



INDEPENDENT FISCAL OFFICE

August 31, 2023

The Honorable Bryan Cutler
Minority Leader
Pennsylvania House of Representatives
423 Main Capitol Building
Harrisburg, PA 17120

Re: Requested Actuarial Note for House Bill 1416, Printer's Number 1584 Amendment A01791

Dear Leader Cutler:

This letter responds to your July 7, 2023 request concerning an actuarial note for Amendment A01791 to House Bill 1416, Printer's Number 1584. The bill would amend Title 24 (Education) and Title 71 (State Government) of the Pennsylvania Consolidated Statutes to provide cost-of-living adjustments (COLAs) to certain annuitants of the State Employees' Retirement System (SERS) and Public School Employees' Retirement System (PSERS) that retired prior to July 2, 2001. The COLAs range from 15% to 24.5% of current annuity values depending on year of retirement. The Independent Fiscal Office (IFO) determined that the bill would have a material cost impact and released an actuarial note on June 30, 2023. That note is available on the IFO's website, and a summary of the impacts is shown in the table below.

House Bill 1416, PN 1584 Impact Summary

	SERS	PSERS
Individuals impacted	25,334	43,475
Lifetime increase in benefits	\$566.4	\$1,220.2
Annual amortized costs (10 years)	\$52.5	\$125.1
<u>Initial change in:</u>		
Unfunded Actuarial Liability	\$371.0	\$821.1
Funded ratio	-0.46%	-0.44%
Employer contribution rate	0.74%	0.81%

Notes: Dollars in millions. Data from SERS and PSERS, calculations by the IFO.

Amendment A01791 would prohibit the systems from using newly acquired alternative investments and alternative investment vehicles to fund the COLAs prescribed in the base bill. The restriction would be waived if the investments were approved by the board with a two-thirds majority. The amendment does not prohibit either system from investing in alternative investments or change the COLAs in the base bill. Neither SERS nor PSERS expects a material impact from the restriction as the amendment should not

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prevent the systems from earning their projected net investment return (6.875% for SERS, 7.00% for PSERS). Both systems raised administrative and investment concerns related to the legislation in their responses. Responses submitted to the IFO from SERS and its actuary (Korn Ferry), and PSERS and its actuary (Buck) are attached.

Under section 615-B of the Administrative Code of 1929, the IFO reviews legislative changes that could affect public employee pension or retirement plans and provides actuarial notes for such legislation. Based on commentary from the systems, the IFO determined that there is no material actuarial cost associated with Amendment A01791 to House Bill 1416, Printer's Number 1584 and no further actuarial analysis is required. The office reviewed the legislation for actuarial cost impact only, and not for potential legal, administrative or policy implications.

If you have further questions regarding this response, please contact me at (717) 230-8293.

Sincerely,



Matthew J. Knittel
Director, Independent Fiscal Office

cc: Governor Josh Shapiro
Members of the General Assembly

July 27, 2023

Mathieu Taylor
Independent Fiscal Office
Rachel Carson State Office Building, 2nd floor
400 Market St., Harrisburg, PA 17105

RE: Follow-up: A01790 / A01791

Dear Mathieu,

In addition to the financial cost notes provided by SERS and our actuary, Korn Ferry concerning the amendments identified in your July 10, 2023, request, we wanted to provide some additional perspectives regarding the proposed amendments (**A01790/A01791**) to H.B. 1415 and H. B. 1416.

In short, these amendments would provide that Cost-of-Living-Adjustments (COLAs) shall not be funded by alternative investments or alternative investment vehicles acquired after the effective date unless the investment was approved by 2/3 of the board.

In keeping with SERS' traditional posture, we are neutral on the proposed legislation, but we want to point out some technical aspects and implications that may be worth considering.

Point #1 – Inseparability of Funds: SERS investments and their earnings are one large, commingled pot of funds for actuarial purposes. The overall earnings on the total portfolio help to pay down the plan's overall UAL (there is no contingency for delineating a specific component such as a COLA). The actuarial valuation does not require the consideration of the breakdown of total portfolio earnings into further asset class, sub-asset class, or investment manager.

