



INDEPENDENT FISCAL OFFICE

November 18, 2019

The Honorable Garth D. Everett
House State Government Committee Chairman
Pennsylvania House of Representatives
400 Irvis Office Building
Harrisburg, PA 17120

Re: Requested Actuarial Note for House Bill 1964, Printer's Number 2765

Dear Chairman Everett:

I am writing in response to your request of October 24, 2019 regarding an actuarial note for House Bill 1964, Printer's Number 2765. The bill would amend Title 24 (Education) and Title 71 (State Government) of the Pennsylvania Consolidated Statutes, by providing for changes in transparency and reporting of both state pension systems. The bill contains the following provisions:

- The State Employees' Retirement System (SERS) and Public School Employees' Retirement System (PSERS) must livestream board meetings for public access and post unedited video and records of those meetings online. The videos and records must be retained on the website for seven years.
- Both systems must publish additional reports submitted to the Governor and General Assembly and publish those reports online. The reports would detail (1) investment performance over various periods, (2) performance by asset class and manager, (3) fees and expenses paid to or retained by all investment managers, (4) travel and other expenses incurred by system staff and paid by an external investment manager, fund or consultant and (5) internal control representations relative to deficiencies in systems of internal control.
- Classifies all investment records, including alternative investments, as public records subject to the Right to Know Law, unless a majority of the board finds that access would cause substantial competitive harm to the entity providing the information or have a substantial detrimental impact on the value of an investment to be acquired, held or disposed of by the system or would cause a breach of the system's fiduciary duty.
- A specific provision classifies unredacted marketing materials, including, without limitation, proposed fee terms, prospectuses, staff and consultant investment memorandum, subscription

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agreements, investment management agreements, contracts, side letters and annual investor reports of an alternative investment vehicle as public records.

- Amends the SERS code to make access to its alternative investment records consistent with the rules for PSERS.
- Prohibits the systems from entering into any investment management contract or agreement that contains terms or provisions contrary to the legislation.

The bill would take effect 60 days after being signed into law.

House Bill 1964 would affect administrative costs for both systems, and the Independent Fiscal Office (IFO) contacted the systems for information related to those costs and the potential impact of the bill on their financial operations. The estimates and comments submitted by SERS and PSERS are attached to this letter.

Under section 615-B of the Administrative Code of 1929, the IFO has the responsibility to review legislative changes that may affect public employee pension or retirement plans and to provide actuarial notes for such legislation. The IFO reviewed House Bill 1964, Printer's Number 2765, as well as materials submitted by both pension systems, and in consultation with its contracted actuary (Milliman), concluded that it was not possible to make a determination that there was a definitive actuarial impact from HB 1964 that could be quantified accurately and upon which the actuary could opine. Based on that determination, the bill does not require an actuarial note prior to further consideration by the General Assembly. The office reviewed the legislation for actuarial cost impact, but it has not reviewed the provisions for legal, administrative or policy implications.

I trust this letter adequately responds to your request. If I may provide further assistance, please contact me at (717) 230-8293.

Sincerely,



Matthew J. Knittel
Director, Independent Fiscal Office

cc: Governor Tom Wolf
Members of the General Assembly

November 15, 2019

Matthew Knittel
Director, Independent Fiscal Office
Rachel Carson State Office Building
400 Market Street
Harrisburg, PA 17105

RE: H.B. 1964, P.N. 2765

Dear Matt,

I am writing in response to your letter of October 29, 2019, requesting the State Employees' Retirement System ("SERS") to provide information regarding the potential impact of H.B. 1964 P.N. 2765, which will be included in the IFO's transmittal to legislative and executive branch officials. On behalf of SERS, I offer the following information for your use.

Livestream / Video

The initial cost impact from H.B. 1964 involves the need to livestream board meetings and to develop and maintain a video repository of board proceedings. We estimate an initial implementation cost of \$500,000 to upgrade equipment, facilities and network. We also estimate an annual cost of \$100,000 to maintain the equipment and support the infrastructure.

Additional Reporting Requirements

We estimate an initial cost of \$1.42 million to purchase and implement the software to track the additional information related to fees and expenses that is to be reported. We also estimate an annual cost of \$560,000 for software license fees and additional professional staff to track and report the fees and expenses.

