variation in municipal pension costs. It serves to ensure the efficient use of the available State aid and supports the program's purpose – offsetting municipal pension costs.

One of the proposals given in testimony to the Commission during public hearings was for the General Assembly to consider amending the State aid allocation formula to ensure that distressed pension plans receive additional funding. In the past, the Commission recommended changes in the formula to provide for a more effective allocation to municipal pension plans. By limiting State aid allocations to a level that is less than a given municipality's full pension costs, affected municipalities will share in the financing of their employee pension costs; that cost sharing will help create the necessary incentive for municipalities to control their employee pension costs in the future. A lowered cost limit on the State aid allocations will also serve to lessen the wide disparity in the current State aid allocations that is apparent when the allocations are viewed in terms of the portion of municipal pension costs covered. The Commission's recommendations at the time were to reduce the cost limit on State aid allocations from 100 percent to 75 percent over a five-year period.[22]

An example of a similar cost-sharing arrangement can be found in the handling of employer contributions for PSERS. Under current law, PSERS employers and the Commonwealth share the cost of required employer contributions to the System. The process requires "school entities" to initially pay the entire amount of the required employer contributions. The Commonwealth then reimburses school entities with an amount that is not less than 50% of the aggregate employer contribution rate. The current statewide average is roughly a 55%/45% ratio, with the Commonwealth paying 55%. Limiting State aid allocations to 50 percent would guarantee municipalities will have an equal share in the financing of their employee pension costs similar to the process for public school employers.

In 1990, 87% of the recipient municipalities were receiving allocations that fully funded their employee pension costs. Today, only 38 percent, or 584 municipalities (10 percent of the active membership) are receiving a full cost allocation.[23]

Full subsidization tends to reduce the incentives for municipalities to control their employee pension costs. It also creates an inequity in the State aid allocation formula in that some municipalities receive allocations that cover 100 percent of their pension costs and others receive allocations that cover as little as 30 percent of their pension costs.

VI. CONCLUSION

The Commission concurs with the Governor's assessment that the only unacceptable option is to do nothing. The pension funding crisis that exists at all levels of government must be addressed in a way that acknowledges fiscal reality and the need to protect Pennsylvania's taxpayers from unreasonable contribution volatility. It is hoped that the concepts outlined in this report can provide guidance in developing effective solutions.

---

[22] 2005 Status Report on Local Government Pension Plans, Public Employee Retirement Commission, November 2004, pp. 3-4.

[23] 2012 Status Report on Local Government Pension Plans, Public Employee Retirement Commission, December 2012, pp. 24-25.

APPENDIX 1

TESTIMONIES PRESENTED AT PUBLIC HEARINGS

TESTIMONY OF STEPHEN HERZENBERG, PH.D.
KEYSTONE RESEARCH CENTER
PUBLIC EMPLOYEE RETIREMENT COMMISSION
PUBLIC HEARINGS
SEPTEMBER 5, 2012

Good afternoon Chairman Salamone, Vice Chairman Zervanos, members of the Public Employee Retirement Commission. My name is Stephen Herzenberg and I have a PhD in economics from the Massachusetts Institute of Technology (MIT). I have been the Executive Director of the Keystone Research Center since its creation in the mid-1990s. KRC is an independent, non-partisan economic research and policy organization or "think tank." A core focus of KRC's research is on the performance of the Pennsylvania economy from the perspective of typical families. One component of this research is on retirement security, in both the private and the public sectors.

I appreciate the opportunity to assist you in your effort to support, through fact-based inquiry, the General Assembly in determining the long-term pension policy of the Commonwealth, including the appropriate level and nature of future public sector retirement systems and the methods available to deal with the outstanding liabilities of existing systems.

Three weeks ago, I testified on pension issues before the Pennsylvania House Government and Finance Committees. My written testimony is available on line at http://keystoneresearch.org/media-center/press-releases/undermining-retirement-security-stephen-herzenbergs-testimony-pension-le. On occasion today, I will refer to this written testimony for additional detail. This will allow me to focus my remarks key points that we encourage your Commission to keep in mind as it develops a written report to the General Assembly.

The existing legislative proposals to change public sector pensions increase costs to taxpayers—they are not "better than nothing," "good for taxpayers," or "pension reform."
One of the important points to emerge from the House hearings was that none of the existing legislative proposals on public sector pensions would reduce the outstanding liabilities of Pennsylvania's retirement system for state employees (the State Employee Retiree System or SERS) or for public school employees (the Public School Employee Retirement System or PSERS). These proposals all deal with pensions for some or all *future* employees. These proposals would, to varying degrees, increase the costs to of taxpayers of the outstanding liabilities of the SERS and PSERS systems. The legislative proposals that mandate that new employees participate in new defined contribution or cash balance plans would increase the contribution rates required for current SERS and PSERS defined benefit plans. These existing plans would become closed-end funds with the average age of members increasing as the plans wind down. Plan assets would have to be invested more conservatively as plan participants age. PSERS and SERs investment earnings would fall below current projections of 7.5%.

The fact that switching to DC plans does nothing to address liabilities of the existing DB plans is buttressed by the experience of Michigan and Alaska which were summarized in my testimony before the House (pp. 7-8).

<u>Pennsylvania's public pensions are not especially generous</u>. Some of the rhetoric and advocacy for modifying Pennsylvania's public sector pensions is based on the claim that public sector workers earn outsized pensions. As you develop your report for the legislature, I encourage you to move beyond the myths and sift through the real data on whether Pennsylvania's pensions for state and public school employees are overly generous. Here are the facts that lead us to the conclusion that the current SERS and PSERS state pensions are not overly generous.[1]

Pennsylvania public sector workers earn lower wages and slightly lower wages plus benefits than comparable public sector workers. The most definitive research on public sector pay and benefits in Pennsylvania relative to private sector pay is a report by Rutgers economist Jeff Keefe, published last year by the Economic Policy Institute.[2] Adapting a methodology associated with Chicago school (conservative) Nobel-prize winning economist Gary Becker, Keefe shows that state and local government employees in Pennsylvania are paid substantially less in wages than private sector workers who have the same level of education, experience, and other characteristics that economists typically "control for" when examining relative wages. The public sector wage gap is particularly pronounced at the high end and among more educated workers. Controlling for education (but not other variables), Pennsylvania workers with a four-year college degree or more earn 27% to 59% less in annual wages than similarly educated private-sector workers.[3] At the very top end of the wage distribution, the two highest-paid CEOs in Pennsylvania earned more in 2010 than the highest-paid 100 public sector workers combined.[4] There is a reason people do not say "I'm leaving the private sector to go make more money."

When you take into account benefits, the compensation (wages plus benefits) gap between the private sector and the public sector in Pennsylvania shrinks: public sector workers are still paid less in wages plus benefits, on average, when you control for education and other individual characteristics, but the gap is small.[5]

---

[1] My House testimony, on pages 8-11, also contains a discussion of the adequacy of pension benefits for new employees under a proposed cash balance plan based on an analysis of HB 1677. The analysis there concludes that HB 1677 would lead to a significant additional cut in benefits relative to the Act 2010 changes which already cut pension benefits for new employees by 20%.

[2] Jeffrey Keefe, *Public Versus Private Employee Costs in Pennsylvania: Comparing Apples to Apples* (Washington, DC: Economic Policy Institute, 2011), online at http://keystoneresearch.org/publications/research/public-versus-private-employee-costs-pennsylvania.

[3] Keefe, *Public Versus Private Employee Costs*, Table 2, p. 5. Including benefits, the total compensation gap (wages plus benefits) for workers with a college degree or more is almost as big, ranging from 21% to 57%.

[4] For details and sources, go to http://thirdandstate.org/2011/april/ceo-pay-soars-while-workers%E2%80%99-pay-stalls.

[5] Keefe, *Public Versus Private Employee Costs*, Table 4, p. 9. The annual wage and compensation gaps are still statistically significant: public compensation trails private sector by 5.4%. When examining compensation per hour,

The 2010 Act 120 reforms made Pennsylvania public sector pensions substantially less generous to employees and less costly to employers.[6] The Act reduced the future cost to state government of SERS and PSERS pensions in the following ways:

- The pension multiplier, which determines the final level of the retirement benefits, was reduced by 20 percent, falling from 2.5 percent to 2 percent per year of service. An exception was made for those new hires that upon joining SERS/PSERS elect to pay the full cost difference for the 2.5 percent multiplier. Whether through lower benefits (for the majority of new employees who are choosing the 2 percent multiplier) or through higher employee contributions (for the small share that are choosing the 2.5 percent multiplier), the cost to the employer (state government or school district)—i.e., the generosity of the pension—is reduced.
- The vesting requirement was increased from five years to 10 years;
- A cap was placed on the maximum pension benefit, so that retirees with longer years of service cannot earn more than their final salary;
- There were substantial increases in the age and years of service required to retire at full benefit;
- The option that allows a member to withdraw their own contributions when they retire was eliminated.
- The basic contribution rate was effectively raised, because new hires are paying the same amount for a reduced level of benefits; and,
- Pennsylvania was the first in the nation to require new hires to pay an additional "risk sharing" rate of up to 2 percent if SERS/PSERS do not meet their earnings assumptions. So instead of just the employer rate going up following an economic meltdown, employees too will directly share in the pain.

With the changes, the cost of benefits earned by new PSERS employees ("normal costs") was reduced by 60 percent to 3 percent of salary; for new SERS employees the cost for new employees was lowered to 5.1%.[7] Over the next 30 years, the savings from Act 120 project to more than $19 billion in the PSERS plan and another $7 billion in the SERS plan.

Pennsylvania state government and school employees contribute more than similar employees in other state and their employers (state government and school districts) contribute less than in most other states. The 2010 reforms strengthened one feature of Pennsylvania's current plans that stands out in comparison to other plans: the heavy reliance on **employee** contributions. For example, the average school employee in Pennsylvania is paying 40 percent more toward her retirement benefits than public employees in other states. By contrast, **employer** contributions in Pennsylvania have been substantially lower than the national average over the

---

the gap shrinks to 2.1% for all public employees and 3.8% for state government employees, neither of which is statistically significant.

[6] Act 120 also lowered near-term required employer contributions to SERS and PSERS from the state and school district more than desirable. This aspect of the legislation "kicked the can down the road."

[7] These are the estimated costs for pensions of new members of PSERS and SERS which consciously or by default select a 2.0 multiplier (i.e., Class T-E members).

last decade. In 2010, for example, PSERS and SERS had the second lowest percentage paid of Annual Required Contributions in the entire United States.[8] While nationally employers contribute more toward retirement than do their employees, the reverse has been true in Pennsylvania school districts for more than a decade, with school employees paying more than the Commonwealth and district combined. (We need to explore whether this claim is also true for state government employees.)

PSERS and SERS pensions provide adequate but not generous retirement income. To fully assess the generosity of PSERS and SERS pension plans requires complex models beyond the scope of this testimony. Back in 2006, however, in a report jointly published by my organization and the Center for American Progress, economist Christian Weller reported the results of some simulations aimed at gauging the generosity of SERS and PSERS pensions.[9] Weller assumed (based on the actual characteristics of SERS employees) that a "typical" SERS worker has 15 years in a SERS job, 15 years in another job, and then retires at 62. He assumed that a "typical" PSERS employee has 30 years of experience and retires at 62. Based on his models, a PSERS employee would have retirement income equal to 78% of pre-retirement income with 52% of that income coming from their DB pension and the rest from Social Security. A SERS employee would have retirement income equal to only 51% of pre-retirement earnings, which only 31% of that coming from their SERS DB pension.

Retirement experts regard the threshold retirement income for maintaining one's standard of living in retirement as about 75-to-80 percent of pre-retirement income. Based on this threshold, our "typical" PSERS employee meets the threshold while the "typical" SERS employee falls short. Of course, employees that work much more than typical may end up with more generous pensions but the anecdotal exceptional employee is not a basis for a fact-based assessment of the generosity of pensions. The Commission's focus in gauging the generosity of pensions should be the "typical" employee and, if possible, a "weighted average" of pension recipients that reflects accurately the entire population of public employees (based on their years of service, age at retirement, date of retirement, etc.) Another very important point is that Weller's analysis was for SERS and PSERS prior to the Act 120 changes, which, in effect, cut pensions by at least 20%.

One major reason that Pennsylvania public sector pensions are not especially generous, and automatically become less generous for already-retired workers every year, is that benefits are based on the employees top salary years *unadjusted for inflation*. Since Pennsylvania SERS and PSERS benefits are not automatically adjusted for the rising cost-of-living, unlike Social Security,

---

[8] Annual Required Contributions—ARC—equals normal cost plus payments on an unfunded liability. ARC is determined in a consistent way across states using Government Accounting Standard Board (GASB) standards. The source for the claim that SERS and PSERS had the second-lowest paid of ARC is National Association of State Retirement Administrators (NASRA) Public Fund Survey FY 10 and PEW Center Trillion Dollar Gap Study 2010.

[9] Christian E. Weller, Mark A. Price, and David M. Margolis, *Rewarding Hard Work: Give Pennsylvania Families a Shot at Middle Class Retirement Benefits* (Keystone Research Center, Harrisburg and Center for American Progress, Washington, DC: October 4, 2006), pp. 11-12; online at http://keystoneresearch.org/media-center/press-releases/state-should-take-action-bolster-retirement-security-says-keystone-resea.

these benefits are eroded by inflation each passing year. For example, anyone who retired in or before 2002, since which there has been no ad-hoc cost-of-living adjustment for retirees, has seen the real purchasing power of their pension eaten away 21.4% by inflation. Taking this inflation into consideration, the multiplier for retirees in 2002 and earlier has effectively been reduced from 2.5 to 1.96—and falling every year.

[Include a concrete comparison on generosity—compared to other states…There's a link, can I be concrete]

For future employees, since pension benefits aren't generous, cuts in pensions won't save money because wages will have to increase to attract and retain qualified workers. The slight public-sector disadvantage in total compensation (wages plus benefits) compared to the private sector, means that it won't be possible for the state or school districts to save money by cutting pensions for future employees without having difficulty attracting and retaining qualified workers.

For current employees and existing retirees, since pension benefits aren't generous, cuts in pensions would be unethical. Setting aside the legal prohibitions on retroactively lowering pensions for workers already in the SERS or PSERS retirement systems, current retirees and current employees, the slight public-sector disadvantage in total compensation (wages plus benefits) compared to the private sector has another implication. It underscores that good pensions are compensation for wages and salaries well below private-sector levels, on average. Many existing workers and retirees might have taken different jobs in the first place, or left public service, if they knew in advance that pension commitments that compensate for lower public sector wages were not going to be honored.

DB plans are the most cost-effective retirement vehicle. Another important part of your deliberations should address the relative cost of managing the existing SERS and PSERS DB plans compared to proposed alternatives. Our understanding is that the combined administrative, asset management, marketing, and trade fees of 401(K) type plans are substantially higher and, moreover, these costs can eat away a substantial share of plan participants' retirement security. A valuable new report by Robert Hiltonsmith of Demos, *the Retirement Savings Dream: The Hidden and Excessive Costs of 401(k)*, documents these costs.[10] The Demos report works through a particular example of the cost of managing DC plans using one of the funds available to Demos's own employees through its DC pension. The report (on p. 8) finds that the fund's costs consume 49.1 percent of earnings in year, after taking into account inflation.

DC plans represent a transfer from Main Street to Wall Street. Based on the higher costs of managing DC plans, our conclusion is that DC plans represent a transfer from Main Street to Wall Street. Public-sector employees get less retirement security for any given amount of

[10] This report is online at http://www.demos.org/publication/retirement-savings-drain-hidden-excessive-costs-401ks.

employee and employer contributions and financial services firms expand their market and their profits. Why is this a good idea?

Who's driving the push for DC plans? One question raised by the idea that DC plans represent a transfer from Main Street to Wall Street is who's driving the lobbying and advocacy for this switch. Is it financial services firms? Given that the groups defending DB plans are no secret—public employees and the unions that represent these employees are behind this defense—it would be a public service for this Commission to provide equivalent information on who is driving the advocacy on the other side. I think lawmakers and the general public might view plans to switch to DC plans more skeptically if they understood that advocacy for these plans was driven by financial services firms with a direct financial interest in the switch.

Revenue must be part of the discussion about addressing unfunded liabilities. We do need more revenues to help deal with unfunded pension liabilities but without requiring more cuts to education, other investments in the future, and essential state services. In the context of pension issues, a number of sources of revenue come to mind: a tax on high-end pensions, so that more affluent retirees can contribute to limiting poverty among other retirees; a portion of revenues from closing corporate tax loopholes, given that financial games contribute both to the erosion of pension security in the private sector and to corporations paying lower taxes than commensurate with their real profitability and operations in Pennsylvania; or a higher tax rate on some classes of non-wage income, such as capital gains, dividends, profits, and interest. (A higher tax rate on unearned income is legal under the state's constitutional uniformity clause: wages and each of the categories of unearned income are separate "classes" of income on each of which may be imposed different tax rates.) Higher tax rates on unearned income would lead to those with the greatest ability to pay contributing a bit more to protect retirement security for public sector workers after they leave their jobs. With regard to this last option, it is worth noting that in 2010, the most recent estimates available, the highest-income 1% of Pennsylvania taxpayers took home a stunning 76% of the total increase of Pennsylvania income.[11] Much of this top 1% income likely was non-wage, "unearned," income, reinforcing the idea that this last proposal targets effectively taxpayers with the ability to pay.

Public-Sector Pensions Should Be Managed Better in the Future. A recent report from the National Institute on Retirement Security builds on recommendations we and CAP made in our 2006 Pennsylvania report and develops a list of *Lessons from Well-Funded Public Pensions: An Analysis of Plans that Weathered the Financial Storm*, online at http://www.nirsonline.org/index.php?option=com_content&task=view&id=613&Itemid=48).

The new study identifies six common elements of public sector defined benefit pension plans that remained well-funded despite two severe economic downturns:

1. Employer pension contributions that pay the full amount of the annual required contribution, and that maintain stability in the contribution rate over time;

[11] For details, see *The State of Working Pennsylvania 2012*, online at http://keystoneresearch.org/media-center/press-releases/state-working-pa-2012-following-lost-decade-pennsylvanians-earning-less-.

2. Employee contributions to help share in the cost of the plan;
3. Benefit improvements, such as multiplier increases, that are actuarially valued before adoption and properly funded upon adoption;
4. Cost of living adjustments (COLAs) that are granted responsibly, for example through an ad hoc COLA that is amortized quickly, or an automatic COLA that is capped at a modest level;
5. "Anti-spiking" measures that ensure actuarial integrity and transparency in pension benefit determination; and

Pennsylvania has the second of these best-practice features, and since the COLA of a decade ago, has, we hope learned the importance of the fourth feature. Pennsylvania does need to lock in feature 4 as well as features 1, 3, and 5.

The Real Retirement Security Crisis is the Lack of Adequate Pensions in the Private Sector. My final point is that the real retirement security crisis is the lack of adequate pensions in the private sector. In this regard, we helped instigate, a decade ago, a legislative proposal for the state to facilitate the creation of "universal savings accounts" for those who have no pension at all in the private sector. The state could create a turnkey system that allows small businesses to set up savings vehicles for their employees, with simple low-cost investment options, and with the default being that employees contribute to these plans. This would be a first step towards addressing the most disturbing pension crisis: the erosion of retirement security in the private sector. On this score we also noted with interest the California legislature passing a law that permits some private-sector employers to participate in public DB plans.

Testimony: Public Employee Retirement Commission
Brian K. Jensen, Ph.D.
Executive Director, Pennsylvania Economy League of Greater Pittsburgh
Wednesday, September 5, 2012

Good morning. Thank you for the opportunity to speak this morning regarding Pennsylvania's public pension problems and the pressing need for reforms to foster pension fund solvency and avoid the looming danger of tax increases and service reductions that will result from inaction. My name is Brian Jensen. I am the executive director of the Pennsylvania Economy League of Greater Pittsburgh.

The Pennsylvania Economy League has a 76-year history of conducting independent, non-partisan research and is committed to sound public policy that enhances the competitiveness of the Commonwealth. In my 25-year career at PEL, I have worked to make Pennsylvania local government more efficient, more effective and more competitive economically.

It is in the light of PEL's tradition of researching and promoting good government management practices and structures that we have been engaged in an ongoing analysis of Pennsylvania's public pension situation. We believe that public pension reform is critical to the financial health of Pennsylvania municipalities and central to Pennsylvania's future generally. This morning, I would like to convey to the Commission some of the highlights of our research and offer some conclusions on sound public policy that is indicated by the research.

With its radical decentralization of municipal pension plans, Pennsylvania is an extreme outlier among the fifty states. Our state has over four times as many public employee pension plans as any other state. Twenty-five percent of the nation's public employee pension plans belong to Pennsylvania's local governments and special districts. Our overly-fragmented municipal pension mishmash – it would be inaccurate to call it a "system" because there is nothing systematic about it – continues to grow with the number of local pension plans increasing steadily each year.

One consequence of having so many local government pension plans is that they tend to be very small. Two-thirds of our state's public pension plans have ten or fewer members and nearly half have five or fewer members. Does such plan fragmentation really matter? Yes. For one thing, an enormous obstacle to the consolidation of police departments and to broader municipal consolidation has been the challenge of resolving differing pension provisions. Fewer, better funded, better outfitted and better staffed police departments would be a happy consequence of a unified municipal pension system.

Additionally, the high administrative costs that result from such radical fragmentation exacerbate the dire fiscal condition of many of our municipal pension plans. According to PERC reports, in 2009, the unfunded accrued liability of our municipal pension plans was about $6.6 billion. Excluding Philadelphia and Pittsburgh, the unfunded liability totaled about $1.4 billion, roughly equal to the entire combined payroll of the host municipalities.

But the "true" fiscal position of our public pensions is not really very transparent or widely known. For example, public pension boards routinely set discount rates at levels that will likely exceed actual long-term investment returns, understating the actual severity of pension underfunding. Several improvements in the recent GASB Statement #68 will provide more transparency in future years. Despite the new accounting standards, however, many if not most Pennsylvania municipalities will fail to reap the benefits they are intended to offer. That is because many if not most Pennsylvania municipalities do not follow GAAP in their financial reports.

The incidence of financially stressed municipalities is geographically widespread in Pennsylvania. At the end of the copy of my written testimony that I have provided, you will see a map showing municipalities in Pennsylvania that PEL has identified as suffering from some category of financial distress, whether it be inclusion in the Act 47 program, identification as a municipality in the annual PEL Municipal Stress Index or one that PEL has identified as suffering from pension plan distress. Underfunded pension plans are a significant contributor to municipal financial stress. According to our analysis, over one-third of Pennsylvanians live in a municipality with a high degree of financial stress. Indeed, there is hardly a county that doesn't have at least one distressed municipality.

Why are so many of the Commonwealth's cities, boroughs and townships struggling to maintain financial health? I would submit the problem stems fundamentally from outdated and intrusive state laws. State law hamstrings municipal financial health by artificially and counterproductively increasing costs.

For example, Pennsylvania law requires cities to offer defined benefit pension plans to police and fire fighters: they are not authorized to offer hybrid systems that would introduce defined contribution plans into the retirement mix. While Americans now live longer, healthier lives and frequently elect to continue to work into their 60s and 70s, cities are required to offer retirement to police and fire fighters at age 50 with 20 years of service regardless of the health of the city’s police and firefighters or the city’s public safety and financial needs.

Pennsylvania’s municipal pension laws have not kept pace with demographic and economic changes. A graph at the end of this testimony shows the local share of Pennsylvania municipal and school district pension costs will escalate more than three-fold in the next five years barring fundamental changes to pension laws.

The Commonwealth will be in no position to provide assistance: its cost for SERS and PSERS are projected to increase to about $4 billion in 2016. This will increase the share of the Commonwealth’s general expenditure budget taken up by pension obligations from 6 percent to 13 percent.

PEL is convinced that pension health is essential to Pennsylvania’s viability as a location to live, work and invest. If we do not correct the problem, everyone will suffer. State, school district and municipal pension distress leads to higher taxes and reduced services, hurting businesses and residents. Ever increasing shares of public sector budgets are devoted to legacy costs. And financially stressed pension plans threaten the employment security of working people.

The growing pension crisis needs to be addressed legislatively. The problem has been easy to see for many years. Yet, recent legislation has addressed only short-term budgetary issues while ignoring long-term cost containment. For example, Act 44 of 2009 achieved asset smoothing, amortization changes and reduced mandatory payments but in its final version did not address sustainable benefit structures for new hires, realistic earnings assumptions, anti-spiking provisions, authority to offer optional defined contribution plans or provide for state administration of severely distressed plans. The can the General Assembly kicked down the road in 2009 has grown to the size of a 55-gallon drum: if we continue to kick it, we are bound to break our foot.

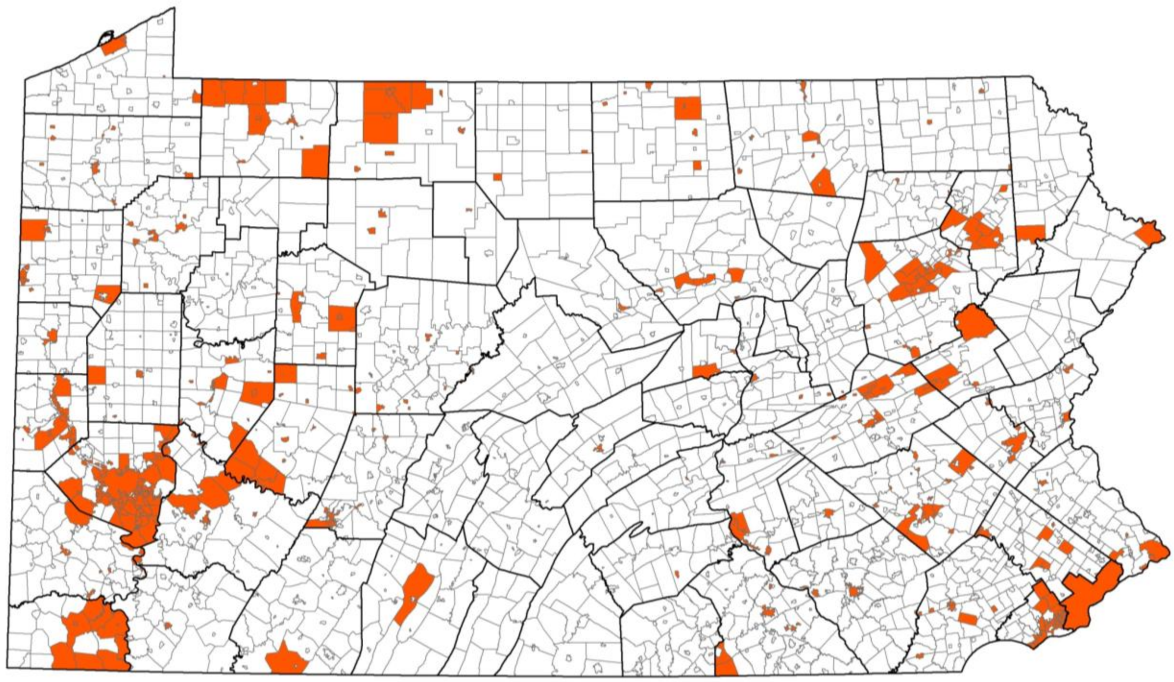
We need to bring reality to our pension practices, lest our municipalities fail. For new hires, we need to shift from defined pension benefit plans to a hybrid plan, such as the cash balance plan. We need to eliminate "spiking" and require pensions to be calculated on base pay only. We need to remove pension benefits from the collective bargaining process. We need to freeze benefits for existing public safety personnel. And we need to decrease the vesting period, increase the retirement age and increase the length of service.

Pennsylvania needs to act to correct its mounting local government pension problems. The Allegheny Conference on Community Development and the Pennsylvania Economy League are proud to be members of the Coalition for Sustainable Communities, a large and growing coalition of more than 30 chambers of commerce and municipal and other business organizations committed to promoting legislative reforms to strengthen our communities. Public pension reform is one of the key goals of the Coalition for Sustainable Communities.

Thank you again for the opportunity to express the Pennsylvania Economy League of Greater Pittsburgh's views on the problems of Pennsylvania's public pensions. I would be happy to address any questions you may have.

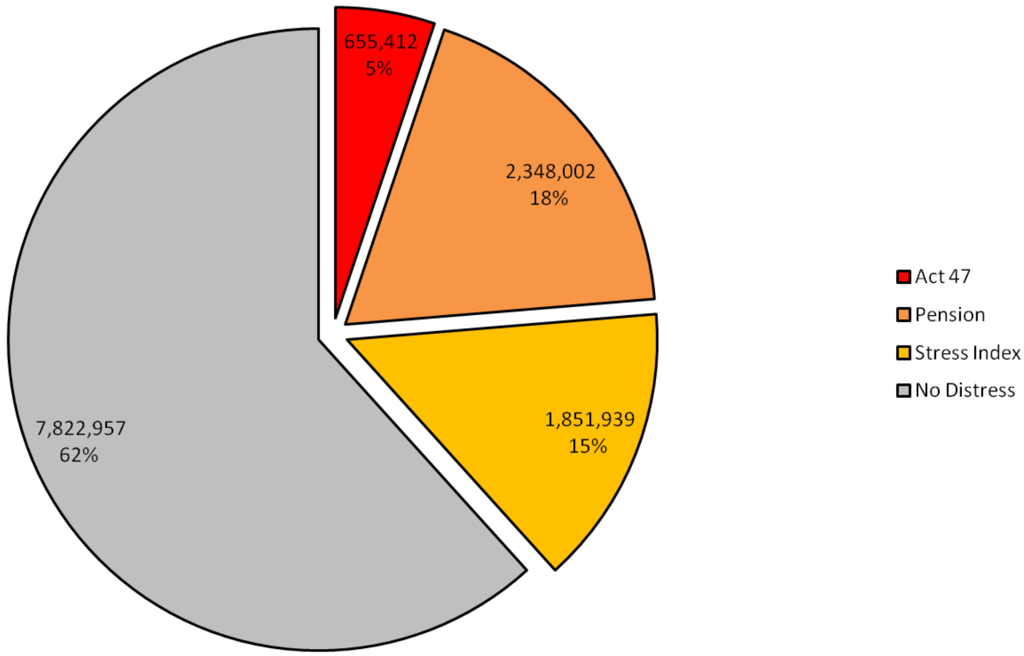
Financial Distress in PA

(Act 47, Pension Distress, PEL Stress Index)



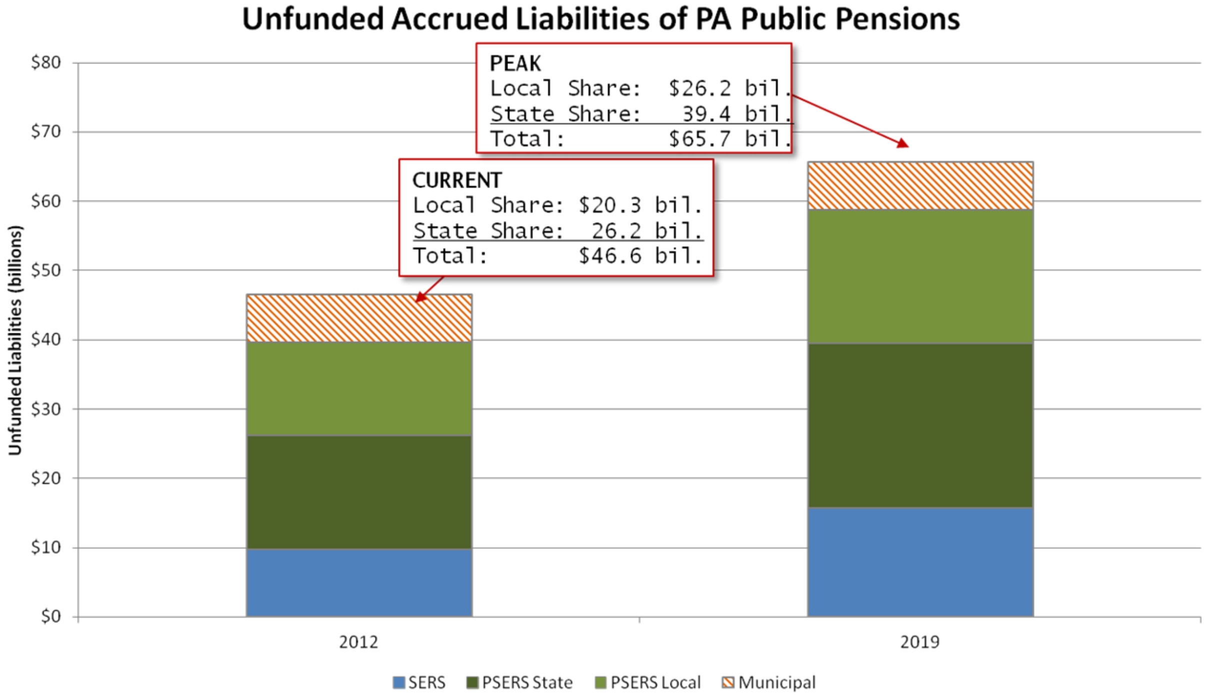
Created by the Pennsylvania Economy League of Greater Pittsburgh, August 2012

38% of Pennsylvanians live in financially stressed municipalities

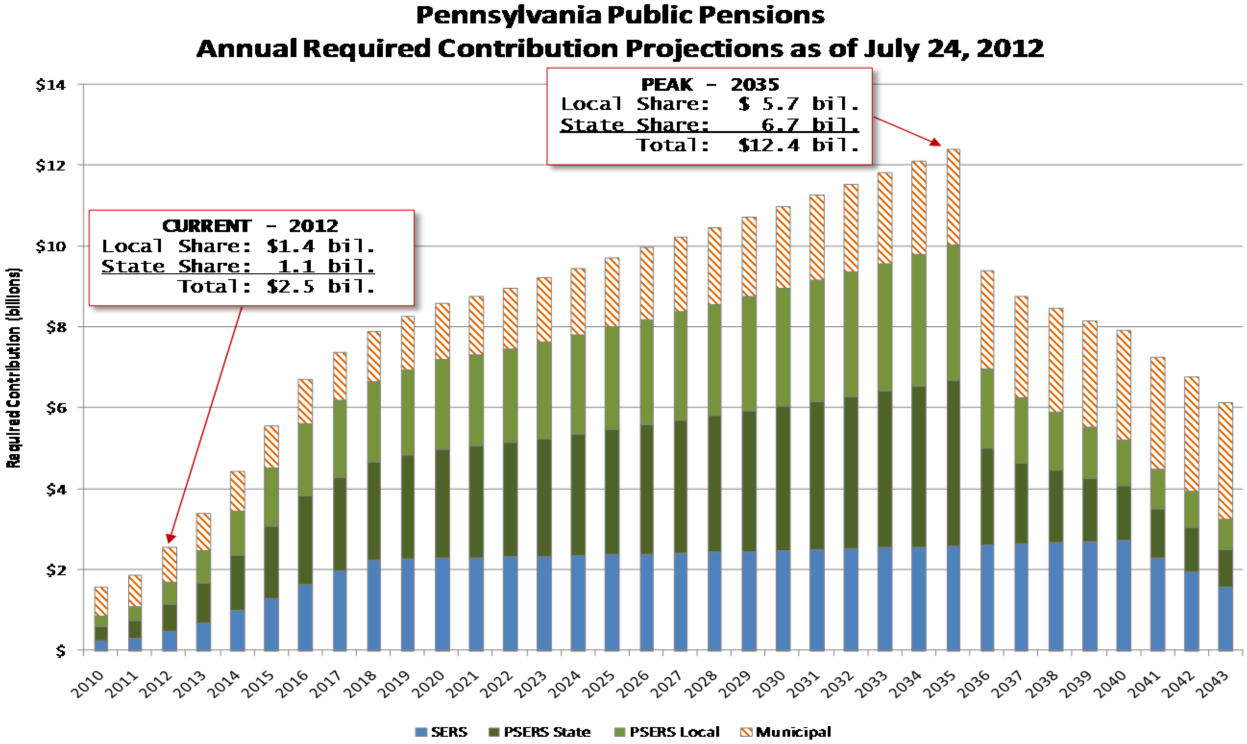


Pennsylvania Economy League of Greater Pittsburgh, August 2012

Unfunded public pension liabilities jump dramatically by 2019

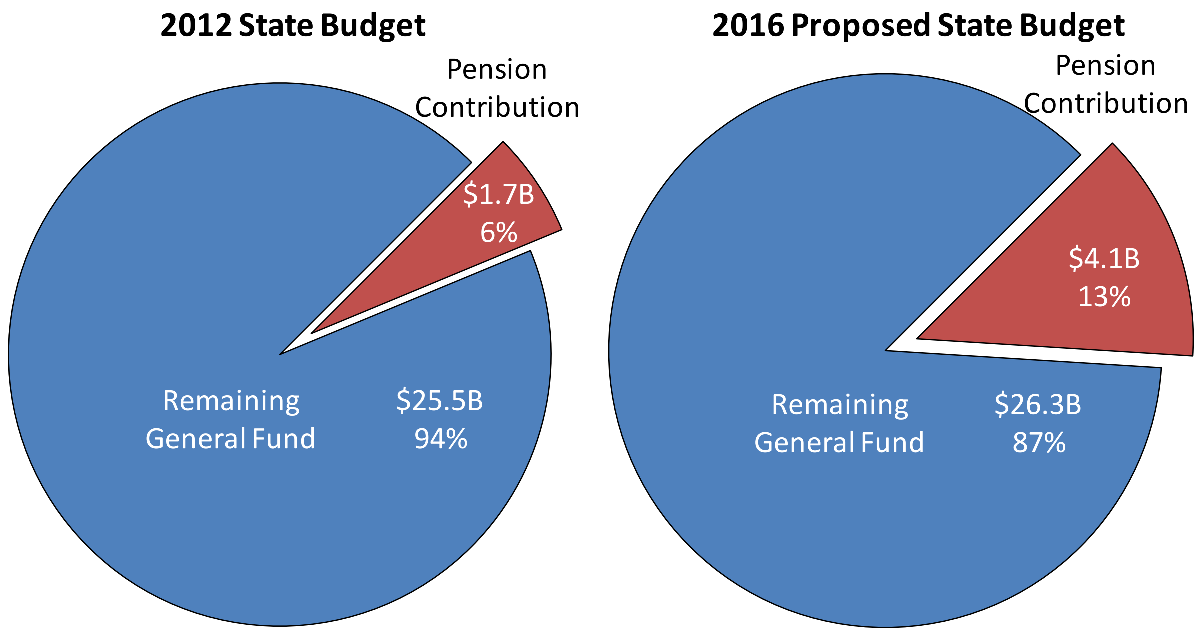


Rising public pension costs will strap us for decades



* Official municipal projections unavailable; PELSW estimated 5% annual increase

State Pension Contribution as Share of Proposed General Fund Budget



Prepared by the Pennsylvania Economy League of Greater Pittsburgh, May 2011

A Comprehensive Proposal for Reforming Pennsylvania's Unsustainable Retirement Systems

Richard C. Dreyfuss
Business Consultant and Actuary
Senior Fellow - The Commonwealth Foundation
Senior Fellow - The Manhattan Institute

PA Public Employee Retirement Commission
September 5, 2012

Managing Pension Liabilities

THE WALL STREET JOURNAL.

The Public Pension Crisis

August 18, 2006; Page A14

"... the fundamental problem is that public pensions are inherently political institutions."

"... the current public pension system simply isn't sustainable in the long run."

How Retirement Benefits May Sink the States
Steven Malanga
April 27, 2012

THE WALL STREET JOURNAL.

- Chicago Mayor Rahm Emanuel: "Unless Illinois enacts (pension) reform quickly, he said, the costs of these programs will force taxes so high that, You won't recruit a business, you won't recruit a family to live here."

- The Chicago Tribune observed after Mr. Emanuel issued his warning on April 4th, "Companies don't want to buy shares in a phenomenal tax burden that will unfold over the decades,". And neither will citizens.

Three Factors Drive the Political Institution of Public Pensions

1) Poor Benchmarking

2) Poor Liability Management

3) Politics

#1 Poor Benchmarking

- Pennsylvania public pay and benefits are typically only benchmarked against public sector practices in other states versus considering market practices in the Pennsylvania private sector.

- Market trends in the private sector are directly relevant to the public sector.

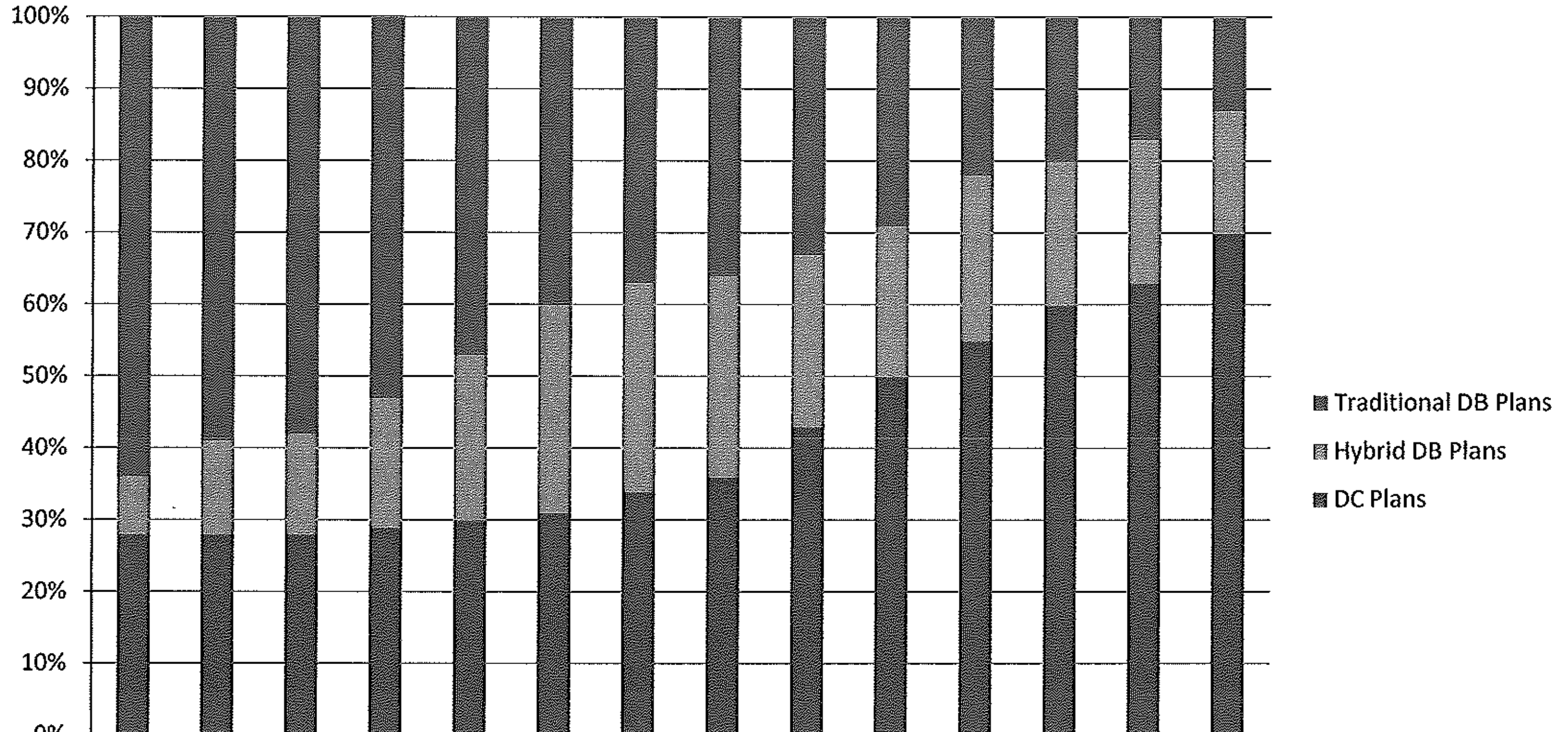
2012 Hewitt/Aon Survey: Retirement Benefits

	PA Companies	US Companies
Number of companies in survey	35	738
Number with Defined Benefit plans	9 or 26%	197 or 27%
Number of DB plans where benefits are based upon highest average pay	1	74
Number with 401(k) plans	35	738
Average employee contribution matched percentage in 401(k) plan	5.2%	5.4%
Average employer matching rate	$.80	$.81
Average employer cost (Basic savings plan match to maximum – often discretionary)	4.13% to 6.58%	4.17% to 6.14%
Number of companies offering some retiree medical insurance coverage	18 or 51%	390 or 53%
Number of companies where retiree pays all	9 or 50%	206 or 53%

Towers Watson Survey
Average DC Employer Cost – 4.77% to 7.67%

http://www.towerswatson.com/assets/pdf/mailings/TW-21621_July-Insider.pdf

Fortune 100 Companies - Trends in Retirement Plans



	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Traditional DB Plans	64	59	58	53	47	40	37	36	33	29	22	20	17	13
Hybrid DB Plans	8	13	14	18	23	29	29	28	24	21	23	20	20	17
DC Plans	28	28	28	29	30	31	34	36	43	50	55	60	63	70

#2 Poor Liability Management

- Few absolute metrics defining the affordability or reasonableness of pension costs given the "perpetual life of the government entity".