Nor does the Retirement Code differentiate in the funding of most benefits. To the extent that it does, those differences are ledger account balances and not separate investment pools, except for the Benefits Completion Plan assets, which are in a different trust and managed and invested separately from the State Employees' Retirement Fund. Thus, what seems to be envisioned – a separate investment pool managed separately to fund the COLAs created by H.B. 1415 or H.B. 1416 – probably would not work statutorily or practically. SERS would be unable at this time to ascertain how investment monies from specific investments would be allocated to COLAs. Setting up such a system/process would incur administrative and operational costs requiring additional study.

Point #2 - Supermajority Implications: One result of enacting A01790 or A01791 could be to place the entire Fund under a supermajority requirement for any investments in the alternative investment class or using alternative investment vehicles. The amendments “work” to prohibit the funding of the COLAs through alternative investments and alternative investment vehicles – not in the way the amendment language seems to suggest – but rather by prohibiting the entire Fund from using these types of investments unless approved by a supermajority of the Board.

We also note that “Alternative investment” and “Alternative investment vehicle” are defined terms in the Retirement Code, specifically 71 Pa. C.S §5102:

"Alternative investment." An investment in a private equity fund, private debt fund, venture fund, real estate fund, hedge fund or absolute return fund.

"Alternative investment vehicle." A limited partnership, limited liability company or any other legal vehicle for authorized investments under section 5931(i) (relating to management of fund and accounts) through which the system makes an alternative investment.

These are the definitions that are applicable to A01790 and A01791.

Point #3 - Fiduciary Duties: Placing a 2/3 requirement on the ability of the Board to approve an alternative investment or alternative investment vehicle (for it to be considered worthy of funding a COLA), possibly enters a gray area relating to the fiduciary duty of the SERS Board (working with its Investment staff and consultants) to determine the efficacy and viability of a proposed investment.

In short, there is a rollback of fiduciary flexibility inherent in A01790 and A01791. In a sense, these amendments are a minor reversion back to a “legal list” approach to investment authority.

Please note that it is and has been SERS’ position that the General Assembly can impose these sorts of restrictions on the Board and that the Board (as a creature of legislation) has only those powers granted to it by the General Assembly. These are technical aspects that we are only pointing out.

We also note that this is not necessarily an absolute prohibition on alternative investments and alternative investment vehicles.

Please let us know if you have any questions or concerns.

Thank you again for your consideration and for giving us the opportunity to provide input on these proposals.

Best,

Thomas Derr, Director
Communications & Policy



Actuarial Cost Note Regarding H.B. 1416, P.N. 1584
Including Amendments A01806, A01821, A01771 and A01791
To Estimate the Cost Impact of a Proposed Cost of Living Adjustment
to the Pennsylvania State Employees Retirement System

July 21, 2023

The following is an actuarial cost note which describes, and presents the estimated cost impact of proposed legislation (under House Bill 1416, Printer's Number 1584 that would provide a Cost of Living Adjustment (COLA) to certain retired members of the Pennsylvania State Employees' Retirement System (SERS), commencing with the first monthly annuity payment after January 1, 2024.

Design of the COLA

If this bill became law, retired members meeting all three (3) of these conditions would be eligible for the COLA:

- The retired member must be either a retiree who has reached superannuation age or a disabled retiree or an early retiree (who would become eligible for the COLA upon reaching superannuation age) receiving an annuity on January 1, 2024;
- The retired member's most recent effective date of retirement would have to be prior to July 2, 2001, and
- The retired member's credited service may not include any service credited as Class AA or Class D-4 (or Class T-D).

If enacted, the amount of the COLA increase, which would commence with the first monthly annuity payment after January 1, 2024, will be determined as a percentage of the amount of the monthly annuity payment on January 1, 2024, such percentage being specifically prescribed on the basis of the eligible member's most recent effective date of retirement. Table 1 on the following page provides the specific COLA increase percentages and effective dates of retirement proposed under this bill.

Other noteworthy provisions relating to the design of this proposed COLA include:

- Beneficiaries or survivors of members who die before January 1, 2024 are not eligible and
- The COLA will be payable under the same terms and conditions as provided under the option plan in effect as of January 1, 2024.

Funding of the COLA

The bill states that "... the additional liability for the increase in benefits provided under this section shall be funded in equal dollar installments over a period of 10 years beginning July 1, 2024."