In addition, it is our belief that SERS' public reporting requirements specifically detailed in Section 5902(e)(4.1)(ix) on page 12, lines 1 through 6 ("Unredacted marketing materials, including without limitation, proposed fee terms, prospectuses, staff and consultant investment memorandum, subscription agreements, investment management agreements, contracts, side letters and annual investment reports of the alternative investment vehicle.") may have an adverse impact and lower SERS' assumed rate of return and increase employer contribution levels.

To gain a better understanding of the potential implications of the requirements included in H.B. 1964, SERS reached out to a number of SERS' existing top-performing private equity firms regarding the public reporting requirements of Section 5902(e)(4.1)(ix) in H.B. 1964. In each case, the firm, each of whom asked not to be identified, indicated that they would not partner with SERS in the future if this particular section were implemented. It seems reasonable then that based

on this input, SERS runs the risk of not being able to invest in other top-performing investment opportunities (e.g. private equity, private real estate, and private credit). Not being able to have access to invest in top-performing investment opportunities may result in SERS not investing in private equity, private real estate, or private credit. If that were the case, SERS may need to revise its target asset allocation strategy and reallocate all private equity, private real estate, and private credit target allocations to lower expected return investment classes such as public equity and fixed income. The reallocation from higher expected returning asset classes to lower expected returning asset classes may lead to a lower assumed rate of return or to having a more volatile asset allocation mix to achieve the target rate of return and increased employer contribution levels.

While there is no absolute certainty that we would be shut out from such top-performing investment opportunities, based on the feedback received, as fiduciaries, it is a clear risk that we must take into consideration.

An analysis from Callan (Table 1), our general investment consultant, depicts how such a scenario of not investing in private equity, private real estate, and private credit could reduce the expected return, decrease liquidity to pay benefits, and/or increase the risk profile of the SERS fund.

Asset allocation “A” in Table 1 is SERS’ proposed asset allocation which is projected to achieve SERS’ actuarially assumed rate of return, target a lower annual investment management fee structure, target a higher allocation to liquid assets with low correlation to the public equity markets, target a lower allocation to less-liquid assets, and mitigate long-term risks of the fund.

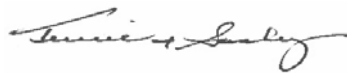
Asset allocation “B” in Table 1 depicts how such a scenario of not investing in private equity, private real estate, and private credit could reduce the expected actuarially assumed rate of return to 6.566%, if the assets allocated to those targeted areas were shifted to public equities. A lower rate of return would most certainly trigger an increase in the employer contribution rate, and lowering the actuarial assumed rate immediately has a negative impact on the funded status.

Asset allocation “C” in Table 1 depicts how such a scenario of not investing in private equity, private real estate, and private credit could increase the risk of the fund in an effort to maintain SERS’ actuarially assumed rate of return to not trigger a potential increase in employer contributions. This asset allocation shows an increase in projected volatility (standard deviation) from 13.66% to 15.68% due to an increased allocation to public equity and a decreased allocation to fixed income. Note that the projected Sharpe Ratio also goes down from 0.32 to 0.28, so risk-adjusted returns are lower. This asset allocation also constrains the Board’s ability to achieve its goal of increasing liquidity that is uncorrelated to equity markets to pay benefits during an economic downturn since the target allocation to core fixed income and inflation protection decreased. The target allocation to core fixed income decreased from 22.0% to 9.0%, inflation protection decreased from 4.0% to 0.7%, and public equity increased from 42.0% to 83.3%.

Again, while there is no absolute certainty that we would be shut out from such top-performing investment opportunities, since the risk exists, I felt it prudent as a fiduciary to provide scenarios that could result if we were.

Please feel free to contact me if you have any additional questions or concerns.