- Entire defined-benefit (DB) funding system is based upon annual investment assumption in the 8% range recently revised to 7.5% for PSERS and SERS.

- A 2011 Wilshire Associates study indicated none of the 126 state retirement systems (including PSERS and SERS) will be able to meet its actuarial assumed rates of return over the next 10 years. Likely return is estimated at 6.5%.

- A 2012, study by Welton Investment Corp yielded a composite forward expected annual return of 5.69% per annum for the next 7 to 10 years.

#3 Politics

Pensions as political capital

- **Pension Fund <u>Surplus</u> =** Political Capital & Benefit Improvements for Participants and/or Retirees

- **Pension Fund <u>Deficits</u> =** Underfunding by Taxpayers

- **Maintaining or Improving Benefits = <u>High</u>** Political Rate of Return

- **Reforming and Properly Funding Plans = <u>Low</u>** Political Rate of Return

Some Examples of Politics and Public Pensions

- PITTSBURGH TRIBUNE-REVIEW Tuesday, April 6, 2010: "***Onorato's boast about pension fund solvency raises eyebrows***"
  - **"If we did everything actuaries recommended, we wouldn't have a dollar left," (Allegheny County Treasurer John) Weinstein said.**

- Pittsburgh Post-Gazette - August 24, 2012: "**City pension board rejects studying 'realistic' returns" (currently at an 8% investment assumption)**
  - **"To me, this is where this is going, and I'm not going to do it," Mayor Ravenstahl said**

- **Quoting from the actuarial note accompanying Act 120 of 2010:**
  - **"However, it should be noted that the employer contribution collars (in effect through 2015) represent a departure from the norms of actuarial funding practice. The effect of the bill as amended would be to suppress the employer contributions to both PSERS and SERS resulting in significant underfunding of both retirement systems."**

The Consequences of Properly Funding PSERS

- Indiana PA Gazette: 7/11/2010: ***"Federal funds still the wild card for school budgets, pensions"***

  Steve Nickol – PSEA : "You can't realistically expect the districts in the state to come up with that amount of money as currently projected."

  "If they did, there's no way at the bargaining table they (teachers) would be able to get any increases. They're going to get pushed back as they have in recent years over health care and reductions in their benefit package."

"…. in hindsight, the proper way to have done it would have been to fully fund the system to start with."

- Patriot News: 8/23/2010: **Cornwall-Lebanon School Board, teachers approve new contract, salary increases average 3.5%**

Examples of Politics in Public Defined Benefit Plans

1) Retroactively improving benefits; Granting ad-hoc benefit improvements

2) Postponing (often repeatedly) the attainment of a 100% funded ratio to a time well beyond the average remaining career of the current workforce

3) Deferring contributions, not contributing the actuarially recommended contributions, being GASB non-compliant, ignoring actuarial guidance

4) Introducing a new pension plan to transfer unfunded liabilities

5) Using rosy economic assumptions to minimize contributions and avoid raising taxes or reducing budgets elsewhere

6) Benchmarking only against other public sector pension systems

True Pension Reform Must Satisfy Three Basic Principles – Using Realistic Funding Assumptions

1. Funding must be <u>current</u>.
   - Benefits should be funded as they are earned and "paid-up" in the aggregate at retirement. Achieving a 100% funded ratio.
   - PSERS average age is 44.5. Avg. retirement age 60.9

2. Costs must be <u>predictable</u>.

3. Costs must be <u>affordable</u>.
   - 4-7% of payroll (net of employee contributions)

Five Step Statewide Pension Reform Plan

1. **Establish a single statewide Defined Contribution plan for all new state, school and local government employees with an annual employer cost of 4% to 7% of pay. (Higher match for non-SS members)**
   - No unfunded liabilities, portable benefits
   - Eliminates long-term taxpayer commitments
   - Removes politics from pensions

2. **Prohibit pension obligation bonds or other post-employment benefit (OPEB) bonds on a statewide basis. This concept would also preclude other borrowing to finance benefit plans.**
   - Prevents "generational theft" – deferment of liabilities

3. **Adopt statewide funding reforms consistent with GASB 67 & 68.**
   - Shorter amortization periods, use of market value of assets
   - Goal is an annual employer cost of 4% to 7% of payroll
   - Prohibit benefit improvements if this would result in a funded ratio below 90%
   - New GASB requirement requires unfunded liabilities to appear on balance sheets

Five Step Pension Reform Plan

4. **Modifying unearned pension benefits** (as legally permitted)
   - This includes increasing member contributions, reducing formula benefits, increasing the normal retirement age, curtailing early retirement subsidies
   - Eliminating pension COLAs
   - Revising Other Post-employment Benefits (OPEB)
   - Statewide ban on Deferred Retirement Option Programs (DROPs)

5. **Consider funding reforms only after prior steps are achieved**
   - Challenge is to do this without increasing taxes or through new borrowing

Omitting any steps ≠ comprehensive pension reform

PA "Non-Reform" Reform Ideas

Reforms we don't need and can't afford...

Item	Detail	Why it is a problem
Using pension obligation bonds or other borrowing strategies to finance the retirement benefit systems	Issuing bonds to fund pension plan deficits	Increases risk to taxpayers with a certain incentive to increase pension benefits
An early retirement incentive plan		Enhances already generous benefits. Long amortization periods. Only works if backfill rate is below 40%
"Fresh start" (reset) of any unfunded liability beyond the average remaining duration of active members. Other funding techniques which defer costs including assigning such costs to new employees.	Creates a new "mortgage"	Increases generational theft An easy political solution
A new and reduced DB plan and/or an optional DC plan		Even a new DB will not escape the politics of public pensions. Consider PSERS and SERS - 10 years ago – lessons of history.
A new cash balance (hybrid) plan or a reduced set of new DB & DC plans	A new DB plan which where the accrued benefit is an account balance	Same politics and funding problems associated with defined benefit plans

A Political Problem: The 15 PA Pension Half-Truths

Contention	**Fact**
1) The fiscal problems typified by SERS and PSERS are simply a matter of underfunding by taxpayers.	a) 1990s required little if any taxpayer contributions due to surplus – this was a common result b) Since 2003, unaffordable contributions have been legislatively manipulated downward creating the 2012 sustained plateau. The liability was re-deferred in 2010. c) The 2003 & 2010 funding deferrals were fully supported by many institutional groups including organized labor. d) The 2010 PSERS unfunded liability of $27B is <u>approximately</u>: ➢ 45% due to investment losses, ➢ 25% due to underfunding, ➢ 15% due to benefit improvements, ➢ 15% due to lowered asset expectations.

A Political Problem: The 15 PA Pension Half-Truths

Contention	Fact
2) Act 120 of 2010 (HB 2497) will save taxpayers $1.4B for PSERS and $1.5B for SERS over the 33 year period 2011-2043. The net cost for new entrants (after member contributions) is in the range of 3% of payroll.	This analysis was from 2010: a) Assumes an annual 8% asset return. PSERS and SERS <u>subsequently</u> lowered their assumed rate to 7.5% resulting in an estimated <u>immediate</u> unplanned combined increase of $6.7B in the unfunded liability. b) Violates sound and proper funding principle relating to remaining average career timeframe. c) Future savings are predicated on PSERS payroll increasing from $14B to $45B or by 321% by 2044. d) Assumes unsustainable future contributions will actually be made – not re-deferred. e) Assumes no future benefit changes including ad-hoc retiree COLAs.

A Political Problem: The 15 PA Pension Half-Truths

Contention	Fact
4) Defined Benefit plans are 46% less expensive to provide the equivalent benefit compared to a Defined Contribution plan. ("A Better Bang for the Buck")	This contention relies on three dubious assumptions: a) DB rates of return will exceed DC rates of return (26%). No longer a realistic assumption with low-fee target date funds. b) Pooling of Mortality (15%) - A DC participant who dies prematurely logically wishes to retain his/her account balance for their heirs rather than the benefit of remaining retirees in the plan. c) Perpetual Investment Horizon (5%) – True rate is actually duration specific. ➢ Savings from removing politics from pensions: Priceless

A Political Problem: The 15 PA Pension Half-Truths

14) New entrants are needed to keep the pension system solvent and / or help pay down the unfunded liability.	a) Pensions should be funded as benefits are earned. b) Such a contention is an admission of a poor funding policy. The common and easy political solution is to further defer contributions and assign these costs to new entrants to avoid the appearance of a contribution rate that should otherwise dramatically increase. c) The unfunded liability will be paid regardless of new entrants. Actual funding is indifferent as to the cost-allocation method. d) This is generational theft
15) An increasing ratio of retirees to actives represents a significant fiscal concern.	a) If plans are properly funded this should be a straightforward expectation. Active members don't exist to fund retirees. b) However, there may well be non-pension policy implications.

A Half-Truth : The nature of transition costs in converting from DB to DC plans

- GASB (the accounting requirement) currently stipulates that a closed DB plan needs to amortize unfunded liabilities on a level dollar basis and is silent on the duration. This higher near-term recognition of costs is referred to as the "transition cost".

- Some DB plan apologists claim this required accounting treatment constitutes a funding mandate which should preclude consideration of major reform initiatives such as adopting a DC plan for new hires.

- Consider the "mandate" of funding the "transition cost" versus a frequently observed practice of otherwise not contributing the Annual Recommended Contribution.

- For additional information:

http://www.arnoldfoundation.org/news/foundation-debunks-myths-about-fixing-public-pensions

Nebraska

- In 1964 Nebraska established a DB plan for teachers and judges and a DC plan for other state and county employees.

- During the period from 1983 to 1999, state and county workers averaged a 6 percent return on their money--versus an 11 percent return in the DB plan. Reports indicate more than half of the DC assets were in invested in the stable value fund which was the default option.

- Given this poor investment diversification by many participants in the DC plan and the richness of the teachers DB plan, many state employees sought to be included into the teachers plan.

Nebraska

- After such an initiative was priced, the conclusion was that plan was unaffordable.
- As a result, in 2002 a new DB was created with lower benefits than the teachers plan and existing DC participants were given the option to join this new plan.
- According to reports, approximately 70% stayed in the DC plan.

One Final Thought ....
On "Generational Theft"
Thomas Jefferson Wrote in 1813

- "We shall all consider ourselves unauthorized to saddle posterity with our debts, and morally bound to pay them ourselves."

PUBLIC EMPLOYEE RETIREMENT COMMISSION
PUBLIC HEARING ON LOCAL PENSION PLANS

Deputy Auditor General For Audits Thomas Marks

Sept. 19, 2012

Good morning, Chairman Salomone, Executive Director McAneny, commission members, legislative appointees and other attendees.

Thank you for the opportunity to discuss the very important issue of public pension reform in the Commonwealth of Pennsylvania. While much of the discussion today will center on the Public School Employees' Retirement System and the State Employees' Retirement System pension plans – both of which face significant challenges of their own – we should not neglect or overlook the need to discuss pension reform at the local government level as well.

The Commonwealth of Pennsylvania has more than 3,200 local government pension plans – an extraordinarily high number that accounts for about one-fourth of all the municipal pension plans in the United States. These plans provide retirement benefits to police officers, firefighters, and non-uniformed personnel.

The Department of the Auditor General is responsible for auditing about 2,600 of Pennsylvania's 3,200 local government pension plans; the remaining 600 are county and municipal plans over which we have no jurisdiction.

The main reason Pennsylvania has so many municipal pension plans is simple – we have more municipal governments than any other state in the nation. And many of these municipalities are so small that you might say we are a commonwealth of micro-governments.

To illustrate my point consider this: the median size of a municipal government in New Jersey is about 22,000 people; in Pennsylvania, it’s 1,900.

A consequence of our many micro-governments has been a proliferation of micro pension plans. Roughly two-thirds of the municipal pension plans that we audit in Pennsylvania have 10 or fewer members.

By comparison, according to a recent survey conducted by the U.S. Census Bureau which reported the number of defined benefit plans maintained by state and local governments, the states surrounding Pennsylvania have done a much better job of limiting the number of small municipal pension plans.
In West Virginia, there are only 40 local government defined benefit pension plans. In Maryland, there are 14; in New York, 8; in Delaware, 5; and in New Jersey, 3.

The Department of the Auditor General’s Bureau of Municipal Pension Audits conducts audits of the 2,642 pension plans established by Pennsylvania municipalities and regional entities that participate in the state’s General Municipal Pension System State Aid Program. Our audits determine whether the local government pension plans are administered in compliance with state laws, contracts, administrative procedures, and local ordinances and policies. Of these 2,642 pension plans, 963 cover police officers, 81 cover paid firefighters and 1,598 cover other non-uniformed municipal employees.

To help the General Assembly and the taxpayers of Pennsylvania understand the challenges going forward, the Department of the Auditor General -- the state's independent fiscal watchdog -- has completed a special report, issued today. It's called *Analysis of Local Government Pension Plans*, and it examines the financial condition of local government pension plans that receive state aid to cover uniformed and non-uniformed employees in Pennsylvania's cities, boroughs, and townships.

Our review included an emphasis on data collected from audit reports of local government pension plans released between July 1, 2009 through June 30, 2011. It identifies the most common audit findings of the pension plans and highlights the funding status of individual pension plans pursuant to distress recovery parameters set by the Financially Distressed Municipal Pension System Recovery Program, established by Act 44 of 2009.

Based on the Financially Distressed Municipal Pension System Recovery Program and data obtained from PERC, our special report presented the pension plans in three categories. They are:

- Severe Distress (less than 50 percent funded): 52 plans, or 2 percent, fall into this category.
- Moderate Distress (50 – 69 percent funded): 234 plans, or 9 percent.
- Minimal Distress (70 – 89 percent funded): 633 plans, or 25 percent.

Between July 1, 2009 and June 30, 2011, the Department of the Auditor General released 2,023 audit reports of local government pension plans; 32 percent, or 647, of those audits cited pension plans for errors resulting in $2,074,829 due back to the commonwealth, in addition to other monetary effects totaling $5,022,549.

Our special report identified seven common deficiencies in the municipal pension plans -- including three issues that affect the financial health of the local government pension plans. They are:

- Providing excess benefits that require higher municipal contributions necessary to fund pension plans in accordance with Act 205 funding standards.
- Submitting inaccurate payroll and employment data. Payroll and employment data is used to determine the amount of state aid due to municipalities for distribution to pension plans to assist in covering pension plan costs.
- Failure of municipal pension plan officials to determine and to pay minimum municipal obligation annual funding requirements.

In July of 2008, I initiated a new policy within the Department of the Auditor General which established that errors that result in an underpayment of state aid to a municipality may, under certain circumstances, be rectified by the distribution of additional state aid to affected municipalities. As a result of this policy, between July 1, 2008 and June 30, 2011 the Department of the Auditor General issued payments totaling $687,623 to local government pension plans that qualified for the reimbursement – to assist the plans' in maintaining a satisfactory funding level. While those reimbursement dollars help pension plans in meeting their obligations, they do not cure the problem. There must be comprehensive reform to address the funding challenges faced by local government pension plans.

Given the current economic conditions of the commonwealth and the ever-increasing strain that the funding of municipal pension plans is placing on local governments, the time is now to discuss changes to Pennsylvania's municipal pension system – changes that must balance the obligation of providing retirement benefits to hard-working, policemen, firemen and other public servants, with the need to protect taxpayers in these challenging economic times.

In a spirit of bipartisan cooperation, I will outline several common-sense proposals that I believe the General Assembly and the Corbett administration should consider as part of any solution to municipal pension reform. As always, I stand ready and willing to work with you to effect these changes.

Here are my proposals:

- First, the General Assembly should consider consolidating local government pension plans into a statewide system for different classes of employees that would apply to current and/or future municipal employees. An alternative solution would be to maintain the existing system of individual pension plans but consolidate their administration into one entity such as the Pennsylvania Municipal Retirement System or the State Employees' Retirement System.
- The General Assembly also should consider amending the formula for the allocation of General Municipal Pension System State Aid funding to ensure that distressed pension plans receive additional funding.
- Due to demographic changes, such as increased life expectancies, pension plans' normal retirement provisions should maintain a

balanced age and service component and not rely solely on a years-of-service formula that can dramatically increase a pension plan's actuarial accrued liability.

- And finally, there needs to be a full debate in the General Assembly regarding benefit structures to be maintained by local government pension plans For example, these possible structures include defined benefit plans, defined contribution plans, and hybrid plans that incorporate features of both defined benefit and defined contribution formulas.

Besides these recommendations, there are several policy and procedural modifications that could be made to improve the administration of local government plans. For example:

- Municipal officials should review the benefit structure and the funding of a defined benefit pension plan from a long-term perspective and not let temporary market fluctuations influence their decisions regarding investment policy and benefit modifications.
- Plan officials should consider consulting with legal counsel, plan consultants and actuaries prior to making decisions regarding amending the plan's benefit structure and funding levels.
- Plan officials should consult available reference sources, when possible, when making investment decisions or in the consideration of changing plan custodians.

- Plan officials should monitor custodial account statements to make sure all state aid is properly deposited into eligible pension plans to fund authorized pension plan costs.

In closing, I want to commend the Public Employee Retirement Commission for its independent oversight of local government pension plans. I also wish to acknowledge the contributions of PERC in the development of the Department of the Auditor General's *Analysis of Local Government Pension Plans* special report.

I hope you will find the information in this report helpful in bringing about necessary changes to Pennsylvania's local government pension plans. The Department of the Auditor General looks forward to continuing to work with you on this important issue. I would be happy to answer your questions.

###

Testimony of Charles B. Zogby, Secretary of the Budget
September 5, 2012

To Members of the Public Employee Retirement Commission –

The Corbett administration appreciates receiving Chairman Salomone's letter of August 13, 2012, regarding the Commission's upcoming hearings on pension reform. With input from key stakeholders, the administration is working on developing a pension reform proposal for inclusion in Governor Corbett's 2013-14 Executive Budget.

The administration is currently engaged in a process of reviewing various pension reform concepts and ideas pertaining to the State Employees' Retirement System (SERS) and the Public School Employees' Retirement System (PSERS); we will not have a specific proposal to share and discuss with the Commission during the course of its upcoming fall hearings. We do, however, respectfully submit this written testimony to make clear the Administration's firm belief that implementing pension reform is vitally necessary and in the best interests of the commonwealth.

The Case for Pension Reform in Pennsylvania

The members of the Public Employee Retirement Commission are fully aware of the current financial position of both SERS and PSERS. The latest actuarial valuations show that SERS has an unfunded liability of $14.7 billion and is 65.3 percent funded, while PSERS has an unfunded liability of $26.5 billion and is 69.1 percent funded.

While the numbers from the actuarial valuations are revealing and certainly a cause for concern, as made plain by a recent downgrade in Pennsylvania's credit rating by Moody's Investors Service, the administration is also acutely aware that consistent annual increases in employer contributions to both SERS and PSERS are crowding out funds in the commonwealth's budget for other important public services. This growing level of employer contributions is also putting a significant strain on the budgets of our local school districts in that the commonwealth and our school districts share in funding the employer contributions to PSERS.

In the current 2012-13 fiscal year budget, the General Fund appropriation for the commonwealth's share of the employer contribution to PSERS is $856.1 million. This is up $255.9 million, or 43 percent, from last year's amount of $600.2 million. This required increase results in $255.9 million in funding that is not available this fiscal year to support our PreK-12 classrooms, higher education, human services or public safety. Moreover, it is interesting to note that the entire 2012-13 General Fund budget increased by only $370.7 million, or 1.4%, over the 2011-12 enacted budget. The $255.9 million increase in the commonwealth's contribution to PSERS accounts for 69 percent of the entire increase in the General Fund budget. The only other increases were essentially for our required general obligation debt service payments on bonds previously issued by the commonwealth to fund capital budget projects, as well as some additional funding to support financially distressed municipalities and school districts.

We also note that it was necessary to reduce most commonwealth agency budgets in 2012-13 from the prior year. The agency budgets include funds that pay salary and employee benefit costs, including the employer contribution to SERS. The employer contribution to SERS is projected to be $677.4 million in the 2012-13 fiscal year. This is up $209.3 million, or 45 percent, from last year's amount of $468.1 million. Again, these increased pension costs are crowding out funds within agency budgets and challenging commonwealth agencies to carry out their core missions. Every dollar expended on increasing pension contributions takes a dollar away from highway and bridge repair, upkeep of our state parks, the State Police and other vital services provided by state government.

As we begin planning for the 2013-14 budget cycle, the commonwealth confronts the same dynamic of increasing pension costs as in the current fiscal year. Under the provisions of Act 120 of 2010, the commonwealth's share of the employer contribution to PSERS is projected to increase from the aforementioned $856.1 million in the current 2012-13 budget to $1.23 billion in 2013-14. This is a staggering increase of $373.9 million, or 44 percent. Our school districts will see a similar increase, further constraining their capacity to retain staff and maintain manageable class sizes. The employer contributions to SERS are projected to increase from the aforementioned $677.4 million in the current 2012-13 budget to $971.3 million in 2013-14, an increase of $293.9 million or another 43 percent. Increases of these magnitudes are projected to recur in each of the next several fiscal years. *(Please see the attached table).*

The projected annual increases in pension costs for the commonwealth and our school districts are clearly not sustainable. Neither the commonwealth's budget, nor the budgets of our school districts, can continue to withstand such increases. Therefore, the only option that can be considered off the table is to "do nothing". As stated, the Corbett administration is reviewing options to propose a pension reform plan in the Governor's 2013-14 Executive Budget. We look forward to reviewing the testimony the Commission receives during its upcoming hearings and working with the General Assembly to chart a course for real and sustainable reform of our public pension systems.

Thank you.

PSERS and SERS Employer Contribution Projections

Governor's Budget Office Projections as of September 5, 2012

(Dollars in Millions)

	FY2011-12 Actual	FY2012-13 Budget	FY2013-14 Projected	FY2014-15 Projected	FY2015-16 Projected	FY2016-17 Projected	FY2017-18 Projected
PSERS							
PSERS Contribution Rate (%)	8.65%	12.36%	16.75%	21.25%	25.70%	26.70%	27.30%
PSERS Commonwealth Share ($)	**$600.2**	**$856.1**	**$1,230.0**	**$1,660.5**	**$2,108.8**	**$2,298.6**	**$2,459.5**
SERS							
SERS Contribution Rate (%)	8.00%	11.50%	16.00%	20.50%	25.00%	29.50%	32.50%
SERS Total ($)	**$468.1**	**$677.4**	**$971.3**	**$1,282.4**	**$1,611.6**	**$1,959.7**	**$2,223.9**
Total Commonwealth Contributions	**$1,068.3**	**$1,533.5**	**$2,201.3**	**$2,942.9**	**$3,720.4**	**$4,258.3**	**$4,683.4**

Testimony of James B. Allen

Before the Public Employee Retirement Commission

September 19, 2012

Good morning. Allow me to begin by thanking the Commission for the invitation to present my thoughts on those topics the Commission is charged to monitor, particularly, as the invitation suggested:

1. The existing structure of both state and local public pension systems,
2. The potential obstacles challenging the sustainability of public pension plans, and
3. The recommendations for reforms to deal with those issues.

I was specifically energized by the understanding that the Commission is seeking "... to provide a factual context for the General Assembly to use in <u>determining the long term pension policy of the Commonwealth, including the appropriate level and nature of future public sector retirement systems</u> and the methods available to deal with the outstanding liabilities of existing systems." It is this goal that causes me to step out of my comfort zone and testify today in two capacities. (Emphasis added)

I do need to state the obvious. I believe I was invited to testify because I am, and have been for over twenty eight years, the Secretary of the Pennsylvania Municipal Retirement System, or "PMRS" as we refer to ourselves. In a minute I will address our agency's experiences and our role in serving the needs of approximately 25% of Pennsylvania's local government pension plans. Before I do so, I must share that the second half of my testimony will be offered up as individual testimony, not as a policy statement of the PMRS, our Board, or our membership. It will be my candid observations as a professional who has worked with local governments in one capacity or another for close to forty years. But first the story of PMRS.

Yes, we are a state agency. It is surprising to me that so many people have not heard of us or think of us as a private corporation. We were created by the

General Assembly in 1974 to assist local governments by providing sound, cost efficient, professional pension administration. For the record, there are three state-wide pension plans, not two. Since it is likely that many have never heard of us or worse yet overlook our services and history, let me share some important facts about us and the plans we administer:

1. We are an "independent" state agency (read not under the Governor's jurisdiction.) I am appointed by an eleven member Board that has the fiduciary responsibility for the Pennsylvania Municipal Retirement Fund.

2. The Board is composed of the State Treasurer, who is also the custodian of the System's Fund, the Secretary of the Commonwealth, and nine other individuals who are in most cases to be specifically nominated to the Governor who then has the prerogative to appoint them to two, four year terms. The designated nominating organizations are:

   The County Commissioners Association
   The Pennsylvania League of Cities
   The Pennsylvania Association of Township Commissioners
   The Pennsylvania State Association of Township Supervisors
   The Pennsylvania State Association of Boroughs, and
   The Pennsylvania Municipal Authorities Association

   Two individuals who are active members of the System are also to be nominated, one each, by "associations representing municipal firemen and municipal police." The final appointee is to be a "retired member" of the System.

3. Municipalities may optionally enroll their pension plan or plans in PMRS by adopting an ordinance and executing a contract and having at least seventy-five percent (75%) of the existing members of the plan to be enrolled approve of the transfer to PMRS. As of today, we have over 950 individual pension plans, ranging in size from the City of Allentown's

Municipal Employee Pension plan with 550+ active and vested members and another 175 retirees and assets of over $100 million to approximately a dozen plans with no active members, just one or two retirees.

4. Combined our Board has fiduciary responsibility for approximately 14,000 current or former public employees and approximately $1.6 billion in assets.

5. Some of the more interesting facts about our agency are:
   a. Each plan defines its own benefit structure. We have some municipalities with benefits better than those offered by SERS and we have other plans that can only be defined as "bare bone" plans. Note that we also have been administering Cash Balance plans since the late 1980's and have over 230 currently with approximately 1,000 members.
   b. Each plan's actuarial experience (their individual cost) is determined independently of any other plan within the System. We have plans that have a normal cost as high as 40+% of payroll and some that have a normal cost of less than 3% of payroll. Just as interesting is that we have plans that are as much as 800% funded and some that are only 5% funded. As a single fund, although not technically equivalent, we are 102% funded on a basis of actuarial assets to actuarial liabilities and on a basis of actuarial assets to market value we are approximately 82% funded.
   c. The System pools four types of costs and / or experiences: Retiree Life Expectancy; Disability Funding; Administrative Costs and Investment Performance.
   d. We administer to our members with a staff complement of less than 30 employees and with NO state funding. All of our revenue for

operating our agency comes from the fees we charge our plans and a portion of the investment income.

e. Everyone likes to talk about the money, so let me share some information about our portfolio. At year's end, December 31, 2011, we had approximately $1.49 billion under management. While this certainly pales in comparison to PSERS and SERS, we were still ranked as the 694th largest pension plan in the United States by the trade publication "Pension & Investments." Our asset allocation was, as of June 30, 2012:

Asset Class	Target	Actual
Domestic Large Cap Equities	25%	24.4%
Domestic Small Cap Equities	15%	14.4%
International Broad Market	15%	12.4%
International Emerging Mkt	10%	9.1%
Sub-Total Equities	65%	60.3%
Fixed Income (All Domestic)	20%	21.2%
Real Estate	15%	15.7%
Cash	0%	2.5%

6. Because of legislative and structural design we must take an extremely conservative approach to our portfolio. We assume an actuarial investment return of six percent (6.0%), net of expenses and we must book a six percent (6%) return to all of our plans every year regardless of what we make or don't make. We have no investments in hedge funds, private equity, or venture capital. About as exotic as we get is our $42 million in forest acreage. We employ fourteen different money managers and one investment consultant. I would note that staff has recommended to our

Board that we drop the assumed rate of return to 5.5% net of expenses effective January 1, 2013. Our Board will be considering this recommendation at their meeting tomorrow.

7. As to performance, our conservative approach has hurt us when times are good, as you might imagine, and it has helped us when times are not so good. I have attached information on the portfolio's returns as well as the published returns for both SERS and PSERS. The information was gleaned from the agencies' Comprehensive Annual Financial Reports (CAFRs).

   While the returns may not be as much as we would have liked, we are nevertheless proud of them. We believe that through full market cycles, we have proven that we can maintain a performance that ranks in the top third of our class of peers.

8. I believe I may have imposed on your generous invitation, but I would be remiss if I did not share one additional very important fact about our agency – we are extremely frugal and very proud of it. Whether it is by the design of the System that we have to be conservative, whether it is the make-up of our Board or whether it is the entrepreneurial nature of our agency – our plans do not have to join us, they can "do it themselves" or contract with private providers; whatever the reason, we do watch the pennies. I wanted to share a second set of numbers that are attached to this testimony. They, too, are drawn from the PSERS, SERS and PMRS CAFRs. While they probably do not get as much attention as the investment portfolio numbers, they are very important to our Board, our staff and our membership. They show that in terms of costs for administering the pension plans, either by plan member or by assets under

management, PMRS is the most cost efficient of the three state pension funds.

Let me conclude this portion of my testimony by acknowledging that our Board has repeatedly shared that we will not comment on legislation unless it specifically impacts the operations of the System. Secondly, we believe in the model which created us, and believe our success is shown in the plans we administer. We do find it ironic that there are still so many who call for the consolidation of local government pension plans when the opportunity already exists for them to voluntarily consolidate via our agency. We believe we have seen the future and the future is PMRS.

And now, with your indulgence, I would like to take a few more minutes of your time to address the Commission from a very personal perspective. The following thoughts are mine and not the agency that employs me. They are offered in no particular order and I realize they may be considered contrary to the prevailing themes that have been and will be offered the Commission. That being said, here goes:

1. The failure of the Commonwealth lies in NOT having a "... long term pension policy of the Commonwealth." I challenge anyone at the Commission or any member of the General Assembly to set forth the current Commonwealth pension policy. Where has the Commonwealth set forth what a good, acceptable pension is for a public employee? What percentage should be employer funded and what percentage should be employee funded? Frankly, we don't know what to aim for without setting forth a policy or a goal. This should be the number one priority of the Commission and the General Assembly. Define what is desirable, acceptable and affordable, and then we can decide how the risk should be shared.

2. Too much time is being wasted attempting to determine the most appropriate "tool" to use when we don't even know what we are building. The issue isn't whether we should be creating defined benefit

plans or defined contribution plans – these are merely the tools. To reiterate Point 1, without a blue print or an idea of what we are trying to 'build", how can we possibly know what tool we should use to build it?

3. That being said, I cannot emphasize enough the beauty of a properly designed Cash Balance plan. The balancing of employer/employee risk matched by a logical employee/employer contribution rate, plus the advantage of a low administrative cost topped off with the ability to insure longevity risk. If there is a universal tool invaluable when building a proper public pension policy, to my way of thinking it is the Cash Balance plan.

4. Any attempt to "solve" the public pension enigmas that does not address longevity risk is doomed to ultimately fail. Solutions will be short lived. Longevity risk is a huge problem that is too often being ignored.

5. I believe that everyone should have some "skin in the game" in order for a public pension plan to be properly designed and monitored. When State Aid to Municipal Pension Plans funds 100% of a municipality's pension costs, trustees' oversight is diminished and too much risk is either transferred to others or worse yet, simply ignored. The less responsibility a local government official has for funding a pension plan, the less likely it will be that he or she fulfills their duty to monitor it.

6. And on this last point, while it may seem counter to my argument for greater municipal officials' involvement, I would specifically maintain that anyone who has a responsibility to fund a public pension plan be relegated to a minority role on a public pension plan board. Legislators, employees, city councilman, township supervisors should not comprise a majority status on public pension funds as their duel and often competing duties abrogates, more often than not, their fiduciary duties to the plan members. A majority of any Board of Trustees should be independent citizens who are held to trustee standards by the courts.

7. Finally, the easiest reform that can take place is to mandate full disclosure of a pension plan's costs, assets, and liabilities, and the assumptions used in developing those numbers. Too often I find that trustees are in the dark as to a plan's true costs. I believe that the Government Accounting

Board Standards and in particular GASB 67 & 68 will help bring transparency to this side of the business – at least that is my strong hope.

Before I conclude let me address the oft used cliché of the unfunded liability of public pension plans as the unaddressed "elephant in the room." I once took a disaster training course sponsored by the Federal Emergency Management Agency and the instructor used the same cliché but in a slightly different reference when discussing disasters. He said he was often asked as an emergency management official in charge of disaster recovery, "How do you start to eat an elephant? His simple intelligent answer was, "One bite at a time."

While demands will pull us all in many directions, the fact remains no matter what is done, a promise was made. It must be addressed and the only way to address it is to take one bite at a time. Start with the "prospective" employees. Fully fund their benefit. Then deal with the negative cash flow that the distressed plans have. Then deal with administrative inefficiencies. Then deal with funding the previous promises. As Secretary of PMRS I have seen this step by step approach work time and time again. Ask me about Harrisburg's municipal pension plan and their firefighter's pension plan. Ask me about Allentown City's municipal pension plan. Ask me about Clairton's fire and police plans. There are successes to be touted. Doing nothing but complaining and pointing fingers never helps the people when there is a disaster; and ladies and gentlemen we are facing a public pension plan funding disaster, so let's take the first bite!

I looked upon this occasion as one of the most critical presentations I will ever make. I beseech you not to get caught-up in the details but rather to look at the big picture. I think you, as members of the Public Employee Retirement Commission, are in a position that you can focus such a discussion. I encourage you to truly develop, or at least assist in the development, of a Commonwealth public pension policy. I encourage you to do so as stewards of the public's trust. My final observation is, if not you then who will provide the leadership we so desperately need at this time?

I close by thanking you once again for your patience and for your invitation. I welcome your questions.

COMPARATIVE RATES OF RETURN

	PSERS	SERS	PMRS
2011	20.37	2.7	-1.9
2010	14.6	11.9	13.8
2009	(26.5)	9.1	18.8
2008	(2.8)	(28.6)	(24.8)
2007	8.2	17.2	8.2
2006	18.04	16.4	12.6
2005	12.9	14.5	8.6
2004	19.7	15.1	13.1
2003	2.7	24.3	23.4
2002	(5.3)	(10.9)	(8.9)
2001	(7.4)	(7.9)	(3.9)
2000	12.2	2.2	1.5
1999	12.4	19.9	15.3
1998	16.0	16.3	17.4
1997	19.1	18.0	18.2
1996	17.9	15.9	16.4
1995	17.1	25.5	24.0
1994	1.9	(1.1)	(0.3)
1993	13.3	13.2	13.4
1992	14.2	7.4	6.1
1991	8.1	22.6	18.4
1990	9.2	1.0	1.0

For the five-year and 10-year periods ended December 31, 2011, SERS returned 1.0 percent and 6.00 percent respectively.

For the five-year and 10-year periods ended December 31, 2011, PMRS returned 1.5 percent and 5.3 percent respectively.

PSERS numbers were not available.

For the five-year and 10-year periods ended June 30, 2011, PSERS returned 3.89 percent and 6.25 percent respectively.

For the five-year and 10-year periods ended June 30, 2011, PMRS returned 4.5 percent and 5.8 percent respectively.

SERS numbers were not available.

PMRS and SERS are December 31;
* All PSERS rates as of June 30 year end
PMRS numbers are gross returns, SERS & PSERS are net

Data gathered by PMRS staff from all agencies' Comprehensive Annual Financial Report

PER MEMBER ADMINISTRATIVE COSTS
2011

	PMRS (Dec. 31)	SERS (Dec. 31)	PSERS (June 30, 2011)
Expenses:			
Admin Expenses	3,142,005	26,706,000	57,745,000
Invest. Expenses	6,507,370	197,505,000	514,695,000
Commissions	835,940	4,500,000	11,800,000
	10,485,315	228,711,000	584,240,000
Membership:			
Retired	4,184	115,342	185,000
Active	9,210	107,021	282,000
Vested	987	6,189	112,000
	14,381	228,552	579,000
Total Cost/Mbr	**729.11**	**1,000.70**	**1,009.05**

Cost Per Member
2011

	PMRS	SERS	PSERS
Admin Expenses	218.48	116.85	99.73
Invest. Expenses	452.50	864.16	888.94
Commissions	58.13	19.69	20.38
	729.11	**1,000.70**	**1,009.05**

Net Assets Held In Trust

PMRS	SERS	PSERS
1,490,169,104	24,377,179,000	51,433,181,000

Cost as % of Assets

PMRS	SERS	PSERS
0.70%	0.94%	1.14%

PER MEMBER ADMINISTRATIVE / INVESTMENT COSTS PER MEMBER

	PMRS	SERS	PSERS
2011	729.11	1,000.70	1,009.05
2010	699.31	1,167.92	1,019.69
2009	661.12	1,282.00	981.28
2008	716.70	1,554.41	878.82
2007	755.41	1,722.21	762.50
2006	757.04	1,543.99	602.14
2005	683.00	1,262.17	543.88
2004	659.90	1,101.85	561.91

Source Of Information: Comprehensive Annual Financial Report (CAFR) for each system.

Testimony of

David E. Durbin, Executive Director

Pennsylvania State Employees' Retirement System

before the

Public Employee Retirement Commission

regarding

Pennsylvania's Public Pension Systems

September 19, 2012 – 9:30 am – 461 Main Capitol

Good morning Mr. Salomone, members of the commission, Mr. McAneny, staff, and guests. I am Dave Durbin, executive director of the Pennsylvania State Employees' Retirement System (SERS). I am pleased to be a part of this session because I think the work you are doing here today is extremely important.

Before I begin, I would like commend the commission for dedicating so much time today and over the coming weeks to provide all stakeholders with opportunities to share their concerns and ideas about the commonwealth's public pension systems. This issue is significant to tax payers, homeowners, school districts, governments, public employees, retirees and others. The stakes are high.

Few know better than you how far-reaching Pennsylvania's public pension systems really are. SERS alone currently serves approximately 115,000 retired, 107,000 active and 6,000 inactive/vested members—that's roughly the equivalent of the populations of Allentown, Lancaster and Harrisburg combined. When you add those served by the Public School Employees' Retirement System, the Municipal Employees' Retirement System, and the scores of independent plans, well over a million Pennsylvanians are members of public pension plans.

First, a few facts that are already widely understood and reported:

- Typical SERS members pay 6.25% of their salary over their careers and the typical SERS benefit at normal retirement age is about $24,500 per year.

- SERS has an unfunded liability of about $14.7 billion.

- The liability is for benefits that have already been earned by employees and is largely the result of making retirement benefits more generous without funding (Act 120 has since reversed many benefit enhancements); employer contributions of $0 for a number of years; changing the actuarial recognition of gains and losses; and suffering unprecedented investment losses associated with the Great Recession.

- The driver of the commonwealth's rising employer contribution rate is the liability, not the cost of current benefits. The current employer cost of benefits is about 5.1% of payroll for SERS members hired on or after January 1, 2011.

- Any attempt to reduce the liability by reducing benefits or increasing contributions of existing employees is likely to face litigation and, based on judicial precedent, may be stymied by constitutional issues.

There's nothing new in this information; you've heard it before. These facts help us frame the problem but they don't necessarily help us figure out what to do about it.

There is no shortage of ideas; many have been discussed already today. Among those I have heard or read about include, for example:

- Let Act 120 play out, allowing SERS to regain fully funded status in about 40 years.
- Create additional tiers of defined benefits for new employees with higher employee contributions, lower multipliers, longer vesting, different final average salary calculation, etc.
- Change future benefits for current employees.
- Look at above-the-baseline benefit enhancements to see if they can be rolled back.
- Alter assumptions of current plans, including amortization schedules, assumed rates of return, salary growth, etc.
- Identify revenue and/or dedicate a government funding stream.
- Commit budget surpluses to the pension systems.
- Move to a defined contribution plan.
- Start a cash balance or other hybrid plan.
- Issue pension obligation bonds.

The list goes on.

Policy makers, academics, financial professionals, labor leaders, advocates, citizens, employees, retirees and others have well-informed, well-intentioned perspectives. In fact, over the past year, I've had the good fortune to interact with a wide array of smart, reasonable people, all working in good faith to solve this serious cash-flow problem. What I believe I have found is that people are proposing and evaluating ideas on different principles.

The most common principles I have come across so far seem to be:

1) actual cost to provide the benefit
2) current and projected employer contribution rates
3) employee vs. employer risk
4) public/private sector parity
5) benefit adequacy

Given how long this debate has been underway and how many people are involved, I believe that it is clear that no single proposal can address all of these principles to everyone's satisfaction. If there were, we would already have a solution in place.

No system is inherently good or inherently bad and there can be wide latitude within different kinds of systems. So what combination of solutions—and to what extent of each—will be acceptable and effective in Pennsylvania?

