PUBLIC EMPLOYEE RETIREMENT COMMISSION

ACTUARIAL NOTE TRANSMITTAL

Bill ID: Senate Bill Number 606, Printer's Number 672

System: State Employees' Retirement System,
Public School Employees' Retirement System and
Municipal Police Pension Systems

Subject: Statewide Local Government Police Employee Retirement System

---

SYNOPSIS

Senate Bill Number 606, Printer's Number 672, would amend the Public School Employees' Retirement Code and the State Employees' Retirement Code by mandating the establishment of a centrally administered statewide retirement system for all local government police employees. A local government is defined by the bill as any municipality, excluding a county. The bill will systematically implement a gradual consolidation and integration of the existing decentralized local police pension plan structure into a single statewide system to be known as the Government Employees' Retirement System. The new system will be of a size, scope and structure intended to assure fiscal and actuarial stability, proper funding, benefit adequacy, benefit equity and security, administrative cost savings and increased efficiency, prudent investment of assets, enhanced member services, and employee portability.

DISCUSSION

Pennsylvania currently has approximately 970 pension plans for municipal police employees, representing one-third of all municipal pension plans in the Commonwealth. Based upon 2003 Act 205 reporting period data, including the City of Philadelphia, these plans had a total of 18,151 active members, with an average membership of 18.6 members per plan. Three hundred fifty-two (352) of the police plans, or 36%, had three or fewer active members; and 340 plans, or 35%, had from 4 to 10 members. In total, these 970 police pension plans were paying benefits to approximately 18,352 retired members and beneficiaries. It should be noted that the City of Philadelphia represents approximately 35% of the active membership and 56% of the retired members and beneficiaries.

The transition to a statewide system will occur gradually through the mandatory participation of police employees hired after the later of January 1, 2006, or the expiration of a current collective bargaining agreement. Under the bill, a local government police pension plan established prior to January 1, 2006, may continue to operate until either all of the plan's current members and beneficiaries are voluntarily transferred to the new statewide system, or until the local police pension plan no longer has members or beneficiaries representing actual or potential liabilities. The bill permits the continuance of existing, self-administered

DISCUSSION (CONT'D)

local government retirement systems, but it prohibits the establishment of any new police retirement systems by local governments except through participation in the Government Employees' Retirement System. Provisions are also included in the bill for the optional participation by current employees, provided that both the affected municipality and the employees agree on the terms of participation and that all existing pension liabilities are fully-funded prior to participation.

For the purposes of this analysis, the Commission staff and the Commission's consulting actuary have assumed that no existing police pension plans will voluntarily transfer current members into the statewide plan. Instead, the Commission's consulting actuary has assumed that only police employees hired after December 31, 2005, will become members of the statewide plan, as mandated by the bill. The actuary's assumption results in the gradual recognition of the aggregate effects of full implementation of the statewide plan over the course of 20 years, after which time all local government police officers will be members of the statewide system.

Organization and Administration

Under the bill, the new statewide retirement system for police employees will be administered under the auspices of an existing state agency – the State Employees' Retirement System (SERS). The State Employees' Retirement System possesses both the necessary staff and expertise to effectively administer such a large retirement plan. Under the bill, SERS will be administratively combined with the statewide local government police employees' retirement system to form a consolidated entity that will be known as the Government Employees' Retirement System (GERS).

To permit local governments to retain control of pension fund assets and to ensure there is no potential for the transference of State costs to local governments, the bill provides for asset management and funding determination functions to be segregated and controlled by a Local Government Employees' Retirement Board that is separate and distinct from the State Employees' Retirement Board. The Board's membership will consist of six members (three local government officials or employees, and three active or retired local government police employees) appointed by the Governor with the advice and consent of the Senate. The Local Government Police Employees' Retirement Board will administer the Local Government Employees' Retirement Fund and will have powers and duties essentially identical to those of the State Employees' Retirement Board.