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Proposed COLA Increases

The proposed COLA increase percentages are presented in Table 1 below.

Table 1 Proposed COLA Increases Effective After January 1, 2024 & Payable to Eligible Retired Members Who Retired Prior to July 2, 2001	
Most Recent Effective Date of Retirement	Proposed COLA Increase
Prior to July 2, 1982	24.5%
July 2, 1982 - July 1, 1983	24.0%
July 2, 1983 - July 1, 1984	23.5%
July 2, 1984 - July 1, 1985	23.0%
July 2, 1985 - July 1, 1986	22.5%
July 2, 1986 - July 1, 1987	22.0%
July 2, 1987 - July 1, 1988	21.5%
July 2, 1988 - July 1, 1989	21.0%
July 2, 1989 - July 1, 1990	20.5%
July 2, 1990 - July 1, 1991	20.0%
July 2, 1991 - July 1, 1992	19.5%
July 2, 1992 - July 1, 1993	19.0%
July 2, 1993 - July 1, 1994	18.5%
July 2, 1994 - July 1, 1995	18.0%
July 2, 1995 - July 1, 1996	17.5%
July 2, 1996 - July 1, 1997	17.0%
July 2, 1997 - July 1, 1998	16.5%
July 2, 1998 - July 1, 1999	16.0%
July 2, 1999 - July 1, 2000	15.5%
July 2, 2000 - July 1, 2001	15.0%
July 2, 2001 and After	0.0%

Estimated COLA Impact and Costs

Table 2 on the following page presents some approximate statistics related to the impact if this proposed COLA were to become law, as well as the estimated additional liability and annual cost to SERS, based upon funding in equal dollar annual installments over a 10-year period beginning July 1, 2024.

The estimated number of retirees to receive the proposed COLA is based on the number eligible to receive the COLA as of December 31, 2022. The average increase is the overall average increase the eligible members (as of December 31, 2022) would receive.



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Table 2 Impact & Estimated Cost of Proposed COLA Increase (dollars in millions)	
Effective date of first COLA payment	After January 1, 2024
Funding date	July 1, 2024
Estimated number of retirees to receive COLA	25,334
Average COLA increase	17.79%
Expected payroll in fiscal year 2024/2025	\$7,103.6
Increase in liability	\$371.0
Level annual 10-year funding payment	\$52.5
As a percent of projected payroll	0.74%

Under Amendment A01806, the COLA payments and funding will be deferred until after the plan reaches a funded ratio of at least 95%. When a December 31 valuation achieves the funding threshold, then a notice is transmitted to the Legislative Reference Bureau for publication. The COLAs will be effective for retirees in the plan on January 1 after the publication occurs. The funding of the COLA will begin on the July 1 following the effective date of the COLA. Current projections have SERS reaching 95% funding on December 31, 2041, so the COLA is expected to be paid beginning January 2043 to all retirees in pay status. The funding of this COLA is expected to begin July 1, 2043.

Table 3 Impact & Estimated Cost of Proposed COLA Increase As Amended By A01806 (dollars in millions)	
Expected date of first COLA payment	After January 1, 2043
Expected Funding date	July 1, 2043
Estimated number of retirees to receive COLA	4,759
Estimated Average COLA increase	17.26%
Expected payroll in fiscal year 2043/2044	\$11,101.1
Expected Increase in liability	\$26.2
Level annual 10-year funding payment	\$3.7
As a percent of projected payroll	0.03%

Under Amendment A01821, the COLA payments and funding will be deferred until after the plan reaches a funded ratio of at least 100%. When a December 31 valuation achieves the funding threshold, then a notice is transmitted to the Legislative Reference Bureau for publication. The COLAs will be effective for retirees in the plan on January 1 after the publication occurs. The funding of the COLA will begin on the July 1 following the effective date of the COLA. Current projections have SERS reaching 100% funding on December 31, 2047, so the COLA is



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expected to be paid beginning January 2049 to all retirees in pay status. The funding of this COLA is expected to begin July 1, 2049.