What I would like to submit today is a framework for people—policymakers, stakeholders and citizens—to evaluate various pension reform proposals as they emerge. I suggest that each person consider these issues in light of the commonwealth's fiscal realities and his or her personal values:

- *Actual cost to provide the benefit.* While there are different classes of service, the normal cost—the cost to the employer to provide one year of covered service—for a typical new employee's SERS benefit is 5.1% of the employee's salary.

  To put that number in perspective, according to the Commonwealth Foundation, "A good benchmark for government benefits is private companies, which typically provide retirement benefits that cost between 4% and 7% of salary per year."

- *Current and projected employer contribution rates.* As I have indicated, the current and projected employer contribution rates are being largely driven by the $14.7 billion that is needed to pay for benefits that have already been earned by employees.

  The commonwealth's current employer contribution rate for SERS pensions is 11.5% of payroll. This rate is set by the Act 120, which limits increases by 4.5% of payroll per year for a number of years. Were it not for Act 120, the actuarially required contribution necessary to pay for current benefits and to pay down the unfunded liability would be about 26.4%.

  The 4.5% annual increase—from 11.5% this year to 16% next year, for example—is the basis for the "Pac Man" reference about the budget. Without additional revenues, state agencies must absorb the increase in pension-related personnel costs within their existing resources. (Collectively bargained salary increases and rising health care costs also contribute significantly to the growth of

- *Employee vs. employer risk.* In traditional defined benefit plans, pre-set formulas determine how much retired employees are entitled to receive every month for the rest of their lives. If plan investments don't earn the assumed rate of return or if employees live longer than anticipated, for example, the employer is still obligated to pay the benefit. Thus, in the case of a defined benefit plan, the employer bears the risk.

  In traditional defined contribution plans, employers contribute a certain amount to an account and employees contribute a certain amount to an account. Employees (whether sophisticated investors or not) make the investment choices. Upon retirement, employees gain access to whatever is in the account. If investments didn't earn a significant return (or incurred losses) or the retiree lives longer than anticipated, the retiree may run out of money. Thus, in the case of a defined contribution plan, the employee bears the risk.

  A number of hybrid plans have found unique ways to share risk between employers and employees. And, to a lesser extent, Act 120 introduced risk-sharing to SERS' plan by creating a mechanism that increases the employee contribution rate if employers are meeting their payment obligations but SERS investments fail to achieve the assumed rate of return for a number of years.

- *Public/private sector parity.* Some feel that, if 401(k) plans are appropriate for private-sector employees, public-sector employees should not enjoy a different benefit—particularly a benefit which has been portrayed as more expensive and more generous.

  Very often, this conversation also includes other distinctions between public and private sector benefits, such as overall compensation packages.

- *Benefit adequacy.* With care, any system can be crafted to provide an adequate retirement benefit, depending on what an employer is willing to require of employees and how much an employer is willing to pay. The current debate seems to look at adequacy in two ways:

  > From a fiscal perspective: At what point does a retirement benefit become too little to keep a senior from relying on other state programs and, thus, costing government more? At what point does the retirement benefit improve the commonwealth's overall bottom line by attracting and retaining high-quality employees?
  >
  > From an ideological perspective: What's the appropriate benefit to acknowledge an employee's contribution to the workplace and ensure a safe retirement with dignity?

Different people will weigh and evaluate these principles differently – individuals may be willing to "trade off" gains in some areas for challenges in other areas. To use just the first principle as an example, some people may be not be willing to accept a higher cost of benefits for any reason. Others may be willing to accept a higher cost of benefits in order to shed employer risk. Others may be willing to accept a higher cost of benefits to ensure that the benefit is adequate to safeguard other public resources.

Differences will occur on each point. These are all legitimate and appropriate policy conversations and, with hope, a common framework will allow us to more constructively work through the issues.

Thank you for allowing me to appear before you today. As you know, SERS has long held that it is our responsibility to ensure that the commonwealth's retirement plan is administered prudently and with integrity. We believe that the system and level of benefits provided to employees is the purview of the Governor and the General Assembly.

With that said, we take our fiduciary responsibility very seriously. We will continue to make ourselves available to share our expertise with and provide accurate data to anyone who requests our assistance.

Working together, I am sure that we can find a solution that respects our hard-working public employees just as it respects Pennsylvania's hard-working taxpayers.

I welcome your questions.

TESTIMONY OF STEVEN NICKOL, PSEA

PUBLIC EMPOYEE RETIREMENT COMMISSION
PENSION REFORM TESTIMONY AND DISCUSSION
October 3, 2012

Good afternoon Chairman Salomone and members of the Public Employee Retirement Commission, I am Steven Nickol, Assistant Director of Retirement Programs with the Pennsylvania State Education Association (PSEA). On behalf of the 187,000 members of PSEA, I thank you for inviting our testimony on this issue of critical importance to our members and the Commonwealth.

With regard to my own background, I was a member of the House of Representatives representing a district in York and Adams Counties from 1990 to 2008, during which time I sat on the Public School Employees' Retirement System (PSERS) Board. Several months after leaving office, I was offered and accepted a position with the PSEA as a retirement consultant. I work with school employees on a daily basis to advise them on retirement-related matters.

PSERS dates back to 1917, and the State Employees' Retirement System (SERS) to 1923. These two pension funds have survived almost 100 years and weathered even the Great Depression, all without their sustainability being questioned until now. This underscores the point that the crisis facing the Commonwealth today in terms of pension funding is of recent vintage, manmade, and the result of a period of neglect for proper funding.

Ironically, the seeds of the present problem were sown in the best of times. As a result of the tremendous investment returns earned by the pension funds in the late 1990's, the pension rate at PSERS hit zero in 2001. Elected officials from the Governor on down to school director all rejoiced; but, what I recall most clearly are comments made by Joe Oravitz, one of my colleagues on the PSERS Board. Joe, who was the Executive Director of the PA School Boards Association, warned the Board, "you all may be celebrating this today, but you are going to regret it tomorrow. Once the rate goes this low, it will be almost impossible to ever get it back up to where it should be."

His comments were prophetic.

In 1998, the employer pension rate for PSERS fell below the cost of benefits earned by school employees during the year – the so-called employer normal cost rate. It has remained below this rate until just about 2 months ago. This means that employers have been paying in less than the cost of benefits for 14 years. The cost was deferred and added to the system's unfunded liability.

A normal rate floor that was included in Act 120 has now kicked, albeit about 14 years too late. Act 120 also greatly reduced the employer normal cost of benefits for new employees, producing a significant savings to employers as we move forward.

I would like to boil the challenge we are now facing down to what I believe are its base elements.

(Reach for white board and write “3%” on it)

When we are dealing with for all the bills presently before the General Assembly is the retirement cost for new employees – and by that I mean those subject to the provisions of Act 120 of 2010 - this is the current cost for the Commonwealth and school districts combined: 3%.

From this point forward, it is all simple math. Any new or alternate pension plan that does not beat this number, will not offer long-term cost savings to taxpayers or the Commonwealth.

(Now erase the “3%” and write: 21.43%
6.95%
+ .63%
29.06%)

The PSERS rate is projected to peak in 2020. Here is a breakdown of the rate in that year: 21.43% is the unfunded liability rate to pay off current debt, 6.95% is the average cost of benefits earned by both pre- and post-Act 120 employees in 2020, and the .63% is the cost of health insurance premium assistance.

(Strike out the 6.95%, .63% and 29.06%)

Even if you totally eliminate the future cost of benefits earned by school employees, and eliminate the health care premium assistance, the rate simply to pay off the debt that was allowed to accumulate over the last decade would be 21.43%. No plan can be called an alternative to the current plan if it does not address this problem.

PSEA fully appreciates the magnitude of the crisis that was brought to a head by the recent recession following a decade in which employers did not make their normal payment obligations. We understand the impact on the Commonwealth and school districts, and this is why we fully cooperated with key members of the General Assembly in the drafting of pension reform legislation in 2010.

We are not alone. As a result of the recent recession, no fewer than 43 states have made changes to their retirement plans counting from 2009. I have personally read many of the news clips as legislatures across this nation have struggled with making changes to their state retirement plans. Frankly, many of these states have received major positive headlines for changes that are minor in comparison to what was accomplished here in Pennsylvania.

The General Assembly has not received nearly enough credit for passage of Pennsylvania's pension reform legislation: Act 120 of 2010. This is probably because many policymakers do not understand the full significance of the changes they made in terms of reducing the long-term cost of benefits.

Please allow me to quickly review the changes the General Assembly has already made for new school employees:

- The pension multiplier, which determines the final level of the retirement benefits, was reduced by 20 percent, and dropped from 2.5 to 2. An exception was made for those new hires that upon joining PSERS elect to pay the full cost difference for the higher multiplier, so that employers will not pay any of the additional cost.
- The vesting requirement was increased from 5 to 10 years;
- A cap was placed on the maximum pension benefit, so that retirees with longer years of service cannot earn more than their final salary;
- There were substantial increases in the age and years of service required to retire at full benefit;
- The option that allows a member to withdraw their own contributions when they retire was eliminated.
- The basic contribution rate was effectively raised, because new hires are paying the same amount for a reduced level of benefits; and,
- Pennsylvania was the first in the nation to require new hires to pay an additional "risk sharing" rate of up to 2 percent if PSERS does not meet its earnings assumptions. So instead of just the employer rate going up following an economic meltdown, employees too will directly share in the pain.

With the changes, the employer share of the cost of benefits earned by new employees was reduced by 60 percent from more than 8 percent to 3 percent of salary - the figure I referenced previously in my comments. These cost savings are not immediately obvious because employers in PSERS pay a blended rate based on the average cost for all members. The savings nevertheless are quite significant, and were projected by this commission in 2010 to total more than $19 billion over the next 30 years as new employees gradually become a larger share of the workforce.

The cost savings are masked by the rate increases associated with paying off the debts that were allowed to accumulate over the last decade, long before the new employees whose benefits were cut were even hired. In fact, with the employer normal cost of pension benefits at only 3 percent of salary for new hires, combined with the fact that these employees are chipping in at least 7.5 percent of their own salaries, it is the employees that are currently paying the lion's share of the cost of their own pension benefits.

Yet, the PSERS rate is continuing to climb despite Act 120 because previous legislatures "kicked the can down the road." For a decade the General Assembly made short-sighted decisions and did not properly fund the obligations it had to the pension systems. And I remind you that school district employees never stopped paying their 7.5 percent, even when the state was not paying any contributions at all.

The situation became critical with the investment losses in 2008 and 2009, and the bill is now coming due with interest. This is money that will need to be paid off regardless of what further changes are made to the pension system for future employees, current members, or even if the legislature abandoned the pension system altogether. In 2010, the legislature corrected these decisions by implementing a payment plan for its debt.

Here are some important points that are clear from a national comparison of PSERS and other similar state-sponsored pension plans where members participate in Social Security:

- The average school employee in Pennsylvania is paying 40 percent more toward her retirement benefits than public employees in other states.
- Employer contributions in Pennsylvania have been substantially lower than the national average over the last decade. In fact, in 2010, PSERS had the 2nd lowest percentage paid of the Annual Required Contributions (also known as the ARC and determined using GASB standards) in the entire United States. The average annual PSERS benefit payment is $23,466.
- Nationally, employers contribute more toward retirement than do their employees. This has been the reverse here in Pennsylvania for more than a decade with employees paying more than the Commonwealth and district combined.
- School employees in Pennsylvania never missed one pension payment, and always paid the full amount required by law.

In addition to reducing the long term cost of benefits, Act 120 also:

- Eliminated the impending 2012 pension spike created by state law;
- Committed the Commonwealth and districts to a schedule of stepped-up payments to pay off the pension debt; and,

- Ended the Employer Contribution Rate Holiday where the employer paid less than the normal rate for more than a decade.

When the pension reform law was passed in 2010, the General Assembly adopted the rate collars and knew exactly how high the rate would climb. I think everyone involved realized that the rate increases would be painful; however, no one at the time realized that the rate increases would hit at the very same time school districts were hit by an $800 million cut in school funding. In addition, no one thought the recovery from the recession would be so slow and continue to have such an impact on state and school district revenues.

Ironically, many districts had planned responsibly and established reserves to help meet the projected increases in the PSERS rate. Unfortunately, with the loss of state funding, these districts were forced to raid reserves to meet current costs, and so the PSERS rate hikes will hit them with more force than anticipated.

Unfortunately, there is no way magic way that I know of to deal with the hole created by these unfunded liabilities. They represent a debt that has already been incurred and has grown to the current level as a result of deferring payment. PSEA is more than willing to work with lawmakers to look again at these funding issues, but we are concerned that many of the solutions put forward to this point will actually dig the hole deeper and further increase costs in the long run.

Again, thank you for allowing me to offer this testimony.

TESTIMONY OF RICHARD ROWLAND, PA ASSOCIATION OF SCHOOL RETIREES

Thank you for the opportunity to provide testimony today. My name is Richard Rowland and I serve as executive director of the Pennsylvania Association of School Retirees, more commonly known as the PASR. We are the state's largest volunteer membership organization for retired public employees with a state and local chapter membership of more than 50,000 retired teachers, administrators, and public school support personnel---all annuitant members of PSERS. Founded in 1937, the mission of our organization is to serve others in need and help one another enjoy retirement.

PASR is currently discussing two proposals with officials in the Governor's Office and various leaders in the General Assembly. One we call a "Pension Reform II Proposal" is intended to provide a more practical way of managing the increases in employer contributions that the systems require, to reduce the existing unfunded accrued liabilities and provide more money for the systems to invest, and to utilize the systems investments and disbursements to strengthen Pennsylvania's economy and create more jobs for its citizens. The other proposal we refer to as a "Pension Contributors' Protection Act" is intended to require greater scrutiny of proposed changes to the pension systems and establish safeguards to prevent future governors and legislators from mismanaging the systems, as past governors and legislators have done.

The problems associated with our retirement systems are complex. Proposed solutions will be equally complex and, therefore, difficult to explain to individuals with limited knowledge of pension system funding, the economy, or the processes that our elected leaders in Harrisburg use to make decisions concerning the pension systems. To help the members of the Commission better understand our proposals, I provided copies of two articles that we recently published to help our members understand the proposals. I hope you might have an opportunity to read the articles, if you haven't already, because in the short time I have allotted I will not be able to thoroughly explain both and, in fact, will need to focus my remarks on just one---our Pension Reform II Proposal.

In our view the most immediate and serious problem that needs to be addressed is the schedule of employer contribution rate increases currently mandated by ACT 120 of 2010. We agree with Governor Corbett and others who have expressed concern that the rate increases are untenable. If not changed, the increases will require significant state and local tax increases or result in very deep cuts in state and local expenditures for education and all other vital governmental programs. Neither alternative is acceptable in this current economy where most citizens cannot afford to pay more in taxes and too many are dependent upon and cannot afford to lose the services our government provides.

What we are suggesting is that total contributions to the retirement systems each year be capped at amounts equal to a fixed percentage of the state's total revenues, that two-third majorities be required for the legislature to enact further changes to the funding provisions for the retirement systems, and that the state consider putting an across the board cap on reimbursement of Social Security costs to deter school districts from using the savings from not having to contribute as much to PSERS as they have been expecting to raise salaries beyond reasonable levels.

These changes will provide needed assurance that increases in contributions to the retirement systems do not exceed the state and school districts ability to pay the increases, and that Pennsylvania is committed to increasing contributions as it acquires the means to do so.

I am sure the managers of our systems will not like this, because these changes would not enable them to obtain the additional funds they need to invest and stem the systems' negative cash flows. We believe there is an alternative to dramatically increasing employer contributions now, however, during these hard economic times and the polarized political environment in which we find ourselves today. We can look at ways to enable the systems to retain and continue to invest more of the monies that they currently have in their funds.

In our opinion, reducing the existing unfunded liabilities and providing the systems more money to invest can be achieved without breaking the promise, impairing the contract, and reducing the benefits our public employees are entitled to receive based upon the benefit formula prescribed in law. We simply need to correct and alter the options that employees have for collecting their benefits in retirement. We need to remove the incentive that now exists for employees to withdraw their personal contributions in lump sum and create an incentive for employees to leave their contributions in the funds for continued investment.

There is an inconsistency in the retirement codes that provides a higher annuity than what is appropriate to individuals who elect to withdraw part of their benefit in lump sum at retirement. The codes require on the one hand that if employees elect a payment option other than the maximum single life annuity prescribed by the defined benefit pension formula, the total value of the alternate payment option must be actuarially equivalent to the value of the maximum single life annuity. On the other hand, the codes require the actuaries to utilize a 4% earnings assumption when calculating the annuities. The result is that individuals who elect to withdraw part of their benefit in lump-sum, and the vast majority do, end up receiving a higher than appropriate monthly annuity. We need to change the 4% earnings assumption to equal the boards' actual, long-term earnings assumption. Doing so would significantly reduce the current measurement of unfunded liabilities and weaken the incentive that now exists for employees to withdraw their contributions in lump sum.

Simply correcting the calculation of residual annuities when individuals take lump sum withdrawals will reduce the unfunded liabilities but not likely create enough of an incentive for individuals to forego such withdrawals. We suggest a further incentive be established, a new option, for employees to take the lump sum amount they are entitled to withdraw and purchase a second annuity that increases in amount by 3 or 4 % a year to offset the erosion of their total income due to inflation. Particularly in today's low-interest rate and highly-volatile investment environment, we believe most employees would welcome the opportunity to purchase some inflation protection and allow the systems to continue investing their monies.

We believe these option changes would greatly reduce the outflow of monies from the funds in the form of lump sum withdrawal payments. The impact on the systems can be quite significant. Of the $5.3 billion expended from PSERS in 2010/11, nearly $850 million was in the form of lump sum payments, an amount nearly equal to what the state has budgeted for contributions to PSERS in this current fiscal year.

It is important for everyone to understand that the benefits retirees receive from the system are largely paid for from the investment earnings generated by the systems, and not from the employee and employer contributions. Nearly 70 cents of every dollar paid in benefits to retirees today was derived from investment earnings. We need to enhance the systems' ability to generate greater investment revenue to meet its obligations to future retirees. Of course, investment earnings alone will not eradicate the existing unfunded liabilities. Increases in employer contributions are absolutely required, but we must acknowledge the current economic and political realities. We simply cannot increase employer contributions as much as we may need or want to at this time.

Only a strong, vibrant, and growing economy will fix the problems with our public retirement systems. We need to have stable and growing financial markets, consistent growth in state revenues, and our citizens need to receive the increases in income that will enable them to pay the higher taxes that may ultimately be needed to eliminate the deficits accumulated in the systems. All attention needs to be focused on using the tools we have at our disposal to strengthen Pennsylvania's economy, and that includes our public employee retirement systems.

Overlooked in the debate about the retirement systems, thus far, is the very significant and important roles they play in our economy...providing capital for business development through investment of the systems' assets and providing a secure and consistent flow of money into the economy via the expenditure of retirement benefits by annuitants. To strengthen the economy we are suggesting that the retirement systems consider whether they might be able to invest some of their assets to provide capital for the creation and development of small businesses in Pennsylvania, and we are suggesting that a modest cost-of-living adjustment be provided to at least the annuitant members of the system who have been retired ten or more years.

PSERS and SERS have both established very effective programs to provide venture capital for medium to large scale businesses, by taking equity positions in venture capital firms that specialize in helping established companies expand and bring new products to market. Might a similar program be developed for creating and growing small businesses in Pennsylvania? I have heard economists say many times that our future economic growth and job creation will come from small businesses. It is certainly worth exploring whether or not the systems can assist in the creation of small businesses in Pennsylvania, while continuing to adhere to their fiduciary responsibilities.

I have also heard economists tell us that we are a consumer-driven economy and that the slow growth we are experiencing now is due to lack of consumer confidence and declines in real income. Our incomes haven't been increasing and we are afraid to spend more for fear we may lose our jobs and receive less or no income later.

The retired public school employees currently receive an average annual pension of less than $24,000 a year and they have received no adjustments to their retirement incomes in ten years. As a result, the value or purchasing power of their annuities has declined by 24%--the cumulative rate of inflation since 2002, when the legislature last authorized a cost-of-living adjustment for public retirees. Like employed workers who have been receiving no raises, retirees have been reducing their discretionary spending to pay the increasing costs of nondiscretionary items like taxes, utilities, gas, and food. The decrease in discretionary spending, by workers and retirees alike, is the principal reason our economy is not growing as it should.

We urge Governor Corbett and the legislators to consider devoting some of the savings that our Pension Reform II Proposal might provide to granting cost-of-living adjustments to our retired public employees. We need to think of COLAs, not as a benefit *to* retirees, but as a means of infusing more dollars into our economy *through* retirees.

The economic impact of retired public employee expenditures in Pennsylvania has been well documented by the National Institute on Retirement Security. I included the summary from the Institute's study with the materials I provided the Commission. I hope you will read that as well.

Thank you for the opportunity to present our ideas today. I will be happy to answer any questions.

Pension Reform II: Finish the Job!

(published in PASR's 2012 AfterSchool magazine)

Various legislative leaders have announced that "public pension reform" is again at the top of the legislators' list of priorities. Governor Corbett has stated this issue must be addressed before the next budget and is developing a proposal to do so. It is reported that he intends to present his proposal to address the very complex problems confronting our retirement systems when he presents his budget proposal in February 2013.

Pension reform is coming again. What will those reforms look like and how will they impact school retirees today and tomorrow? Will these reforms fix or break our retirement system, the Public School Employees Retirement System (PSERS), which has worked so very well for most of the 95 years that it has been in existence? Much will depend upon what the governor chooses to advocate.

PASR is presenting a proposal for consideration by the Governor and members of the General Assembly that we refer to as our suggestions for a Pension Reform II Proposal. The PASR Board of Directors unanimously voted at its meeting in August to present it to the Governor and members of the General Assembly.

PASR's Pension Reform II Proposal is complicated. The problems this proposal seeks to resolve are very complex, so a huge challenge we have is explaining it to our members, legislators, and others who have limited knowledge of how pension systems work and impact our economy. A thought occurred to me that our *AfterSchool* readers might find it a little more interesting if I explained the proposal as I would if given the opportunity to meet with and explain it to Governor Corbett.

If your elected leaders and I met with Governor Corbett to present PASR's suggestions to fix the pension problems, I would say this to him...

Governor Corbett, thank you for taking time to meet with us and for considering our ideas for further reforming the public employee retirement systems. The proposal we present to you today is intended to accomplish three objectives:

1.) Provide a more feasible way to increase state and school district contributions to the retirement systems;

2.) Reduce the existing unfunded accrued liabilities and provide our systems with the additional funds needed for investment; and

3.) Strengthen the economy and support the development of small businesses and job creation benefitting all citizens of our Commonwealth.

We have seven specific suggestions that if incorporated in a comprehensive reform bill would accomplish these objectives and place Pennsylvania on a solid path to resolving the problems that were created by prior mismanagement of the public retirement systems. I will attempt to explain the rationale for each of these suggestions.

First, Governor, we wholeheartedly agree with you that the schedule of employer contributions to the retirement systems that is currently mandated in law is untenable. If not changed, the increases would require the state and school districts to further cut other vital government services or raise taxes; neither of these options is feasible in this present economy. We must enact changes that will allow employer pension contributions to rise in accordance with the state and school districts' ability to pay for the increases.

Our first suggestion is to place a cap on employer contribution increases each year that is tied to a percentage of the state's total revenues. Currently, the percentage of total state revenues allocated for contributions to PSERS is a little less than three percent. Place a cap on contributions to PSERS equal to this or some higher percentage of total state revenues based upon what your budget experts advise our state can afford.

Tying total contributions to a percentage of total state revenues will allow pension contributions to rise in direct proportion to the state's and most school districts' ability to pay these obligations. As you know, the bond rating agencies recently downgraded Pennsylvania's credit rating, citing concern about our state's ability and its commitment to properly fund its pension obligations. Our suggestion of tying total contributions to a percentage of total state revenues will provide some assurance that the state will have the ability to pay the required pension contributions, but more will need to be done to provide assurance that the state will maintain its commitment to increase contributions to the retirement systems as total state revenues increase. We suggest that a reform proposal also contain provisions to a required two-thirds vote in the House and Senate, as well as approval by the governor, in order to enact any further changes to the funding requirements for PSERS. While not a guarantee that future governors and legislators will not vote to break this commitment, such a requirement would certainly make it much more difficult for them to do so.

We understand that capping increases in pension contributions may prompt a concern that school boards will take the "savings" from not being required to contribute as much as they anticipated for pensions and using the funds to increase salaries. In fact, this is what districts did for the past 14 years. They were not required to contribute the amounts that retirement systems' actuaries said were necessary to pay for the retirement benefits that employees were earning each year. Continued salary growth during periods of economic weakness and stagnant revenue growth poses immediate budgetary problems for school districts and serves to exacerbate the long-term challenge of meeting our pension obligations for both the state and local school districts.

The 2010 pension reforms sought to address this potential problem by changing the pension exemption provisions in the ACT 1 requirements for obtaining voter approval of proposed school district property tax increases. In our opinion, the pension exemption provisions in ACT 1 do not provide an effective deterrent for school districts to raise salaries (and taxes) during periods of stagnant revenue growth. Instead, the provisions are enabling districts to scapegoat or point the finger of blame at pension increases for their "need" to raise taxes, when in reality it is salary increases that have been fueling the growth of total school district expenditures.

We suggest, as an alternative or in addition to the pension exemption provisions incorporated in ACT 1, that the state impose caps on the amounts that it reimburses school districts for their employer contributions to Social Security. Whether capped at the current amounts or preferably with inflation adjustment provisions, school districts should be required to bear the full cost of additional Social Security contributions resulting from their decisions to raise salaries above a reasonable level. This, in our view, would provide a more effective deterrent than what we currently have in law.

Governor Corbett we also agree with you that we have to find a way to reduce the current unfunded accrued liabilities of our retirement systems. We further understand that if we cannot increase employer contributions to the retirement systems as much and as fast as the systems need, we must identify an alternative source of funds for the systems to invest and earn what is needed to pay the benefits promised to our public employees when they retire. This is an enormous challenge, given the constitutional contract impairment protections afforded public employees and all Pennsylvania citizens. The solution, we believe, lies not in reducing the benefits promised to and largely paid for by our public employees, but in altering and expanding the options available to members in how they might choose to receive their benefits in retirement.

This association has sought for years to call attention to and correct what we believe to be an error in the retirement codes governing the calculation of annuities when members elect to withdrawal all or a portion of their contributions in lump sum at retirement. On one hand, the retirement codes require that if an individual elects to withdraw some of his/her benefit in lump sum and receive a reduced monthly annuity, the total value of the lump sum and reduced annuity must equal the value of the maximum single life annuity that person is entitled to receive as prescribed by the pension formula (years of service credit X percentage multiplier X final average salary = maximum single life annuity.) On the other hand, the codes require that the actuaries calculate the reduced annuity amount when a person takes a lump sum withdrawal by using an assumption that the monies withdrawn in one lump sum would have generated investment earnings for the fund equal to four percent per year. In reality, the systems would earn much more from continued investment of the monies if left in the funds at retirement.

The result of this inconsistency is that individuals who elect to take a lump-sum withdrawal receive a significantly higher monthly annuity than what is appropriate. We suggest that the four percent earnings assumption currently required for the calculation of annuities, when individuals elect to withdraw a portion of their benefits in lump-sum be corrected to equal the retirement systems' actual, long-term investment return assumption (currently seven and a half percent). Doing so would provide a substantial reduction in the systems' unfunded liabilities and reduce what is now an encouragement for members to withdraw their contributions in lump sum at retirement.

Employees, instead, need to be provided with an incentive to leave their contributions in the system for continued investment. It is important to understand, Governor, that investment earnings generated from the investment of employee and employer contributions pay for 70 percent of the benefit amounts that individuals receive in retirement. We simply cannot afford and should not expect either the taxpayers or the employees to pay off the existing debt with increases in contributions, certainly not now in the present economic environment, but look instead to find ways to increase the other, far greater revenue source our retirement systems have—investment earnings.

We suggest that employees be given a new option to purchase a second "inflation protection" annuity with the amounts they are currently entitled to withdraw in lump sum at retirement. The annuity should be calculated so as to be actuarially equivalent to the lump-sum withdrawal amount and provide for a benefit that increases in amount by either three or four percent per year. Combined, these two annuities will provide much needed protection from the declines in purchasing power that the employees will experience in retirement due to inflation. The addition of this option would provide a powerful incentive for employees to leave their contributions in the retirement systems for continued investment, particularly when interest rates are as low as they are now and alternatives to purchase similar inflation protection are severely limited.

Election of this option by employees would decrease the systems' liabilities and very significantly increase the amounts that the retirement systems have to invest. Currently PSERS is expending nearly one billion dollars annually in lump sum withdrawal payments—a greater amount than what the state currently has budgeted for contributions to PSERS. We believe our suggestions would produce an effect on the retirement systems that is equivalent to doubling the employer contributions and that they would not impair the Constitutional rights of employees and/or the contractual obligations of the employers.

Finally, Governor, it is important to understand (as we believe you do) that the Commonwealth's budgetary challenges and the problems with the public employee retirement systems cannot be fully resolved without a strong, vibrant, growing economy. We trust that you are considering everything at your disposal that could serve to strengthen our economy. The public employee retirement systems are very powerful and effective tools that can be used to help strengthen our economy.

The people working at our retirement systems do not stuff the contributions they receive under their mattresses, and retirees do not stuff their monthly annuity payments under theirs. The monies contributed to the retirement systems are invested in companies throughout the world, providing the capital that businesses need to innovate, expand, hire, and pay employees. The monies expended from the retirement funds in benefit payments to retirees are, in turn, spent by the retirees—again providing income and capital for businesses and fueling the economic cycle.

We suggest that the retirement systems be directed to consider investing some of their assets to promote small business development in Pennsylvania, while continuing to adhere to their fiduciary responsibilities. The retirement systems have both developed very effective programs to secure equity positions in entities that specialize in providing venture capital to businesses. Admittedly, this association was skeptical and expressed opposition when the legislature first granted the retirement systems authority to allocate a portion of their investments to venture capital. In the nearly two decades since, the systems have proven that they can make relatively safe venture capital investments and earn significant returns for the funds.

The systems' venture capital investments are currently directed at providing funds for existing, medium to large-scale firms seeking capital for expansion or to bring new products to market. Most economists state, however, that future economic growth and job creation will come from the creation and expansion of small businesses. Many potential small business owners, though, are finding it extremely difficult, if not impossible, to obtain financing from banks due to the onerous regulations and strict underwriting requirements imposed by the federal government and banks since the near collapse of the nation's financial institutions in 2008. The state is also very limited in the amount of funds it has available for small business loans. It would be worthwhile, we believe, to at least explore the possibility of the retirement systems providing capital to small businesses, perhaps by securing equity positions in third-party venture capital firms, as the systems have successfully done for larger entities.

Economists are also quick to point out that 70 percent of our nation's economy is driven by consumer spending. The fundamental problem with our economy right now is lack of consumer confidence and spending. Continued high unemployment, the sharp decline in property values, and falling household incomes are to blame. Governor, the people simply are not receiving the additional income that would enable them to increase their spending and fuel economic growth. We need policies that will result in people receiving more income to spend.

More than 250,000 retired state and public school employees in Pennsylvania have received no increases in their pensions in the past decade since the legislature and governor last authorized a cost-of-living adjustment. As a result, the real value and purchasing power of retirees' monthly annuities have declined by more than 24 percent—the cumulative rate of inflation since 2002. Understand, Governor, like employees depending upon periodic increases in their paychecks to meet their rising living expenses, retirees need increases in their pension checks.

We understand that there are many who might argue that state and public school employees who retired in the past ten years do not really need a cost-of-living adjustment and, therefore, may not spend any additional dollars given to them to help fuel economic growth. We have thousands in our membership who would vehemently argue otherwise. To our knowledge, though, no one is arguing that employees retired ten or more years do not need an increase or that they would not spend any additional dollars they might be given. We recommend that a comprehensive pension reform proposal include provisions to grant cost-of-living adjustments to at least the state and public school employees who have been retired ten or more years. The adjustments should be structured as the Commonwealth has done in the past, providing a graduated scale of percentage increases with individuals retired longer and experiencing greater erosion of income due to inflation receiving greater increases.

Governor, there is a wealth of information and data from several national entities quantifying the economic benefits provided by pensions that we would be happy to share with you and the honorable members of the General Assembly, including information specific to Pennsylvania. We simply request that you do not discount the possibility of including cost-of-living adjustments for current retirees in a comprehensive pension reform measure based upon political considerations, but instead direct a cost/benefit analysis and make a determination based upon what you believe to be in the best interest of our economy and all citizens of our great state.

Thank you for the opportunity to share our suggestions for further reforming our public employee retirement systems. We wish you all the best.

That is how I would explain our proposal if your officers and I were given the opportunity to sit down and talk with Governor Corbett. What do you think? Would you like to help us make such a presentation? If you want to encourage Governor Corbett to meet with us, please send the Governor a polite and respectful note. Correspondence to the Governor should be addressed as follows:

The Honorable Thomas Corbett
Governor of Pennsylvania
225 Main Capitol Building
Harrisburg, PA 17120
www.governor.state.pa.us

Fix It and Secure It:
PASR's Pension Contributor's Protection Act

(published in the September 2012 PASR Newsletter)

Everyone pretty much agrees that the Public School Employees' Retirement System (PSERS) worked very well from its founding in 1917 until 2001, when Governor Ridge signed ACT 9 into law. At the time, Ridge and the legislators in office dramatically increased benefits for future retirees, while prohibiting the PSERS Board of Trustees from increasing the contributions required from the state and school districts to pay for these benefit enhancements.

It is important to bear in mind that the employees at the time, many of whom have subsequently retired and are now receiving the higher benefits from ACT 9, are in no way responsible for the fiscal problems that we are struggling to resolve today. First, the employees did not lobby for the pension benefit increases. The legislators wanted to increase their own retirement benefits, and Ridge wanted to provide pensions for his administration's personnel who would not receive pensions, as ten years of service was required to qualify for a pension.

Recognizing they could not increase their own take from the retirement systems' assets without increasing benefits for other members of the systems, politicians expanded the proposal to increase benefits for all members who would retire in the future. In short, they offered to increase all the active employees' retirement benefits in an attempt to conceal or divert attention from their own greed. The vast majority of employees had no idea the legislature was considering increasing their retirement benefits and were pleasantly surprised when it did so. Their union leaders did not tell them about the harm it would cause the retirement system and Pennsylvania's taxpayers, and they fought hard to silence and discredit PASR's efforts to warn everyone.

Although Ridge and the legislators who voted to pass ACT 9 required employees to contribute more to help fund for the higher benefits, they also included provisions in the law prohibiting the state and school district contributions from being increased for ten years. So, the employees did what was required of them, pay more while they were working to receive more in retirement, but the employers' representatives opted to defer the additional contributions required of the state and school districts for a decade.

The passage of ACT 9 severely damaged the retirement systems and imposed an enormous burden on Pennsylvania's taxpayers. These are facts. Lies are being told that the systems cannot be fixed and that the members of the systems are responsible for the mess. But the fact remains, these retirement systems worked very well for 80 years; however, they were poorly managed for 13 years, beginning with the administration of Governor Tom Ridge and continuing until the end of Governor Ed Rendell's administration, when the legislators finally stood up and enacted necessary reforms to put the systems back on track with the passage of ACT 120 of 2010. In 2011, Governor Corbett signed a budget into law that ends the underfunding of PSERS.

A main argument now being advanced by the advocates of closing the retirement systems and replacing them with inferior 401(k)-style individual retirement savings accounts is that current and/or future governors and legislators would return to granting higher than necessary benefits and contributing less than what is needed to pay for the benefits promised to public employees. Governors and legislators cannot be trusted to continue managing the systems properly, the Commonwealth Foundation and others argue, so the responsibility must be taken from them, and employees should be allowed to manage their own retirement savings.

We vehemently disagree with the suggestion that legislators cannot be trusted to manage the systems properly. If fully informed of the consequences of their actions well before they are required by their leaders to vote on a proposal, the vast majority of legislators would make the proper decision. ACT 9 occurred because the legislators were not made aware of what the proposal would do to the systems and taxpayers until after the leaders required them to vote on the proposal and Governor Ridge signed it into law. The legislative leaders in 2001 misled and outright lied to their caucus members and to the public about the impact of that legislation on the retirement systems and future taxpayers.

Thankfully, the legislative leaders in 2001 are all gone now, removed from office by the voters, by the members of their caucuses, and/or by state and federal prosecutors for other crimes that they committed while in office. The fact that those responsible for promoting the passage of ACT 9 are no longer in power is important to bear in mind as we talk about ways to prevent future legislators from voting a similar catastrophe for our retirement system.

There are certainly things that Governor Corbett and our current legislators can do to ensure that their successors continue to manage the retirement systems properly. PASR is recommending seven specific suggestions that we collectively refer to as the Pension Contributors' Protection Act. These common sense changes will serve to protect both the members and the taxpayers who contribute to the public employee retirement systems.

First, we need to charge Pennsylvania's Auditor General with the responsibility of periodically reviewing the retirement system's actuarial assumptions, projections, and practices. The Auditor General is independently elected, not subject to control by the governor or legislature, and serves as the state's fiscal watchdog, yet he/she is not required to audit the management of the state's largest assets—the retirement systems—and has done only once in 95 years.

Many of our long-term members will recall the rally we held at the Capitol in May 2002. Eight thousand of our members and colleagues from the Pennsylvania Association of Retired State Employees (PARSE) sought to call the public's attention to the harm that ACT 9 would render to the retirement systems and threat that it posed to Pennsylvania's taxpayers at the end of a decade. We called for independent investigations by the state's Attorney General and the Auditor General.

Auditor General Bob Casey heeded our call and sought to conduct performance audits of PSERS and SERS. The systems refused to submit to audit and Casey had to go to court to compel the systems to submit, fighting a more than two-year legal battle through the Commonwealth Court to obtain an order for the systems to comply. PASR actively supported him in this fight and, in our opinion, paid a heavy price for this support when, in 2004, PSERS "discovered" that members on their board and employees of the system had been giving PASR "address information for new retirees and abruptly ceased sharing this information.

In any event, Casey won the legal fight; his successor, Auditor General Jack Wagner completed the audit and reported the results to the public in September 2006. He succeeded in raising the alarm PASR and PARSE members sought to raise in May 2002, issuing a stern warning that taxpayers were going to be hit with massive increases to the retirement systems beginning in 2012. The press finally took notice and started to report on the impending disaster. Governor Rendell and the legislative leaders could no longer ridicule and dismiss PASR's charges as being "sour grapes," claiming we were simply upset that retirees were not included in the benefit increases provided by ACT 9 of 2001.

Currently, the retirement systems are required to hire another actuary, every five years, to review the experiences, actuarial assumptions, and methods recommended and used by their regular actuaries. This responsibility, referred to as the "five-year experience reviews" should be shifted to the Office of Auditor General. In our opinion, the state's fiscal watchdog should conduct an independent review of the retirement systems ongoing operations every five years.

The state currently has established an appointed body, called the Public Employees Retirement Commission, to review and issue advisory opinions and cost estimates on any proposed changes to the public employee retirement systems. The law requires that the Commission issue an opinion to the legislature, upon request of legislative leaders, identifying any public policy concerns and providing actuarial cost estimates on bills or amendments to bills seeking changes in the retirement codes. Neither chamber of the legislature can vote final passage of a bill seeking to amend the retirement codes without first obtaining an opinion, called an "actuarial note," from the Commission.

The functions of the Public Employee Retirement Commission, identifying policy concerns and rendering cost estimates are very important and need to be strengthened. The Commission must be provided more opportunities to identify policy concerns before they issue their actuarial notes, and the legislature must be given more time to review and consider their reports before voting on changes to the retirement codes.

Governor Ridge and legislative leaders agreed to the provisions of what became to be ACT 9 late in the evening on Friday, May 4, 2001. The retirement systems were called that night and instructed to draft the language to implement the "deal" over the weekend. The Public Employees Retirement Commission was scheduled to meet the following Monday, May 7, and were directed to get its actuaries to provide cost estimates and vote to approve an actuarial note at that meeting. The Commission did so and by the next morning (May 8, 2001), both the House and Senate had voted to pass the bill and sent it to Governor Ridge to be signed into law. There was no thorough review by the legislature and no opportunity for anyone who saw the problems to voice objection and stop the proposal from becoming law.

We believe the law should be amended to provide that the Commission schedule public hearings on all proposals to amend the retirement codes before issuing its actuarial notes to the General Assembly. In our view, all entities seeking to change the benefits and/or funding provisions of the retirement systems, as well as entities opposed to such, should be afforded the opportunity to give public testimony and assist the Commission in its responsibility to identify policy considerations for the General Assembly.

Furthermore, the legislature should amend its rules to provide at least two weeks from when the Commission issues an actuarial note before either the House or Senate can vote final passage on a bill to amend the retirement codes. In our view, legislators must be given time to review the Commission's actuarial notes and hear from their constituents before enacting changes to the public employee retirement systems. As everyone should now realize, changes to the public employees retirement systems can impact, positively or negatively, all citizens of the Commonwealth.

Requiring periodic reviews by the Auditor General and strengthening the functions of the Public Employee Retirement Commission will certainly help provide legislators with more and better information about the retirement systems, but the first line of defense and principle advocates for the systems must be the systems' boards of trustees. The PSERS Board of Trustees, in particular, is structured to represent the interests of the state, school districts, and active and retired members. It is in the best position to render opinions on proposed changes to the retirement system that reflect the concerns of both members and taxpayers, state government, and local school districts. Yet, the PSERS Board of Trustees imposes upon itself a policy not to do so. This policy must change.

The PSERS Board of Trustees needs to be empowered to express opinions on proposals affecting the retirement system and to legally challenge those who might seek to force them to abdicate their fiduciary responsibilities. Currently, the Boards restrict themselves and staff to rendering assistance to legislators in drafting legislation and providing cost estimates on legislative proposals to change benefits or funding requirements. The trustees will not take positions on the proposals advocated by others, nor advocate any proposals of their own to address the needs of the system and/or its members. The trustees will not legally challenge directives from the Governor's Office or the Legislature that conflict with the trustees' fiduciary responsibilities to manage the systems for the sole and exclusive benefit of the systems' members and in the best interests of all the systems' contributors.

The trustees will not legally challenge directives conflicting with their fiduciary responsibilities because their attorneys are provided by the Governors' Office. The law needs changed to allow the PSERS Board of Trustees to select and hire independent legal council. If the legislature passes and the governor signs into law a measure requiring the trustees to do something contrary to their state and federally mandated fiduciary responsibility, the trustees cannot file suit and ask the courts to determine and resolve the conflict. No attorney for the Board, who was hired and can be fired by the governor, will ever lead a challenge to the Governor in court.