DISCUSSION (CONT'D)

Administrative Expenses

Municipal governments are increasingly required to react to multiple levels of state and federal legislation concerning tax and other employment related issues. Within Pennsylvania's decentralized system, the availability and accuracy of reliable data are accordingly becoming more critical. Plan documents, including demographics, earnings, and payment records, must be maintained over the active and retired life of employees, which often exceeds fifty years. Small municipalities very often lack the administrative continuity to perform these functions on a long-term basis.

Additionally, the high per-member costs associated with administering so many small municipal plans has long been a concern of the Commission. These administrative costs are significantly greater for most local government police plans than for either large municipal plans, such as the City of Philadelphia, or for statewide plans such as the State Employees' Retirement System (SERS). A review of the Commission's 2003 Act 205 reporting data revealed that the average per-member administrative cost for the Commonwealth's approximately 970 local government police pension plans (including Philadelphia) was $865.

The Commission's consulting actuary estimated the administrative cost savings associated with the consolidation of administrative functions through the proposed statewide retirement system. Based upon the average per-member administrative costs under SERS of $175, the reduction in annual administrative expenses in year 20 would be approximately $22.6 million, or 1.26% of total projected payroll. Clearly, the relative administrative efficiency and effectiveness of a single, consolidated statewide retirement system over the administration of large numbers of very small municipal plans is evident.

Actuarial Cost Methodology

Actuarial cost methodology is used in the administration of a retirement system to determine a total cost that is systematically funded in advance of the actual pension benefit payments. Actuarial cost methodology is used to assure the predictability of the ongoing funding requirements of the retirement system. The broad base of demographic experience afforded by a pension plan with a large membership allows greater accuracy in the choice of actuarial assumptions and consequently improves the reliability of the actuarial cost determinations. However, when actuarial cost calculations are performed for a pension plan with a small membership, there is a limited base of demographic experience upon which to base the choice of actuarial assumptions. Because actuarial assumptions are largely based on statistical averages, the size of the plan directly affects the probability of the predicted events being

DISCUSSION (CONT'D)

realized. In the absence of an adequate experience base, the selection of accurate actuarial assumptions is difficult, and the reliability of the actuarial cost determinations is reduced. As stated previously, a review of the Commission's 2003 Act 205 reporting data reveals that the average membership of police pension plans in the Commonwealth is approximately 18.6 members per plan. No accepted actuarial cost method can be reliably applied to these small pension funds.

Investment of Plan Assets

Investment management is another function that demonstrates the relative inefficiency of the current decentralized structure of local government police employee retirement systems. In addition to compounding the direct costs attributable to the investment function, the dispersed investment activity limits access to certain investments that require minimum threshold deposits and impedes the level of diversification that would be available to a larger fund. To the extent that the lack of investment diversification or the limited access to investment vehicles diminishes earnings, the current decentralized structure of local government retirement systems increases the pension costs that must be financed with tax revenues.

Comparing the investment performance of local government police employee retirement systems to that of SERS further illustrates the negative impact that the current system of decentralized investment management has on local governments. In making this comparison, the Commission was confined to comparing reported rates of return in the even-numbered calendar years from 1996 through 2002, even though these were years of low return for SERS. The use of these time periods is compelled by the alternate year reporting established by Act 205 and the lack of data concerning unrealized capital gains and losses in municipal plans other than Philadelphia prior to the 1997 Act 205 filing period. This analysis evinced a non-Philadelphia municipal rate of return of 3.9%, while SERS achieved a return of 5.9% during the same time frame, for a difference of 2.0%. Comparing SERS to Philadelphia's fiscal data at the same time points[1] resulted in Philadelphia returns of 8.3% and SERS returns of 11.8%, for a difference of 3.5%. Weighting those results to conform to the fact that Philadelphia holds thirty percent (30%) and the remaining municipal police pension plans hold seventy percent (70%) of total police pension fund assets leads to a total difference between SERS and the aggregated municipal rate of return of 2.45%. If all assets, liabilities, and active and retired memberships were transferred to a single statewide system, an increase in investment returns

---

[1] The City of Philadelphia's pension plans report investment earnings on a fiscal year basis ending June 30, while the State Employees' Retirement System reports on a calendar year basis, ending December 31 of each year. The comparison was made between Philadelphia's fiscal results and SERS' mid-year investment returns.