Table 4 Impact & Estimated Cost of Proposed COLA Increase As Amended By A01821 (dollars in millions)	
Expected date of first COLA payment	After January 1, 2049
Expected Funding date	July 1, 2049
Estimated number of retirees to receive COLA	2,109
Estimated Average COLA increase	17.20%
Expected payroll in fiscal year 2043/2044	\$12,667.6
Expected Increase in liability	\$7.8
Level annual 10-year funding payment	\$1.1
As a percent of projected payroll	0.01%

Amendment A01771 would restrict state employees who first become members of the House of Representatives on or after December 1, 2024 from entering the defined benefit plan. These Representatives can elect to be covered by the DC only plan. All legislators represent about 0.2% of the total SERS payroll, so the transition to excluding House members would be gradual and ultimately have very little impact on the plan. We assume most of these new members would elect the DC only plan. DC only members would have contributions made to SERS on their behalf by their employer to fund the unfunded liability. A new member entering the defined benefit plan begins with no liability which accumulates over time through normal costs that are contributed annually to the Plan. Excluding this near equal accumulation of assets and liabilities for this small group has a de minimis impact on the SERS funded position.

Amendment A01791 limits the investment options for contributions made to fund the COLA. SERS cannot invest these funds into alternative investments. Since the COLA will be paid immediately, it is likely that any contributions will be invested in liquid assets and not tied up in long-term investments that carry penalties if the funds are needed too soon. The addition of the contributions may free up other assets to be invested in alternative investments, but the amendment is not restricting all funds from alternative investments. Since the contributions will not be invested in a manner restricted by this amendment, and the fund is still expected to earn its annual 6.875% return on average, there is no cost impact from this amendment.

Methods and Assumptions Underlying Table 2 Results

The data used for this cost estimate is based on a special run provided by SERS that included all retirements through December 31, 2022. The data included age, gender, date of retirement, and both the initial and current monthly benefit for the retired population as of December 31, 2022. The estimated number of retirees to receive the COLA is based on the number of retirees in payment status as of December 31, 2022.



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The liability was determined by using the actuarial assumptions and methods underlying the December 31, 2022 actuarial valuation. The expected payroll figure shown above is as of the first fiscal year in which the COLA will be funded. It is the December 31, 2022 valuation funding payroll projected forward one year.

The valuation results were produced using a proprietary actuarial valuation system, Pension Valuation Language (PVL). PVL has been actively used for over 40 years to perform annual funding/accounting valuations, gain and loss analyses, and cost studies for a wide variety of retirement systems. PVL was created specifically to value pension plan liabilities and uses the applicable assumptions and methods along with the pension plan census data to produce appropriate results. Test lives are generated to review the accuracy of both the input and output, allowing the users to confirm with a high degree of accuracy how the programmed benefit is applied to an individual along with the proposed decrements and other assumptions. The actuarial team loads the participant data, programs the benefit provisions, enters the applicable assumptions into the model, and reviews sample life output and results under the supervision of a credentialed actuary or actuaries who are proficient users of the software. We are not aware of any material limitations in the model nor any material inconsistencies in the assumptions used within the model.

Potential Risks Related to the COLA

The liabilities and costs in this cost note are based upon actuarial assumptions utilized in the December 31, 2022 actuarial valuation of SERS. These measurements represent a single estimate of the future liabilities and costs of SERS. Since the actual liabilities and costs will be determined based upon (i) the future actuarial assumptions underlying such future measurements and (ii) the actual future experience of SERS, there is a risk that future measurements will differ from those presented in this cost note.

To provide readers of this cost note with a greater appreciation for the sensitivity of these results to potential future changes in both the underlying actuarial assumptions and future SERS experience, we have performed three additional liability calculations:

- One liability calculation, based upon a 5.875% underlying interest rate assumption (a full 1% lower than the 6.875% assumption currently applicable to SERS). This is for the purpose of showing the extent of increase that would occur in our liability result if a 1% lower interest rate assumption applied in the future. Our resulting liability (based on the 5.875% interest rate) was \$390.9 million, or 5.4% greater than the Table 2 liability increase of \$371.0 million.
- A second liability calculation, based upon the assumption that the actual future mortality rates experienced by the retirees eligible for the proposed COLA increases are 10% lower than those currently assumed for SERS annuitants for a 10-year period and then revert back to current mortality assumptions after. This is in order to show the extent of increase that would occur in our liability result if the COLA-eligible SERS retirees had favorable future longevity. Our resulting liability (based on the more favorable mortality rates) was \$384.6 million, or 3.7% greater than the Table 2 liability increase of \$371.0 million.
- A third liability calculation, based upon both of the two adjustments described above.