The trustees will not express opinions on proposed changes to the retirement codes because PSERS' budget and authorizations to hire and pay employees must be approved by the Governor's Office and the General Assembly. The laws need to be changed to give the PSERS Board of Trustees greater control of its budget and decisions concerning the hiring and compensation provided to its employees. Understand, while the monies to pay PSERS' operating expenses come from the retirement fund's investment earnings, not general fund tax revenues, it is the governor who recommends and the legislature that approves how much the PSERS Board can take from the retirement fund to pay its operating expenses. If the trustees were to express opinions on issues contrary to that of the governor or legislative leaders, the governor and legislators can retaliate with reductions in their operating budgets and deny requests to hire and pay the employees that are needed to invest and manage the funds. Budget oversight is needed from the governor and legislators, certainly, but not absolute control by them.

Finally, while representation on the PSERS Board of Trustees is well balanced between the various components of the state, school districts, and members of the system, the voice of retired members, of annuitants, needs to be strengthened. When ACT 9 was passed, the PSERS Board of Trustees was required to convene and vote to reduce the employer contribution rate it had set months earlier for the ensuing fiscal year. There was but one trustee who did not personally benefit from ACT 9, the sole annuitant representative serving on the Board, Sally Turley.

PSERS Annuitant Representative Sally Turley voiced strong objections and concerns for the future of the system, to the silence of most everyone else on the Board and the ridicule of a few. Had there been a second annuitant representative serving with her, she could have proposed a motion, obtained a second to the motion, and compelled a vote, thereby establishing a public record for those who abdicated their fiduciary responsibility to speak or attempt to avert the problems we face today.

There is a great reluctance to talk about the passage of ACT 9. It is painful for all concerned, particularly so for this association. PASR and all of its members have suffered the most from the passage of ACT 9. The association lost its ability to identify, contact, and invite all retirees to join and support the association, in retaliation for its attempts to warn the public and stop the underfunding. Long-term retirees in desperate need have not received any cost-of-living assistance in ten years. Our more recently retired colleagues, who never asked for and were required to pay more for their higher benefits, are being scorned by their neighbors who are now threatened with massive tax increases to pay higher taxes to "bail out" our retirement systems. Politicians seeking to divert attention from their own actions or seeking to skirt responsibility to fix the problems created by their predecessors are pointing the fingers of blame at public employees and retirees. Enough is enough.

George Santayanna's famous quote is applicable here; "Those who cannot learn from history are doomed to repeat it." The reality is that all in leadership today were not in leadership back in 2001, and the majority of legislators serving in the General Assembly today were elected since then are not aware of how ACT 9 came to pass. As painful as it may be, PASR must retell the story of what happened in 2001 and teach our legislators the lessons learned from that time, and we must trust that our elected leaders today will take action to ensure that history does not repeat itself.

PASR is proactive, forward-looking, and optimistic that those who we elect to represent us in Harrisburg, Governor Corbett and our legislators, are capable of doing the right things. That some in the past did wrong by taxpayers and retirees does not mean that our political leaders today and in the future would not do what is right.

As explained in the most recent issue of the AfterSchool magazine, we are advocating a plan to spare Pennsylvania's taxpayers, improve the financial condition of our retirement system, and strengthen this state's economy for the benefit of all its citizens. And, as explained here in this article, PASR is offering a plan to help ensure that Pennsylvania continues to properly manage it public employee pension systems. Our goal is to fix it and protect it, and we will challenge anyone who seeks to break or replace the retirement system that has served the needs of all retired public school employees very well for 95 years.

PENNSYLVANIA

NATIONAL INSTITUTE ON Retirement Security
Reliable Research. Sensible Solutions.

Pensionomics 2012:

Measuring the Economic Impact of DB Pension Expenditures

Key Findings

Benefits paid by state and local pension plans support a significant amount of economic activity in the state of Pennsylvania.

Pension benefits received by retirees are spent in the local community. This spending ripples through the economy, as one person's spending becomes another person's income, creating a multiplier effect.

In 2009, expenditures stemming from state and local pensions supported...

- 99,383 jobs that paid $4.6 billion in wages and salaries
- $13.7 billion in total economic output
- $1.8 billion in federal, state, and local tax revenues

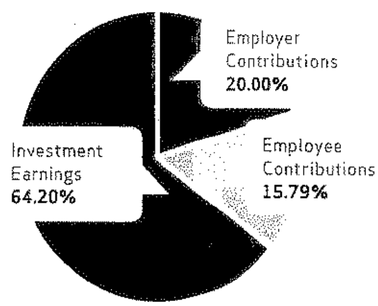
... in the state of Pennsylvania.

Each dollar paid out in pension benefits supported $1.59 in total economic activity in Pennsylvania.

Each dollar "invested" by Pennsylvania taxpayers in these plans supported $7.95 in total economic activity in the state.

Overview

Expenditures made by retirees of state and local government provide a steady economic stimulus to Pennsylvania communities and the state economy. In 2009, 384,834 residents of Pennsylvania received a total of $8.6 billion in pension benefits from state and local pension plans.



The average pension benefit received was $1,869 per month or $22,424 per year. These modest benefits provide retired teachers, public safety personnel, and others who served the public during their working careers income to meet basic needs in retirement.

Between 1993 and 2009, 20.00% of Pennsylvania's pension fund receipts came from employer contributions, 15.79% from employee contributions, and 64.20% from investment earnings.* Earnings on investments and employee contributions—not taxpayer contributions—have historically made up the bulk of pension fund receipts.

Impact on Jobs and Incomes

Retiree expenditures stemming from state and local pension plan benefits supported 99,383 jobs in the state. The total income to state residents supported by pension expenditures was $4.6 billion.

To put these employment impacts in perspective, in 2009 Pennsylvania's unemployment rate was 8.0%. The fact that DB pension expenditures supported 99,383 jobs is significant, as it represents 1.6 percentage points in Pennsylvania's labor force.

Economic Impact

State and local pension funds in Pennsylvania and other states paid a total of $8.6 billion in benefits to Pennsylvania residents in 2009. Retirees' expenditures from these benefits supported a total of $13.7 billion in total economic output in the state, and $7.9 billion in value added in the state.

$6.5 billion in direct economic impacts were supported by retirees' initial expenditures. An additional $3.6 billion in indirect impact resulted when these businesses purchased additional goods and services. $3.7 billion in induced impacts occurred when employees hired by businesses as a result of the direct and indirect impacts made expenditures.

Total Economic Impact $13.7 billion

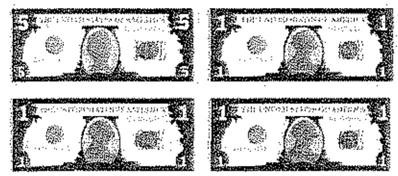
DIRECT IMPACT	INDIRECT IMPACT	INDUCED IMPACT
$6.5 billion	$3.6 billion	$3.7 billion

Totals may not add up exactly due to rounding. For more information on the data and methodology used for these estimates, please refer to Boivie, I. 2012. *Pensionomics: Measuring the Economic Impact of DB Pension Expenditures*. Washington DC: National Institute on Retirement Security. www.nirsonline.org

Economic Multipliers

Taxpayer Contribution Factor*

$1.00
contributed by taxpayers to Pennsylvania pensions over 30 years



$7.95
total output

Each $1 in taxpayer contributions to Pennsylvania's state and local pension plans supported $7.95 in total output in the state. This reflects the fact that taxpayer contributions are a minor source of financing for retirement benefits—investment earnings and employee contributions finance the lion's share.

Pension Benefit Multiplier

$1.00
pension benefits paid to retirees in Pennsylvania

$1.59
total output

Each $1 in state and local pension benefits paid to Pennsylvania residents ultimately supported $1.59 in total output in the state. This "multiplier" incorporates the direct, indirect, and induced impacts of retiree spending, as it ripples through the state economy.

*Caution should be used in interpreting these numbers. See the Technical Appendix of the full *Pensionomics* report for details.

Impact on Tax Revenues

State and local pension payments made to Pennsylvania residents supported a total of $1.8 billion in revenue to federal, state, and local governments. Taxes paid by retirees and beneficiaries directly out of pension payments totaled $146.0 million. Taxes attributable to direct, indirect and induced impacts accounted for $1.7 billion in tax revenue.

Federal Tax	1.2 billion
State/Local Tax	636.0 million
Total	**$1.8 billion**

Economic Impacts by Industry Sector

The economic impact of state and local pension benefits was broadly felt across various industry sectors in Pennsylvania. The ten industry sectors with the largest employment impacts are presented in the table below.

Industry	Employment Impact (# Jobs)	Labor Income Impact	Value Added Impact	Output Impact
Food Services and Drinking Places	8,433	$176,753,009	$248,535,504	$494,337,626
Private Hospitals	6,480	$439,189,483	$468,919,065	$957,749,596
Real Estate Establishments	5,622	$72,400,824	$538,582,302	$743,369,101
Physicians, Dentists, and other Health Practitioners	4,966	$399,981,495	$426,618,534	$704,791,501
Nursing and Residential Care Facilities	4,733	$181,078,609	$195,494,382	$326,860,364
Retail Stores - Food and Beverage	2,556	$73,325,099	$118,947,458	$135,922,841
Individual and Family Services	2,331	$59,609,943	$59,780,210	$89,360,241
Colleges, Universities, and Professional Schools	2,018	$106,019,134	$109,480,857	$200,399,832
Retail Stores - General Merchandise	2,008	$53,491,212	$87,005,469	$98,880,230
Wholesale Trade Businesses	1,998	$162,658,918	$279,248,834	$380,774,725

Industry totals include impacts from in-state pension payment only, and do not account for the recaptured "leakage" impacts from other states.

Testimony of Christian Leinbach:
Berks County Commissioner since January 2008
Chair of the Board of Commissioners
Chair of the Retirement Board
Current Vice President County Commissioners Assoc. of PA (CCAP)
Incoming President of CCAP for 2013
Board Member National Association of Counties (NACo)
Vice President NACo North East U.S. Caucus of Counties

Impact of current Pension Laws on Berks County: Charts

- Berks County paid over $83 million in ARC payments over the last 10 years
    -
    - $37.5 million in ARC payments the first five years
    - $46.5 million in ARC payments the last five years
    - Represent 4.5 - 5 mil impact on county property taxes
- The ARC and Retroactive rule make giving a COLA almost impossible

What Berks County Would Like to see Changed:

- Allow PA Counties to implement a Defined Contribution Plan with grandfathering of current employees in the current system. The best scenario would be to move everyone to the new system but that could create legal a cost concerns.
- Give PA Counties Flexibility in defining details of plan. i.e. Let counties decide if they offer an option for existing employees transfer to the new plan.
- Provide a structure that creates pension like rules for the defined contribution plan with some ability for lump-sum rollover when leaving county employment. i.e. Cannot borrow from plan, plan managed by a board or professional financial management firm.
- Allow for a county contribution but do not require in light of varying economic circumstance of counties; however, if you do it should not exceed 3%.

What Impact a Defined Benefit Plan would have on Berks County: (See Charts)

- (DB) Percent of property tax used to pay the annual ARC – Retrospective and Prospective
- Total cost over past 8 years $68,693,411
- Total cost over next 5 years $62,074,945
- (DC) Percent of property tax used to pay the annual ARC - Prospective
- Total savings over next 5 years $46,630,045

If we do not do something soon we may find ourselves so deep in the whole we can't get out. Remember the "rule of holes." When you are in a hole, stop digging. We need to stop digging now and provide a new pension structure to counties.

Pension Reform Analysis

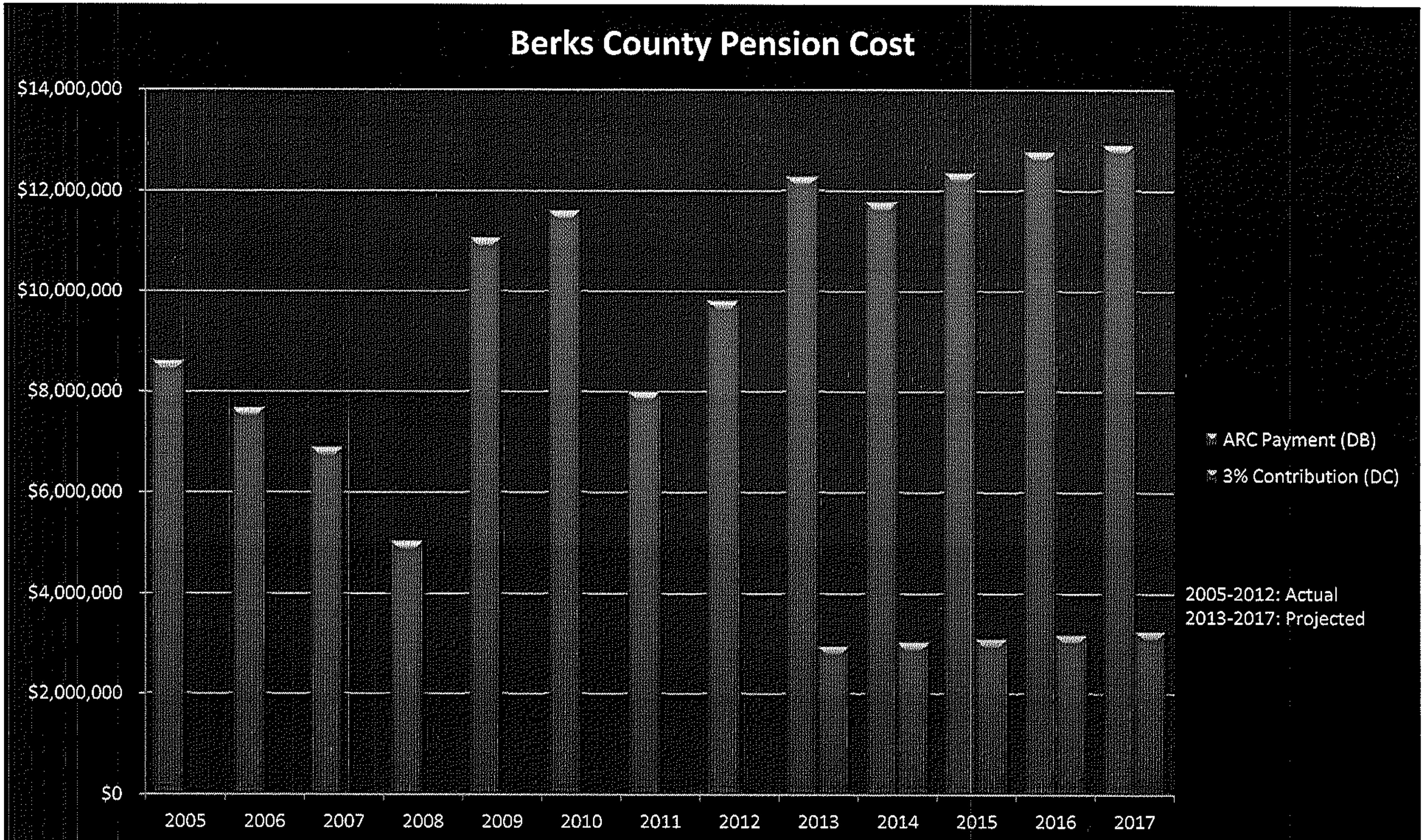
Historical Annual Pension Cost (ARC)

	2005	2006	2007	2008	2009	2010	2011	2012
Budget Tax Revenue	$116,644,317	$119,125,162	$122,374,786	$124,548,188	$125,531,444	$127,008,976	$127,650,000	$128,162,015
ARC Payment	$8,612,860	$7,675,390	$6,902,040	$5,039,939	$11,064,607	$11,599,747	$8,002,599	$9,796,229
% of Tax Revenue	7.38%	6.44%	5.64%	4.05%	8.81%	9.13%	6.27%	7.64%

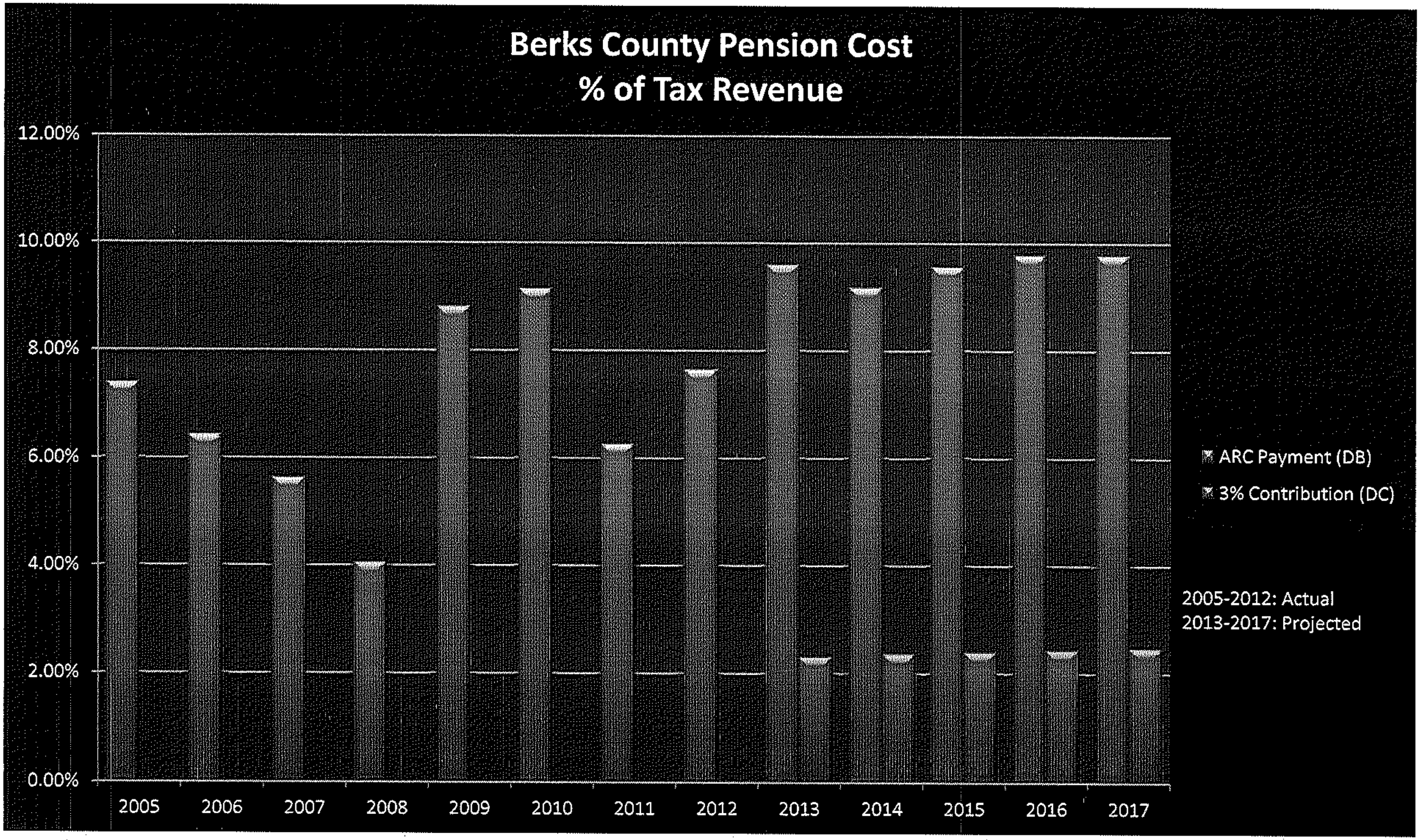
Forecasted Annual Pension Cost - Defined Benefit vs. Defined Contribution

	2013	2014	2015	2016	2017
Budget Tax Revenue	$127,998,779	$128,420,162	$129,302,452	$130,544,051	$131,828,856
ARC Payment	$12,272,291	$11,784,579	$12,352,119	$12,770,985	$12,894,971
% of Tax Revenue	**9.59%**	**9.18%**	**9.55%**	**9.78%**	**9.78%**
Projected Wages	$98,007,546	$100,425,565	$102,904,037	$105,444,467	$108,048,410
3% Contribution	$2,940,226	$3,012,767	$3,087,121	$3,163,334	$3,241,452
% of Tax Revenue	**2.30%**	**2.35%**	**2.39%**	**2.42%**	**2.46%**
Projected Savings	**$9,332,065**	**$8,771,812**	**$9,264,998**	**$9,607,651**	**$9,653,519**

Pension Reform Analysis



Pension Reform Analysis



Testimony of Fran Burns, Executive Director,
Pennsylvania Intergovernmental Cooperation Authority,
before the Pennsylvania Public Employee Retirement Commission

October 3, 2012

Good afternoon, Chairperson Salomone and members of the Public Employee Retirement Commission. My name is Fran Burns, and I am Executive Director of the Pennsylvania Intergovernmental Cooperation Authority (PICA). The funding of pension systems is a significant issue in Philadelphia, as in other local governments across the Commonwealth, and I appreciate the opportunity to testify today.

Background on PICA

PICA was created by the Commonwealth in 1991 as an independent authority to oversee the finances of the City of Philadelphia, create a long-term financial planning process and pull the city out of deficit through $1 billion in bond issuance. While PICA issued bonds remain outstanding ($494 million outstanding as of June 30, 2012), PICA exercises the power of review concerning the fiscal and budgetary affairs of the City.

PICA was created not only to ensure that the City maintain a balanced budget and a responsible financial planning process but also to foster sound financial planning and budgetary practices that address the underlying problems which result in deficits. In accordance with this mandate, PICA has issued reports examining major challenges to the City's long-term financial stability. In 2005, PICA issued a paper on the problems of the City's pension system and possible solutions, which I'll highlight later in this testimony.[1]

Philadelphia's Pension System

The Philadelphia Public Employees Retirement System provides benefits to police, fire and civilian workers of the City of Philadelphia through the administration of 18 separate plans dating from origin in 1915. The Philadelphia pension system is one of the largest municipal pension systems in the country with 64,349 members in the system, of which 21,134 were retirees as of July 1, 2011.

Generally, benefit plans are distinguished by whether they apply to police, fire, non-uniformed, or elected employees. There are also three broad categories of plans. "Plan 87" which applies to employees hired after January 8, 1987, "Plan 67" which applies to employees hired prior to January 1987 and "Plan 10" a new category of pension plans that is a hybrid defined benefit/defined contribution plan. There are currently no city employees enrolled in Plan 10.

Philadelphia's system does not incorporate an automatic annual cost-of-living adjustment (COLA). Instead, a Pension Adjustment Fund (PAF) provides ad hoc benefit supplements that are dependent on investment earnings. When it was created, the PAF allowed for automatic

[1] *An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund*, PICA Issues Report, December 21, 2005.

contributions only if the fund was over 70 percent funded, to prevent taking resources from a seriously underfunded system. In 2007, Philadelphia City Council passed a bill (over the Mayor's veto) which allowed for automatic contributions to the PAF based solely on rates of return, regardless of the funding status of the Pension Fund.

Growing Unfunded Liability

The financial health of the City's pension fund has deteriorated significantly over the past decade. The funded ratio declined significantly from 72.7 percent in 2002 to 45.0 percent in 2008. Since 2008, the ratio has increased slightly, to 49.7 percent. The unfunded actuarial accrued liability (UAAL) of the pension system has increased in seven out of the past nine years, with the UAAL increasing from $1.836 billion in 2002 to $4.768 billion in 2011. The unfunded liability now represents 348 percent of covered salaries, compared to 152 percent in 2002. Research suggests that the funding level of Philadelphia's pension fund is particularly low compared to other major local pension systems. The Center for Retirement Research at Boston College found that Philadelphia's municipal pension system funding ratio of 47.0 percent in 2011 was the seventh lowest out of 97 major local pension systems in the United States.[2]

Philadelphia's Contribution Levels

Prior to FY04, the City would make annual payments of the actuarially determined normal cost, as well as an amortization payment based on a 30-year amortization of the unfunded liability. Beginning with FY04, the City reduced its contribution to the Act 205 mandated minimum municipal obligation (MMO), which resulted in short term reductions in annual contributions, but also contributed to the rapid growth in the unfunded liability from 2004 to 2008.

As a result of the 2008-2009 financial crisis, the City received State authorization under Act 44 of 2009 to defer $155 million of its FY10 MMO and $80 million of the FY11 MMO. These deferred amounts must be repaid, along with 8.25 percent interest, by the end of FY14.[3] Additionally, Act 44, allowed the City to base its MMO on a "fresh start" amortization of the July 1, 2009 UAAL, with the amortization based on level payments over a 30 year period altering the existing 40 year period. This change had the effect of stretching out the City's payments to amortize the unfunded liability, and substantially reduced the level of the MMO beginning in FY11. The City has always met its required MMO payments.

Investment Earnings Assumption

Some academic experts have argued that the appropriate discount rate for measuring pension liabilities is a risk-free rate, to reflect the relatively low uncertainty associated with required projected pension payments.[4] Adoption of a risk free rate would result in dramatic increases in

---

[2] Alicia H. Munnell, Jean-Pierre Aubry, and Kelly Haverstick, "The Funding Status of Locally Administered Pension Plans," Boston College, Center for Retirement Research, December 2008; Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz, and Laura Quinby, "An Update on Locally-Administered Pension Plans," Boston College, Center for Retirement Research, July 2011.
[3] At the time Act 44 was passed, 8.25 percent was the City pension fund's assumed rate of return on investments.
[4] See, for example, Andrew G. Biggs, "The Market Value of Public-Sector Pension Deficits," Retirement Policy Outlook, No. 1 (Washington, DC: American Enterprise Institute for Public Policy Research, 2010); and Robert

estimates of the unfunded liability. It has been suggested that the use of the assumed rate of return of investments as the method of discounting pension liabilities masks the true dimensions of the pension underfunding problem. Higher than realistic earnings assumptions may also have the effect of increasing the incentive of investment managers to invest in more risky assets, which could result in less consistent returns, or lower returns over the long term. This is a national problem. Nonetheless, it is particularly a concern in Philadelphia due to the City's already relatively low funding ratio.

In recent years, the City has lowered its assumed investment rate of return, from 9 percent in 2004, to 8.75 percent in 2005, 8.25 percent in 2009, 8.15 percent in 2010, and 8.1 percent in 2011. Nonetheless, the City's current 8.1 percent rate remains high compared to some other municipal pension plans. Many plans are moving toward long-term investment return assumptions in the range of 7 percent, and some have questioned whether even 7 percent is realistic.[5] The City's actual investment return in FY12 was 0.05 percent.

The risk of a relatively high assumed rate of return is that actual performance below the assumption will result in higher required contributions. The risk to Philadelphia is somewhat mitigated by the City's move in 2009 from a five-year to ten-year smoothing period. The increase in the asset smoothing period for deviations between actual and assumed investment gains should have the effect of diminishing year to year changes in the level of the City's pension costs due to changes in investment returns.

<u>Impact on the Operating Budget</u>

As the City's unfunded pension liability has increased over the past decade, so have its annual contributions to the pension fund. In FY01, the General Fund contribution to the fund was $194.3 million, or 6.7 percent of General Fund obligations. By FY09, the contribution had increased to $459.0 million, 11.7 percent of General Fund expenditures. In FY12, without deferrals, the City's contribution is estimated to have increased to $554.3 million, 16.0 percent of General Fund obligations. Payments are projected to peak in FY14 at 18.1 percent and drop to 16.4 percent of General Fund obligations in FY17.[6] This amount is larger than any direct agency appropriation projected for FY17, including the Philadelphia Police Department. Further, the actual amount could be increased depending on actual economic and demographic experience over the next five years, most notably if actual investment returns fall below the City's assumed 8.1 percent rate of return.

<u>Pension Obligation Bonds</u>

The City's pension costs include debt service on Pension Obligation Bonds (POB). Proceeds from these bonds in the amount of $1.25 billion were deposited into the pension fund in February 1999. However, the impact of the POB proceeds on the long-term health of the pension fund

---

Novy-Marx and Joshua D. Rauh, 2009, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23 (4): 191-210.

[5] Mary Williams Walsh and Danny Hakim, "Public Pensions Faulted for Bets on Rosy Returns," *New York Times*, May 27, 2012.

[6] These amounts include the City's required annual payments of debt service for pension obligation bonds.

was minimal because the issuance occurred before the stock market declines in 2001 and 2002. The overall rate of return on investments was negative in two of the three fiscal years after the POB issuance (a decline of 6.0 percent in FY01 and 5.2 percent in FY02). Accordingly, the UAAL declined following the POB issuance from $2.7 billion in 1998 to $1.4 billion in 1999, but increased significantly after 2001 as the investment losses were recognized in actuarial valuations. The funded ratio increased from 52.3 percent in 1998 to 76.7 percent in 1999, peaked at 77.5 percent in 2001, and then declined to 51.6 percent in 2006.

At the same time, the City has been required to meet increasing POB debt service costs.[7] POB debt service began in FY99, with an initial cost of $12.5 million, and has increased to $124.7 million in FY13. Debt service will peak at $134.7 million in FY16, and remain at that level through 2026. It will increase slightly to $135.9 million in 2027 and 2029, before increasing to $232.4 million in 2030, the final year of payments. The General Fund portion of the POB debt service is projected at $107.1 million in FY13, which represents 17.0 percent of the overall General Fund pension contribution.

Pension Research

In December 2005, PICA issued a report that outlined the significant increases in pension costs from FY01 through FY06, as well as the decline in the funded ratio of the City's pension fund from 76.9 percent in FY01 to 59.8 percent in FY05. According to the report, the structure of Philadelphia's pension plan benefit is similar to that in nine other major cities, with respect to retirement age, minimum years of service, and the multiplier used to determine benefits. However, there were four areas in which Philadelphia's pension system diverged from the nine other cities, all relating to funding. First, the sum of employee contribution rates and the normal cost rate were relatively low in Philadelphia. Second, Philadelphia's assumed rate of return on investments of 9 percent was the highest among the comparison cities. Third, the funding ratio of the pension system was well below the median of other cities. Finally, the City's 40-year period for amortizing the unfunded liability was higher than the median 30-year amortization period in other cities.

The PICA report recommended increasing the retirement age; decreasing benefit multipliers; increasing the period used to calculate average final compensation; and increasing employee contribution rates. The report also recommended that that City offer a defined contribution plan, pay more than required MMO contributions and reduce the earnings assumption.

Special Pension Commission Study

State Act 44 of 2009 established a Special Pension Commission, chaired by PICA's chairperson, which is responsible for preparing benefit plan studies of each City of Philadelphia pension plan. Mr. Salomone and his designee are members of the committee. Consistent with its mandate, the Special Pension Commission's first benefit plan study was submitted to the General Assembly on August 5, 2011. One of the components of the study, prepared by Milliman, Inc., compared pension benefits provided by the City of Philadelphia with benefits provided by six other

[7] The overall interest rate on these bonds was 6.61 percent.

jurisdictions - the Commonwealth of Pennsylvania, the State of New Jersey, Baltimore, Houston, Phoenix, and San Diego.

In general, Milliman found that for municipal workers hired under the more recent City Pension Plan 87, benefits in Philadelphia are generally higher than comparison jurisdictions but benefits are comparable for workers hired under the earlier City Plan 67. Philadelphia's pension benefit for police employees were found to be comparable to other jurisdictions. Benefits provided to fire employees in Plan 87 were found to be relatively low compared to other jurisdictions and those hired earlier in Plan 67 receive benefits comparable to the 6 jurisdictions studied.

The Milliman study also compared municipal employee contributions to support pension fund costs. For current hires, Philadelphia employees contribute an average of 1.94 percent of wages, compared to contributions that range from 5.0 percent (Phoenix) to 8.47 percent (San Diego). For earlier hires, Philadelphia employees contribute an average of 3.75 percent, compared contribution rates ranging from 5.0 percent (Phoenix) to 10.4 percent (San Diego). Notably, Baltimore and Houston do not require employee contributions for municipal employees.

Other Research on Philadelphia's Pension System

One of the most comprehensive studies of Philadelphia's pension system was a 2008 report commissioned by the Pew Charitable Trusts and the Economy League of Greater Philadelphia.[8] Written by Katherine Barrett and Richard Greene, the report found that the average city pension benefit in Philadelphia is comparable to other cities, but that the amount paid into the system by City employees is generally below other major cities. It also found that the current unfunded liability is largely the result of periods in the 1970s and 1980s when the City made minimal contributions to the pension fund. Barrett and Greene made many recommendations to address Philadelphia's pension problem, including: increasing current employee contribution; a careful analysis of the level of pension benefits in Philadelphia compared to other cities; review of investment practices; evaluation of benefit levels in relation to an appropriate standard of income replacement, taking into account Social Security; public reporting of investment performance; a change to the City Charter to increase the number of pension board members who have no personal interest in the system; and institution of a new pension plan for new hires that would increase the retirement age, change vesting requirements, reduce the multiplier, and include a hybrid defined benefit-defined contribution plan. The report also recommended consideration of paying off the unfunded liability over a thirty year period, consistent with GASB recommendations.

Policy Options to Consider

Policy reforms need to be considered in terms of the fundamental purpose of a pension system to provide replacement income adequate to ensure maintenance of living standards after retirement. Some experts believe that a replacement ratio – post-retirement income from all sources expressed as a percentage of pre-retirement income from all sources – ranging from 77 to 90

[8] Katherine Barrett and Richard Greene, *Philadelphia's Quiet Crisis: The Rising Cost of Employee Benefits* (Philadelphia: Pew Charitable Trusts and Economy League of Greater Philadelphia, 2008).

percent is an appropriate goal.[9] Philadelphia's pension system clearly meets this goal for those workers who spend a substantial portion of their careers as City employees.

Aside from the question of whether Philadelphia's pension benefits are appropriate in relation to basic standards of income replacement, there is the question of whether they are competitive with other jurisdictions and whether they are financially sustainable over the long term. On this question, the research tends to conclude that the City's current benefits are generally more than competitive and they are not financially sustainable.

States and localities around the country have been taking various steps to reduce the costs of pensions so that they are financially viable. Common steps include those mentioned already in this testimony: increased employee contribution rates, reduced multipliers, reductions in cost of living adjustments, stricter requirements for vesting, changes to the calculation of final average compensation, higher retirement ages, movement to hybrid defined contribution/defined benefit plans. The City of Philadelphia has made some progress, with contracts with the police and fire employees now requiring higher contributions or participation in a hybrid defined contribution benefit plan for new hires. Under new contracts for correctional officers, Deputy Sheriffs, and court and Register of Wills, newly-hired employees are required to participate in the city's hybrid pension plan, Plan 10. City Council has also taken steps to reduce the cost of the Deferred Retirement Option Plan (DROP).

Funding into the pension system will come from either employees, government or return on investment. The government options to put more money into the system fall into categories of efficiency savings, cost reductions, service reductions, tax increases and identifying new revenue streams. The City of Philadelphia is currently considering privatization of the Philadelphia Gas Works (PGW). Net proceeds from a privatization transaction such as the sale of PGW could be deposited into the pension fund resulting in a significant reduction in the unfunded liability, relief to the general fund and a reduction in amortization payments going forward. Monetizing large assets to invest in pension funds or reduce long term debt is an area that some municipalities have successfully executed but remains a complex option and few and far between.

The pension liability presents the greatest risk to the City's fiscal health. From 2001 to 20112, the City's general fund contribution to the pension system grew by 185% and controls 16% annual expenditures, larger than Police department expenses. With only 49.7 percent of the funded the unfunded accrued liability in 2011 is $4.78 billion. The time to act with significant purpose is now. PICA will continue to raise the issue to the forefront and be a helpful partner.

I hope this testimony has been useful. Please reach out to me if we can be of assistance as you continue your work. I welcome any questions at this time and thank you for again for the opportunity to testify.

[9] Jun Peng and Ilana Boivie, "Sensible Solutions: Lessons from Well-Funded Public Pensions: An Analysis of Six Plans that Weathered the Financial Storm" (Washington, DC: National Institute of Retirement Security, June 2011).

Testimony of

Jeffrey B. Clay, Executive Director

Public School Employees' Retirement System

before the

Public Employee Retirement Commission

October 3, 2012

Good afternoon Chairman Salomone, members of the Commission, Executive Director McAneny, staff and guests. I am Jeffrey Clay, Executive Director of the Public School Employees' Retirement System (PSERS). Thank you for the opportunity today to provide brief comments about the pension issue and also for your sponsorship of these hearings.

As previous speakers at these hearings have noted, the pension issue is a significant fiscal issue currently facing the Commonwealth, its public schools and their taxpayers. That said it also involves very important and vital policy decisions.

As you are aware, I have been intimately involved with PSERS' funding challenges for more than ten years. During this time I have met with various groups and individuals and heard their concerns and diverse viewpoints on addressing the pension issue; just like you have heard throughout your own hearings.

From PSERS' perspective, however, the "pension issue", can be broken into two separate issues; a pension funding issue and a pension design/reform issue. Neither issue has a quick, clean or easy answer to it.

The first issue, and I would suggest, the primary one of the two, is the proper funding of PSERS and specifically the significant unfunded liability that PSERS has incurred for benefits already earned. In essence, it is a debt that has to be paid and, unfortunately, is growing due to the continued intentional underfunding of the System. It is this issue that is driving the rising employer contribution rates, which are causing the budgetary stress for both the Commonwealth, school employers and their taxpayers. In short, the question is how to pay the pension bill that is due in both a fiscally responsible and actuarially sound manner?

Before turning to the second issue, it is important to understand the causes of the funding issue as they are often misunderstood. It is also important to understand what caused the issue as they impact the proposed solutions that are being discussed. For example, I have heard that some place the entire blame of the funding issue on Act 2001-9, while others blame the System's under performance of its assumed investment rate of return at certain times. In fact, the causes of the unfunded liability debt are multiple and vary when examined from both a short-term and long-term perspective.

Over the short-term (10+ years) the causes include:

- The actuarial and funding methodology changes made by Acts 2002-38, 2003-40, and 2010-120, which intentionally underfunded PSERS by suppressing the employer contributions (school employer and Commonwealth) for the last 10+ years below the employer normal cost[1]
- The negative arbitrage caused by intentionally paying below the employer's normal cost for 10+ years when there has been an unfunded accrued liability, which means the Commonwealth and school employers did not pay for the annual benefits earned by members, much less the principal and interest needed to amortize the accrued unfunded liability debt that existed during this period
- Two historic downturns in the investment markets within a very short 10 year timeframe
- Acts 9 and 38 benefit enhancements (increased multiplier and Cost-of-Living Adjustment)

Over the long-term (30+ years) the causes include:

- Failure to properly fund with "new money" post-funded benefit increases (ad hoc COLAS, early retirement incentives, Act 9 enhancements, etc.) over an extended period of time, which effectively siphoned away any "surplus" produced by above actuarial assumption performance by

[1] The employer normal cost is the annual cost that the employer incurs for the benefits that the active members earned in that year, presuming all Plan assumptions are met. The employer normal cost could be compared to an employer match in 401(k) plan.

PSERS, thus eliminating its ability to mitigate the impact of under actuarial assumption performance by the System
- Failure to pay off, in a timely fashion, the unfunded liability created by post-funded benefit enhancements, thereby adding additional liability
- The cumulative impact of the above on PSERS' investment performance—less assets to invest, reduced employer contributions, greater benefits payments, creation of negative cash flow and thus greater need to maintain liquidity, etc.

With that background, the second issue is the perceived need for additional pension reform over and beyond that already accomplished by Act 2010-120, which in the case of PSERS, resulted in $24.65 billion in savings by reducing future benefits for new school employees. The Act 120 benefit reductions also will lower over time PSERS' 8%+ employer normal cost of the pre-Act 120 plan to approximately 3%. As a result the benefits for new employees under Act 120 are now primarily funded by the members themselves. Moreover, Act 120 members, who contribute either 7.5% or 10.3% of their pay, are subject to a risk share provision that permits their contribution rate to be adjusted up or down depending on the investment performance of the Fund, thus introducing a defined contribution component to the new tier of benefits. These benefits reductions and savings tend to be overlooked because Act 120 also deferred employer contributions payments, at a cost of $23.27 billion, to provide a more reasonable payment schedule to both the Commonwealth and school employers, i.e. continued the underfunding.

In light of this, why is additional pension design/reform being discussed? Some view it as the way to completely resolve the pension funding issue. As noted above, however, PSERS' unfunded liability is made up of many components of which underfunded benefit enhancements is only one. Thus additional pension reform in the form of further reductions in PSERS' benefits, by itself, will not solve its funding issue. At best any additional pension reform will only marginally produce future savings that can be used to partially help offset/pay the accrued unfunded debt of PSERS. As such it is only one of a series of smaller solutions that are needed to help mitigate the funding issue including:

- One time cash infusions/prepayments of the debt, e.g., through sale of assets or the use of pension obligation bonds (POB's)[2]
- Providing a dedicated source of funding
- Continued performance of PSERS' assets, which provide 70% of the of funding for the Plan
- Continued significant increases in employer contributions

In short, there is no simple, easy solution or "silver bullet" to resolve PSERS' funding issue. The systemic and intentional underfunding of the System has simply gone on too long.

Before closing, I would like to echo a comment made by Jim Allen in his testimony about the absence of and need to develop a long-term pension policy that would then drive the resolution of the issues noted here and especially the nature of additional pension reform. One of the critical components of that hoped for policy is the need to address the adequacy of retirement benefits in both the public and private sector, for the real story is that Americans, in general, are unprepared for retirement. Indeed, they typically have no resources to support them if they should become unable to work, let alone sustain them in retirement. The social service cost implication of this situation is not being acknowledged and will become a huge burden in the future if not dealt with in a thoughtful, deliberate manner. The prudent resolution of PSERS' funding challenges is an opportunity to take one small step in addressing this larger issue.

Again, I thank you for the opportunity to appear today and I look forward to your questions.

[2] The use of POB's are currently prohibited under Act 120.

TESTIMONY OF RICH HILLER, SR. V.P., GOVERNMENT & RELIGIOUS MARKETS, TIAA-CREF

Pennsylvania Pension Reform: A Way Forward

While the existing unfunded liabilities have to be addressed in order to put the state on sound financial footing, a pension plan for future state employees that provides benefit adequacy but avoids the likelihood of new unfunded liabilities must be implemented. A reasonable path to consider is to utilize defined contribution as a primary retirement plan component or in a defined benefit/defined contribution hybrid design.

CORE DC PLAN MODEL

A core or primary DC plan could be open only to new employees, or to both new employees and select existing participants. Some governments have reservations about migrating from the traditional DB structure to a core DC format. Plan sponsors cite a variety of risks that can cause standard DC designs (e.g. 401(k) or 457(b)) to fail, including inadequate savings and confusing investment choices. However, plan sponsors can establish plan features that will help ensure adequacy of contributions and investment structures that support appropriate investment decision-making. Plan objectives should include:

Provide Employees with the Means to Build Sufficient Savings. While participation is key, so are contribution rates. Under-saving remains one of the biggest factors affecting retirement preparedness. Plan sponsors can help by setting:

- Shorter vesting schedules.
- Total contributions by employer and employee that represent at least 12% of employee pay if the participant will receive Social Security and at least 18% if the participant will not be receiving Social Security benefits. Higher contribution rates for public safety employees are needed to address earlier retirement ages.