DISCUSSION (CONT'D)

would, therefore, be expected. As the data in the following table shows, even a one percent increase in future investment returns would yield an additional increase in revenues of approximately $34 million (after full implementation).

The following table is intended to illustrate the potential annual increase in investment returns based upon four projected investment return scenarios.

Potential for Increased Investment Earnings Resulting from Statewide Plan

Assumed Increase in Investment Return	Reduction in Employer Costs in Dollars [2]	Reduction in Employer Costs as a % of Projected Payroll [2]
1%	$ 34,000,000	1.89%
2%	$ 68,000,000	3.78%
2.4% [3]	**$ 82,000,000**	**4.56%**
3%	$102,000,000	5.76%

Even a conservative evaluation of the data demonstrates that a statewide retirement system for municipal police employees would reduce the government revenues needed to finance police pension benefits while effecting an improved benefit structure for most municipal police officers that is both equitable and uniform.

Benefit Structure

Much of the benefit disparity of municipal police pension plans results from the confusing and sometimes conflicting state laws governing police pension benefits. There are more than a dozen state laws, many of which have been amended repeatedly, that directly affect the benefits to be provided to municipal police officers. Most municipal police pension plans have

[2] The Reduction in Employer Costs in Dollars is based upon the projected future payroll at a specific time that is twenty years after implementation of the bill. The percentage changes are not dependent upon that payroll projection and are ongoing into the future.

[3] As previously discussed, the Commission staff believes the 2.4% increase expectation to be the most reasonable, based upon a review of the most recent four Act 205 biennial reporting periods (8 years) of average investment returns of municipal police plans compared with the average investment returns of SERS over the same alternate year time period.

DISCUSSION (CONT'D)

a benefit structure with a basic benefit of 50 percent of final average salary, after meeting age and service requirements. Some plans, however, provide benefits as low as 20 percent of final salary and some are as high as 80 percent of final salary. The normal cost rates among municipal police plans also vary greatly and are another indicator of the disparity in benefits. Normal costs, when stated as a percentage of payroll, during the 2003 Act 205 reporting period were as low as 2.2 percent of payroll and as high as 35.3 percent of payroll.

Under the bill, benefits for police employees would be determined in accordance with the current accrual rate system used to calculate retirement benefits for SERS members. Under the SERS Code, the pension benefit is determined using a formula which is the product of a basic accrual rate multiplied by the member's years of credited service, multiplied by the member's final average salary (average of the highest three years of income) multiplied by the member's class of service multiplier. Under the bill, local governments will utilize four membership classifications to provide police employee pension benefits, and the new membership classifications will be integrated into the existing SERS membership and benefit structure. The following table illustrates the four police employee classifications and their corresponding benefit structures:

Classification	Benefit Accrual Rate [4]	Superannuation Age	Member Contribution Rate
Class P1	2.5% for first 20 years; 2.0% for years over 20	Age 50 or 20 years of service	6.25% for first 20 years; 5.0% for years over 20
Class P2	2.25%	Age 50	5.625%
Class P3	2.0%	Age 50	5.0%
Class P4	1.75%	Age 55	4.375%

The bill provides for employee participation in the selection of the benefit classifications in instances where pension benefits are now being provided and it assures that the pension benefits of current employees are not reduced. Ancillary benefits, including vesting, disability and death benefits, are in accordance with the existing SERS benefit structure.

[4] This Benefit Accrual Rate represents the basic accrual rate multiplied by the appropriate class of service multiplier.

DISCUSSION (CONT'D)

Additionally, the bill requires the Local Government Police Employees' Retirement Board to establish a supplemental local government retirement benefit accumulation plan, which is a voluntary program to be funded through matching employer and employee contributions accumulated in individual employee accounts that may be used to provide supplemental benefits in retirement.