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Our resulting liability (based on the 5.875% interest rate and the 10% lower assumed mortality rates for 10 years) was \$405.6 million, or 9.3% greater than the Table 2 liability increase of \$371.0 million.

- The amendments that introduce funding thresholds reduce the impact by delaying the implementation of the COLA. If the plan does not achieve the funding target by our projection, then the impact of the COLA will be delayed and reduced further. Alternatively, if the funding target is reached early, then the impact of the COLA will be higher than presented. Since the impact of the delayed COLA is expected to be small, the timing of granting the COLA only poses a small risk.

Again, we are presenting the above supplemental results to be responsive to ASOP 51, hoping to enhance understanding and appreciation of SERS' risk exposure for readers of this cost note.

Actuarial Certification

To the best of our knowledge, the information we are presenting herein is complete and accurate and all costs and liabilities have been determined in conformance with generally accepted actuarial principles and on the basis of actuarial assumptions and methods which are reasonable (taking into account the past experience of SERS and reasonable expectations) and which represent our best estimate of anticipated experience under the plan.


The actuaries certifying to this valuation are members of the Society of Actuaries or other professional actuarial organizations and meet the General Qualification Standards of the American Academy of Actuaries for purposes of issuing Statements of Actuarial Opinion.

Please let us know if you have any questions on any of this.

Respectfully submitted,

Korn Ferry

By: 
Kristopher E. Seets, F.S.A.
Member American Academy of Actuaries
Enrolled Actuary No. 23-8055

By: 
Craig R. Graby
Member American Academy of Actuaries
Enrolled Actuary No. 23-7319

July 21, 2023



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

PSERS
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Harrisburg PA 17101-1905

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Local: 717.787.8540
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July 24, 2023

Mathieu Taylor
Fiscal Analyst II
Independent Fiscal Office
Rachel Carson State Office Building, 2nd floor
400 Market St. | Harrisburg, PA 17105

Dear Mathieu:

As requested, the Pennsylvania Public School Employees' Retirement System (PSERS) reviewed Amendments A01790 / A01791, which, respectively, amend House Bill 1415, Printer's No. 1583, and House Bill 1416, Printer's No. 1584.

The identical amendments would prohibit PSERS and the State Employees' Retirement System (SERS) from using future alternative investments or alternative investment vehicles that did not have a 2/3 majority vote of their respective Boards of Trustees to pay for the cost-of-living adjustments (COLAs) outlined in the underlying bills.

In response to your request, PSERS' actuarial firm, Buck, reviewed the amendments. A copy of Buck's review is provided. The rest of this letter serves as a separate PSERS staff review of the amendments' possible effects on the System's administrative operations, legal compliance, and governance rules.

Section 8102 of Retirement Code defines "alternative investment" as an "investment in a private equity fund, private debt fund, venture fund, real estate fund, hedge fund or absolute return fund." Section 8102 defines "alternative investment vehicle" as a "limited partnership, limited liability company or any other legal vehicle for authorized investments under section 8521(i) (relating to management of fund and accounts) through which the system makes an alternative investment."

As written, the amendments do not require a supermajority vote of the PSERS Board of Trustees on all future alternative investments or alternative investment vehicles for PSERS to invest in such vehicles. A simple majority vote on these types of investments would still suffice as outlined in the Board's current Bylaws, which require a quorum and a majority of those present to carry all motions or resolutions. However, alternative investments or alternative investment vehicles that do **not** receive a supermajority vote could **not** be used to fund the COLAs for the eligible PSERS annuitants Buck previously identified in its June 26, 2023 reviews of the underlying bills.

PSERS defined benefit plan currently does not segregate any investment earnings/losses, or employee and employer contributions to cover a particular expense. PSERS defined benefit plan operates as a trust in which all investment earnings/losses on all investments, as well as employee and employer contributions, are pooled into one overarching account to pay for all members' current and future benefits and the System's costs. Section 8401(c) of the Retirement Code states:

Assets held in trust. --All assets and income in the plan that have been or shall be withheld or contributed by the participants, the Commonwealth and employers in accordance with this part shall be held in trust in any funding vehicle permitted by the applicable provisions of the IRC [Internal Revenue Code] for the exclusive benefit of the plan's participants and their beneficiaries until such time as the funds are distributed to the participants or their beneficiaries in accordance with the terms of the plan document. The assets of the plan held in trust for the exclusive benefit of the participants and their beneficiaries may be used for the payment of the fees, costs and expenses related to the administration and investment of the plan and the trust.