Ensure Participation in the DC Plan. A common misconception about DC plans is that they lower participation. Plan sponsors can establish plan features that encourage participation and overcome employee inertia, by establishing:

- Mandatory enrollment through an automatic enrollment mechanism.
- Lower, or no, age restrictions on participation.

DB/DC Hybrid Design

A properly designed hybrid plan couples a degree of guaranteed benefits through a smaller traditional defined benefit plan with a risk-managed defined contribution plan that is focused on income adequacy in retirement as its primary goal. The defined contribution portion of this hybrid design properly focuses on retirement income and risk management rather than on asset accumulation, thus distancing itself from a typical 401(k) or 457(b) plan. The reduced DB benefit can help governments lower new DB funding obligations for future years of service while still providing a guaranteed benefit protecting participants from investment and longevity risk. The addition of the DC plan is designed to fulfill the remaining retirement needs of employees without adding any pension funding risk to the Commonwealth of Pennsylvania or its taxpayers. Defined contribution critics tend to compare aspects of defined benefit plans with 401(k) or 457(b) supplemental savings structures, not with a properly designed, risk-managed defined contribution pension structure. In fact, defined contribution core retirement plans have been providing superior lifetime retirement income to government employees for almost a century. In these plans risks are minimized and shared through several design features while costs are kept low and employee career mobility is addressed in a way that is not possible in traditional defined benefit plans.

The plan should be designed to provide income adequacy in retirement for employees. Most experts agree that an income replacement ratio of somewhere around 75% is appropriate for most employees. With this as a background, let's look at specific design features.

Contribution rates for the defined contribution portion of a hybrid would depend on whether the particular employee group participates in Social Security or not.

DC PLAN CONTRIBUTION RATE REQUIRED TO ACHIEVE A 75% INCOME REPLACEMENT RATIO

Entry Salary	DB Formula	Social Security Replacement Ratio	DC Rate With Social Security	DC Rate Without Social Security
$40,000	**1.0%**	**31.7%**	**2.5%**	**12.1%**
$60,000	**1.0%**	**26.6%**	**4.1%**	**12.1%**
$80,000	**1.0%**	**22.6%**	**5.3%**	**12.1%**

Assumptions:
Entry Age is 30, Retirement Age is 65; Salary Increase is 4%; DB benefit replacement ratio is equal to formula times 35 years of service; Interest Rate is 6%; DC accumulation is used to purchase a Single Life Annuity w/10 years guaranteed; Annuity purchase rate based on 4% interest and current TIAA mortality; Social Security benefits based on current benefit formula, and 3% inflation
The above scenarios are based on hypothetical assumptions and are not intended to represent the performance of any specific investment product. They cannot be used to predict or project investment company performance.

As noted above, the hybrid plan for new Pennsylvania employees is not intended to replace the traditional DB plan. Rather it incorporates the DB plan, at a lower benefit formula, into the hybrid design. A 1% DB multiplier will likely require a total contribution rate of between 5% and 6% of payroll with normal assumptions. Given that, the total cost of the DB/DC hybrid would range between 8.5% and 18.5% of payroll depending on Social Security participation. This total cost can be split between employer and employee in any way that meets the workplace objectives of the Commonwealth.

Risk-Managed Construction

Several design considerations to the core defined contribution design or to the defined contribution portion of the hybrid plan should be incorporated to help maximize the likelihood of retirement income adequacy while minimizing risks.

- **Investment Design** – Since employees need to properly diversify their investments and rebalance their portfolios regularly to maintain a prudent asset mix, these aspects need to be incorporated in plan features. With the proper plan architecture plan sponsors can support wise participant decision making by offering:

    - A limited lower cost investment menu that would include 15-20 preselected options representing best in class funds in the various asset classes. These options can and should include fixed and variable annuities.
    - Automatic asset allocation vehicles such as lifecycle or target-date funds that provide an age appropriate asset allocation.
    - Individual investment advice to help educate participants and enhance their decision-making prowess.
- **Accumulation Distribution at Retirement**
    - A mechanism to automatically convert a sufficient portion of a participant's accumulated assets to a low-cost annuity, or other lifetime income vehicle, upon retirement in order to guarantee lifetime income.
    - Restrictions to prevent employees from taking large early distributions from their plan, thus preventing leakage from their accounts and helping them retain sufficient assets for retirement.
- **Communication, Education and Advice** - A comprehensive program to help plan participants understand the options that they have and make sound decisions must be part of the overall plan.
    - Included in this program should be the availability of communications, education and advice through multiple channels including face-to-face, web-based and telephone.
    - Specific investment advice, with fiduciary responsibility, should be available to employees through all channels and without additional cost to the participant.
    - Counseling on retirement income preparedness and options is also a key part of the communications plan.

Consider also that career mobility is now the norm in essentially all employment categories. According to the US DOL, Bureau of Labor Statistics,[i] median years of tenure with current employer in the private sector in 2010 was 4.0 years. In the state government sector the same median tenure figure was 6.4 years. While tenure with state government employers remains longer than in the private sector, these statistics clearly illustrate the need for portability of retirement benefits for government employees.

In November 2011, Rhode Island, faced with one of the highest levels of unfunded pension liabilities on a per capita basis in the U.S. (along with Illinois), passed sweeping legislation that addressed their public pension crisis. State employees and teachers participating in a traditional defined benefit plan were moved, for future service, to a new hybrid model comprised of the traditional plan with reduced benefit levels and costs paired with an individual risk-managed defined contribution account. The hybrid model also applies to new members of Rhode Island's public retirement system.

Several municipalities, including the $56 billion Virginia Retirement Systems and the $22 billion Utah Retirement Systems have moved toward hybrid defined benefit/defined contribution models, while others are considering legislation that goes in that direction.

The $9.4 billion Orange County Employees Retirement System recently gave new employees a choice to join the defined benefit plan or a newly created defined benefit/defined contribution hybrid, while the Atlanta City Council approved a hybrid plan for all new employees last year.

While the traditional defined benefit pension plan remains prominent in the public sector, it is being scrutinized and reconsidered. Traditional 401(k) or 457(b)-style defined contribution plans have also proven to be too risky to serve as a primary retirement savings vehicle. The core DC or hybrid plan design features outlined here offer plan stakeholders in the Commonwealth of Pennsylvania a way forward that can address the lifetime income security needs of employees while being sensitive to the funding concerns facing governments. As stewards of public employees' retirement security, Pennsylvania leaders need to act with reason, fairness and a measure of expediency.

---

[i] United States Department of Labor, Bureau of Labor Statistics, Economic News Release, **Employee Tenure Summary, September 14, 2010**

**TESTIMONY OF JEAN FRIDAY, PRESIDENT,
PA ALLIANCE FOR RETIRED AMERICANS**

I'm Jean Friday, President of the Pennsylvania Alliance for Retired Americans and I'm a retired steelworker. Better known as PARA, we are an organization of union retirees and community groups with over 300,000 members across Pennsylvania and 147 affiliated chapters. Our mission is to educate seniors and the public about retiree issues, and organize seniors to advocate for their interests in Harrisburg and Washington.

As I understand it, the purpose of this commission and these hearings is to offer residents of Pennsylvania and other interested parties an opportunity to join the Commission members as you examine the subject of the retirement needs of public employees in order to formulate principles, develop objectives and recommend legislation. Thank you for the opportunity to be here today to discuss this vitally important issue and offer our perspective on retirement security and defined benefit pensions.

As I travel over the state visiting our members, it becomes apparent that most of our retirees are covered by employer provided pensions that enable them to live comfortably. But seniors are nevertheless concerned for their children and grandchildren's future as retirement security continues to erode. All of us want them to have the same opportunities that we have experienced, especially the ability to retire and enjoy life as we have. So it is also part of our mission to work to leave a solid legacy for our future generations.

As a woman entering the job market in the 1950s, I never expected to earn a pension at that time. Typical of that era, you could change jobs easily and were always able to improve your life by an increasing your income. Eventually, I applied for a position at the nearby US Steel Clairton Works. Much to my surprise, I was offered a position in the Quality Control Laboratory as a union salary worker- the first woman to be hired in that lab. At that time, the union had bargained for a 13 week vacation and it was also a time of the deepening of the Vietnam War. I was hired to replace the men who would be taking that vacation and also **because I couldn't be drafted into the service.**

The years went quickly and I thoroughly enjoyed my work. When the 1980s came with the downsizing of the steel industry, I survived that time period thanks to my seniority. But that was the eye opener for me about pensions, watching men who were ready to retire gratefully accepting their pensions, while people midway in their career at least received pensions and insurance, and others not as fortunate but who still received deferred benefit pensions which would be paid when they reached the age of retirement.

I worry about young people today coming out of college who can't find a job. I have to believe that if pensions were as prevalent today as they were in my time, more jobs would be available for them. How many people in the work force are in their late 50s, 60s or even 70s would gladly retire and free up a job opportunity for a young person if they only had the security of a pension? Instead, many workers near retirement saw the 2008 crash wipe out their 401k and force their retirement into the unforeseeable future. I think this is one reason why the most recent recession hit us so much harder than previous recessions. Pensions were a vital firewall that kept economic hard times from getting out of control.

In 1986, US Steel introduced 401Ks, but having known members of my family who lost money in the stock market, I had little interest in them. That suspicion was comfirmed when the stock market fell in 1989 and many of my friends lost a major portion of their retirement account. But luckily they **continued to accrue continuous service with their benefit defined pensions.**

In the 1990s, after recuperating from breast cancer, I decided it was time to retire. At that time, we used what was known as the "3 legged stool" to decide if we were financially able to retire. The legs were made up of

(1 the pension accrued based on earnings, length of service and the current multiplier under the existing contract, (2 Social Security benefit earned over the years, and (3 savings. Almost everyone in the post-war era had continued to invest in US Savings bonds so even that helped to balance the stool. If you look at that today, you can see that some of those legs are wobbly if nonexistent.

As you can see, I retired from work, but not from life or caring for people. My pension has made that possible. I joined the Steelworker Organization of Active Retirees at the Clairton Coke Works where I am still President of that Chapter After retirement, my husband Ed and I were thrilled to be able to finally make that "trip of a lifetime" to see our beautiful National Parks as a reward for our years of working. **It was the the culmination of a life-long dream.** And we were finally able to spend more time with our families and become involved with our community, working with the senior centers in our area.

I rely on my pension check and Social Security check which are both direct deposited into our checking account. If we had to rely on a 401k, instead of our pension, Ed and I would worry about out-living our retirement income. We would also worry about the economy and the stock market impacting our quality of life. Our pensions give us the peace of mind that can only come from having a reliable source of income. We lived with economic worries throughout our working lives. I believe that retirees earn the right to stop worrying about our financial situation. Most of us have plenty of young people in our lives to worry about!

As President of the Alliance for Retired Americans, no matter where I go to visit our affiliates, we all share the sentiment that our generation was also the "Lucky Generation" who had the good fortune to live the American Dream. And we all want the same American Dream for our children and grandchildren and our future generations. As we say in PARA, **we don't want to be the last generation to retire.**

TESTIMONY OF DOMINIC SGRO, AFSCME COUNCIL 13

Thank you Mr. Chairman and the rest of the Public Employee Retirement Commission for this opportunity to address the important issue of public employee pensions.

My name is Dominic Sgro. I am the Director of AFSCME District Council 83, here today to speak on behalf of Executive Director David Fillman of the American Federation of State, County and Municipal Employees (AFSCME) Council 13, who could not attend today's meeting. Council 13 represents over 65,000 members in Pennsylvania, of whom 45,000 are employees of the Commonwealth of Pennsylvania, and 20,000 members work for various Counties, Townships, Boroughs, Cities, Authorities, School Districts and non-profit employers.

A majority of our members are Commonwealth of Pennsylvania employees who participate in the State Employees Retirement System (SERS) and we also represent thousands of School District employees, who are members of the Pennsylvania School Employees Retirement System (PSERS). There have been a number of pension proposals that may affect all of our members and we are greatly concerned with some of the proposals under consideration.

Mr. Fillman serves as a Governor-appointed trustee to SERS and has proudly done so since his appointment in the year 2000, and re-appointed by Governor Corbett last year. As a trustee, Mr. Fillman monitors the investments and benefits for Commonwealth employees which are represented by over 20 different labor organizations. The system also covers management employees, the Governor, the General Assembly, and the Judiciary in PA. He is also the Chairman of the Coalition of Labor Engagement and Accountable Revenues (CLEAR) Coalition. This is a group of 8 labor organizations representing over 1.1 million members, many of whom represent public employees who would be affected by any pension changes.

I can assure you that no one is more committed to a well-run and properly funded retirement system than AFSCME and the other members of the CLEAR Coalition. For the vast majority of our members, their pension is their life savings. The pension system is also extremely important to the Commonwealth. It ensures that a substantial portion of the population can retire with dignity, serves as a very effective recruitment and retention tool so that the public sector can employ a high quality workforce despite often paying below market wages, as well as plays an important role in Pennsylvania's economic development.

I think we should begin any discussion over possible changes to pension benefits with an understanding that the Courts of Pennsylvania have ruled that the State Constitution prohibits any reduction to the contractually owed defined benefit pension to all current members and annuitants of SERS, as well as PSERS.

In 2010, with the funding coming due for the 2001 benefit enhancements, members of the CLEAR Coalition started working with the legislature and then-Governor Rendell to help relieve the long term funding issues that were approaching in 2012. That "2012 Spike" was actually being reduced considerably in the mid-2000's until the stock market collapse in 2008. Everyone's investments, not only in pensions but world-wide, took a nose dive. To add to that difficulty, the Commonwealth took a perfectly legal holiday on their contributions, which were justified by the fact that the returns on our investments in the good days pre-2008 were well into the double digits. For SERS, the Commonwealth paid very low contributions for years by taking advantage of the high rates of return. However, our members in SERS continued to pay their 6.25%, and PSERS members paid 7.5%, in good times and bad. In fact, we probably wouldn't be having this discussion if the returns were still as high as they were.

We should remember that over the long term, and despite the 2008 setback, our retirement systems' investments have actually outperformed assumed rates of return which are currently 7.5%. So, although the 2008-2009 market crash has significantly affected the funding level of our plans, it is not the sole cause of the unfunded liabilities. It is indisputable that the Commonwealth has consistently deferred making required contributions, and continued to do so when we passed Act 120 almost two years ago.

Over the last ten years, employer contributions to SERS have been the smallest component of additions to the retirement system's assets. Employer contributions were set legislatively and did not fully meet the level set by the actuaries to keep the plans fully funded. For example, in the SERS plan, employer contributions totaled $2.0 billion from 2002 to 2011, representing 9% of total additions to plan net assets, compared to $3.3 billion or 16% of total additions attributed to employee contributions, and $15.4 billion, or 75%, of total additions attributed to investment earnings.

The CLEAR Coalition, along with the largest State and School District employee unions, worked in harmony with the legislature and supported Act 120 that was signed by Governor Rendell in November of 2010. For new employees of SERS, effective 1/1/11, and new employees of PSERS effective on 7/2/11 we:

* Rolled back all of the benefit enhancements from 2001, yet new employees are paying the higher contribution rates (6.25 or 7.5%). This means new workers will have higher retirement ages, longer vesting periods, and accrue 20% less in benefits for each year of service;

* Offered an opportunity for new employees to get the post 2001 enhancements, AT THEIR COST raising their contribution rates to 9.3% and 10.3% for SERS & PSERS respectively;

* Eliminated "OPTION 4", the lump sum payouts; and,

* Created a sliding scale "shared risk" formula, that increases new employee contributions if investments do not meet expectations, but with the caveat that employers would not have contribution holidays as before.

Act 120 also addressed employer funding and puts the Commonwealth on a path to achieve fully funded pension plans in the future. Act 120 was very clearly a case of shared sacrifice by all stakeholders. Employees will pay more, for lower benefits, and the employers are committing to funding the pension plans on an actuarially sound basis. We believe Act 120 is an effective solution and should be given time to be fully implemented.

You should also be aware that retirees did not escape sacrifice either. An important issue that sets Pennsylvania apart from most other states is the lack of a regular and recurring COLA (cost of living allowance) benefit for retirees. Although the vast majority of public employees in other states receive COLA increases annually, the Commonwealth of PA has saved almost $2 billion in pension costs by denying this benefit to our pensioners for over 10 years. A regular and recurring COLA typically adds 20% to 30% to the ongoing cost of the pension benefit.

Despite the passage of Act 120, there remains considerable concern with the cost of pensions in Pennsylvania. As I have already mentioned, much of this cost stems from the state's deferral of required contributions and recent investment loses. But the most important issue to keep in mind as you consider this issue is that the current unfunded obligations owed by the employers to the pension plan must be paid regardless of any changes made to the plans. In other words, the unfunded liabilities are for service already performed for which the employers did not adequately contribute. Basically, this is a debt that must be paid and the legislature would be unable to reduce that debt under existing interpretations of the State Constitution. Any action now will only affect the cost for future service performed by new employees.

In fact, moving to a defined contribution, 401k-type system would actually increase costs significantly. When the state of Nevada considered closing its defined benefit pension plan in favor of a defined contribution arrangement, actuaries determined that it would cost the state an additional $1.2 billion dollars in the first two years alone. This is because the plan must change its investment mix, accelerate its amortization of unfunded liabilities and incur substantial administrative costs in setting up and operating two different systems. We should expect the costs in Pennsylvania to substantially exceed that estimate in Nevada given the larger size and coverage of SERS and PSERS.

We also know that conversion to a 401k-type system would have negative consequences for employees. According to the National Institute on Retirement Security "Even after accounting for all the significant advantages of a DB retirement system over DC accounts, research shows that DB plans are more economically efficient then DC plans. DB pensions can deliver the same level of retirement benefits at nearly half the cost of a DC plan." Despite rhetoric to the contrary, a defined contribution plan is bad for both employees and taxpayers.

In this regard it's important to understand that the ongoing costs to the employers to pay for future pensions benefits accrued by employees is just 5.1% of pay for SERS and 8.1% for PSERS. The reason contributions are greater than that, and are scheduled to increase further, is because the state has deferred its past contributions. In essence, the state has borrowed from the pension plans and it must now pay that debt. As I have said previously, those payments must be made even if changes are made to future benefits. But it is unlikely that the legislature could design a reasonable retirement benefit that costs less than the current benefit. For these reasons, a change in benefits is not only unnecessary, it is counterproductive.

Keep in mind, SERS and PSERS pay out over $6.5 billion dollars in pension benefits each year to 300,000 annuitants. The average benefit from both systems is just $24,000 a year; in fact 70% of SERS annuitants receive benefits of less than $24,000. Because almost 90% of our pensioners live in the state, $6 billion in economic activity is generated as pensioners buy goods from local merchants, and pay local, school and state taxes. The costs?? For every dollar of $2.7 billion that is for payments to SERS annuitants only; 9 cents is from employers/taxpayers; 16 cents is from SERS members, so they have more skin in the game; and 75 cents has been from SERS investment income.

Finally, all of us as public employees didn't come into public service seeking high wages, stock options, or golden parachutes. Many of our public jobs come with inherent physical demands, as well as physical hazards. Much more so than the private sector. OSHA laws don't cover PA public employees. Direct care nursing jobs are plagued with back and other injuries, often from clients that have "acted up." Correctional Officers and other Law Enforcement Officers protect us from the worst of the worst. Highway Workers have some the highest rates of occupational injuries and death. Unfortunately, 100 AFSCME PennDOT workers have lost their lives making the roads safer for the driving public.

We must also consider that a traditional DB pension plan has what no DC plan has...disability retirement. After subjecting Commonwealth employees to life threatening or debilitating injuries, the least we can do is provide them with a reasonable return for their sacrifices and provide a safety net in the event of injury. If the retirement benefit is converted to a defined contribution arrangement, the employers must be prepared to pay for the added and considerable cost of obtaining life and disability insurance for its workforce. Finally, we should consider that our current pension plan offers our employers flexibility. The Commonwealth has reduced its work force on numerous occasions by offering early retirement options. These savings help keep down the General Operating Budget; yet this would not be possible under a DC, hybrid, or cash balance plan.

Other programs funding in the Budget have grown considerably more than our pension obligations. As an aggregate, using 2009 data, the US Census Bureau calculates that spending on state and local employees' pensions nationwide is just 2.9% of all state and local spending and just 1.7% of all state and local government spending in Pennsylvania. While the level of pension expense is likely to grow in Pennsylvania, that cost must be put in context. During the 2002 to 2009 period, the employer contribution rate to SERS never once exceeded 5% of payroll. At this time the SERS Board is doing everything possible in asset allocation, and administration, to help raise investment revenues and reduce costs. The current system and benefit structure is effective. A change to a new system will not address our funding challenges, but will create a host of new problems and challenges in the years ahead.

Thank you for the opportunity to present this testimony before you.

November 15, 2012

Testimony of Les Neri, President,
Fraternal Order of Police, Pennsylvania State Lodge

Good morning. My name is Les Neri. I am proud to serve as the elected President of the Fraternal Order of Police, Pennsylvania State Lodge, which represents more than 40,000 active and retired law enforcement officers and their families throughout the Commonwealth of Pennsylvania. Before my election as President of the FOP I was proud to serve as a Police Officer and Detective for more than 26 years in Tredyffrin Township in Chester County before my retirement in 2008.

On behalf of the members of the Fraternal Order of Police and their families, I would like to extend my thanks to the members of the Commission for your consideration of retirement issues affecting public workers, and for your longstanding support of Pennsylvania's law enforcement officers.

I appear before the Commission today to present the viewpoint of the Fraternal Order of Police on the critical importance of maintaining fair and secure retirement benefits for the men and women who risk their lives each day to keep Pennsylvanians safe. The FOP's input is critical to any consideration of pubic pension benefits, as we represent members in every form of public pension plan, from local police pension plans, to PMRS plans, to SERS and PSERS plans. And remember that the thousands of FOP members within SERS are not limited to just State Troopers – the FOP represents approximately 1,000 law enforcement professionals in other Commonwealth departments, including Capitol Police, Attorney General's Agents, Liquor Control Agents, Probation & Parole Agents, Park Rangers and Conservation Officers. Any change to municipal pension laws or to SERS and PSERS affects our members.

This series of PERC hearings over the past few months has offered a variety of opinions on possible alternatives to the longstanding and predominant defined-benefit pension system that has been available to law enforcement officers in Pennsylvania and elsewhere for decades. We believe that any fair consideration of options must also include the option to maintaining a defined-benefit system.

So let me provide the FOP's perspective of defined-benefit pensions – If structured properly, managed correctly and conservatively, and operated with the involvement of all stakeholders, including police, defined-benefit pension plans work. This is not to say that we cannot tweak the system from time to time as needed. By way of example, consolidating Pennsylvania's 963 municipal police pension systems under one statewide system would reduce municipal police pension costs dramatically.

As for the other options, I think that it is also clear, and has become even more clear during these hearings, that defined-contribution plans are not the answer. Some people may think that forcing employees into DC plans is the magic solution to everyone's problems, but the creation of a new DC plan does nothing to eliminate or even reduce the unfunded liability of our current pension systems. In fact, it probably makes matters worse. When you look at the short and long terms costs, the closing expenses, the negative economic impact of a coming generation of pauper retirees, it is clear that DC plans offer no real solution.

DC and hybrid plans aren't fair to any employee, but they are especially unfair to law enforcement not only because of the work that we perform but also the fact that over half of Pennsylvania's law enforcement officers are not covered under the federal Social Security system. The FOP's members retire sooner than other types of employees because of the physically demanding work that we are required to perform. It's not a reward, it's a recognition that older officers can be at a disadvantage when it comes to keeping Pennsylvanians safe. So we retire younger. Forcing law enforcement officers into a defined-contribution pension system will give them fewer years to build a sufficient retirement savings, and likely will result in 60 and 70 year old police officers on the street protecting the public. FOP members who are subject to a mandatory retirement age – and we have many of them – those officers will just be out of luck altogether. That's just not right.

DC and hybrid plans also fail to take into account the reality that law enforcement officers sustain permanent and disabling injuries as a result of our work. Now, if an officer is maimed in the defense of citizens after 7 or 8 years of service, or 3 or 4, or 19 or 20, they can retire and receive a percentage of their salary. That's a fair compromise – our members risk their lives and permanent injury, and in exchange they retire as if they had reached age and service requirements.

But with a DC or hybrid pension plan all of that goes away. If you have the double misfortune not only of becoming disabled at work but also of becoming disabled earlier in your career, you will be sent packing with the few dollars that are in your retirement account. I ask you, is that fair? Is that how we should treat men and women who risk their lives to keep Pennsylvanians safe? I think the answer is an obvious no.

In conclusion, I would like to thank the Commission for considering the issue of alternative pension systems for public workers like law enforcement officers. And I would like to reiterate that in the FOP's experience the longstanding defined-benefit system works and the proposed "magic" DC and hybrid plan solutions will not work, especially for law enforcement professionals in municipal systems, SERS, PMRS, and PSERS.

Thank you for your consideration of this important issue. I would be happy to answer any questions.

Testimony of Jeanne M. Boone
on behalf of American Federation of Teachers' active and retired employees
Public Employee Retirement Commission
Thursday, November 15, 2012

Good morning, Chairman Salamone and members of the Public Employee Retirement Commission. Thank you for this opportunity to speak here today. My name is Jeanne Boone, and I am a retired teacher and former president of the Philadelphia Federation of Teachers' Retirement Chapter. I am speaking today on behalf of the American Federation of Teachers-Pennsylvania, which represents more than 40,000 active and retired teachers, college faculty members, support staff and state employees who depend on pensions for financial security.

During my career, I contributed 5.5 percent of every paycheck to fund a secure retirement for myself. I bought back service credit for the two years I served in the U.S. Marine Corps during World War II. When I retired after a 36-year teaching career, I had a total of 38 years' credit toward my pension and retired on a gross monthly pension of $1,614.25 a month. I believed that the state would keep its promise to public employees and manage our pensions wisely.

Over the past 27 years, however, I and other retirees have received just four cost-of-living-adjustments. My pension has increased just 31% in 27 years, while inflation increased 111%! The cost of everything I pay – real estate taxes, medical insurance, long-term-care premiums, food and prescriptions – has increased three times faster than my pension.

Now, Gov. Corbett says that in his 2013-14 budget, he plans to "reform" the teachers' and state employees' pension systems. Proposals include eliminating the defined-benefit pensions that I and other retirees depend on and replacing them with 401(k)-style retirement accounts or other inferior programs. Not only would such changes not fix the problem of unfunded liabilities facing our pension systems, it would actually make matters worse by diverting current employees' contributions away from PSERS and SERS. Without new contributions and sound investments, the pension system we depend upon will collapse.

Teachers and other public employees have <u>always</u> made their pension contributions. But from 2000 to 2010, state lawmakers allowed the state and school districts to pay little or nothing into the system, creating a gap between the system's assets and what it owes retirees. Retirees should not have to pay for lawmakers' mistakes.

In 2010, a coalition of organizations, including AFT Pennsylvania, worked with lawmakers to pass Act 120, a responsible solution that allows the state to keep its promise to retirees while stabilizing PSERS over the long-term. Act 120 ended 10 years of underfunding by eliminating the employer contribution "holiday." It capped the maximum pension benefit and increased the age required to retire with full benefits. Over 30 years, it will save Pennsylvania taxpayers $24.6 billion in future pension costs. If Act 120 is implemented fully, it will address concerns about the pension system gradually, rather than all at once.

As PERC members, you understand the importance of pensions to individual retirees as well as to the economic vitality of Pennsylvania. I urge you to help us keep the promise that has been made to tens of thousands of retired teachers and school and public employees by maintaining and strengthening our defined-benefit pensions.

PSERS PENSION REPORT
1986 to 2012
of
Jeanne M. Boone
Retired Teacher from the Philadelphia Public Schools

YEAR	GROSS BENEFIT	PREM. ASST	TOTAL BENEFIT	IRS DEDUCT	HEALTH INS.	NET BENEFIT
1986	1614.25		1614.5	159.33		1454.92
1987	1724.5		1724.5	201.67		1522.83
1988	1724.5		1724.5	196.19		1528.31
1989	1802		1802	205.24		1596.76
1990	1802		1802	202.22		1599.78
1991	1802		1802	199.02	182.48	1420.5
1992	1802	55	1857	195.34	246.69	1402.4
1993	1802	55	1857	189.12	296.87	1389.41
1994	1944.36	55	1999.36	210.47	296.87	1492.02
1995	1944.36	55	1999.36	181.67	296.87	1472.02
1996	1944.36	55	1999.36	179.52	329.32	1461.72
1997	1944.36	55	1999.36	177.82	355.67	1437.07
1998	2138.8	55	2193.8	206.36	458.92	1499.72
1999	2138.8	55	2193.8	205.74	255.82	1703.44
2000	2138.8	55	2193.8	205.12	280.25	1679.63
2001	2138.8	55	2193.8	203.86	274	1732.14
2002	2352.68	100	2452.68	295.15	274	1813.53
2003	2352.68	100	2452.68	395.25	300	1757.43
2004	2352.68	100	2452.68	395.25	300	1747.88
2005	2352.68	100	2452.68	394.8	300	1902.88
2006	2352.68	100	2452.68	394	163	1895.68
2007	2352.68	100	2452.68	393.5	163	1896.18
2008	2352.68	100	2452.68	392.75	180	1879.93
2009	2352.68	100	2452.68	392.34	197	1901.09
2010	2352.68	100	2452.68	355	199	1898.68
2011	2352.68	100	2452.68	355	199	1858.68
2012	2352.68	100	2452.68	395	199	1858.68

APPENDIX 2

ACTUARIAL NOTE PROVIDED BY
DAVID H. KILLICK
CONSULTING ACTUARY
CONRAD SIEGEL ACTUARIES

Conrad Siegel
ACTUARIES

The Employee Benefits Company

501 Corporate Circle • P.O. Box 5900 • Harrisburg, PA 17110-0900
Phone (717) 652-5633
Fax (717) 540-9106
www.conradsiegel.com

January 2, 2013

Mr. James L. McAneny
Executive Director
Public Employee Retirement Commission
P.O.Box 1429
Harrisburg, PA 17105-1429

Re: SERS and PSERS Funding

Dear Jim:

The accrued liability of a pension plan is the portion of future benefits to be paid to the plan members that is attributable to service already performed as of the valuation date. Since the service upon which this accrued liability is based has already been performed, the pension funds should maintain a level of assets equal to the accrued liability. Based upon the last actuarial valuation reports for SERS and PSERS, the aggregate unfunded accrued liabilities for the two plans is $41.1 billion ($14.6 billion for SERS, $26.5 billion for PSERS). These unfunded accrued liabilities must be funded at some point in the future.

An argument can be made that deferring the payment of these unfunded accrued liabilities many years down the road is financially advantageous due to the effects that inflation has on the value of the dollars spent to fund such liabilities. However, given that these liabilities have been calculated using a 7.5% interest rate, and that inflation has not exceeded 7.5% since 1981, recent inflation experience would suggest that paying off these liabilities sooner rather than later would be desirable. If we return to an economic environment such as during the period 1974–1981 where inflation averaged over 7.5% per year, the argument to delay payment of these unfunded accrued liabilities based upon the effects of inflation might have some merit.

An annual employer contribution to a pension plan typically includes an amount to cover the normal cost, which is that portion of the actuarial present value of pension plan benefits which is allocated to a valuation year by the actuarial cost method used, and an amortization payment which is designed to pay interest on and reduce any unfunded accrued liability that exists under the plan. Under SERS, the total employer contribution rate calculated reflecting the collar on the rate at which employer contributions may rise from year to year pursuant to Act 120, in fiscal year 2012–2013 is 11.50% of covered payroll. Of this 11.50% employer contribution rate, 5.10% consists of the employer normal cost. Therefore, the portion of the employer contribution that is being applied to amortize the unfunded accrued liability is only 6.40% of payroll. Under the actuarial method used in preparing the actuarial valuation report, the annual payment amount required to amortize the unfunded accrued liability is calculated to be 21.29% of payroll. Therefore, there is a shortfall of funding based upon the actuarial cost method of 14.89% of payroll (21.29% – 6.40%).

Under PSERS, the total employer contribution rate after applying the collar, is also 11.50% of covered payroll for the 2012–2013 fiscal year. The employer normal cost is 8.66%, leaving 2.84% of payroll as the portion of the employer contribution to be applied toward amortizing the unfunded accrued liability. Under the actuarial cost method used in preparing the actuarial valuation report, the portion of the annual employer contribution required to amortize the unfunded accrued liability is calculated to be 12.99%. This results in a funding shortfall toward amortizing the unfunded accrued liability of 10.15% of payroll (12.99% – 2.84%).

Act 120 provides for increasing employer contributions to fund the normal cost of benefits being accrued in future years by the active members of the plans as well as amortization of the existing unfunded accrued liabilities. However, the rates of increases in employer contributions to the plans in the next few years pose a great challenge for the State budget. Given the projected increases in employer contributions to these plans in coming years, a more gradual approach to amortizing the unfunded accrued liabilities should be considered.

Methods for amortizing the unfunded accrued liabilities include level dollar amortization and level percentage of projected payroll amortization. Under level dollar amortization, the amount to be amortized is divided into equal dollar amounts to be paid over a given number of years. Part of each payment is interest on the outstanding balance and part of each payment is principal (similar to a mortgage payment on a home). Because annual covered payroll of active members can be expected to increase in future years as a result of inflation, level dollar payments generally represent a decreasing percentage of annual payroll.

Under level percentage of projected payroll amortization, amortization payments are calculated so that they increase by a constant percentage each year over the amortization period. If the increases in annual amortization payments are at the same rate as the increases in annual covered payroll of active members, while the dollar amounts of annual payments increase over time, they generally represent a level percentage of payroll each year.

The method for amortizing the unfunded accrued liabilities can be based upon a closed amortization period or an open amortization period. Under a closed amortization period, a specific number of years is utilized in the calculation of the initial amortization amount and the number of years remaining in the amortization period declines by one each year until the period expires. Under an open amortization period, the amortization period chosen to determine the initial amortization amount (i.e., 30 years) is used at each subsequent actuarial valuation date.

Based upon Act 120, beginning July 1, 2010, the unfunded actuarial accrued liabilities under SERS are amortized over a 30-year closed period using level dollar amortization payments. Subsequently, any increase in accrued liability under SERS enacted by legislation is amortized over a 10-year closed period using level dollar amortization payments. Under PSERS, beginning July 1, 2011, the unfunded actuarial accrued liabilities are amortized over a 24-year closed period using level percentage of pay amortization payments. Subsequently, any increase in accrued liability under PSERS enacted by legislation is amortized over a 10-year closed period using level percentage of pay amortization payments.

The following table illustrates four different methods for amortizing the unfunded accrued liability under SERS ($14,663,401,000) over a 30-year closed period. For purposes of calculating the amortization contribution each year as a percentage of annual covered payroll of active members, the total annual payroll of active members is assumed to increase at the rate of 3.0% per year. This is similar to projections of annual payroll made by the SERS actuary. The four methods are as follows:

1. Amortization payments which increase at the rate of 5.0% annually.
2. Amortization payments which increase at the rate of 4.0% annually.
3. Amortization payments which increase at the rate of 3.0% annually.
4. Level dollar amortization payments.

Amortization of Unfunded Accrued Liability
(In Thousands)

SERS

Unfunded Accrued Liability - $14,663,401
Initial Payroll - $5,890,704
Interest - 7.5%
Annual Payroll Growth - 3.0%

	30-Yr Level % (5.0%)			30-Yr Level % (4.0%)			30-Yr Level % (3.0%)			30-Yr Level Dollar		
Year	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance
1	$673,475	11.43%	$15,039,170	$758,357	12.87%	$14,947,922	$849,273	14.42%	$14,850,188	$1,154,947	19.61%	$14,521,588
2	$707,149	11.65%	$15,406,923	$788,691	13.00%	$15,221,173	$874,751	14.42%	$15,023,594	$1,154,947	19.04%	$14,369,139
3	$742,506	11.88%	$15,764,248	$820,239	13.12%	$15,481,004	$900,994	14.42%	$15,181,795	$1,154,947	18.48%	$14,205,257
4	$779,631	12.11%	$16,108,463	$853,048	13.25%	$15,725,053	$928,024	14.42%	$15,322,805	$1,154,947	17.94%	$14,029,083
5	$818,613	12.35%	$16,436,589	$887,170	13.38%	$15,950,723	$955,864	14.42%	$15,444,461	$1,154,947	17.42%	$13,839,696
6	$859,544	12.59%	$16,745,324	$922,657	13.51%	$16,155,171	$984,540	14.42%	$15,544,415	$1,154,947	16.91%	$13,636,105
7	$902,521	12.83%	$17,031,013	$959,564	13.64%	$16,335,278	$1,014,076	14.42%	$15,620,114	$1,154,947	16.42%	$13,417,245
8	$947,647	13.08%	$17,289,618	$997,946	13.77%	$16,487,632	$1,044,499	14.42%	$15,668,787	$1,154,947	15.94%	$13,181,970
9	$995,029	13.33%	$17,516,683	$1,037,864	13.91%	$16,608,501	$1,075,834	14.42%	$15,687,424	$1,154,947	15.48%	$12,929,050
10	$1,044,781	13.59%	$17,707,295	$1,079,378	14.04%	$16,693,806	$1,108,109	14.42%	$15,672,764	$1,154,947	15.03%	$12,657,161
11	$1,097,020	13.86%	$17,856,046	$1,122,554	14.18%	$16,739,097	$1,141,352	14.42%	$15,621,268	$1,154,947	14.59%	$12,364,880
12	$1,151,871	14.13%	$17,956,988	$1,167,456	14.32%	$16,739,514	$1,175,592	14.42%	$15,529,102	$1,154,947	14.16%	$12,050,678
13	$1,209,464	14.40%	$18,003,588	$1,214,154	14.46%	$16,689,762	$1,210,860	14.42%	$15,392,110	$1,154,947	13.75%	$11,712,911
14	$1,269,938	14.68%	$17,988,674	$1,262,720	14.60%	$16,584,070	$1,247,186	14.42%	$15,205,793	$1,154,947	13.35%	$11,349,811
15	$1,333,434	14.97%	$17,904,383	$1,313,229	14.74%	$16,416,154	$1,284,602	14.42%	$14,965,281	$1,154,947	12.96%	$10,959,479
16	$1,400,106	15.26%	$17,742,098	$1,365,758	14.88%	$16,179,176	$1,323,140	14.42%	$14,665,301	$1,154,947	12.58%	$10,539,872
17	$1,470,111	15.55%	$17,492,385	$1,420,388	15.03%	$15,865,696	$1,362,834	14.42%	$14,300,153	$1,154,947	12.22%	$10,088,794
18	$1,543,617	15.85%	$17,144,926	$1,477,204	15.17%	$15,467,629	$1,403,719	14.42%	$13,863,666	$1,154,947	11.86%	$9,603,885
19	$1,620,798	16.16%	$16,688,437	$1,536,292	15.32%	$14,976,188	$1,445,830	14.42%	$13,349,174	$1,154,947	11.52%	$9,082,609
20	$1,701,838	16.48%	$16,110,595	$1,597,744	15.47%	$14,381,827	$1,489,205	14.42%	$12,749,466	$1,154,947	11.18%	$8,522,236
21	$1,786,930	16.80%	$15,397,940	$1,661,654	15.62%	$13,674,186	$1,533,882	14.42%	$12,056,753	$1,154,947	10.86%	$7,919,836
22	$1,876,276	17.12%	$14,535,788	$1,728,120	15.77%	$12,842,022	$1,579,898	14.42%	$11,262,619	$1,154,947	10.54%	$7,272,256
23	$1,970,090	17.45%	$13,508,126	$1,797,245	15.92%	$11,873,136	$1,627,295	14.42%	$10,357,974	$1,154,947	10.23%	$6,576,107
24	$2,068,594	17.79%	$12,297,496	$1,869,134	16.08%	$10,754,301	$1,676,114	14.42%	$9,333,000	$1,154,947	9.93%	$5,827,747
25	$2,172,024	18.14%	$10,884,882	$1,943,900	16.23%	$9,471,182	$1,726,397	14.42%	$8,177,098	$1,154,947	9.64%	$5,023,260
26	$2,280,625	18.49%	$9,249,576	$2,021,656	16.39%	$8,008,241	$1,778,189	14.42%	$6,878,827	$1,154,947	9.36%	$4,158,436
27	$2,394,657	18.85%	$7,369,039	$2,102,522	16.55%	$6,348,648	$1,831,535	14.42%	$5,425,839	$1,154,947	9.09%	$3,228,751
28	$2,514,389	19.22%	$5,218,748	$2,186,623	16.71%	$4,474,177	$1,886,481	14.42%	$3,804,810	$1,154,947	8.83%	$2,229,339
29	$2,640,109	19.59%	$2,772,037	$2,274,088	16.87%	$2,365,096	$1,943,075	14.42%	$2,001,365	$1,154,947	8.57%	$1,154,972
30	$2,772,114	19.97%	-$83	$2,365,051	17.04%	$48	$2,001,367	14.42%	-$3	$1,154,947	8.32%	$27

Under the first option with amortization contributions increasing at the rate of 5.0% annually, the first year amortization contribution is $673,475,000. This amounts to 11.43% of covered payroll, $5,890,704,000. The annual amortization contribution increases to an amount of $2,772,114,000 in year 30, at which time the accrued liability is fully-funded. Based upon an assumption that active members' payroll will grow at the rate of 3.0% annually, the amortization contribution in year 30 is 19.97% of payroll.

Under option 2, with amortization contributions increasing at the rate of 4.0% annually, the amortization contribution during the first year is $758,357,000. This amounts to 12.87% of covered payroll. The amortization contribution in year 30 increases to $2,365,051,000, which is 17.04% of payroll.

Under option 3, with amortization contributions increasing at the rate of 3.0% annually, the amortization contribution in the first year is $849,273,000, which is 14.42% of covered payroll. The amortization contribution in year 30 increases to $2,001,367,000, but since the annual amortization contributions are increasing at the same rate as the rate of growth of the total payroll of active members, the amortization contribution in year 30 remains at 14.42% of payroll.

Under option 4, the annual amortization contribution for the entire 30-year period is $1,154,947,000. During year 1, this amounts to 19.61% of covered payroll. Over the 30-year amortization period, the amortization contribution decreases as a percentage of payroll each year down to 8.32% of payroll in year 30.

When comparing the options, option 1 results in the lowest amortization contribution in year 1. Under this option, the amortization contribution in year 1 is less than the interest accruing on the unfunded accrued liability balance. Therefore, the unfunded accrued liability increases during the first 13 years until such point as the amortization contribution amount each year is larger than the interest on the unfunded accrued liability. The amortization contribution as a percentage of payroll increases each year over the 30-year period; however, the increase in each year is less than 0.4% of payroll.