Sincerely,



Terrill (Terri) J. Sanchez
Executive Director

Pennsylvania State Employees' Retirement System
30 North 3rd Street, Suite 150, Harrisburg, PA 17101-1716
P: 717.787.9657 | F: 717.783.7300

Attachments

Table 1

	A	B	C
	SERS Proposed Target 7.00%	Reduced PE 0%, RE 0%, PC 0%	Target 7.00% Reduced PE 0%, RE 0%, PC 0%
Public Equity			
Global Equity	0%	0.0%	0.0%
US Equity	25%	40.2%	50.0%
Intl Developed Equity	13%	20.1%	25.0%
Emerging Market Equity	4%	6.7%	8.3%
Private Equity	14%	0.0%	0.0%
Real Estate Composite	8%	0.0%	0.0%
Private Credit	4%	0.0%	0.0%
Fixed Income			
Core Fixed Income	22%	23.0%	9.0%
TIPS	4%	4.0%	0.7%
Opportunistic FI	4%	4.0%	5.0%
Cash	2%	2.0%	2.0%
Total	100%	100%	100%
10 Yr. Geometric Mean Return	7.000%	6.566%	7.000%
Projected Standard Deviation	13.66%	12.55%	15.68%
10 Yr. Simulated Sharpe Ratio	0.32	0.32	0.28



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

November 15, 2019

Mr. Matthew Knittel
Director, Independent Fiscal Office
Rachel Carson State Office Building
400 Market Street
Harrisburg, PA 17105

Subject: House Bill Number 1964, Printer's Number 2765

Dear Mr. Knittel:

I am writing in response to your request for a cost analysis of House Bill Number 1964, Printer's Number 2765. The bill would amend both the Public School Employees' Retirement Code and the State Employees' Retirement Code to impose significant investment transparency and reporting requirements upon the Public School Employees' Retirement System (PSERS) and the State Employees' Retirement System (SERS). This letter and the accompanying analysis provided by PSERS' investment consultant, Aon, address the bill's impact upon PSERS only. Due to time constraints, it is not possible to provide an actuarial analysis of the bill at this time. However, a full analysis of the actuarial cost impact, which is significant, will be provided to the IFO in the next few days.

First, I must make clear that PSERS does not oppose transparency and does not oppose many provisions in HB 1964. PSERS is a nationally recognized leader among its peers in the area of financial reporting and has received numerous awards including 36 consecutive annual awards for Excellence in Financial Reporting from the Government Finance Officers Association (GFOA). PSERS has voluntarily adopted the Institutional Limited Partnership Association (ILPA) for uniform disclosure of financial data in all new investment relationships. In addition, PSERS Board, who are representatives for either the members or the employers, receive much of the transparency discussed in the bill for their deliberations on potential investments. This type of transparency is available to PSERS staff and the Board since it is currently protected from disclosure under the current Right-to-Know Law. Should this bill become law in its current form, this type of transparency will no longer be available to PSERS and would compromise PSERS' ability to competitively invest in alternative investments.

As indicated in the attached analysis conducted for PSERS by Aon (PSERS general investment consultant) in consultation with Hamilton Lane (PSERS Private Markets advisor), certain mandates contained in House Bill 1964 would impose very significant lost investment opportunity costs on the PSERS Fund and would also impose costly administrative burdens on the System. In its analysis, Aon projects a decline in expected investment returns of 4 basis points in fiscal year 2021 and falling by 85 basis points per year beginning in fiscal year 2031 and beyond. The magnitude of this decline is difficult to overstate as it would effectively cripple PSERS' alternative investment program which currently comprises over 40% of the total Fund. **An 85 basis point drop in returns will result in the loss of approximately \$490 million annually based on today's net asset value of approximately \$58 billion**

that would otherwise have been earned by the Fund. Our estimate of lost earnings based on our current net asset value, held constant, compounded at our actuarial rate of return of 7.25% over 30 years is approximately \$30 billion. These resulting losses would significantly increase annual employer costs and taxpayer costs.

Following are more concerns and observations related to specific provisions contained in the bill:

- Livestreaming all board meetings and maintaining the recordings for a period of seven years is a significant cost to the system, requiring the purchase of additional equipment, bandwidth, and server space. (bill page 1, line 16 – page 2, line 6)
- This bill makes every record of the system and board a public record unless the board determines by majority vote that the disclosure of the information will either cause substantial competitive harm or have a substantial detrimental impact on the value of an investment. This appears to include information on specific members, banking information, material non-public information (the disclosure of which may constitute insider trading), privileged documents (including attorney/client), and medical information. (bill page 2, lines 7-29)
 - PSERS would now be required to compile and disclose information that does not currently exist in a record.
 - This broad level of disclosure could violate privileges and other laws, including:
 - Federal/SEC prohibitions – including insider trading disclosures
 - Attorney-Client privilege
 - Sensitive personal and banking information – including individual members’ Defined Contribution Account information and PSERS banking information
- Sensitive or financial alternative investment information that was only obtained by agreeing not to redisclose the information is no longer protected and must be disclosed. There is no exception for information obtained under existing contracts, meaning PSERS could be required to violate contracts currently in effect. (bill page 2, line 16-21).
 - This provision also puts PSERS at a competitive disadvantage as it would no longer be able to guaranty confidentiality, and therefore, will not receive confidential information necessary to perform due diligence or negotiate fee reductions.
- The new section requiring disclosure of “unredacted marketing materials, including, without limitation, proposed fee terms, prospectuses, staff and consultant investment memorandum, subscription agreements, investment management agreements, contracts, side letters, and annual investor reports of the alternative investment vehicle” for all alternative investments is a drastic increase in disclosure that appears to require the unredacted disclosure of alternative investment contracts, side letters, proposed fee terms, and staff and consultant investment memorandum. This requires the disclosure of confidential information (including PSERS banking information) and represents a significant administrative cost. Because the information must be disclosed “unredacted,” this provision would most likely result in PSERS being shut out of investing in alternative investments as most managers would chose not to work with PSERS. (bill page 5, lines 21-26)
- The broad disclosure requirement without any “reasonableness” or time limit would further increase the administrative burden and expense of complying with this legislation as currently written. (the addition of subsection (s) beginning page 5, line 28).
- Disclosure of internal control representations/management letters from auditors and independent accounting firms could result in the disclosure of confidential and privileged information. These letters often contain system vulnerabilities, the disclosure of which would make PSERS more susceptible to cyber/criminal attack. (bill page 7, lines 3-15).

In conclusion, at a time when the Commonwealth and school district employers are struggling to make the required actuarially-determined contribution to the Fund, it would be counterproductive to impose these costly new mandates on PSERS and risk a substantial decline in investment opportunities, favorable terms and investment returns. If this bill passes in its current form, the Board may be obligated to reduce the actuarial expected rate of return from 7.25% to 6.50% due to our model of lost earnings, increasing the unfunded liability by billions of dollars and increasing the employer contribution rate.

I trust this letter adequately responds to your request. Please contact me by email (ggrell@pa.gov), or by cell phone at (717) 836-8969 with any questions or concerns.

Sincerely,



Glen R. Grell
Executive Director
PSERS

Attachments: November 15, 2019 letter from Aon on HB 1964
November 15, 2019 letter from Hamilton Lane Advisors, LLC on HB 1964



To: PSERS Investment Staff
From: Hamilton Lane Advisors, L.L.C.
Date: November 15, 2019
Subject: Proposed Transparency Bill

Memorandum

The following memorandum has been created at the request of the Investment Staff of the Commonwealth of Pennsylvania, Public School Employees' Retirement System ("PSERS"), in response to the General Assembly of Pennsylvania's House Bill No. 1964, Session 2019, as amended, on second consideration for the House of Representatives on October 22, 2019 (the "Bill"). This memorandum outlines considerations and potential risks to the newly proposed bill on transparency.

Hamilton Lane has and remains committed to providing clients with transparency and is a leading provider of data and technology, facilitating transparency in the private markets. However, there are certain aspects of the proposed bill that could pose significant risks to the PSERS private markets program.

Overview & Risks Associated with Additional Requirements of House Bill No. 1964

Below is a summary of the most recent requirement to make publicly accessible via internet website all materials presented to the PSERS Board, as well as, any material or data received or used by the investment staff relating to a proposed investment. The following information for alternative investments has been specifically outlined to constitute a public record under the Right-To-Know Law:

- (i) The name, address and vintage year of the alternative investment vehicle.
- (ii) The identity of the manager of the alternative investment vehicle
- (iii) The dollar amount of the commitment made by the system or plan to the alternative investment vehicle.
- (iv) The dollar amount of cash contributions made by the system or plan to the alternative investment vehicle.
- (v) The dollar amount of cash distributions received by the system or plan to the alternative investment vehicle.
- (vi) The gross and net internal rate of return of the alternative investment vehicle since inception, provided that the system or plan shall not be required to disclose the gross or net internal rate of return under circumstance in which, because of the limited number of portfolio assets remaining in the alternative investment vehicle, the disclosure could reveal the values of specifically identifiable remaining portfolio assets to the detriment of the alternative investment.
- (vii) The aggregate value of the remaining portfolio assets attributable to the system's or plan's investment in the alternative investment vehicle, provided that the system or plan shall not be required to disclose the value under circumstances in which, because of the limited number of portfolio assets remaining in the alternative investment vehicle, the disclosure could reveal the values of specifically identifiable remaining portfolio assets to the detriment of the alternative investment
- (viii) The dollar amounts of total management fees, costs and expenses paid to or retained from the alternative investment vehicle by the system or plan on an annual fiscal year-end basis, itemized by gross management, carried interest and other expenses.
- (ix) Unredacted marketing materials, including, without limitation, proposed fee terms, prospectuses, staff and consultant investment memorandum, subscription agreements, investment management agreements, contracts, side letters and annual investment reports of the alternative investment vehicle.



Generally speaking, requirements (i) through (viii) are reasonable, and although onerous could be produced and shared on a periodic basis. There are two notable exceptions, which include items (vi) and (ix).

For item (vi), the performance of the portfolio, gross of underlying investment manager fees, is not something Hamilton Lane currently calculates for PSERS or any of its other clients, as gross performance calculations are not standard industry practice. Calculating a gross IRR would require investment managers to send gross cash flows to PSERS and Hamilton Lane, as relating to the percentage of PSERS ownership in the fund. General Partners (“GPs”) of funds typically track the gross cash flows at the overall fund level. Given the emphasis on reporting net performance, industry practice is to provide cash flow information net of fees for a Limited Partner’s (“LP’s”) specific ownership.

Item (ix) is potentially problematic as it requires disclosure of confidential, and what could be deemed to be proprietary or trade secret information as identified by partners in the PSERS private markets investing program. Many of the materials listed in item (ix) frequently include detailed information about the financial health, management teams and operational initiatives of each underlying portfolio company, which is information not available to the public. Other sensitive items contained in item (ix) materials are: investing approach, GP personnel details, and pipelines of investment opportunities. The terms of limited partnership or other agreements detail confidential elements of the contract between a limited partner and general partner, and the sponsors of those investments view many of those terms as trade secrets. The materials outlined in (ix) are made available to Hamilton Lane and PSERS by the prospective manager, under the assumption that it is confidential and being used for the sole purpose of making an investment decision. In many scenarios, Hamilton Lane and/or PSERS is required to sign a Non-Disclosure Agreement to obtain these diligence materials. For all these reasons, should PSERS be required to implement item (ix) as outlined above, there is a real business risk that diminished access to managers and information could result, which may have a negative impact on PSERS ability to meet its private market portfolio objectives and ultimately the overall return target for the pension.

As the consultant for PSERS private markets, private credit and private real assets portfolios, Hamilton Lane currently produces investment and operational diligence reports for prospective alternative investments under consideration by the PSERS Board. These separate diligence reports contain detailed information on the prospective manager’s team, targeted strategy, historical track record and operational processes. The detail encompassed within these reports is confidential and proprietary and could be deemed to be trade secrets, and provides insight into the competitive advantages of a particular manager and how they have or intend to add value to the underlying businesses that they acquire. The analytics in our reports are proprietary and confidential to Hamilton Lane and only for the use of our clients. We view the public release of these reports as problematic for our competitive advantage, and not consistent with the agreement currently in place with PSERS.

We note that Hamilton Lane is a partner to many public institutions, including those that are subject to public disclosure laws. Many of these laws contain carve-outs for information deemed proprietary or trade secret or which could hurt the competitive advantage of the party whose information is being disclosed. Market practice is typically to provide assurances to prospective managers in side agreements that measures will be taken to protect their sensitive or proprietary information from public disclosure.

Conclusions:

In summary, disclosure of the diligence materials referenced in item (ix) is problematic for PSERS alternative investments program, as most managers expect and require confidentiality for the trade secret components of their business approach. Additionally, private markets consultants like Hamilton Lane, whose service model is to review and dissect the track records and value-add capabilities of these alternative investment managers, would not want their confidential materials and analytical tools made publicly available. In addition, in connection with item (vi), we reiterate that gross fee calculations are not industry standard and could present reporting challenges.