To comply with the amendments, PSERS would need to create a separate account – or a trust – to segregate the investment assets and their related earnings/losses for future alternative investments or alternative investment vehicles that do not receive supermajority votes to exclude them from funding for the COLAs.

PSERS would need to investigate the possible legal, administrative and financial ramifications of segregating future alternative investments or alternative investment vehicles that do not receive supermajority approval and cannot be used to pay for COLA expenses for the eligible annuitants.

If the proceeds of future alternative investments or alternative investment vehicles cannot be segregated to pay for the legislation's COLAs, another means to meet the requirements of the legislation would need to be explored, including any potential investment and/or actuarial implications the alternative means may have. The underlying bills state COLAs for eligible PSERS annuitants "shall be funded in equal dollar annual installments over a period of 10 years beginning July 1, 2024." Presumably, then, the 2/3 majority voting requirement needed to use alternative investments or alternative investment vehicles to pay for the COLAs would sunset after the COLAs are fully funded.

PSERS staff believes the amendments, as written, would not impact their fiduciary duty to diligently underwrite a prospective alternative investment or alternative investment vehicle, bringing forward investments that in staff's professional judgment would be additive to PSERS ability to meet all of PSERS funding needs. Finally, PSERS staff defers to the will of the Board for the final interpretation and guidance on how staff were to proceed with implementing the amended bill should it become law.

Should you have additional questions, please contact me at 717-720-4770 or via email at stesack@pa.gov.

Thank you.

Steve Esack



200 Plaza Drive
1st Floor
Secaucus, New Jersey 07094

July 24, 2023

Ms. Terrill J. Sanchez
Executive Director
Pennsylvania Public School Employees' Retirement System
5 North 5th Street
Harrisburg, PA 17101

Re: Amendment A01791 to House Bill 1416, Printer's No. 1584

Dear Ms. Sanchez:

As requested, we have examined Amendment A01791 to House Bill 1416, Printer's No. 1584 (A01791). A copy of the Independent Fiscal Office's (IFO) request for analysis, the text of A01791, and our original Cost Analysis of House Bill 1416, Printer's No. 1584, are attached to this letter.

Our understanding of A01791 is that, unless two-thirds of members of the Board vote in favor of doing so, the additional liability resulting from the increases in benefits provided by House Bill 1416, Printer's No. 1584, cannot be funded by an alternative investment or alternative investment vehicle purchased for or acquired by PSERS after the effective date of the benefit increase. Any funding restriction that may impact asset allocation or investments may change PSERS's investment risk or necessitate a change in the assumed rate of return used in funding, which could have an actuarial impact. However, because a relatively small proportion of PSERS's assets would be subject to the provisions of A01791, it is unlikely to have a material actuarial impact if adopted.

As required by the original House Bill 1416, Printer's No. 1584, our cost analysis was based on the assumption that the additional liability due to the benefit increase would be amortized in equal dollar annual installments over a period of 10 years beginning July 1, 2024. As we are not PSERS' investment consultant, we are not able to comment on the potential administrative or fiscal impact(s) that A01791 would have during the 10-year funding period.

Please refer to our cost analysis of the original House Bill 1416, Printer's No. 1584, for the assumptions and methods used in this analysis, as well as caveats and disclosures under applicable Actuarial Standards of Practice.

This cost analysis was prepared under my supervision. I am a Fellow of the Society of Actuaries and a Member of the American Academy of Actuaries. I meet the Academy's Qualification Standards to issue this Statement of Actuarial Opinion. This report has been prepared in accordance with all applicable Actuarial Standards of Practice, and I am available to answer questions about it.

Please contact me if you have any questions concerning this report.

Sincerely,

David L. Driscoll, FSA, MAAA, EA, FCA
Principal, Consulting Actuary

Enc.

Pc: Brian Carl