Under option 2, the unfunded accrued liability increases for 12 years, at which point the amortization contribution exceeds the interest on the unfunded accrued liability. The increase in the annual amortization contribution as a percentage of payroll each year is less than 0.2%.

Under option 3, the unfunded accrued liability increases for 9 years, at which point the annual amortization contribution exceeds the interest on the unfunded accrued liability. As a percentage of payroll, the annual amortization contribution is unchanged during the 30-year period.

Under option 4, the unfunded accrued liability decreases each year during the 30-year amortization period. This is due to level amortization contributions which, as a percentage of payroll, are 2.36 times higher in year 1 than in year 30.

Act 205 of 1984 mandated actuarial funding standards for municipal pension plans in the Commonwealth of Pennsylvania. Municipalities were able to amortize any unfunded actuarial accrued liabilities in their pension plans as of the effective date of Act 205 over a 30-year period. As part of a recovery program for severely distressed municipal pension systems, any unfunded actuarial accrued liabilities in effect at the establishment of Act 205 could be amortized by municipalities over a period of 40 years. This extended period of amortization provided the affected municipalities with some short-term relief, allowing the municipalities to prepare for increasing levels of contributions which were required to fund these unfunded accrued liabilities. Act 205 has been considered a success due to the improved funding status of municipal pension plans, especially those plans that were considered distressed when Act 205 went into effect. Based upon the success municipalities experienced under Act 205 in the funding of their pension plans, a strategy for amortizing the unfunded accrued liabilities under SERS and PSERS should consider 40-year amortization of the current unfunded accrued liabilities.

The next table illustrates the same four methods for amortizing the unfunded accrued liability under SERS over a 40-year closed period.

Amortization of Unfunded Accrued Liability
(In Thousands)

SERS

Unfunded Accrued Liability - $14,663,401
Initial Payroll - $5,890,704
Interest - 7.5%
Annual Payroll Growth - 3.0%

	40-Yr Level % (5.0%)			40-Yr Level % (4.0%)			40-Yr Level % (3.0%)			40-Yr Level Dollar		
Year	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance
1	$559,171	9.49%	$15,162,047	$650,488	11.04%	$15,063,881	$749,270	12.72%	$14,957,691	$1,083,050	18.39%	$14,598,877
2	$587,130	9.68%	$15,668,037	$676,508	11.15%	$15,466,427	$771,748	12.72%	$15,249,888	$1,083,050	17.85%	$14,529,514
3	$616,486	9.86%	$16,180,417	$703,568	11.26%	$15,870,074	$794,901	12.72%	$15,539,112	$1,083,050	17.33%	$14,454,949
4	$647,310	10.06%	$16,698,089	$731,711	11.37%	$16,273,740	$818,748	12.72%	$15,824,392	$1,083,050	16.83%	$14,374,792
5	$679,676	10.25%	$17,219,795	$760,979	11.48%	$16,676,218	$843,310	12.72%	$16,104,663	$1,083,050	16.34%	$14,288,622
6	$713,660	10.45%	$17,744,095	$791,418	11.59%	$17,076,160	$868,609	12.72%	$16,378,758	$1,083,050	15.86%	$14,195,990
7	$749,343	10.65%	$18,269,359	$823,075	11.70%	$17,472,067	$894,668	12.72%	$16,645,397	$1,083,050	15.40%	$14,096,411
8	$786,810	10.86%	$18,793,740	$855,998	11.82%	$17,862,274	$921,508	12.72%	$16,903,181	$1,083,050	14.95%	$13,989,363
9	$826,150	11.07%	$19,315,159	$890,238	11.93%	$18,244,939	$949,153	12.72%	$17,150,580	$1,083,050	14.51%	$13,874,286
10	$867,458	11.29%	$19,831,279	$925,847	12.05%	$18,618,024	$977,627	12.72%	$17,385,924	$1,083,050	14.09%	$13,750,579
11	$910,831	11.51%	$20,339,482	$962,881	12.16%	$18,979,279	$1,006,956	12.72%	$17,607,391	$1,083,050	13.68%	$13,617,594
12	$956,372	11.73%	$20,836,843	$1,001,396	12.28%	$19,326,223	$1,037,165	12.72%	$17,812,993	$1,083,050	13.28%	$13,474,634
13	$1,004,191	11.96%	$21,320,102	$1,041,452	12.40%	$19,656,129	$1,068,280	12.72%	$18,000,566	$1,083,050	12.90%	$13,320,953
14	$1,054,400	12.19%	$21,785,629	$1,083,110	12.52%	$19,965,995	$1,100,328	12.72%	$18,167,756	$1,083,050	12.52%	$13,155,746
15	$1,107,120	12.43%	$22,229,397	$1,126,435	12.64%	$20,252,527	$1,133,338	12.72%	$18,311,999	$1,083,050	12.16%	$12,978,148
16	$1,162,476	12.67%	$22,646,939	$1,171,492	12.76%	$20,512,113	$1,167,338	12.72%	$18,430,510	$1,083,050	11.80%	$12,787,230
17	$1,220,600	12.91%	$23,033,315	$1,218,352	12.89%	$20,740,793	$1,202,358	12.72%	$18,520,263	$1,083,050	11.46%	$12,581,994
18	$1,281,630	13.16%	$23,383,061	$1,267,086	13.01%	$20,934,235	$1,238,429	12.72%	$18,577,972	$1,083,050	11.12%	$12,361,365
19	$1,345,712	13.42%	$23,690,150	$1,317,769	13.14%	$21,087,701	$1,275,582	12.72%	$18,600,069	$1,083,050	10.80%	$12,124,188
20	$1,412,997	13.68%	$23,947,939	$1,370,480	13.27%	$21,196,012	$1,313,849	12.72%	$18,582,686	$1,083,050	10.49%	$11,869,224
21	$1,483,647	13.95%	$24,149,114	$1,425,299	13.40%	$21,253,516	$1,353,265	12.72%	$18,521,628	$1,083,050	10.18%	$11,595,137
22	$1,557,829	14.22%	$24,285,631	$1,482,311	13.53%	$21,254,045	$1,393,863	12.72%	$18,412,347	$1,083,050	9.88%	$11,300,493
23	$1,635,721	14.49%	$24,348,653	$1,541,604	13.66%	$21,190,875	$1,435,679	12.72%	$18,249,918	$1,083,050	9.60%	$10,983,752
24	$1,717,507	14.77%	$24,328,482	$1,603,268	13.79%	$21,056,677	$1,478,749	12.72%	$18,029,007	$1,083,050	9.32%	$10,643,254
25	$1,803,382	15.06%	$24,214,482	$1,667,399	13.92%	$20,843,475	$1,523,112	12.72%	$17,743,837	$1,083,050	9.04%	$10,277,220
26	$1,893,551	15.35%	$23,995,001	$1,734,095	14.06%	$20,542,584	$1,568,805	12.72%	$17,388,160	$1,083,050	8.78%	$9,883,732
27	$1,988,229	15.65%	$23,657,280	$1,803,458	14.20%	$20,144,560	$1,615,869	12.72%	$16,955,213	$1,083,050	8.53%	$9,460,733
28	$2,087,641	15.95%	$23,187,362	$1,875,597	14.33%	$19,639,135	$1,664,345	12.72%	$16,437,682	$1,083,050	8.28%	$9,006,010
29	$2,192,023	16.26%	$22,569,990	$1,950,621	14.47%	$19,015,153	$1,714,276	12.72%	$15,827,662	$1,083,050	8.04%	$8,517,182
30	$2,301,624	16.58%	$21,788,494	$2,028,645	14.61%	$18,260,496	$1,765,704	12.72%	$15,116,605	$1,083,050	7.80%	$7,991,692
31	$2,416,705	16.90%	$20,824,673	$2,109,791	14.76%	$17,362,008	$1,818,675	12.72%	$14,295,275	$1,083,050	7.57%	$7,426,790
32	$2,537,540	17.23%	$19,658,668	$2,194,183	14.90%	$16,305,412	$1,873,235	12.72%	$13,353,693	$1,083,050	7.35%	$6,819,520
33	$2,664,417	17.56%	$18,268,820	$2,281,950	15.04%	$15,075,221	$1,929,432	12.72%	$12,281,080	$1,083,050	7.14%	$6,166,705
34	$2,797,638	17.91%	$16,631,520	$2,373,228	15.19%	$13,654,643	$1,987,315	12.72%	$11,065,798	$1,083,050	6.93%	$5,464,930
35	$2,937,520	18.25%	$14,721,051	$2,468,157	15.34%	$12,025,472	$2,046,935	12.72%	$9,695,278	$1,083,050	6.73%	$4,710,521
36	$3,084,396	18.61%	$12,509,404	$2,566,884	15.49%	$10,167,982	$2,108,343	12.72%	$8,155,955	$1,083,050	6.53%	$3,899,531
37	$3,238,616	18.97%	$9,966,097	$2,669,559	15.64%	$8,060,805	$2,171,593	12.72%	$6,433,189	$1,083,050	6.34%	$3,027,717
38	$3,400,546	19.34%	$7,057,967	$2,776,341	15.79%	$5,680,799	$2,236,741	12.72%	$4,511,182	$1,083,050	6.16%	$2,090,517
39	$3,570,574	19.71%	$3,748,948	$2,887,395	15.94%	$3,002,909	$2,303,843	12.72%	$2,372,889	$1,083,050	5.98%	$1,083,027
40	$3,749,102	20.10%	-$166	$3,002,891	16.10%	$20	$2,372,958	12.72%	-$74	$1,083,050	5.81%	-$25

Under the first option with amortization contributions increasing at the rate of 5.0% annually, the first year amortization contribution is $559,171,000. This amounts to 9.49% of covered payroll. The annual amortization contribution increases to an amount of $3,749,102,000 in year 40, at which time the accrued liability is fully-funded. The amortization contribution in year 40 is 20.10% of payroll. Under this scenario, the unfunded accrued liability increases for 23 years until such point as the amortization contribution amount each year is larger than the interest on the unfunded accrued liability.

Under option 2, with amortization contributions increasing at the rate of 4.0% annually, the amortization contribution during the first year is $650,488,000. This amounts to 11.04% of covered payroll. The amortization contribution in year 40 increases to $3,002,891,000, which is 16.10% of payroll. Under this scenario, the unfunded accrued liability increases for 22 years, at which point the amortization contribution exceeds the interest on the unfunded accrued liability.

Under option 3, with amortization contributions increasing at the rate of 3.0% annually, the amortization contribution in the first year is $749,270,000, which is 12.72% of covered payroll. The amortization contribution in year 40 increases to $2,372,958,000, which is still 12.72% of payroll. Under this scenario, the unfunded accrued liability increases for 19 years, at which point the amortization contribution exceeds the interest on the unfunded accrued liability.

Under option 4, the annual amortization contribution for the entire 40-year period is $1,083,050,000. During year 1, this amounts to 18.39% of covered payroll. Over the 40-year amortization period, the amortization contribution decreases as a percentage of payroll each year down to 5.81% of payroll in year 40.

Amortizing the unfunded accrued liability over 40 years instead of 30 years provides funding relief during the initial years of amortization. The reduced level of funding during the initial years of amortization results in amortization contributions required in years 31–40 after the commencement of the amortization of the unfunded accrued liability.

The next two tables illustrate the same four methods for amortizing the unfunded accrued liability under PSERS ($26,499,252,000) over a 30-year closed period and 40-year closed period, respectively. Again, for purposes of calculating the amortization contribution each year as a percentage of annual covered payroll of active members, the total annual payroll of active members is assumed to increase at the rate of 3.0% per year. This is similar to projections of annual payroll made by the PSERS actuary. While the numbers are different from the illustrations for SERS, the results are similar to the different amortization methods under SERS.

Amortization of Unfunded Accrued Liability
(In Thousands)

PSERS

Unfunded Accrued Liability - $26,499,252
Initial Payroll - $14,297,000
Interest - 7.5%
Annual Payroll Growth - 3.0%

	30-Yr Level % (5.0%)			30-Yr Level % (4.0%)			30-Yr Level % (3.0%)			30-Yr Level Dollar		
Year	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance
1	$1,217,083	8.51%	$27,178,332	$1,370,480	9.59%	$27,013,430	$1,534,780	10.73%	$26,836,807	$2,087,186	14.60%	$26,242,971
2	$1,277,937	8.68%	$27,842,924	$1,425,299	9.68%	$27,507,241	$1,580,823	10.73%	$27,150,183	$2,087,186	14.17%	$25,967,469
3	$1,341,834	8.85%	$28,488,672	$1,482,311	9.77%	$27,976,799	$1,628,248	10.73%	$27,436,080	$2,087,186	13.76%	$25,671,304
4	$1,408,926	9.02%	$29,110,727	$1,541,604	9.87%	$28,417,835	$1,677,096	10.73%	$27,690,908	$2,087,186	13.36%	$25,352,927
5	$1,479,372	9.19%	$29,703,707	$1,603,268	9.96%	$28,825,660	$1,727,408	10.73%	$27,910,762	$2,087,186	12.97%	$25,010,671
6	$1,553,341	9.37%	$30,261,644	$1,667,398	10.06%	$29,195,131	$1,779,231	10.73%	$28,091,396	$2,087,186	12.59%	$24,642,747
7	$1,631,008	9.55%	$30,777,934	$1,734,094	10.16%	$29,520,614	$1,832,608	10.73%	$28,228,198	$2,087,186	12.23%	$24,247,228
8	$1,712,558	9.74%	$31,245,279	$1,803,458	10.26%	$29,795,943	$1,887,586	10.73%	$28,316,158	$2,087,186	11.87%	$23,822,045
9	$1,798,186	9.93%	$31,655,625	$1,875,597	10.36%	$30,014,372	$1,944,213	10.73%	$28,349,840	$2,087,186	11.52%	$23,364,973
10	$1,888,095	10.12%	$32,000,094	$1,950,620	10.46%	$30,168,533	$2,002,540	10.73%	$28,323,348	$2,087,186	11.19%	$22,873,622
11	$1,982,500	10.32%	$32,268,914	$2,028,645	10.56%	$30,250,380	$2,062,616	10.73%	$28,230,287	$2,087,186	10.86%	$22,345,418
12	$2,081,625	10.52%	$32,451,336	$2,109,791	10.66%	$30,251,133	$2,124,494	10.73%	$28,063,727	$2,087,186	10.55%	$21,777,600
13	$2,185,706	10.72%	$32,535,552	$2,194,183	10.76%	$30,161,222	$2,188,229	10.73%	$27,816,160	$2,087,186	10.24%	$21,167,195
14	$2,294,992	10.93%	$32,508,602	$2,281,950	10.87%	$29,970,217	$2,253,876	10.73%	$27,479,455	$2,087,186	9.94%	$20,511,009
15	$2,409,741	11.14%	$32,356,276	$2,373,228	10.97%	$29,666,763	$2,321,492	10.73%	$27,044,810	$2,087,186	9.65%	$19,805,610
16	$2,530,228	11.36%	$32,063,001	$2,468,157	11.08%	$29,238,502	$2,391,137	10.73%	$26,502,698	$2,087,186	9.37%	$19,047,306
17	$2,656,740	11.58%	$31,611,731	$2,566,883	11.19%	$28,671,990	$2,462,871	10.73%	$25,842,814	$2,087,186	9.10%	$18,232,129
18	$2,789,577	11.80%	$30,983,816	$2,669,559	11.30%	$27,952,613	$2,536,757	10.73%	$25,054,011	$2,087,186	8.83%	$17,355,814
19	$2,929,055	12.03%	$30,158,868	$2,776,341	11.41%	$27,064,493	$2,612,860	10.73%	$24,124,237	$2,087,186	8.58%	$16,413,775
20	$3,075,508	12.27%	$29,114,612	$2,887,395	11.52%	$25,990,380	$2,691,246	10.73%	$23,040,465	$2,087,186	8.33%	$15,401,083
21	$3,229,284	12.51%	$27,826,728	$3,002,890	11.63%	$24,711,552	$2,771,983	10.73%	$21,788,618	$2,087,186	8.08%	$14,312,439
22	$3,390,748	12.75%	$26,268,679	$3,123,006	11.74%	$23,207,687	$2,855,143	10.73%	$20,353,486	$2,087,186	7.85%	$13,142,147
23	$3,560,285	13.00%	$24,411,523	$3,247,926	11.86%	$21,456,742	$2,940,797	10.73%	$18,718,640	$2,087,186	7.62%	$11,884,083
24	$3,738,299	13.25%	$22,223,716	$3,377,843	11.97%	$19,434,816	$3,029,021	10.73%	$16,866,340	$2,087,186	7.40%	$10,531,664
25	$3,925,214	13.51%	$19,670,889	$3,512,957	12.09%	$17,115,999	$3,119,892	10.73%	$14,777,432	$2,087,186	7.18%	$9,077,814
26	$4,121,475	13.77%	$16,715,620	$3,653,475	12.20%	$14,472,213	$3,213,488	10.73%	$12,431,240	$2,087,186	6.97%	$7,514,925
27	$4,327,549	14.04%	$13,317,177	$3,799,614	12.32%	$11,473,043	$3,309,893	10.73%	$9,805,447	$2,087,186	6.77%	$5,834,820
28	$4,543,926	14.31%	$9,431,244	$3,951,599	12.44%	$8,085,552	$3,409,190	10.73%	$6,875,977	$2,087,186	6.57%	$4,028,706
29	$4,771,123	14.59%	$5,009,631	$4,109,663	12.56%	$4,274,081	$3,511,466	10.73%	$3,616,849	$2,087,186	6.38%	$2,087,134
30	$5,009,679	14.87%	-$51	$4,274,049	12.69%	$34	$3,616,810	10.73%	$43	$2,087,186	6.19%	-$55

Amortization of Unfunded Accrued Liability
(In Thousands)

PSERS

Unfunded Accrued Liability - $26,499,252
Initial Payroll - $14,297,000
Interest - 7.5%
Annual Payroll Growth - 3.0%

	40-Yr Level % (5.0%)			40-Yr Level % (4.0%)			40-Yr Level % (3.0%)			40-Yr Level Dollar		
Year	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance	Amortization Contribution	Percentage of Payroll	EOY UAL Balance
1	$1,010,516	7.07%	$27,400,391	$1,175,542	8.22%	$27,222,988	$1,354,058	9.47%	$27,031,084	$1,957,255	13.69%	$26,382,647
2	$1,061,042	7.21%	$28,314,801	$1,222,564	8.30%	$27,950,456	$1,394,680	9.47%	$27,559,134	$1,957,255	13.29%	$26,257,296
3	$1,114,094	7.35%	$29,240,760	$1,271,466	8.38%	$28,679,914	$1,436,520	9.47%	$28,081,810	$1,957,255	12.90%	$26,122,544
4	$1,169,799	7.49%	$30,176,283	$1,322,325	8.46%	$29,409,409	$1,479,616	9.47%	$28,597,359	$1,957,255	12.53%	$25,977,686
5	$1,228,289	7.63%	$31,119,094	$1,375,218	8.55%	$30,136,755	$1,524,004	9.47%	$29,103,856	$1,957,255	12.16%	$25,821,963
6	$1,289,703	7.78%	$32,066,596	$1,430,227	8.63%	$30,859,518	$1,569,724	9.47%	$29,599,192	$1,957,255	11.81%	$25,654,561
7	$1,354,188	7.93%	$33,015,838	$1,487,436	8.71%	$31,574,989	$1,616,816	9.47%	$30,081,054	$1,957,255	11.47%	$25,474,604
8	$1,421,897	8.09%	$33,963,486	$1,546,933	8.80%	$32,280,160	$1,665,321	9.47%	$30,546,913	$1,957,255	11.13%	$25,281,151
9	$1,492,992	8.24%	$34,905,781	$1,608,810	8.88%	$32,971,701	$1,715,280	9.47%	$30,994,006	$1,957,255	10.81%	$25,073,188
10	$1,567,642	8.40%	$35,838,499	$1,673,163	8.97%	$33,645,928	$1,766,739	9.47%	$31,419,312	$1,957,255	10.49%	$24,849,628
11	$1,646,024	8.57%	$36,756,911	$1,740,089	9.06%	$34,298,777	$1,819,741	9.47%	$31,819,539	$1,957,255	10.19%	$24,609,301
12	$1,728,325	8.73%	$37,655,730	$1,809,693	9.14%	$34,925,765	$1,874,333	9.47%	$32,191,097	$1,957,255	9.89%	$24,350,949
13	$1,814,742	8.90%	$38,529,062	$1,882,081	9.23%	$35,521,961	$1,930,563	9.47%	$32,530,074	$1,957,255	9.60%	$24,073,221
14	$1,905,479	9.08%	$39,370,352	$1,957,364	9.32%	$36,081,942	$1,988,480	9.47%	$32,832,214	$1,957,255	9.32%	$23,774,664
15	$2,000,753	9.25%	$40,172,320	$2,035,658	9.41%	$36,599,755	$2,048,134	9.47%	$33,092,885	$1,957,255	9.05%	$23,453,714
16	$2,100,790	9.43%	$40,926,894	$2,117,085	9.50%	$37,068,870	$2,109,578	9.47%	$33,307,055	$1,957,255	8.79%	$23,108,694
17	$2,205,830	9.61%	$41,625,144	$2,201,768	9.60%	$37,482,135	$2,172,866	9.47%	$33,469,254	$1,957,255	8.53%	$22,737,797
18	$2,316,121	9.80%	$42,257,200	$2,289,839	9.69%	$37,831,718	$2,238,052	9.47%	$33,573,542	$1,957,255	8.28%	$22,339,082
19	$2,431,927	9.99%	$42,812,168	$2,381,432	9.78%	$38,109,057	$2,305,193	9.47%	$33,613,476	$1,957,255	8.04%	$21,910,464
20	$2,553,524	10.19%	$43,278,043	$2,476,690	9.88%	$38,304,795	$2,374,349	9.47%	$33,582,061	$1,957,255	7.81%	$21,449,700
21	$2,681,200	10.38%	$43,641,606	$2,575,757	9.98%	$38,408,716	$2,445,579	9.47%	$33,471,718	$1,957,255	7.58%	$20,954,378
22	$2,815,260	10.59%	$43,888,323	$2,678,788	10.07%	$38,409,673	$2,518,947	9.47%	$33,274,229	$1,957,255	7.36%	$20,421,908
23	$2,956,023	10.79%	$44,002,222	$2,785,939	10.17%	$38,295,514	$2,594,515	9.47%	$32,980,692	$1,957,255	7.14%	$19,849,501
24	$3,103,824	11.00%	$43,965,778	$2,897,377	10.27%	$38,052,997	$2,672,351	9.47%	$32,581,467	$1,957,255	6.94%	$19,234,165
25	$3,259,015	11.21%	$43,759,770	$3,013,272	10.37%	$37,667,705	$2,752,521	9.47%	$32,066,117	$1,957,255	6.73%	$18,572,678
26	$3,421,966	11.43%	$43,363,140	$3,133,803	10.47%	$37,123,945	$2,835,097	9.47%	$31,423,347	$1,957,255	6.54%	$17,861,580
27	$3,593,064	11.65%	$42,752,831	$3,259,155	10.57%	$36,404,650	$2,920,150	9.47%	$30,640,937	$1,957,255	6.35%	$17,097,149
28	$3,772,717	11.88%	$41,903,623	$3,389,521	10.67%	$35,491,264	$3,007,754	9.47%	$29,705,672	$1,957,255	6.16%	$16,275,386
29	$3,961,353	12.11%	$40,787,940	$3,525,102	10.78%	$34,363,624	$3,097,987	9.47%	$28,603,261	$1,957,255	5.98%	$15,391,991
30	$4,159,421	12.35%	$39,375,658	$3,666,106	10.88%	$32,999,832	$3,190,926	9.47%	$27,318,260	$1,957,255	5.81%	$14,442,341
31	$4,367,392	12.59%	$37,633,886	$3,812,750	10.99%	$31,376,113	$3,286,654	9.47%	$25,833,976	$1,957,255	5.64%	$13,421,468
32	$4,585,762	12.83%	$35,526,733	$3,965,260	11.09%	$29,466,668	$3,385,254	9.47%	$24,132,377	$1,957,255	5.48%	$12,324,029
33	$4,815,050	13.08%	$33,015,060	$4,123,870	11.20%	$27,243,507	$3,486,811	9.47%	$22,193,983	$1,957,255	5.32%	$11,144,282
34	$5,055,802	13.33%	$30,056,202	$4,288,825	11.31%	$24,676,283	$3,591,416	9.47%	$19,997,760	$1,957,255	5.16%	$9,876,054
35	$5,308,592	13.59%	$26,603,681	$4,460,378	11.42%	$21,732,097	$3,699,158	9.47%	$17,520,996	$1,957,255	5.01%	$8,512,709
36	$5,574,022	13.86%	$22,606,884	$4,638,793	11.53%	$18,375,302	$3,810,133	9.47%	$14,739,178	$1,957,255	4.87%	$7,047,113
37	$5,852,723	14.12%	$18,010,723	$4,824,345	11.64%	$14,567,279	$3,924,437	9.47%	$11,625,847	$1,957,255	4.72%	$5,471,597
38	$6,145,359	14.40%	$12,755,266	$5,017,319	11.76%	$10,266,207	$4,042,170	9.47%	$8,152,453	$1,957,255	4.59%	$3,777,918
39	$6,452,627	14.68%	$6,775,337	$5,218,012	11.87%	$5,426,810	$4,163,435	9.47%	$4,288,194	$1,957,255	4.45%	$1,957,213
40	$6,775,258	14.96%	$85	$5,426,732	11.99%	$83	$4,288,338	9.47%	-$155	$1,957,255	4.32%	-$46

The following table illustrates the first year total employer contribution rate under SERS and PSERS for each of the amortization methods listed above for a 30-year and 40-year period. The total employer contribution rate is equal to the sum of the employer normal cost rate and the first year amortization rate.

SERS

	Employer Normal Cost	First Year Amortization	Total Employer Contribution
30-Year Level % (5.0%)	5.10%	11.43%	16.53%
30-Year Level % (4.0%)	5.10%	12.87%	17.97%
30-Year Level % (3.0%)	5.10%	14.42%	19.52%
30-Year Level Dollar	5.10%	19.61%	24.71%
40-Year Level % (5.0%)	5.10%	9.49%	14.59%
40-Year Level % (4.0%)	5.10%	11.04%	16.14%
40-Year Level % (3.0%)	5.10%	12.72%	17.82%
40-Year Level Dollar	5.10%	18.39%	23.49%

PSERS

	Employer Normal Cost	First Year Amortization	Total Employer Contribution
30-Year Level % (5.0%)	8.66%	8.51%	17.17%
30-Year Level % (4.0%)	8.66%	9.59%	18.25%
30-Year Level % (3.0%)	8.66%	10.73%	19.39%
30-Year Level Dollar	8.66%	14.60%	23.26%
40-Year Level % (5.0%)	8.66%	7.07%	15.73%
40-Year Level % (4.0%)	8.66%	8.22%	16.88%
40-Year Level % (3.0%)	8.66%	9.47%	18.13%
40-Year Level Dollar	8.66%	13.69%	22.35%

For SERS, the first year total employer contribution rates range from 14.59% for 40-year level percentage amortization payments increasing at the rate of 5.0% annually to 24.71% for level dollar amortization payments over a 30-year period. Under PSERS, the total employer contribution rates during the first year range from 15.73% to 23.26%.

The following two tables illustrate the projected employer contribution rates under current law for both SERS and PSERS for the next 30 fiscal years as well as projected employer contribution rates under the 8 optional amortization methods. It should be noted that for PSERS, the employer contribution rates listed are only for pension benefits. Such employer contribution rates do not include the health care contribution rate (which is 0.86% of payroll for the 2012–2013 fiscal year).

Under current law, the total employer contributions for SERS and PSERS are limited by the collars on the rate at which employer contributions may rise from year to year pursuant to Act 120 during the first four years included in the tables. This reduced level of contributions, which compared to the actuarially determined employer contribution rates result in an increased level of employer contributions in subsequent years. Under the optional amortization methods illustrated in the tables, there are no collars used in the calculation of the employer contribution rates. These contribution rates are actuarially determined based upon the amortization method being utilized.

SERS Projected Employer Contribution Rates
Based Upon Optional Amotization Methods

		Current Law	Amortization Method 30-Yr Level % (5.0%)	30-Yr Level % (4.0%)	30-Yr Level % (3.0%)	30-Yr Level $	40-Yr Level % (5.0%)	40-Yr Level % (4.0%)	40-Yr Level % (3.0%)	40-Yr Level $
Fiscal Year	Employer Normal Cost	Total Employer Contribution	Total Employer Contribution	Total Employer Contribution	Total Employer Contribution	Total Employer Contribution	Total Employer Contribution	Total Employer Contribution	Total Employer Contribution	Total Employer Contribution
2012/2013	5.10%	11.50%	16.53%	17.97%	19.52%	24.71%	14.59%	16.14%	17.82%	23.49%
2013/2014	5.10%	16.00%	16.75%	18.10%	19.52%	24.14%	14.78%	16.25%	17.82%	22.95%
2014/2015	5.10%	20.50%	16.98%	18.22%	19.52%	23.58%	14.96%	16.36%	17.82%	22.43%
2015/2016	5.10%	25.00%	17.21%	18.35%	19.52%	23.04%	15.16%	16.47%	17.82%	21.93%
2016/2017	5.10%	29.50%	17.45%	18.48%	19.52%	22.52%	15.35%	16.58%	17.82%	21.44%
2017/2018	5.10%	32.49%	17.69%	18.61%	19.52%	22.01%	15.55%	16.69%	17.82%	20.96%
2018/2019	5.10%	31.92%	17.93%	18.74%	19.52%	21.52%	15.75%	16.80%	17.82%	20.50%
2019/2020	5.10%	31.22%	18.18%	18.87%	19.52%	21.04%	15.96%	16.92%	17.82%	20.05%
2020/2021	5.10%	30.53%	18.43%	19.01%	19.52%	20.58%	16.17%	17.03%	17.82%	19.61%
2021/2022	5.10%	29.84%	18.69%	19.14%	19.52%	20.13%	16.39%	17.15%	17.82%	19.19%
2022/2023	5.10%	29.18%	18.96%	19.28%	19.52%	19.69%	16.61%	17.26%	17.82%	18.78%
2023/2024	5.10%	28.54%	19.23%	19.42%	19.52%	19.26%	16.83%	17.38%	17.82%	18.38%
2024/2025	5.10%	27.91%	19.50%	19.56%	19.52%	18.85%	17.06%	17.50%	17.82%	18.00%
2025/2026	5.10%	27.30%	19.78%	19.70%	19.52%	18.45%	17.29%	17.62%	17.82%	17.62%
2026/2027	5.10%	26.71%	20.07%	19.84%	19.52%	18.06%	17.53%	17.74%	17.82%	17.26%
2027/2028	5.10%	26.14%	20.36%	19.98%	19.52%	17.68%	17.77%	17.86%	17.82%	16.90%
2028/2029	5.10%	25.59%	20.65%	20.13%	19.52%	17.32%	18.01%	17.99%	17.82%	16.56%
2029/2030	5.10%	25.05%	20.95%	20.27%	19.52%	16.96%	18.26%	18.11%	17.82%	16.22%
2030/2031	5.10%	24.53%	21.26%	20.42%	19.52%	16.62%	18.52%	18.24%	17.82%	15.90%
2031/2032	5.10%	24.02%	21.58%	20.57%	19.52%	16.28%	18.78%	18.37%	17.82%	15.59%
2032/2033	5.10%	23.53%	21.90%	20.72%	19.52%	15.96%	19.05%	18.50%	17.82%	15.28%
2033/2034	5.10%	23.05%	22.22%	20.87%	19.52%	15.64%	19.32%	18.63%	17.82%	14.98%
2034/2035	5.10%	22.59%	22.55%	21.02%	19.52%	15.33%	19.59%	18.76%	17.82%	14.70%
2035/2036	5.10%	22.14%	22.89%	21.18%	19.52%	15.03%	19.87%	18.89%	17.82%	14.42%
2036/2037	5.10%	21.71%	23.24%	21.33%	19.52%	14.74%	20.16%	19.02%	17.82%	14.14%
2037/2038	5.10%	21.28%	23.59%	21.49%	19.52%	14.46%	20.45%	19.16%	17.82%	13.88%
2038/2039	5.10%	20.87%	23.95%	21.65%	19.52%	14.19%	20.75%	19.30%	17.82%	13.63%
2039/2040	5.10%	20.48%	24.32%	21.81%	19.52%	13.93%	21.05%	19.43%	17.82%	13.38%
2040/2041	5.10%	16.62%	24.69%	21.97%	19.52%	13.67%	21.36%	19.57%	17.82%	13.14%
2041/2042	5.10%	13.82%	25.07%	22.14%	19.52%	13.42%	21.68%	19.71%	17.82%	12.90%

PSERS Projected Employer Contribution Rates
Based Upon Optional Amortization Methods

		Current Law	Amortization Method	30-Yr Level % (5.0%)	30-Yr Level % (4.0%)	30-Yr Level % (3.0%)	30-Yr Level $	40-Yr Level % (5.0%)	40-Yr Level % (4.0%)	40-Yr Level % (3.0%)	40-Yr Level $
Fiscal Year	Employer Normal Cost	Total Employer Pension Contribution		Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution	Total Employer Pension Contribution
2012/2013	8.66%	11.50%		17.17%	18.25%	19.39%	23.26%	15.73%	16.88%	18.13%	22.35%
2013/2014	8.57%	16.00%		17.25%	18.25%	19.30%	22.74%	15.78%	16.87%	18.04%	21.86%
2014/2015	8.27%	20.50%		17.12%	18.04%	19.00%	22.03%	15.62%	16.65%	17.74%	21.17%
2015/2016	8.01%	25.00%		17.03%	17.88%	18.74%	21.37%	15.50%	16.47%	17.48%	20.54%
2016/2017	7.77%	27.51%		16.96%	17.73%	18.50%	20.74%	15.40%	16.32%	17.24%	19.93%
2017/2018	7.54%	28.38%		16.91%	17.60%	18.27%	20.13%	15.32%	16.17%	17.01%	19.35%
2018/2019	7.34%	29.38%		16.89%	17.50%	18.07%	19.57%	15.27%	16.05%	16.81%	18.81%
2019/2020	7.14%	30.13%		16.88%	17.40%	17.87%	19.01%	15.23%	15.94%	16.61%	18.27%
2020/2021	6.95%	30.06%		16.88%	17.31%	17.68%	18.47%	15.19%	15.83%	16.42%	17.76%
2021/2022	6.76%	30.05%		16.88%	17.22%	17.49%	17.95%	15.16%	15.73%	16.23%	17.25%
2022/2023	6.58%	30.24%		16.90%	17.14%	17.31%	17.44%	15.15%	15.64%	16.05%	16.77%
2023/2024	6.40%	30.30%		16.92%	17.06%	17.13%	16.95%	15.13%	15.54%	15.87%	16.29%
2024/2025	6.23%	30.35%		16.95%	16.99%	16.96%	16.47%	15.13%	15.46%	15.70%	15.83%
2025/2026	6.05%	30.38%		16.98%	16.92%	16.78%	15.99%	15.13%	15.37%	15.52%	15.37%
2026/2027	5.88%	30.43%		17.02%	16.85%	16.61%	15.53%	15.13%	15.29%	15.35%	14.93%
2027/2028	5.71%	30.47%		17.07%	16.79%	16.44%	15.08%	15.14%	15.21%	15.18%	14.50%
2028/2029	5.52%	30.48%		17.10%	16.71%	16.25%	14.62%	15.13%	15.12%	14.99%	14.05%
2029/2030	5.34%	30.52%		17.14%	16.64%	16.07%	14.17%	15.14%	15.03%	14.81%	13.62%
2030/2031	5.16%	30.56%		17.19%	16.57%	15.89%	13.74%	15.15%	14.94%	14.63%	13.20%
2031/2032	4.98%	30.60%		17.25%	16.50%	15.71%	13.31%	15.17%	14.86%	14.45%	12.79%
2032/2033	4.80%	30.65%		17.31%	16.43%	15.53%	12.88%	15.18%	14.78%	14.27%	12.38%
2033/2034	4.63%	30.71%		17.38%	16.37%	15.36%	12.48%	15.22%	14.70%	14.10%	11.99%
2034/2035	4.45%	30.76%		17.45%	16.31%	15.18%	12.07%	15.24%	14.62%	13.92%	11.59%
2035/2036	4.27%	17.85%		17.52%	16.24%	15.00%	11.67%	15.27%	14.54%	13.74%	11.21%
2036/2037	4.10%	14.54%		17.61%	16.19%	14.83%	11.28%	15.31%	14.47%	13.57%	10.83%
2037/2038	3.93%	12.99%		17.70%	16.13%	14.66%	10.90%	15.36%	14.40%	13.40%	10.47%
2038/2039	3.76%	11.05%		17.80%	16.08%	14.49%	10.53%	15.41%	14.33%	13.23%	10.11%
2039/2040	3.60%	9.42%		17.91%	16.04%	14.33%	10.17%	15.48%	14.27%	13.07%	9.76%
2040/2041	3.44%	7.87%		18.03%	16.00%	14.17%	9.82%	15.55%	14.22%	12.91%	9.42%
2041/2042	3.30%	6.62%		18.17%	15.99%	14.03%	9.49%	15.65%	14.18%	12.77%	9.11%

Once a strategy for amortizing the existing unfunded accrued liabilities has been created and implemented, a strategy for amortizing future changes in unfunded accrued liabilities should also be created and implemented. In all likelihood, actuarial valuation reports prepared for both plans during the next few years will indicate actuarial losses causing an increase in the unfunded accrued liabilities. This is primarily the result of the shortfall in actuarial funding that is occurring due to the use of the collars pursuant to Act 120 as well as additional recognition of actuarial losses that have occurred in recent years due to the use of the asset smoothing methods in determining the actuarial value of assets. Any calculated actuarial losses should also be amortized in addition to the amortization of the existing unfunded accrued liabilities under the plans. Under Act 205, actuarial gains and losses are amortized using level dollar amortization for a 20-year closed period. In an effort to make future years' employer contribution streams more manageable for purposes of preparing future budgets, use of a longer amortization period as well as use of an open amortization period method may be desirable. Subsequent actuarial gains and losses can be aggregated at each actuarial valuation date with the hope that gains will occur to offset losses and limit the additional employer contribution needed to amortize any net actuarial losses.

In an effort to maintain a disciplined approach to making the required employer contribution each year, it may be worthwhile to establish a strategy which requires amortization of net actuarial losses; however, does not allow for a reduction in amortization payments due to net actuarial gains. Under this approach, the amortization payments for the existing unfunded accrued liabilities would continue to be made until such time as the accrued liabilities become fully-funded. If this occurs prior to the end of the initial amortization period due to actuarial gains, the amortization portion of the total employer contribution would cease at such time. This strategy would also serve to assist in the management of the total employer contributions in future years by not allowing such contributions to be reduced based upon favorable actuarial experience, only to be increased shortly thereafter based upon unfavorable actuarial experience. Also, any increases in accrued liability enacted by legislation would continue to be amortized over a 10-year closed period under each plan.

If a 40-year amortization method is elected for purposes of paying off the existing unfunded accrued liabilities under SERS and PSERS, an argument could be made that the "can is being kicked down the road" to future generations with respect to solving this problem. I would not view the decision to utilize a 40-year amortization method to fund the existing unfunded accrued liabilities as "kicking the can down the road." I would view the decision as the implementation of a plan to address the funding shortfall which is more manageable (and more likely to be carried out) than the plan under current law.

With best regards,

Yours sincerely,

Dave

David H. Killick, F.S.A.
Consulting Actuary

DHK:smf

APPENDIX 3

SELECTED APPROVED CHANGES TO STATE PUBLIC PENSION PLANS SINCE 2009

The following table was compiled by the Commission staff and based on information provided by the National Association of State Retirement Administrators, retirement systems and the National Conference of State Legislatures. It shows selected approved changes to state public pension plans to restore or preserve plan sustainability.

SELECTED APPROVED CHANGES TO STATE PUBLIC PENSION PLANS SINCE 2009

System	Contribution Changes	Benefit & Actuarial Funding Changes
Retirement Systems of Alabama	Raised contribution rates for current and future employees, as follows: • general state employees and teachers, from 5% to 7.5%; • firefighters, law enforcement officers and correctional officers, from 6% to 8.25% and 8.5% Employer rates will be reduced commensurate with the increase in employee rates.	Benefit levels remain unchanged.
Arizona State Retirement System	Employee and employer contributions are matched and adjusted annually based on actuarial results; they rose on 7/1/10 from 9.0% to 9.6%; this includes the retiree health insurance benefit.	For new hires after 7/1/11: • Changed from Rule of 80 to Rule of 85 • Increased final average salary period from high 3 years to high 5 • Eliminated access to employer contributions for terminating participants Also, • Made service purchases cost neutral • Decreased interest rate paid on refunds • Requiring employers to pay Arizona State Retirement System for early retirement incentives • Rescinded modified DROP Program Early retirement provisions revised commensurate with change in normal retirement eligibility Changes approved in 2010.
Arizona statewide plans	Increased employee contributions for participants in the Public Safety Personnel Retirement System (firefighters and police officers), rising gradually from current level of 7.65% to 11.65%. Also, requires employers to contribute for retirees who return to work.	Changed terms of the investment-performance-based COLA for participants in the Correctional Officers, Public Safety Personnel, and Elected Officials plans. A COLA may be paid only if the funds' total return exceeds 10.5%, and the amount of the COLA is linked to the plans' funding condition. Changes approved in 2011.

System	Contribution Changes	Benefit & Actuarial Funding Changes
California PERF	• Capped the amount of compensation used to calculate the benefits to 100% of the Social Security contribution cap (for employees eligible for Social Security) • Required new members to contribute 50% of the annual Normal Cost State employee contributions, which for most workers are set in labor contracts, are rising by 2% to 5% of pay for most employees, depending on bargaining unit and employee classification.	For new hires after 1/1/13: • New defined benefit formula for non-public safety employees (2% multiplier at age 62 w/ a maximum benefit of 2.5% at age 67) • Created three new formulas for public safety employees with benefit multipliers ranging from 1.5% to 2.7% and retirement ages ranging from 50 to 57 For new hires after 11/10/10: • Increased final average salary period from one year to three • For general state employees, a higher normal retirement age, from 55 to 60 • For state public safety employees, lower retirement multiplier, from 3.0% to 2.5% or 2.5% to 2.0%; and higher retirement age, from 50 to 55, depending on employee classification Changes approved in 2012 and 2010. (PERF is an agent plan with many state and local employers. The changes shown here affect state employees; other employers have also made changes to benefits and/or contributions.)
California STRS	• Required new members to contribute 50% of the annual Normal Cost of the DB benefit • Required the contribution rate for public employers to equal at least the Normal Cost rate (less the member contribution)	For new hires after 1/1/13: • Increased final average salary period from one year to three • Increase the minimum retirement age to 55 w/ 5 years of service and the normal retirement age to age 62, up from age 60 • Reduced the retirement factor from 1.4% to 2.4% (age 55 to 67) to 1.16% to 2.4% (age 55 to 67) Changes approved in 2012.
Colorado PERA	Employee and employer contribution rates will rise incrementally for several years. Additionally, the legislature approved temporary increases in contribution rates for state employees by 2.5%, for FY 2012 only, and reduced employer rates by a commensurate amount.	• Lower auto-COLA for existing retirees, to lesser of CPI-W or 2.0% • Require future retirees to be retired for 1 year before receiving a COLA • 5-year service credit required on 50% employer match on contribution refunds, effective 1/1/11 Increased actuarial reduction for early retirement. Changes approved in 2010 and 2011.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Delaware PERS	Increased employee contribution rates from 3% to 5% on salaries above $6,000, effective 1/1/12.	For new hires as of 1/1/12: • 10-year vesting period, from 5 • Raised normal retirement eligibility to 65 years of age with 10 years of service, 60/20, or any/30, up from 62/5, 60/15, or any/30 • Overtime will be excluded from final average salary calculation Increased actuarial reduction for early retirement. Changes approved in 2011.
Florida Retirement System	FRS, which previously was a non-contributory plan, will require participants to contribute 3% of pay beginning 7/1/11.	For new hires as of 7/1/11: • 8-year vesting period, from 6 • 8-year final average salary period, from 5 • Raised normal retirement age, from 62 to 65, and 55 to 60 for public safety workers Also, eliminates COLA for all service earned after 6/30/11. Changes approved in 2011. (FRS participants maintain option to select a DB or DC plan as their primary retirement benefit.)
Hawaii ERS	Increased employee contribution rates for those hired after 6/30/12, as follows: • General employees and teachers, from 7.8% to 9.8%, and public safety personnel, from 12.2% to 14.2%. Higher employer rates will be phased in over several years, from 15% to 17% for general employees and 19.7% to 25% for public safety.	For new hires after 6/30/12: • Normal retirement age changed to 60 with 10 years of service or at age 55 with 25 years of service. Police and firefighters eligible to retire after 25 years of service • Vesting period increased from 5 to 10 years • Final average salary calculated from the highest 5 years (up from highest 3) • Retirement multiplier reduced from 2% to 1.75% • COLA reduced from 2.5% to 1.5%
Illinois statewide plans (except judges and legislators)	None	For new hires as of 1/1/11: • Normal retirement age increases to 67, from 60 • Minimum retirement age of 62 • Final average salary basis is now highest 8 of last 10 years, up from final 4 • Limits pension benefit to 75% of final average salary or $106,800, indexed to the lesser of 3% or half of CPI • COLAs will be lesser of 3% or half of CPI, non-compounded, from current auto 3% compounded • COLAs begin at age 67 Early retirement provisions revised commensurate with change in normal retirement eligibility. Suspends pension benefits for those who return-to-work for another public employer in the state. Changes approved in 2010.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Iowa PERS	Contribution rates will rise incrementally, from 4.7% to 5.3% for employees and 7.25% to 8.15% for employers. Thereafter, the board has authority to adjust the total rate by up to 1%.	• Vesting period for those not vested (currently 4 years) on 7/1/12 will increase to 7 years. • Increased final average salary period from 3 years to 5 Increased actuarial reduction for early retirement. Changes approved in 2010.
Kansas PERS	Cap on permissible annual increase in employer rates will rise gradually from 0.6% to 1.2% by 2017. Participants employed before 1/1/09 may choose to keep the 4% contribution rate with a lower future benefit accrual, or opt for 6% rate and keep the same benefit accrual rate.	For new hires as of 1/1/15: • A new cash balance plan with employees contributions of 6% and employers contributing pay credits that grow with increasing employee service length. Accounts will grow at an annual rate of 5.25% which may be higher if investment returns permit. See KPERS Contributions column entry. Also, those employed after 12/31/08 will be permitted to choose to retain their 1.75% multiplier and forfeit accrual of their COLA (for all service), or to retain their COLA and reduce future accrual rate from 1.75% to 1.4%. All changes would become effective in 2014. Changes approved in 2012 and 2011. The legislation also directs that 80% of proceeds from excess real estate property sales will be used to pay down KPERS' unfunded liability.
Kentucky TRS	None	For new hires after 6/30/08: • Increased normal retirement eligibility from 55/5 to 55/10; retained 60/27 • Established graduated retirement factor schedule that is lower for those who accrue less than 30 years of service, beginning with 1.7% for 10 years and less Increased actuarial reduction for early retirement. Changes approved in 2008.
Maine PERS	None	• Increased age when most new hires and those with less than 5 years of service on 7/1/11 are eligible to retire, from 62 to 65. Members may be able to purchase other types of service to remain in the Age 62 plan. • The retiree COLA will be frozen for 3 years, then based on CPI up to 3%. Retirees will receive a COLA only on their first $20,000 of benefits, indexed each year by the CPI. • State employees or teachers who are 1) normal retirement age; 2) retire after 7/11, and, 3) return to work in a position covered by the State/Teacher plan may work no more than 5 years and only at a salary not more than 75% of that established for the position. Changes approved June 2011.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Maryland State Retirement Agency	For existing state workers and teachers not yet paying 7%, raised contribution rate to that level. Establishes 7% employee contribution rate for all new hires as of 7/1/11.	For new state workers and teachers as of 7/1/11: • Increased vesting period from 5 years to 10 • Increased final average salary period from 3 years to 5 • Increased normal retirement eligibility to Rule of 90 or 65/10 For existing state workers and teachers and new hires as of 7/1/11, reduced auto-COLA to CPI up to 2.5% when assumed investment return is achieved; 1% when it's not. Also, approved changes to DROP and other benefit provisions affecting state and local police and corrections officers. For new state workers and teachers as of 7/1/11: • Increased early retirement eligibility to age 60 or 15 years of service Changes approved in 2011.
Massachusetts teachers, state, and local	None	For teachers and employees of the state and political subdivisions hired after March 2012, not including public safety officers: • Increased minimum retirement age from 55 to 60 • Reduced retirement multipliers • Increased final average salary period from 3 years to 5 • Made changes reducing benefits for newly-hired public safety officers Changes approved in 2011.
Michigan Public School ERS	New hires on or after 7/1/10 participate in a hybrid plan featuring higher employee contributions to the DB plan and mandatory participation in the DC plan.	New school system hires have a hybrid plan instead of the current DB plan. Hybrid plan features the same multiplier as the legacy DB plan, but requires higher employee contributions and mandatory participation in DC plan. Changes approved in 2010.
Minnesota PERA	Employer contribution rates increased from 7.0% to 7.25% and employee contributions increased from 6.0% to 6.25%, on 1/1/11.	• Reduction in COLA for existing retirees from 2.5% to 1.0%, until funding ratio = 90% • Reduction in interest paid on inactive and terminating accounts. • Increase in vesting period, from 3 years to 5 Changes approved in 2010.
Minnesota SRS	None	• Reduction in COLA for existing retirees from 2.5% to 2.0%, until funding ratio=90% • Reduction in interest paid on inactive and terminating accounts. • Increase in vesting period, from 3 years to 5 Changes approved in 2010.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Minnesota Teachers	Employer and employee contributions will rise by 0.5% each year, from 5.5% each to 7.5%, phased over 4 years. After the phase-in, the Minnesota TRA board has authority to adjust future rates (within limits) should the system have a contribution deficiency or sufficiency.	• For existing retirees, 2-yr suspension of COLA followed by permanent reduction in COLA from 2.5% to 2.0%, until funding ratio=90% • Reduction in interest paid on inactive and terminating accounts. Changes approved in 2010.
Mississippi PERS	Raised contribution rates for all employees by 1.75%.	For new hires after 7/1/11: • Retirement eligibility raised to 30 years of service or age 65. • Effective 7/1/11, employers will be required to pay contributions on any re-employed retiree, and a 90-day break in service will be required (up from 45, with an emergency provision). • Increased age when COLA begins compounding, from 55 to 60. Changes approved in 2010 and 2011.
Missouri State ERS	New hires as of 1/1/11 are required to contribute 4% of pay. Plan is non-contributory for those hired before.	For new hires as of 1/1/11: • 10 year vesting (from 5) • Normal retirement at age 67 or Rule of 90 at age 55 (from 62 or Rule of 80, minimum age 48) For new hires as of 1/1/11: • Age 62 with 10 yrs of service (from 57/5), with reduced benefit Changes approved in 2010.
Missouri Highway Patrol & DOT RS	New hires as of 1/1/11, excluding uniformed patrol employees, are required to contribute 4% of pay. Plan is non-contributory for those hired before.	For new hires as of 1/1/11, excluding uniformed state employees: • 10 year vesting (from 5) • Normal retirement at age 67 or Rule of 90 at age 55 (from 62 or Rule of 80, minimum age 48) For new hires as of 1/1/11, excluding uniformed state employees: • Age 62 with 10 yrs of service (from 57/5), with reduced benefit Changes approved in 2010.
Montana PERA	New hires as of 7/1/11 will contribute 7.9% rather than 6.9%.	For new hires after 6/30/11: • Highest average compensation calculated based on 60 months (up from 36) • Normal retirement eligibility at 65 with 5 years of service, or age 70 • Calculation for retirement multiplier changed according to length of membership service Changes approved in 2011.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Nebraska PERS	Rates for teachers and other school employees will rise from 8.28% to 9.78%, phased in over 2 years beginning 9/1/11. Rates are scheduled to return to 7.28% in 2017. The state contribution of 1%, up from 0.7%, to teacher plans is extended to 2017. Also, state patrol employee and employer rates are increased from 16% to 19% for a 2-year period beginning 7/1/11.	Changes approved in 2011.
Nevada PERS	None	For new hires as of 1/1/10: • Increase retirement age, from 60 to 62 • Remove 25-and-out option for police and firefighters • Retirement multiplier reduced from 2.67% to 2.5% • Revise final average salary calculation to prevent salary-spiking Increased actuarial reduction for early retirement Changes approved in 2009.
New Hampshire Retirement System	Rates for general employees and teachers will rise from 5% to 7%; for police, from 9.3% to 11.55%; and firefighters, from 9.3% to 11.8%.	For new hires as of 7/1/11: • Normal retirement eligibility for firefighters and police will change from age 45 with 20 years of service to age 50 with 25 years of service Changes approved in June 2011. Also placed limits on return-to-work.
New Jersey Division of Pension and Benefits	For general employees and teachers, raises employee contribution rates from 5.5% to 6.5%, then phases in to 7.5% over 7 years. For public safety officers, increases employee rate from 8.5% to 10.0%. The state police rate will rise from 7.5% to 9.0%.	For new hires after 6/28/11: • A new tier is established with a retirement age of 65 • Future COLAs are suspended for all existing and future retirees until plans reach a funding level of 80%. • Early retirement eligibility with 30 years at any age, with a 3% reduction in benefit for each year of age under 65 Changes approved in 2011.
New Mexico Educational Retirement Board	For employees earning $20k and more, increased employee contribution rate by 1.5% and reduced employer rate by same amount.	For new hires after 6/30/09: • Increased normal retirement eligibility from any age w/ 25 years of service to any w/ 30, from Rule of 75 to Rule of 80, and 65/5 to 67/5 Changes approved in 2009.
New Mexico PERA	Increased employee contribution rate by 1.5% and reduced employer rate by same amount.	For new hires after 6/30/10: • Increased normal retirement eligibility from any age w/ 25 years of service to any w/ 30. Retained retirement eligibility of Rule of 80 and 67/5 Changes approved in 2009.

System	Contribution Changes	Benefit & Actuarial Funding Changes
New York State & Local RS	Most new hires between 1/1/10 and 3/31/12 must now make contributions of 3% their entire career, instead of only the first 10 yrs. New hires as of 4/1/12 will make 3% contributions until 4/1/13, after which point the contribution % is based on the employee's earnings.	For new hires as of 1/1/10: • 10-year vesting, from 5 • Limit on use of OT in benefit calculation In addition, for new hires as of 4/1/12: • Increased final average salary period from 3 years to 5 Increased actuarial reduction for early retirement. Changes approved in 2009 and 2012.
New York State TRS	New hires between 1/1/10 and 3/31/12 must now make contributions of 3.5% their entire career, instead of only first 10 yrs. New hires as of 4/1/12 will make 3.5% contributions until 4/1/13, after which point the contribution % is based on the employee's earnings.	For new hires as of 1/1/10: • 10-year vesting, from 5 • Full retirement factor of 2.0% after 25 years of service, up from 20 • Normal retirement at age 57 with 30 years of service, up from age 55 • Limit on use of OT in benefit calculation In addition, for new hires as of 4/1/12: • Increased final average salary period from 3 years to 5 Increased actuarial reduction for early retirement Changes approved in 2009 and 2012.
North Dakota PERS	Increased employee and employer rates by 2% over 2 years beginning 1/1/12. Employee rates will rise to 6% and employer rates will reach 6.12%.	Changes approved in 2011.
North Dakota Teachers	Increased employee rates from 7.75% to 11.75%, in 2 increments of 2% each, effective 7/1/12 and 7/1/14. Raised employer rates from 8.75% to 12.75%. Employee and employer rates will return to 7.75% when funding level reaches 90%.	Changes approved in 2011.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Ohio PERS	None	• Members eligible to retire in 10 years or w/ 20 years of service will be eligible to retire at 1) 32 years of service; 2) age 52 w/ 31 years of service; or 3) age 66 w/ 5 years of service • All other members are eligible for full retirement at age 55 w/ 32 years of service or age 67 w/ 5 years of service • Law enforcement officers retiring in the next 5 years are eligible at age 48; all others are eligible at age 50 or 52 • Employees eligible to retire in 10 years or with 20 years of service see no change in benefit formula. All other employees will receive benefits based on a final average salary of the highest 5 years (up from 3 years) • Those set to retire in the next 5 to 10 years see no changes in benefit calculations. Others will receive 2.2% of final average salary for each year of service up to 35 years (up from 30 years). For each year of service above 35, 2.5% becomes the multiplier Changes approved in 2012.
Ohio State Teachers	Contribution rates will increase from 10% to 14% over the next four years	• After 8/1/15, benefits will be calculated for all members using the average of the highest 5 years of salary (up from the highest 3 years) • Changes to retirement eligibility will be phased in through 8/1/2026, at which time age 60 and 35 years of service will be required for normal retirement eligibility Changes approved in 2012.
Ohio School Employees	None	For employees with less than 25 years if service as if 8/1/17, eligibility to retire with full benefits is increased to age 67 w/ 10 years of service or age 57 w/ 30 years of service Changes approved in 2012.
Ohio Police & Fire	Contribution rates will rise incrementally over three years from 10% to 12.25% of salary	• For employees with less than 15 years of service as of 7/2/13, average annual salary will be based on an average of the highest 5 years of salary (up from the highest 3 years) • New employees are eligible to retire at age 52 w/ 25 years of service (up from age 48 w/ 25 years of service) • For new employees and employees w/ less than 15 years of service, the COLA is changed from 3% to the lesser of 3% or the CPI. The COLA is delayed until age 55 for all employees except survivors and permanent disabilitants Changes approved in 2012.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Oklahoma statewide plans	None	Raised normal retirement eligibility criteria for teachers and state employees. Also, requires provision of a funding source to fund future COLAs. Changes approved in 2011. (Required COLA funding provision is estimated to reduce OK PERS and TRS unfunded liabilities by roughly 30%.)
Pennsylvania Public Schools ERS	For new hires as of 7/1/11, reform bill establishes a "shared risk" provision that could result in higher future employee contribution rates, depending on fund investment performance, and creates a floor for employee rates at their present levels. Also, creates cap on amount employer rates may increase in any year.	For new hires as of 7/1/11: • Reduced retirement multiplier, from 2.5% to 2.0% • Permits option to retain 2.5% multiplier with employee contribution rate of 10.3%, rather than 7.5% current rate • 10-year vesting, up from 5 • Replaces retirement provision of any age with 65 years of age and 3 years of service (from 60/30, 62/3 or any/35); or 35 years of service with Rule of 92 • Imposed collars on the rate at which employer contributions may rise from year to year. Changes approved in 2010. Reform bill prohibits future use of pension obligation bonds to pay down unfunded pension liabilities.
Pennsylvania State ERS	For new hires as of 1/1/11, reform bill establishes a "shared risk" provision that could result in higher future employee contribution rates, depending on fund investment performance, and creates a floor for employee rates at their present levels. Also, creates cap on amount that employer rates may increase in any year.	For new hires as of 1/1/11: • Reduced retirement multiplier, from 2.5% to 2.0% • Permits option to retain 2.5% multiplier with employee contribution rate of 9.3%, rather than 6.25% current rate • 10-year vesting, up from 5 • Raises normal retirement age to 65 from 60, and to 55 from 50, depending on class • Replaces retirement provision of any age w/ 35 years of service with Rule of 92 • Prohibits payment of lump-sum withdrawals with interest for those who qualify for an annuity Imposed collars on the rate at which employer contributions may rise from year to year. Changes approved in 2010. Reform bill prohibits future use of pension obligation bonds to pay down unfunded pension liabilities.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Rhode Island	As part of new hybrid plan for most current participants, employee contributions will be split between the DB and DC components.	New hybrid effective 7/1/12 for current active members features a retirement multiplier of 1.0% with 5% employee contributions and 1% employer made to a DC plan. For teachers without Social Security, an additional 2% employee and 2% employer contribution. Also, revoked automatic COLA up to 3%, in lieu of risk-adjusted COLA targeting 2%, calculated as a 5-year smoothed investment return less 5.50% with a 0% floor and 4% cap, applied to first $25,000 of benefit, indexed. COLA delayed until later of SS NRA or 3 years after retirement. Changes were approved in 2011. A group of public employee unions has filed suit against the benefit reductions.
South Dakota RS	None	• New COLA format, affecting existing retirees, based on plan funding level • Eliminated first-year pro-rated COLAs • Reduced refunds of employer contributions Changes approved in 2010. New limits on return-to-work.
Texas ERS	None	For new hires, retirement eligibility increases to age 65 with 10 years of service, from 60/5. Changes approved in 2009.
Utah RS	Plan currently is non-contributory. New hybrid plan is projected to cost 7.5%. Employers will fund first 10% of the hybrid or DC plan. Difference between the cost of the hybrid and 10% is deposited into employees' DC account. If cost of the hybrid exceeds 10%, employees will pay the difference.	New hires as of 7/1/11 will have their choice of DC or hybrid, and employers will fund the first 10% of either. Employer liabilities for new hires as of 7/1/11 are effectively capped at 10% of pay. Changes approved in 2010.
Vermont SERS	Raised contribution rates for current employees from 5% to 6.3% from 7/1/11 through 6/30/16 (rates lowered to 5% if 100% funding is achieved before 6/30/16).	Changes approved in 2011.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Vermont TRS	Raises contributions for current employees from 3.54% to 5.0%.	For current teachers 5 years or more from normal retirement eligibility: • Raises normal retirement to 65 or Rule of 90, from 62 or any w/ 30 • Increases max benefit to 60% of Final average salary, from 50% • Increases multiplier for those w/ 20 years of service, to 2.0 from 1.67 Increases penalties for early retirement Changes approved in 2010. Also increases limits on maximum permissible benefit and includes anti-spiking provision.
Virginia RS	Beginning 1/1/14, employees hired on or after 1/1/10 will contribute 5%; 4% to the DB component and 1% to the DC component of the new hybrid plan. Employees may contribute up to 5% to the DC component, which would be matched at 3.5% by the employer.	For new hires as of 7/1/10: • New hybrid plan featuring a DB plan with a multiplier of 1.0% and mandatory participation in a DC plan • Normal retirement age tied to Social Security retirement age, up from age 65 • Lower auto-COLA based on the CPI • Final average salary period of 5 years, up from 3 Early retirement provisions revised commensurate with change in normal retirement eligibility Changes approved in 2012 and 2010.
Wyoming RS	Raised contribution rates for employers and employees, require that employees pay the additional amount of 1.43%.	For new hires as of 8/31/12: • Raised normal retirement eligibility from age 60 w/ 4 years of service to age 65 w/ 4 years of service • Reduced retirement multiplier to 2.0%, from 2.125% for the first 15 years of service and 2.25% for years thereafter • Increased final average salary period from highest 3 years to highest 5 years • No COLAs will be paid until the system is fully funded w/ an expectation that it remain so given expected market volatility. Changes approved in 2011 and 2010.

System	Contribution Changes	Benefit & Actuarial Funding Changes
Wyoming RS	Raised contribution rates for employers and employees, require that employees pay the additional amount of 1.43%.	For new hires as of 8/31/12: • Raised normal retirement eligibility from age 60 w/ 4 years of service to age 65 w/ 4 years of service • Reduced retirement multiplier to 2.0%, from 2.125% for the first 15 years of service and 2.25% for years thereafter • Increased final average salary period from highest 3 years to highest 5 years • No COLAs will be paid until the system is fully funded w/ an expectation that it remain so given expected market volatility. Changes approved in 2011 and 2010.

APPENDIX 4

LAURA AND JOHN ARNOLD FOUNDATION POLICY PERSPECTIVE

PENSION LITIGATION SUMMARY

LJAF POLICY PERSPECTIVE

Pension Litigation Summary

Stuart Buck, Ph.D., J.D.

LJAF Strategic Litigation Counsel and Director of Research

January 2013

Table of Contents

Introduction

State and municipal pension systems are in financial trouble. According to a 2012 Pew Center on the States report,[1] state pension plans estimate that they were collectively $757 billion short of the funding needed to meet the pension promises that had, as of that publication, been made to public employees. Moreover, that figure depends on a risky set of assumptions (*e.g.*, expected rate of return and life expectancy) and may be considerably larger if reality does not match the predictions made by each system. Estimates produced using more conservative assumptions, similar to those used for private sector pensions, approximately double the shortfall.[2]

Regardless of the exact size of projected deficits, rising annual pension costs have already spurred financial distress in many jurisdictions. For instance, Central Falls, Rhode Island, recently declared municipal bankruptcy because of unaffordable pension costs. In Chicago, Mayor Rahm Emanuel has pointed out that the city faces $20 billion in unfunded liabilities and will soon spend a staggering $1.2 billion per year solely on pension costs, or roughly 22 percent of Chicago's entire budget. As Mayor Emanuel stated, "Our taxpayers cannot afford to choose between pensions and police officers, or pensions and paved streets."

In light of looming deficits, states and municipalities across the country are taking steps to reform their pension systems. While some reforms are relatively modest, a few jurisdictions have enacted comprehensive reforms that aim to solve their pension problems permanently. Enacted reforms generally have addressed the following: cost-of-living adjustments, increases in retirement age and contribution rates, and establishment of defined contribution, cash balance and hybrid plans.

Once reforms occur, however, they are often challenged in the courts. Within the past three years, at least 24 jurisdictions have faced lawsuits alleging that pension reform measures are unconstitutional. Such jurisdictions include Colorado, Florida, Massachusetts, Minnesota, New Hampshire, New Jersey, New Mexico, Rhode Island, South Dakota, Chicago, San Diego, and San Jose.

The most significant legal claim raised against pension reform legislation is that it violates the Contracts Clause of the U.S. Constitution or a state's constitutional parallel (including additional provisions specifically protecting pension rights). In both the U.S. and state constitutions, such a clause provides that the government may not pass laws that abrogate contractual responsibilities. The argument of pension reform opponents is that a pension promise to a state employee is essentially a contract, and that legislation that diminishes pension benefits alters the terms of the state's contractual obligation to provide the agreed-upon remuneration to the employee.

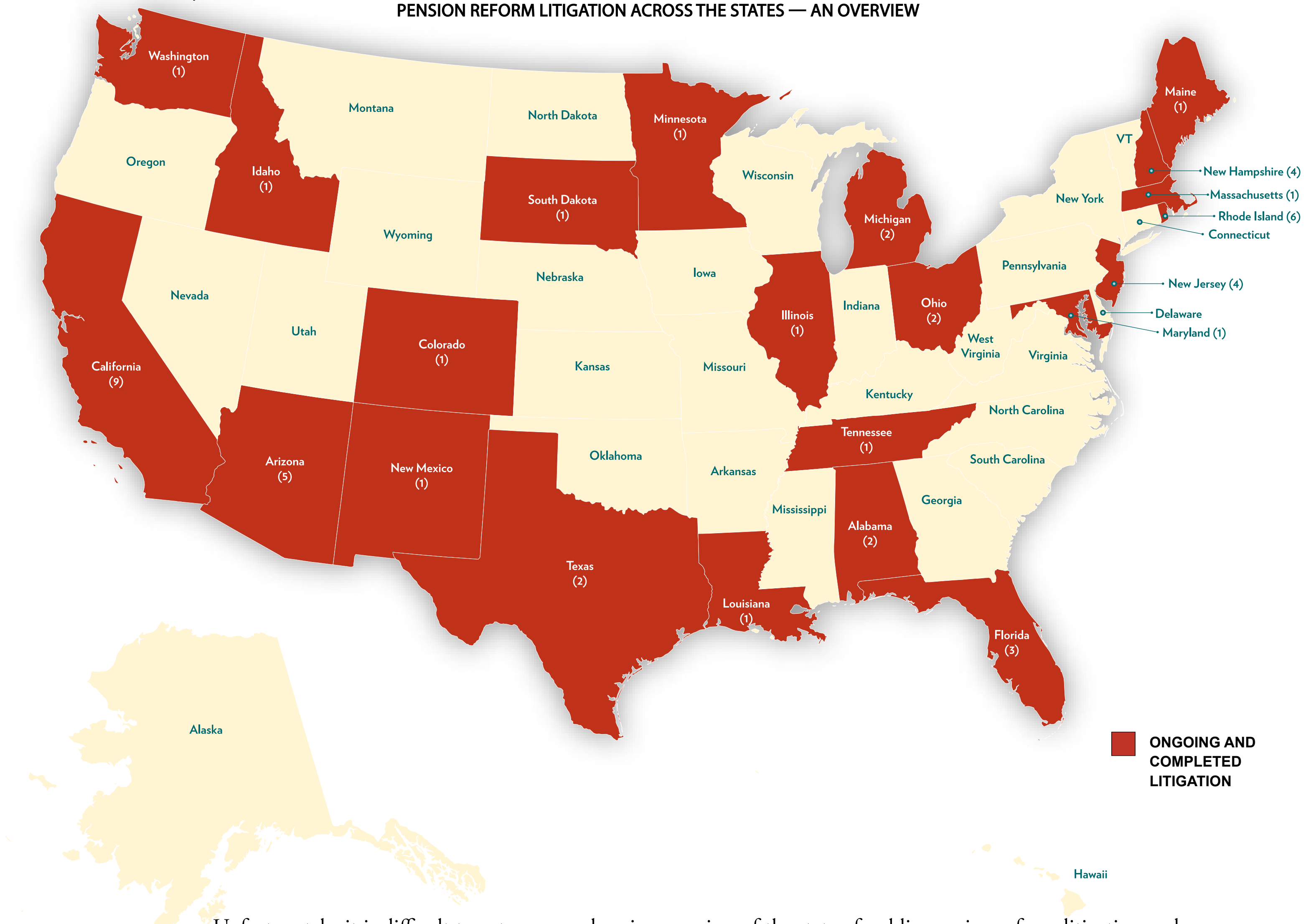
1 Pew Center on the States. (2012). *The Widening Gap: the great recession's impact on state pension and retiree health care costs.* Washington, DC.

2 Novy-Marx, R., & Rauh, J. (2011). Public Pension Liabilities: How Big Are They and What Are They Worth? *Journal of Finance, 66* (4), 1211-1249.

Courts have expressed a wide range of views on pension reform issues, at times arriving at diametrically opposite conclusions. For example, reductions of cost-of-living adjustments were upheld in Colorado, Minnesota, New Jersey, and South Dakota state courts, whereas the same adjustments were struck down in Arizona. Many other significant pension reforms, such as those in Rhode Island or the City of San Jose, California, are currently being litigated. To date, there is little to no definitive guidance or uniformity of interpretation on these matters, either at a state or federal level.

We are currently aware of 51 lawsuits that were filed or that were the subject of a court decision between 2009 and January 2013.

PENSION REFORM LITIGATION ACROSS THE STATES — AN OVERVIEW



Unfortunately, it is difficult to get a comprehensive overview of the state of public pension reform litigation and the many lawsuits around the country because court decisions and litigation documents are very difficult to find online. Many state courts do not have websites that make decisions (much less interim filings by the parties) publicly available, and federal court decisions are often unpublished and available only for a fee via the Public Access to Court Electronic Records system. The following state-by-state review addresses this informational problem.[3] This review represents a centralized resource that monitors the lawsuits and court decisions currently challenging public pension reform.

3 Where possible, we have provided links to actual court documents. Users can click on documents listed in the "Reference Document" box for each case.

Alabama

Taylor v. City of Gadsden

NO. 4:11-CV-03336

United States District Court for the Northern District of Alabama
Judge Virginia E. Hopkins
Filed 9/15/2011

REFERENCE DOCUMENTS:

- Complaint
- Amendment to Complaint
- Order on Motion to Dismiss

Type of Pension Reform: Increased employee contribution.

Title of Bill: HB 414

Date Enacted: 6/9/2011

Basis of Lawsuit: State and U.S. Contracts clauses.

Date of Initial Opinion: 2/23/2012

Outcome of Initial Opinion: Motion to dismiss was denied.

Reasoning: The Court held that the Alabama pension system did establish a contractual relationship and did not have to satisfy the "unmistakable" standard merely to survive a motion to dismiss. Next, the rise in employee contribution rates could possibly be a substantial impairment, because it was not accompanied by any countervailing benefit. The Court, therefore, let the lawsuit go forward to a trial on all of these issues.

Pending Developments: The most recent scheduling order provides that dispositive motions are due by December 14, 2012.

Wood v. Retirement System of Alabama

NO. NOT AVAILABLE

Montgomery County Circuit Court, Alabama
Filed 6/1/2012

Type of Pension Reform: Increased contributions for state judges from 6 percent to 8.5 percent.

Title of Bill: HB 414

Date Enacted: 6/9/2011

Basis of Lawsuit: State constitution prevents reducing judges' pay during their term of office.

Arizona

Barnes v. Arizona State Retirement System

NO. CV-2011-011638

Superior Court of Arizona, Maricopa County
Judge Eileen S. Willett
Filed 7/13/2011

REFERENCE DOCUMENTS:

Court Decision

Type of Pension Reform:	Increased employee contribution.
Title of Bill:	SB 1614
Date Enacted:	4/6/2011
Basis of Lawsuit:	State Contracts Clause and pension protection clause.
Date of Initial Opinion:	2/3/2012
Outcome of Initial Opinion:	Ruling in favor of plaintiffs.
Reasoning:	Given the Arizona constitutional provision stating that pension benefits cannot be diminished or impaired, it was illegal to make employees pay more for a benefit than they had paid when first starting employment. The impairment was substantial and lacked any public purpose.
Pending Developments:	None. As of May 7, 2012, state lawmakers in Arizona enacted House Bill 2264 to reverse the contribution rate change and mandated a refund of the excess contributions.

Fields v. Elected Official Retirement Plan of the State of Arizona

NO. CV-2011-017443

Superior Court of Arizona, Maricopa County
Judge Robert Oberbillig
Filed 9/22/2011

REFERENCE DOCUMENTS:

Court Decision

Type of Pension Reform:	Reduced cost-of-living adjustment.
Title of Bill:	HB 1609
Date Enacted:	4/29/2011
Basis of Lawsuit:	State Contracts Clause and pension protection clause.
Date of Initial Opinion:	5/21/2012 and 8/302012
Outcome of Initial Opinion:	Declaratory ruling in favor of plaintiffs, followed by a later injunction that ordered the state to transfer funds into a reserve for future benefit increases and to pay retirement benefits based on the previous law.

Reasoning: The Arizona Constitution (Article XXIX, section 1(c)) provides that "public retirement benefits shall not be diminished or impaired." In this case, the plaintiffs had all already retired, had "fully performed every condition for a benefit," and "the benefits that Plaintiffs are vested in are plainly the benefits in effect at the time of their retirement." Thus, reducing cost-of-living adjustments thereafter was not allowed.

Pending Developments As of November 12, 2012, the Arizona Court of Appeals docketed an appeal with opening briefs due on December 24, 2012. The State plans to ask for the appeal to be transferred to the Arizona Supreme Court.

Hall v. Elected Officials' Retirement Plan

NO. CV-2011-021234

Superior Court of Arizona, Maricopa County
Judge John A. Buttrick
Filed 11/30/2011

Type of Pension Reform: Reduced cost-of-living adjustment.

Title of Bill: HB 1609

Date Enacted: 4/29/2011

Basis of Lawsuit: Two Arizona appellate judges sued on behalf of all Arizona state judges based on the state Contracts Clause and pension protection clause, but also based on the Arizona Constitution's judicial salary clause.

Pending Developments Motions for summary judgment were filed on November 7, 2012, and oral argument will be heard on February 11, 2013.

Rappleyea v. Public Safety Personnel Retirement System

NO. CV-2012-000404

Superior Court of Arizona
Judge Randall H. Warner
Filed 1/11/2012

Type of Pension Reform: Reduced cost-of-living adjustment.

Title of Bill: HB 1609

Date Enacted: 4/29/2011

Basis of Lawsuit:	This case challenged SB 1609's amendment to the benefit increase mechanism for the public safety personnel pension system. It relies on the Arizona and federal Contracts clauses and the Arizona retirement benefits clause.
Pending Developments	Briefing on motions for summary judgment were completed on December 14, 2012.

Parker v. Public Safety Personnel Retirement System

NO. CV-2012-000456

Superior Court of Arizona
Judge John Rae
Filed 1/12/2012

Type of Pension Reform:	Reduced cost-of-living adjustment.
Title of Bill:	HB 1609
Date Enacted:	4/29/2011
Basis of Lawsuit:	This complaint represented a class of all active law enforcement officers, and is duplicative of the Rappleyea suit above.
Pending Developments	Court has set a hearing on summary judgment for April 26, 2013.

California

SAN DIEGO

San Diego Municipal Employees Association v. City of San Diego

NO. LA-CE-746-M

California Public Employment Relations Board
Filed 6/19/2012

REFERENCE DOCUMENTS:

Proposition B

Type of Pension Reform: Froze pay levels used to determine final average pay; required defined contribution plan for most new employees.

Title of Bill: Ballot Initiative-Proposition B

Date Enacted: 6/16/2009

Basis of Lawsuit: Unfair labor practice.

Pending Developments Post-hearing briefs have been filed, and the state agency will issue an initial opinion soon.

Public Employment Relations Board v. City of San Diego

NO. 37-2012-00092205-CU-MC-CTL

San Diego Superior Court
Judge Luis Vargas
Filed 2/14/2012

REFERENCE DOCUMENTS:

Petition for Writ of Mandate
Minute Order

Type of Pension Reform: Froze pay levels used to determine final average pay; required defined contribution plan for most new employees.

Title of Bill: Ballot Initiative-Proposition B

Date Enacted: 6/5/2012

Basis of Lawsuit: State union law allegedly requiring negotiation with unions before such a ballot measure could be enacted.

Date of Initial Opinion: Not Available

Outcome of Initial Opinion: Stayed administrative proceedings before the Public Employment Relations Board, which had taken jurisdiction over a labor union complaint that the ballot measure was improperly enacted.

Reasoning: No reasoning given.

Date of Appellate Decision: 6/19/2012

Outcome of Appeal: Appellate court overturned the lower court's stay.

Reasoning: The Public Employment Relations Board does have jurisdiction to consider labor complaints. Nor is administrative exhaustion waived.

Date of Subsequent Opinion: 7/31/2012

Outcome: On July 10, 2012, Judge Vargas of the Superior Court issued a temporary restraining order requiring a "temporary delay" in implementing the pension ballot initiatied. Then, on July 31, 2012, Judge Vargas lifted the order and rejected a preliminary injunction against the ballot measure.

Reasoning: Injunctive relief required the court to determine that it is "just and proper" to interfere with the law. The Court chose to exercise discretion to deny relief, because "traditional equitable considerations now weight in favor of the voters, the City of San Diego and of a proper and orderly implementation of the [pension measure]." (Minute Order).

Later Outcome: On October 25, 2012, PERB voluntarily dismissed the case that it had filed as a plaintiff in state court.[4]

SAN JOSE

REFERENCE DOCUMENTS:

- Measure B
- AFSCME Complaint
- Firefighters Complaint
- Harris Complaint
- Mukhar Complaint
- Police Officers' Association Complaint
- City's Federal Complaint
- Federal Court Dismissal

CITY LAWSUIT:

City of San Jose v. San Jose Police Officers' Association | NO. 12-CV-02904

United States District Court for the Northern District of California
Judge Lucy H. Koh
Filed 6/5/2012

UNION LAWSUITS:

Sapien v. City of San Jose | NO. 112-CV-225928
San Jose Police Officers' Association v. City of San Jose | NO. 112-CV-225926
Mukhar v. City of San Jose | NO. 112-CV-226574
Harris v. City of San Jose | NO. 112-CV-226570
American Federation of State, County, and Municipal Employees, Local 101 v. City of San Jose | NO. 112-CV- 227864

Santa Clara County Superior Court
Judge Patricia M. Lucas
Filed 6/5/2012 and 6/6/2012 and 6/14/2012

Type of Pension Reform: Raised employee contribution rates to pay for unfunded liabilities, lowered cost-of-living adjustments for retirees, changed definition of disability pension, and created a "voluntary election program" that allowed employees to opt into a lower level of benefits for a lower contribution rate.

---

4 See www.cbs8.com/story/19919444/perb-drops-lawsuit-over-prop-b

California

Title of Bill:	Ballot Initiative-Measure B
Date Enacted:	6/5/2012
Basis of Lawsuit:	The state court lawsuits, which have been consolidated, make a variety of claims under the California Constitution and California labor and employment laws.
Pending Developments:	The city voluntarily dismissed its own lawsuit on October 1, 2012, because a separate federal declaratory judgment would not have precluded the state court from issuing a judgment on state law grounds.

Colorado

Justus v. State of Colorado

NO. 2010-CV-1589

Second Judicial District Court, Denver County District
Judge Robert S. Hyatt.
Filed 11/19/2010

REFERENCE DOCUMENTS:

- Court Order
- Notice of Appeal
- Appellate Opinion
- Court Decision

Type of Pension Reform:	Reduced cost-of-living adjustment for current retirees.
Title of Bill:	SB 10-001
Date Enacted:	2/23/2010
Basis of Lawsuit:	Plaintiffs alleged that the cost-of-living adjustments reduction violated the U.S. Constitution's Contracts Clause, Takings Clause, and Due Process Clause.
Date of Initial Opinion:	6/29/2011
Outcome of Initial Opinion:	Grant of summary judgment to the state of Colorado and rejection of plaintiffs' claims.
Reasoning:	"Plaintiffs concede that Colorado requires a clear intent to create an enforceable contract right and yet, the various Public Employees Retirement Association (PERA) and DPS COLA provisions contain no durational language of any kind or language suggesting that a contract has been created...None of the PERA or DPS COLA provisions over that 40 years contain language establishing a lifetime right to any particular COLA formula at retirement and no ambiguity exists as to the legislature's ability to constantly modify the COLA provisions for existing retirees." (Court Decision).[5]
Date of Appellate Opinion:	10/11/2012
Outcome of Appeal:	Reversed and remanded.
Reasoning:	The appellate court reasoned that plaintiffs do have a contractual right to some cost-of-living adjustments, but the lower court must determine whether the impairment is substantial, and if so, whether the reduction was necessary to serve a significant public purpose.

5 See www.saveperacola.com/resources/.

Florida

Williams v. Scott

NO. 2011-CA-1584

Circuit Court of the Second Judicial Circuit, Leon County
Judge Jackie L. Fulford
Filed 6/20/2011

REFERENCE DOCUMENTS:

Complaint

Summary Judgment Ruling

Type of Pension Reform: Increased contribution for employees and cost-of-living adjustment suspension.

Title of Bill: SB 2100

Date Enacted: 5/26/2011

Basis of Lawsuit: Plaintiffs challenged a new 3 percent employee contribution, and a reduction in cost-of-living adjustments earned for new service. The complaint alleged violations of the state constitution's Contracts Clause, Takings Clause, and the right to collectively bargain.

Date of Initial Opinion: 3/6/2012

Outcome of Initial Opinion: The new employee contribution and cost-of-living adjustments elimination are unconstitutional. Defendants must reimburse Florida Retirement System (FRS) participants for any funds withheld from them.

Reasoning: "The changes at issue here...are qualitative changes to the plan...FRS members have had continous, unconditional rights to a noncontributory plan with a cost-of-living adjustments since the inception of FRS; these elements are not related to future state service...this court is bound to follow the express language of section 121.011 (3)(d), Florida Statutes. This provision cannot be read as allowing the legislature to redefine established, unconditional contractual rights...as suddenly tied to Years of Service and thereby altogether eliminated in the future. Such a reading would render the express contract...wholly illusory." (Summary Judgment Ruling).

Pending Developments: Hearing before the Florida Supreme Court ocurred September 7, 2012. Decision expected December 2012. The Florida Supreme Court docket is No.SC12-520.[6]

6 See www.jweb.flcourts.org/pls/docket/ds_docket?p_caseyear=2012&p_casenumber=520&psCourt=FSC&psSearchType=.

Florida

MIAMI

Fraternal Order of Police, Miami Lodge 20 v. City of Miami

NO. 10-47918-CA-13.

Eleventh Judicial Circuit, Miami-Dade County
Judge Gerald Trawick
Filed 9/1/2010

REFERENCE DOCUMENTS:

Amended Complaint

Type of Pension Reform: Reduced pension rights.

Title of Bill: Ordinance 10-10901

Date Enacted: 8/31/2010

Basis of Lawsuit: The plaintiffs are not challenging the pension ordinance directly, but rather the Florida Statute (§447.4095) giving the city authority to declare a "financial urgency" that creates an "impasse" for collective bargaining purposes. The plaintiffs allege that this statute violates various Florida constitutional provisions on collective bargaining rights, due process, equal protection, contracts, and is unconstitutionally vague as well.

MIAMI BEACH

City of Miami Beach v. Board of Trustees of the City Pension Fund for Firefighters and Police Officers in the City of Miami Beach

NO. 3D11-2974.

Miami-Dade County Circuit Court
Filed 11/17/2011

REFERENCE DOCUMENTS:

Appellate Opinion

Type of Pension Reform: Lowered future accruals and raised retirement age.

Title of Bill: Not Applicable

Date Enacted: 11/1/2010

Basis of Lawsuit: The pension board refused to implement pension reductions adopted by the city in a collective bargaining agreement on the theory that a voter referendum was required before pension benefits could be lowered.

Date of Initial Opinion: 8/5/2011

Outcome of Initial Opinion: Held in favor of pension board.

Reasoning: Florida statutes require that changes to laws affecting municipal employees be submitted to a referendum of the voters.

Date of Appellate Opinion: 6/27/2012

Florida

Outcome of Appeal:	The Third District Court of Appeals, Docket no. 3D11-2974, held in favor of the city.
Reasoning:	State constitution protects collective bargaining. To require the submission of collective bargaining agreements to voter referendum would undermine this right.

Idaho

Idaho Education Association v. State of Idaho

NO. CVOC-1108212.

Fourth Judicial District, County of Ada
Judge Timothy Hansen
Filed 4/27/2011

REFERENCE DOCUMENTS:

- Complaint
- Decision and Order

Type of Pension Reform: Repealed early retirement incentive for teachers and held that all collective bargaining agreements would expire on June 30, 2011.

Title of Bill: SB 1108

Date Enacted: 3/17/2011

Basis of Lawsuit: Plaintiffs alleged that the restrictions violated the Idaho Constitution's Contracts Clause and single-subject rule.

Date of Initial Opinion: 9/28/2011

Outcome of Initial Opinion: Grant of summary judgment to the State of Idaho.

Reasoning: The provisions all were related directly or indirectly to the same subject: employment of teachers. As for the Contracts Clause: the mere availability of a "one-time incentive" for early retirement did not show "legislative intent to create a contractual right enforceable against the State."

The nullification of all collective bargaining agreements (in a separate section) did impair contracts as an initial matter, but the impairment was justified by important public purposes: creating efficiency and accountability within Idaho's public school system, returning power to local school boards, helping to maintain a "uniform and thorough system of free public education." (Decision and Order).

Unknown as of yet (parties include Chicago Teachers Union, IBEW Local 9, and Laborers' Local 1001).

Cook County Circuit Court
Filed 10/9/2012

Type of Pension Reform:	Limited the ability of state employees to take a leave of absence to work for a labor union but to then receive a higher pension based on the union salary rather than the public employment salary.
Title of Bill:	HB 3813
Date Enacted:	1/5/2012

Louisiana

Retired State Employees Association vs. State of Louisiana

NO. 614675

19th Judicial District Court Baton Rouge
Filed 8/16/2012

REFERENCE DOCUMENTS:

Complaint

Type of Pension Reform:	Established a cash balance plan for new employees.
Title of Bill:	HB 61
Date Enacted:	6/5/2012
Basis of Lawsuit:	The plaintiffs alleged that the Legislature failed to have an actuarial valuation, improperly charges existing members for transition costs to the new system, and failed to be passed by a two-thirds majority, all in violation of the state constitution.

Maine

Maine Association of Retirees v. Board of Trustees of the Maine Public Employee Retirement System

NO. 1:12-CV-00059

United States District Court for the District of Maine
Judge Nancy Torresen
Filed 2/13/2012

REFERENCE DOCUMENTS:

Complaint

Type of Pension Reform:	Reduced cost-of-living adjustments.
Title of Bill:	LD 1043
Date Enacted:	6/20/2011
Basis of Lawsuit:	Plaintiffs alleged that the cost-of-living adjustments reduction violated the U.S. Constitution's Contracts Clause and Takings Clause.
Pending Developments:	As of an October 24, 2012, scheduling order, discovery will be completed by March 27, 2013, and the expected trial date is August 5, 2013.

Maryland

BALTIMORE

Cherry, Jr. v. Mayor and City Council of Baltimore City

NO. 1:10-CV-01447.

United States District Court for the District of Maryland
Judge Marvin J. Garbis
Filed 6/3/2010

REFERENCE DOCUMENTS:

Court Decision

Court Decision on Substantial Impairment

Type of Pension Reform: Reduced cost-of-living adjustments.

Title of Bill: City Ordinance 100-306

Date Enacted: 6/10/2010

Basis of Lawsuit: Plaintiff alleged that the new law violated the U.S. Contracts Clause.

Date of Initial Opinion: 9/6/2011

Outcome of Initial Opinion: The elimination of future "variable benefit" increases (by which employees shared in investment returns that were above expectations) was a "substantial impairment" in some cases. Moreover, this was not a reasonable and necessary way to serve an important public purpose.

Reasoning: **The September 6, 2011, decision:**

The Court did not find an actual Contracts Clause violation yet. Its only holding was about whether a "substantial impairment" had occurred, not whether the impairment was justified.

The Court's holding was in three parts: 1) plaintiffs who had retired were eligible to keep receiving new variable benefit increases in accordance with the terms of their pension plans; 2) plaintiffs who were eligible to retire but were still working could receive variable benefit increases based on past service, but not new variable benefit increases; 3) plaintiffs who were not yet eligible to retire had not suffered any impairment at all.

The September 20, 2012, decision:

This decision considered whether the impairment was "reasonable and necessary to serve an important public purpose."

The Court said that ensuring financial stability is indeed an "important public purpose." But reducing the variable benefit in such a fashion was not "necessary" that is, the "impairment far more drastically impaired the contractual rights of some Plan members than others while a perfectly evident, more moderate and even-handed course would have served its purposes equally well." (pp. 27-28). The Court said that the "choice to use the Tiered cost-of-living adjustments instead of an equally applied cost-of-living adjustments of something less than 2 percent, takes substantially from beneficiaries under 65 years of age on the effective date of the Ordinance to give more to the benefiticaires who were age 65 or more at that time." Thus, the Court struck down the legislation.

Pending Developments: On October 24, 2012, the Court entered an order referring the case (in which state law claims remain undecided) to a magistrate judge for a settlement conference. On October 29, 2012, the city filed a memorandum asking the Court to decide various issues of severability.

Massachusetts

Boston Police Superior Officers Federation v. Patrick

NO. 1:09-CV-11137

United States District Court for the District of Massachusetts
Judge Nathaniel M. Gorton
Filed 7/2/2009

REFERENCE DOCUMENTS:

Complaint

Type of Pension Reform:	Redefined of earnable compensation to prevent benefit spiking.
Title of Bill:	SB 2079
Date Enacted:	6/16/2009
Basis of Lawsuit:	Plaintiffs alleged that the new law violated state and U.S. Contracts clauses.
Date of Initial Opinion:	Not Applicable
Outcome of Initial Opinion:	Not Applicable
Reasoning:	In 2010, the Massachusetts state supreme court issued a ruling holding that certain extra allowances were not part of base compensation in the first place. The parties ultimately agreed to dismiss the lawsuit on May 26, 2011.

Michigan Coalition of State Employee Unions v. State of Michigan

NO. 12-117-MM

State of Michigan Court of Claims
Judge Joyce Draganchuk
Filed 2/13/2012

REFERENCE DOCUMENTS:

- Complaint
- Appellate Order
- Opinion from Court of Claims

Type of Pension Reform:	Raised contribution rate for employees who don't switch to 401(k) plan, replaced retiree health insurance for new employees with a 401(k)-style plan, using six-year average of overtime pay to calculate benefits.
Title of Bill:	HB 4701
Date Enacted:	12/15/2011
Basis of Lawsuit:	Violation of Article XI, Section 5 of the Michigan Constitution for enacting benefit changes without approval or consent from the Michigan Civil Service Commission.
Date of Initial Opinion:	9/25/2012
Outcome of Initial Opinion:	Grant of summary judgment to plaintiffs.
Reasoning:	The Michigan Constitution specifies that the Civil Service Commission has power to "fix rates of compensation for all classes of positions . . . and regulate all conditions of employment." Court therefore agreed with plaintiffs that the "Legislature can neither regulate the conditions of employment in the classified civil service nor fix rates of compensation." Moreover, in a recent case, the Michigan Court of Appeals struck down a 3 percent contribution to retiree health care on precisely these grounds (AFSCME Council 25 v. State Employees Ret. Sys., 294 Mich. App. 1 (2011)).

Not Available

NO. NOT AVAILABLE

30th Judicial Circuit, Ingham County
Judge Rosemaria Aquilina
Filed 9/4/2012

Type of Pension Reform:	Required public school employees to select among the following: increase employee contributions, accept a lesser pension, or freeze their defined benefit pension and switch to a defined contribution plan for future accruals.
Title of Bill:	SB 1040
Date Enacted:	9/4/2012

Michigan

Date of Initial Opinion: 9/4/2012

Outcome of Initial Opinion: On September 4, 2012, the day of enactment, the judge was reported to have granted a temporary restraining order in two lawsuits filed by the Michigan Education Association and by American Federation of Teachers/Michigan, respectively.[7]

Pending Developments: On September 26, 2012, the Michigan Court of Appeals granted a motion for an expedited appeal of the lower court's temporary restraining orders and set a briefing schedule to be completed within 56 days of the order.

7 See www.mea.org/mea-aft-score-wins-against-sb-1040

Minnesota

Swanson v. State of Minnesota

NO. 62-CV-10-05285.

Second Judicial District Court, Ramsey County
Judge Gregg Johnson
Filed 7/2/2010

REFERENCE DOCUMENTS:

Complaint

Court Opinion

Type of Pension Reform: Reduced cost-of-living adjustments.

Title of Bill: SF 2918

Date Enacted: 5/22/2009 for 2009 legislation and 5/10/2010 for 2010 legislation

Basis of Lawsuit: Plaintiffs alleged that cost-of-living adjustment reductions violated the state and U.S. Constitution's Contracts clauses and Takings clauses.

Date of Initial Opinion: 6/29/2011

Outcome of Initial Opinion: Grant of summary judgment to the state of Minnesota and rejection of plaintiffs' claims.

Reasoning: "First, statutes are not contracts absent plain and unambigous terms that show an intent to contract. To decide otherwise risks a serious intrusion into the Legislature's policymaking authority... In the end, the balance achieved fully preserved retirees' pension annuities, provided for annual adjustments to those annuitites, and stabilized the financial deterioration that threatened Minnesota's public pension Plans. There is no legal or equitable reason for the judiciary to interfere with this legislative policy decision... Finally, Plaintiffs' claims fail because they rest on a fundamental disagreement with the Legislature's policy choices...this is not a debate for the Court to join...the Court would threaten the balance of powers between the legislative and judicial branches by second-guessing this legislative wisdom." (Court Opinion).

Pending Developments: No appeal has been filed.[8]

8 See www.macsnc.courts.state.mn.us/ctrack/publicLogin.jsp

New Hampshire

American Federation of Teachers v. State of New Hampshire

NO. 09-E-0290

State of New Hampshire, Merrimack County Superior Court
Judge Larry M. Smukler
Filed 8/1/2009

REFERENCE DOCUMENTS:

Amended Complaint

Type of Pension Reform:	Recalculated cost-of-living adjustments and redefined compensation.
Title of Bill:	HB 653 and HB 1645
Date Enacted:	6/29/2007 and 6/30/2008
Basis of Lawsuit:	Plaintiffs alleged that the law violated the U.S. Constitution's Contracts Clause, Takings Clause, and Due Process Clause, and the state constitution's Contracts Clause.
Date of Initial Opinion:	7/30/2012
Outcome of Initial Opinion:	The parties jointly moved for an interlocutory transfer without ruling, based on the fact that the same court's ruling in the Firefighters case (No. 2011-CV-385) was dispositive.
Pending Developments:	The New Hampshire Supreme Court declined the interlocutory appeal on September 26, 2012. The parties' briefs in the lower court were due on December 14, 2012. [9]

9 See www.molanmilner.com/cases_to_follow

New Hampshire

Cloutier v. State of New Hampshire

NO. 219-2009-CV-00525.

State of New Hampshire Strafford County Superior Court
Judge Kenneth C. Brown
Filed 9/14/2009

REFERENCE DOCUMENTS:

- Court Decision
- Supreme Court Decision

Type of Pension Reform:	Limited benefits to 75 percent of compensation at time of retirement.
Title of Bill:	HB 671
Date Enacted:	7/21/2003
Basis of Lawsuit:	The plaintiffs alleged that the limitation on retirement benefits violated the state constitution's Contracts Clause.
Date of Initial Opinion:	10/14/2010
Outcome of Initial Opinion:	Grant of plaintiffs' motion for summary judgment.
Reasoning:	"The Court finds that although the legislature's intent is unclear from the statutory language itself, the plaintiff's retirement benefits vested when they became permanent employees."…"The previous statutory scheme clearly allowed for the calculation of retirement benefits based on the most recent adjustments in judicial salaries. Thus, the plaintiffs would receive benefits calculated to include raises, COLA's and any other adjustments experienced by the judges who were active post-plaintiffs retirement date. RSA 100 C changes that calculation...the new statute bases the retired judges' benefits on the amount that they had been getting paid at the time each retired… The difference between the parties' calculations, regardless of their dollar amount, is clearly an impairment of the plaintiffs' vested rights under the previous statutory benefit." (Court Decision).[10]
Date of Appellate Opinion:	3/30/2012
Outcome of Appeal:	The New Hampshire Supreme Court upheld one aspect of the trial court's decision but reversed and remanded to reconsider the substantiality question.
Reasoning:	The New Hampshire Supreme Court agreed that pensions are contractual in nature. It disagreed, however, that the limitation here was necessarily substantial. It sent the case back to the trial court to determine "whether the contractual impairment is offset by any compensating benefits." (Court Decision).

10 See www.molanmilner.com/cases_to_follow

REFERENCE DOCUMENTS:

Complaint

Professional Firefighters of New Hampshire v. State of New Hampshire

NO. 217-2011-CV-385.

Superior Court of Merrimack
Judge Richard B. McNamara
Filed 6/29/2011

Type of Pension Reform:	Increased employee contribution.
Type Bill:	HB 2
Date Enacted:	6/29/2011
Basis of Lawsuit:	The plaintiffs alleged that the contribution-rate increase violated the U.S. and New Hampshire Contracts and Takings clauses. The plaintiffs also relied on various New Hampshire constitutional provisions, such as one requiring taxes to be "proportional and reasonable," and one requiring the use of "sound actuarial valuation and practice." (Complaint).
Date of Initial Opinion:	1/6/2012
Outcome of Initial Opinion:	Dismissal, with leave to amend.
Reasoning:	The plaintiffs' claim as to actuarial valuation was dismissed, as they had no economic stake in the matter. Their benefits would be paid regardless. The plaintiffs' claim concerning unfair taxation was also dismissed because their contribution rate was a fee paid into a fund, not a tax used for general revenue. The contribution-rate increase was a substantial violation for employees who had satisfied the 10-year vesting requirement. Nonetheless, the plaintiffs failed to allege that they had met that requirement. The Court dismissed this claim as well, with leave to amend the complaint within 30 days.
Pending Developments:	Plaintiffs amended complaint on February 24, 2012, and the state moved to dismiss on March 22, 2012. Then, on July 24, 2012, the parties all jointly filed an interlocutory appeal with the New Hampshire Supreme Court. That appeal was denied. At the lower court, the parties will have a "case structuring conference" on January 17, 2013, to set dates for discovery and other matters.[11]

11 See www.molanmilner.com/cases_to_follow

New Hampshire

Professional Firefighters of New Hampshire v. State of New Hampshire

NO. 216-2012-CV-00193

Superior Court of Hillsborough
Judge Gillian L. Abramson
Filed 2/29/2012

REFERENCE DOCUMENTS:

Court Decision

Type of Pension Reform: Limited earnable compensation by excluding vacation and sick pay, increasing final average salary calculation period to five years, lowering the maximum benefit, increasing age requirement, reducing the multiplier from 2.5 percent to 2.1 percent, and repealing an accidental disability exception.

Type of Bill: HB 2

Date Enacted: 6/29/2011

Basis of Lawsuit: U.S. and New Hampshire Contracts and Takings clauses.

Date of Initial Opinion: 9/25/2012

Outcome of Initial Opinion: The judge transferred the case to the New Hampshire Supreme Court for an interlocutory appeal.

Reasoning: Similar cases are pending before the New Hampshire Supreme Court.

Pending Developments: With the lower court's approval, the parties filed an interlocutory appeal with the New Hampshire Supreme Court on December 10, 2012.[12]

12 See www.molanmilner.com/cases_to_follow

New Jersey

DePascale v. State of New Jersey

NO. NOT AVAILABLE

Superior Court, Mercer County
Judge Linda Feinberg
Filed 7/21/2011

REFERENCE DOCUMENTS:

Court Brief

Supreme Court Syllabus

Type of Pension Reform:	Increased contribution rates for judges.
Title of Bill:	S 2937
Date Enacted:	6/28/2011
Basis of Lawsuit:	Requiring higher contributions from sitting judges was unconstitutional.
Date of Initial Opinion:	10/26/2011
Outcome of Initial Opinion:	Judge ruled that state judges do not have to pay higher contribution rates.[13]
Reasoning:	State constitution prevents judges from having their salaries diminished while in office.
Date of Appellate Opinion:	7/24/2012
Outcome of Appeal:	In Docket 69,401, the New Jersey Supreme Court issued a ruling striking down pension reform as applied to judges.
Reasoning:	The constitution prohibits the Legislature from diminishing the salaries of judges not other public employees. Increasing contribution rates for judges would essentially diminish their salaries by up to $17,000 a year, and this is unconstitutional.

New Jersey Education Association v. State

NO. 11-5024

United States District Court for the District of New Jersey
Judge Anne E. Thompson
Filed 8/31/2011

REFERENCE DOCUMENTS:

Court Opinion

Type of Pension Reform:	Reduced cost-of-living adjustment and increased employee contribution rate.
Title of Bill:	S 2937
Date Enacted:	6/28/2011
Basis of Lawsuit:	U.S. Contracts Clause.

13 See www.nj.com/news/index.ssf/2011/10/judge_nixes_christie_request_t.html.

New Jersey

Date of Initial Opinion: 3/5/2012

Outcome of Initial Opinion: Dismissal of lawsuit.

Reasoning: The Court held that because the plaintiffs were asking for a return of contributions, their complaint violated the U.S. Constitution's 11th Amendment, which has been interpreted by the Supreme Court to disallow lawsuits against state governments for retrospective money damages.

Pending Developments: Plaintiffs filed a state court lawsuit based on the same claims, on March 29, 2012 (see below).

Berg v. Christie

NO. MER-L-2996-11.

Superior Court, Mercer County
Judge Hurd
Filed 12/2/2011

REFERENCE DOCUMENTS:

State Brief

Type of Pension Reform: Reduced cost-of-living adjustment.

Title of Bill: S 2937

Date Enacted: 6/28/2011

Basis of Lawsuit: Breach of contract, violation of the state Contracts Clause and due process, violation of the New Jersey Civil Rights Act.

Date of Initial Opinion: 5/29/2012

Outcome of Initial Opinion: Judge made an oral decision that plaintiffs are not entitled to cost-of-living adjustments on retirement.[14]

Pending Developments: New Jersey unions plan to appeal.[15]

14 See www.nj.com/hudson/voices/index.ssf/2012/05/daily_poll_should_retired_publ.html. The entire hearing is available via YouTube at http://www.youtube.com/watch?v=R8SDi5uIqhU&feature=youtu.be

15 See www.nj.com/hudson/voices/index.ssf/2012/05/daily_poll_should_retired_publ.html

New Jersey

New Jersey Education Association v. State

NO. MER-L-771-12

Superior Court, Mercer County
Judge Mary Jacobson
Filed 3/29/2012

REFERENCE DOCUMENTS:

Complaint

Type of Pension Reform:	Increased contribution for employees and impairment of retiree medical benefits.
Title of Bill:	S 2937
Date Enacted:	6/28/2011
Pending Developments:	Case is still pending. Union plaintiffs withdrew cost-of-living adjustment complaints from this case and joined those complaints in the separate *Berg* case.

New Mexico

AFSCME v. State of New Mexico

NO. CV-2009-7148.

Second Judicial District Court, County of Bernalillo
Filed 6/15/2009

REFERENCE DOCUMENTS:

Complaint

Type of Pension Reform:	Increased contribution rate.
Title of Bill:	HB 854
Date Enacted:	4/7/2009
Basis of Lawsuit:	Plaintiff argued that increases in employee contributions and reductions in employers' contributions are unconstitutional as they violate Article XX, §22 (A) of the New Mexico Constitution by modifiying benefits for the purpose of funding the State budget and not enhancing or preserving the actuarial soundness of the retirement plans. Plaintiffs argued impairment of contract, undue taxation, and property right in vested benefits.

Ohio

CINCINNATTI

Sunyak v. City of Cincinnati, NO. 11-CV-445 consolidated with Harmon et al. v. City of Cincinnati, NO. 1:12-CV-329

U.S. District Court for the Southern District of Ohio
Judge Michael R. Barrett
Filed 7/1/2011

REFERENCE DOCUMENTS:

Complaint

Class Action Complaint (Harmon)

Type of Pension Reform:	Increased retirement age to 60, put multiplier at 2.2 percent or 2.0 percent for service after 30 years; and lowered cost-of-living adjustment to 2 percent.
Title of Bill:	Ordinance No. 84-2011
Date Enacted:	3/16/2011
Basis of Lawsuit:	Plaintiffs contended the changes violated the U.S. Contracts Clause, substantive due process, procedural due process, the Takings Clause, the Ohio Contracts Clause, and Ohio common law causes of action for breach of contract and breach of fiduciary duty.
Pending Developments:	Consolidated Amended Complaint due by October 1, 2012. Discovery due by March 1, 2013. Motions due by April 1, 2013. Final Pretrial Conference September 2013. Jury Trial October 2013.

CINCINNATTI

Bock v. City of Cincinnati

NO. A-1105049

Hamilton County Court of Common Pleas
Filed 6/1/2011

Type of Pension Reform:	Increased retirement age to 60, put multiplier at 2.2 percent or 2.0 percent for service after 30 years; lowered cost-of-living adjustment to 2 percent.
Title of Bill:	Not Applicable
Date Enacted:	3/16/2011
Basis of Lawsuit:	Plaintiffs contended the changes violated the Contracts Clause.
Pending Developments:	No substantive motions have been filed and no trial has been scheduled.[16]

16 The docket for this case is available at www.courtclerk.org/case_summary.asp?sec=history&casenumber=A%201105049

Rhode Island

Rhode Island Council 94 v. Carcieri

NO. PC 10-2859

State of Rhode Island, Providence Superior Court
Judge Sarah Taft-Carter
Filed 5/12/2010

REFERENCE DOCUMENTS:

Court Decision

Type of Pension Reform:	Retirement age, years of service, final average salary, and cost-of-living adjustments.
Title of Bill:	HB 7397
Date Enacted:	6/30/2009
Basis of Lawsuit:	Plaintiffs alleged the pension legislation violated the Rhode Island Constitution's Contracts Clause and Takings Clause.
Date of Initial Opinion:	9/13/2011
Outcome of Initial Opinion:	Denial of Rhode Island's motion for summary judgment, allowing the lawsuit to proceed further on the merits.
Reasoning:	The Court rejected Rhode Island's apparent argument that it retained the right to reduce or eliminate pension benefits up to the date of retirement. Instead, the Court found that the Rhode Island pension system did create contractual rights, on the ground that 10 years of contributory service service is substantial consideration. The Court was careful to note that its holding did not say anything about whether the pension legislation actually impaired the contractual right to a pension, but was merely about whether the pension was contractual in the first place.
Pending Developments:	A trial will likely take place later in 2012.[17]
Date of Appellate Opinion:	11/22/2011
Outcome of Appeal:	The Rhode Island Supreme Court denied the state's request for an immediate appeal of the initial decision, thus allowing the Court to go forward with a trial.
Reasoning:	The Court finds that the Employees' Retirement System of the State of Rhode Island does give rise to an implied contract and the rights and obligations incident thereto (Decision).

17 See www.ricouncil94.org/NewsEvents/StatePensionLitigationUpdate/tabid/213/Default.aspx

Rhode Island

FIVE LAWSUITS:

REFERENCE DOCUMENTS:

- Complaint
- Motion to Consolidate
- Motion for Temporary Restraining Order

Woonsocket Firefighters, IAFF Local 732, AFL-CIO v. Chafee, C.A.

NO. PC 12-3579

Bristol/Warren Regional School Employees v. Chafee, C.A.

NO. 12-3167

Rhode Island Council 94, AFSCME, AFL-CIO Locals: Boys & Girls Training School, Local 314 v. Chafee, C.A.

NO. 12-3168

City of Cranston Police Officers, International Brotherhood of Police Officers, Local 301, AFL-CIO v. Chafee, C.A.

NO. 12-3169

Rhode Island Public Employees' Retiree Coalition et al. v. Chafee, C.A.

NO. PC 12-3166

Rhode Island Superior Court
Judge Sarah Taft-Carter
Filed 6/22/2012

Type of Pension Reform:	Complete overhaul: suspended cost-of-living adjustments, increased retirement age, moved current employees to hybrid plan.
Title of Bill:	SB 1111
Date Enacted:	11/18/2011
Date of Initial Opinion:	Temporary restraining order denied on 6/22/2012 (date lawsuit was filed).
Pending Developments:	After a hearing on December 7, 2012, the judge sent the cases to mediation, with a report from the parties due on February 1, 2013.

South Dakota

Tice v. State of South Dakota

NO. 10-225

Circuit Court of the Sixth Judicial Circuit in Hughes County
Judge Mark Barnett
Filed 6/11/2010

REFERENCE DOCUMENTS:

Complaint

Memorandum Decision

Type of Pension Reform:	Reduced cost-of-living adjustment for future and current retirees.
Title of Bill:	SB 20
Date Enacted:	3/12/2010
Basis of Lawsuit:	Plaintiffs argued that a reduction in the cost-of-living adjustment violated the state and federal Contracts clauses and the federal Takings Clause.
Date of Initial Opinion:	4/11/2012
Outcome of Initial Opinion:	State of South Dakota received a grant of summary judgment, and plaintiff's claims were rejected.
Reasoning:	"There is no written contract between Plaintiff and Defendants that sets forth the terms, responsibilities, or respective contract rights between the parties. Additionally, no provision within the South Dakota Constitution has been cited by the Plaintiff which would create a constitutional entitlement to any particular cost-of-living adjustment... if the Legislature has been unwilling to forfeit control of cost-of-living adjustments to the South Dakota Retirement System...it is hard for this court to conceive that the Legislature would at the same time forfeit control of a cost-of-living adjustment, entirely, for the lifetimes of one class of beneficiaries." (Memorandum Decision).

Tennessee

TENNESSEE
VALLEY
AUTHORITY

Duncan v. Tennessee Valley Authority Retirement System

NO. 3:10-0217

United States District Court for the Middle District of Tennessee
Judge Aleta A. Trauger
Filed 3/5/2010

REFERENCE DOCUMENTS:

Complaint

Court Order

Type of Pension Reform: Reduced cost-of-living adjustment for future and current retirees.

Title of Bill: Not Applicable

Date Enacted: 8/17/2009

Basis of Lawsuit: Plaintiffs initially argued that the cost-of-living adjustment reduction violated the federal Contracts Clause and the federal Takings Clause but later withdrew those claims. Plaintiffs additionally argued that the cost-of-living adjustment reduction was a breach of contract under generic contract law, and that the pension board violated fiduciary duties under trust law.

Date of Initial Opinion: 9/7/2010

Outcome of Initial Opinion: Dismissal of plaintiffs' claims without prejudice, thus allowing plaintiffs to file a new complaint.

Reasoning: The plaintiffs had withdrawn their constitutional arguments and were relying most heavily on the argument that the board violated fiduciary duties. The court held that the plaintiffs had not produced evidence (at least not yet) that the board had fiduciary duties that would preclude taking Tennessee Valley Authority's finances into account.

Pending Developments: The plaintiffs and defendents filed a joint mediation report on April 20, 2012, announcing that they intended to settle the case via mediation.

City of Fort Worth v. Fort Worth Employees' Retirement Fund of the City of Fort Worth

NO. 342-262392-12

District Court of Terrant County, 342nd Judicial District

Filed 10/23/2012

REFERENCE DOCUMENTS:

- Ordinance
- Complaint
- Motion to Dismiss

Type of Pension Reform:	Reduced multiplier for future years, changed cost-of-living adjustment calculation for future years, raised number of years used for final average salary, and eliminated overtime for that purpose to prevent spiking.
Title of Bill:	Ordinance 20471-10-2012
Date Enacted:	10/23/2012
Basis of Lawsuit:	City is seeking a declaratory judgment that the pension reform bill is lawful.[18]

Van Houten, Jr. v. City of Fort Worth

NO. 4:12-CV-00826-Y

U.S. District Court for the Northern District of Texas

Judge Terry R. Means

Filed 11/19/2012

Type of Pension Reform:	Reduced multiplier for future years, changed cost-of-living adjustment calculation for future years, raised number of years used for final average salary, and eliminated overtime for that purpose to prevent spiking.
Title of Bill:	Ordinance 20471-10-2012
Date Enacted:	10/23/2012
Basis of Lawsuit:	Plaintiffs argued that the Fort Worth pension reform ordinance violates the U.S. Constitution's Contracts Clause, Takings Clause, and substantive due process. In addition, they alleged violations of the Texas Constitution's pension clause, contracts clause, and takings clause.

18 See www.star-telegram.com/2012/10/23/4358587/fort-worth-city-council-approves.html

Washington

Retired Public Employees Council of Washington and Jorgenson v. State of Washington
Consolidated cost-of-living adjustment litigation

MASTER CAUSE NO. 11-2-02213-4

Thurston County Superior Court
Filed 12/16/2011

REFERENCE DOCUMENTS:

Consolidated Ruling

Type of Pension Reform: Eliminated cost-of-living adjustment.

Title of Bill: HB 2021

Date Enacted: 5/16/2011

Basis of Lawsuit: Plaintiffs argued that the cost-of-living adjustment elimination violations the state Due Process and Contracts clauses.[19]

Pending Developments: Summary Judgment hearing is scheduled for June 28, 2012. A ruling would issue some time after the hearing.

19 See www.wfse.org/?zone=/unionactive/view_article.cfm&HomeID=220852&page=Legal

References

American Federation of State, County, and Municipal Employees, Council 18. v. State of New Mexico, No. CV-2009-7148 (2nd Judicial District, Bernalillio County, N.M. 2009).

American Federation of State, County, and Municipal Employees, Local 101 v. City of San Jose, No. 112-CV-227864 (Santa Clara County Superior Court, Cal. 2012).

American Federation of Teachers v. State of New Hampshire, No. 09-E-0290 (Merrimack County Superior Court, N.H. 2010).

Barnes v. Arizona State Retirement System, No. CV2011-011638 (Maricopa County Superior Court, Ariz. 2012).

Berg v. Christie, No. MER-L-2996-11 (Mercer County Superior Court, N.J. 2011).

Bock v. City of Cincinnati, No. A-1105049 (Hamilton County Court of Common Pleas, Ohio 2011).

Boston Police Superior Officers Federation v. Patrick, No. 1:09-cv-11137-NMG (D. Mass. 2009).

Cherry, Jr. v. Mayor and City Council of Baltimore City, No. 1:10-cv-01447-MJG (D. Md. 2012).

Cherry, Jr. v. Mayor and City Council of Baltimore City, No. 1:10-cv-01447-MJG (D. Md. 2011).

City Clerk (2012).Measure B: Public Employee Pension Plan Amendments-To Ensure Fair and Sustainable Retirement Benefits While Preserving Essential City Services. City of San Jose.

City of Miami Beach v. Board of Trustees of the City Pension Fund for Firefighters and Police Officers in the City of Miami Beach, No. 3D11-2974 (3rd District Court of Appeal, Fla. 2012).

City of San Jose v. San Jose Police Officers' Association, No. 12-cv-02904 (N.D. Cal. 2012).

Cloutier v. State of New Hampshire, No. 219-2009-CV-00525 (Strafford County Superior Court, N.H. 2009).

Cloutier v. State of New Hampshire, No. 2010-714 (N.H. 2011).

DePascale v. State of New Jersey, No. 69,401 (Supreme Court, N.J. 2012).

Duncan v. Tennessee Valley Authority Retirement System, No. 3:10-CV-217 (M.D. Tenn. 2010).

Fields v. Elected Official Retirement Plan of the State of Arizona, No. CV-2011-017443 (Maricopa County Superior Court, Ariz. 2012).

Fraternal Order of Police, Miami Lodge 20 v. City of Miami, No. 10-47918-CA-13 (Eleventh Judicial Circuit, Miami-Dade County, Fla. 2012).

Harris v. City of San Jose, No. 112-CV-226570 (Santa Clara County Superior Court, Cal. 2012).

Idaho Education Association v. State of Idaho, Case No. CVOC 1108212 (Fourth Judicial District, County of Ada, Idaho 2011).

Justus v. State of Colorado, Case No. 2010-CV-1589 (Denver County District Court, Colo. 2011).

Justus v. State of Colorado, Case No. 2012 COA 169 (Court of Appeals, Colo. 2012).

Maine Association of Retirees v. Board of Trustees of the Maine Public Employee Retirement System, No. 1:12-cv-00059 (D. Maine. 2012).

Michigan Coalition of State Employee Unions v. State of Michigan, No. 12-117-MM (Court of Claims, Mich. 2012).

Mukhar v. City of San Jose, No. 112-CV-226574 (Santa Clara County Superior Court, Cal. 2012).

New Jersey Education Association v. State, Docket No. MER-L-771-12 (Mercer County Superior Court, N.J. 2012).

New Jersey Education Association v. State of New Jersey, No. 11-5024 (D. N.J. 2011).

Office of the City Clerk (2012). Proposition B: Amends City Charter Regarding Retirement Benefits. City of San Diego.

Professional Firefighters of New Hampshire v. State of New Hampshire, No. 217-2011-CV-385 (Merrimack County Superior Court, N.H. 2011).

Professional Firefighters of New Hampshire v. State of New Hampshire, No. 216-2012-CV-00193 (Hillsborough Superior Court, N.H. 2012).

Public Employment Relations Board v. City of San Diego, No. 37-2012-00092205-CU-MC-CTL (San Diego Superior Court, Cal. 2012).

Retired Public Employees Council of Washington and Jorgenson v. State of Washington, Thurston County, No. 11-2-02213-4 (Thurston County Superior Court, Wash. 2011).

Retired State Employees Association v. State of Louisiana, Docket No. 614675 (19th Judicial District, East Baton Rouge, La. 2012).

Rhode Island Public Employees' Retiree Coalition v. Chafee, No. PC 12-3166 (Providence Superior Court, R.I. 2012).

Rhode Island Council 94 v. Carcieri, No. PC 10-2859 (Providence Superior Court, R.I. 2010).

San Diego Municipal Employees Association v. City of San Diego, No. LA-CE-746-M (Cal. Public Employment Relations Board, Cal. 2012).

San Jose Police Officers' Association v. City of San Jose, No. 112-CV-225926 (Santa Clara County Superior Court, Cal. 2012).

Sapien v. City of San Jose, Case No. 112-CV-225928 (Santa Clara County Superior Court, Cal. 2012).

Swanson v. State of Minnesota, Court File No. 62-CV-10-05285 (2nd Judicial District, Ramsey County, Minn. 2011).

Taylor v. City of Gadsden, No. 4:11-cv-03336 (N.D. Ala. 2011).

Tice v. State of South Dakota, Civil No. 10-225 (6th Judicial Circuit, Hughes County, S.D. 2010).

Tice v. State of South Dakota, Civil No. 10-225 (6th Judicial Circuit, Hughes County, S.D. 2012).

Van Houten v. City of Fort Worth, No. 4:12-cv-00826-Y (N. D. Texas 2012).

Williams v. Scott, Case No. 2011 CA 1584 (2nd Judicial Circuit, Leon County, Fla. 2011).

APPENDIX 5

GLOSSARY OF MAJOR ACTUARIAL TERMS

A Glossary of Major Actuarial Terms

Following is a brief glossary of major actuarial terms used throughout the Commission's report.

Actuarial Accrued Liability (AAL)
Computed differently under different funding methods, the actuarial accrued liability generally represents the portion of the present value of fully projected benefits attributable to service credit earned (or accrued) as of the valuation date.

Actuarial Assumptions
Factors that actuaries use in estimating the cost of funding a defined benefit pension plan. Examples include the rate of return on plan investments, mortality rates, and the rates at which plan participants are expected to leave the system because of retirement, disability, termination, etc.

Actuarial Cost Methods
An actuarial method that defines the allocation of pension costs (and contributions) over a member's working career. All standard actuarial cost methods are comprised of two components: normal cost and the actuarial accrued liability. An actuarial cost method determines the incidence of pension costs, not the ultimate cost of a pension plan; that cost is determined by the actual benefits paid less the actual investment income.

Actuarial Equivalent
A benefit having the same present value as the benefit it replaces. Also, the amount of annuity that can be provided at the same present value cost as a specified annuity of a different type or a specified annuity payable from a different age.

Actuarial Gain or Loss
Experience of the plan, from one year to the next, which differs from that assumed results is an actuarial gain or loss. For example, an actuarial gain would occur if assets earned 10 percent for a given year if the assumed return rate in the valuation is 7.5 percent.

Actuarial Present Value
The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of actuarial assumptions (i.e. interest rate, rate of salary increases, mortality, etc).

Actuarial Valuation Report (AVR)
Actuarial valuations are technical reports providing full disclosure of the financial and funding status of public retirement systems

Actuarial Value of Assets
The value of pension plan investments and other property used by the actuary for the purpose of an actuarial valuation (sometimes referred to as valuation assets). Actuaries often select an asset valuation method that smooths the effects of short-term volatility in the market value of assets.

Age (Retirement)
Normal retirement dependent upon attainment of a specified age and or service threshold.

Aggregate Funding Method
The aggregate funding method is a standard actuarial funding method. The annual cost of benefits under the aggregate method is equal to the normal cost. The method does not produce an unfunded actuarial accrued liability. The normal cost is determined for the entire membership.

Amortization
Paying off an interest bearing liability by gradual reduction through a series of installments, as opposed to paying it off by one lump sum payment.

Annuitant
One who receives periodic payments from the retirement system. This term includes service and disability retirees, and their survivors.

Annuity
A series of periodic payments, usually for life, payable monthly or at other specified intervals.

Beneficiary
The person designated to receive benefits under an employee benefit plan in the event of the death of the person covered by the plan.

Cash Balance Pension Plan
A hybrid defined benefit plan that has some of the features of a defined contribution plan. The most distinguishing feature of a cash balance pension plan is the use of a hypothetical account for each participant. The plan sponsor is responsible for investment decisions.

Credited Service
A period of employment which is recognized as service for purposes of determining eligibility to receive pension payments and/or determining the amount of such payments.

Death Benefit
A benefit payable by reason of a member's death. The benefit can be in the form of a lump sum, an annuity or a refund of the member's contributions.

Deferred Annuity
An annuity for which payments do not commence until a designated time in the future.

Deferred Compensation
Considerations for employment that are not payable until after the regular pay period. The most common form of deferred compensation are pension plans, but private employers may also offer bonuses, incentive clauses, etc.

Defined Benefit Plan (DB)
A pension plan providing a definite benefit formula for calculating benefit amounts - such as a flat amount per year of service; a percentage of salary; or a percentage of salary, times years of service.

Defined Contribution Plan (DC)
A pension plan in which the contributions are made to an individual account for each employee. The retirement benefit is dependent upon the account balance at retirement. The balance depends upon amounts contributed during the employee's participation in the plan and the investment experience on those contributions.

Disability Retirement
A termination of employment involving the payment of a retirement allowance as a result of an accident or sickness occurring before a participant is eligible for normal retirement.

Early Retirement
A termination of employment involving the payment of a retirement allowance before a participant is eligible for normal retirement. The retirement allowance payable in the event of early retirement is often lower than the accrued portion of the normal retirement allowance.

Entry Age Normal Cost Method (EANC)
The EANC method is a standard actuarial funding method. The annual cost of benefits under EANC is comprised of two components: normal cost plus amortization of the unfunded liability. The normal cost is determined on an individual basis, from a member's age at plan entry, and is designed to be a level percentage of pay throughout a member's career if all assumptions are realized and benefit provisions remain unchanged.

401(k), 403(b), and 457 Plans
These defined contribution plans are supplemental plans that allow employees to save for retirement on a tax-deferred basis. 401(k) plans are found in the private sector. 403(b) plans are for employees of public educational institutions and certain non-profit tax-exempt organization. 457 plans (also known as deferred compensation plans) are for governmental employees and non-church-controlled tax-exempt organizations.

Fiduciary
Indicates the relationship of trust and confidence where one person (the fiduciary) holds or controls property for the benefit of another person; anyone who exercises power and control, management or disposition with regard to a fund's assets, or who has authority to do so or who has authority or responsibility in the plan's administration. Fiduciaries must discharge their duties solely in the interest of the participants and their beneficiaries, and are accountable for any actions that may be construed by the courts as breaching that trust.

Funded Ratio
The ratio of a pension plan's current assets to its liabilities. There are several acceptable methods of measuring a plan's assets and liabilities. In financial reporting of public pension plans, funded status is reported using consistent measures by all governmental entities.

Market Value of Assets (MVA)
The market value of assets is the value of the pension fund based on the value of the assets as they would trade on an open market, including accrued income and expenses.

Money Purchase Plan
A type of pension plan where the employer agrees to make a fixed contribution each year for each eligible employee. The contribution is typically expressed as a percentage of the employee's pay and the contribution constitutes a non-discretionary commitment on the part of the employer. The contribution must be made each year, and can only be varied by plan amendment. Although treated differently under federal tax law, money purchase plans are fundamentally defined contribution plans.

Normal Cost
Computed differently under different funding methods, the normal cost generally represents the portion of the cost (or value) of projected benefits allocated to the current plan year. The employer normal cost equals the total normal cost of the plan less employee contributions.

Pension
A series of periodic payments, usually for life, payable monthly or at other specified intervals. The term is frequently used to describe the part of a retirement allowance financed by employer contributions.

Pre-Funding
To accumulate a reserve fund in advance of paying benefits. This is the opposite of "pay-as-you-go," and is the essence of actuarial funding generally.

Present Value
The current value of an amount or series of amounts payable in the future, after discounting each amount at an assumed rate of interest and adjusting for the probability of its payment.

Present Value of Future Benefits (PVFB)
Computed by projecting the total future benefit payments from the plan, using actuarial assumptions (i.e. probability of death or retirement, salary increase, etc.), and discounting the payments to the valuation date using the valuation interest rate to determine the present value (today's value).

Qualified Plan
An employee benefit plan approved by the Internal Revenue Service, meeting requirements set forth in IRS Code Section 401. Contributions to such plans are subject to favorable tax treatment.

Replacement Ratio
A calculation of the degree to which retirement income supplants a pre-retirement member's "take home" pay, less working expenses. To determine this ratio, several factors must be taken into account: a retiree's pre-retirement earnings; changes in tax liabilities after retirement; changes in Social Security tax liability; the elimination of work-related expenses - including contributions to the retirement system; and savings.

Unfunded Actuarial Accrued Liability (UAAL)
The excess, if any, of the Actuarial Accrued Liability over the Actuarial Value of Assets. The present value of benefits earned to date that are not covered by current plan assets.

Vesting
The right of a plan participant to the benefits he or she has accrued, or some portion of them, even if employment under the plan is terminated. An employee who has met the vesting requirements of a pension plan is said to have a vested right. Voluntary and mandatory employee contributions are always fully vested.