The bill also authorizes the provision of retirement benefits for part-time local government employees and specifies the use of simplified individual retirement accounts under section 408 of the IRS Code, and requires that the variable annual contributions be specified as a uniform percentage of compensation.

In making his cost projections, the Commission's consulting actuary assumed that the collective bargaining process would ultimately result in all municipal pension plans providing one of the highest two levels of plan benefits, either P1 or P2. He then estimated the aggregate effect of the change in benefit structure proposed in the bill assuming full implementation after 20 years, based upon a future total active membership of approximately 18,000 police employees with a projected payroll of $1.8 billion, an interest rate assumption of 8.5%, assumed salary increases of 5.5% per year, and utilizing the mortality assumptions currently applied to SERS active members. The actuary estimated that the aggregate normal costs in year 20 for the 18,000 active members would be approximately $243 million, or 13.5% of total projected payroll, representing an aggregate increase in normal cost of approximately $75 million, or 4.17% of projected payroll.

Employee Contributions

The bill requires all active members of the statewide plan to make employee contributions to the plan that correlate to the member's class of service. The employee contribution requirements are displayed in the following table.

Classification	Member Contribution Rate
Class P1	6.25% for first 20 years; 5.0% for years over 20
Class P2	5.625%
Class P3	5.0%
Class P4	4.375%

DISCUSSION (CONT'D)

Under the existing system, the Commission's consulting actuary estimated employee contributions in year 20 of approximately $68 million, or 3.78% of total projected payroll. Under the proposed statewide plan, the actuary estimated that projected annual employee contributions to the statewide system would be approximately $107 million, or 5.94% of total projected payroll. Upon full implementation of the statewide plan after 20 years of transition, the result would be a net increase in employee contributions to the statewide plan of approximately $39 million, or 2.17% of total projected payroll.

Portability

The current lack of portability among police pension plans prevents an employee from transferring pension rights and benefits from one municipal employer to another in conjunction with job changes. Accordingly, many police employees are restricted in their ability to achieve their full career potential. Employers also lose significant flexibility because of the impediment lack of portability imposes on the selection of employees from other municipalities. Under the current decentralized system, it is impracticable to establish an equitable method to value and transfer assets and service credits among municipalities with varying benefit structures, funding mechanisms and funded conditions.

The single, statewide system provided for under the bill provides complete portability for municipal police employees and provides professional police employees the retirement advantages of a single statewide employer.

Effects on Pension Funding

As local police pension plan membership and associated costs are gradually transitioned to the statewide system, more of the cost of funding police pension benefits will shift to the police members, to the same extent as now required of State employees. This will alleviate some of the burden currently imposed upon local taxpayers. To the extent that the need for State aid to municipalities declines, the bill provides a mechanism for handling residual funds by requiring that any unallocated funds in a given year be held in reserve for allocation in the subsequent year. In the event that the unallocated moneys in any year exceed 10% of the total moneys available for allocation in that year, the excess funds will be paid into the Commonwealth General Fund.

SUMMARY OF ACTUARIAL COST IMPACT

The following table depicts the projected aggregate impact of the proposed statewide plan, with an estimated future payroll of $1.8 billion, and with full implementation in 20 years.

	As a Dollar Amount	As a % of Projected Payroll
Increase in Employer Cost		
Projected Increase in Aggregate Normal Costs	$ 75,000,000	4.17%
Offset to Employer Cost		
Projected Increase in Employee Contributions [5]	39,000,000	2.17%
Projected Reduction in Administrative Expenses	22,600,000	1.26%
Projected Increase in Return on Investments [6]	82,000,000	4.56%
Total Projected Employer Annual Cost Savings	**$ 68,600,000**	**3.82%**

POLICY CONSIDERATIONS

In reviewing the bill, the Commission identified the following policy considerations:

Statewide Plan. **(+)** The establishment of a statewide municipal police pension plan would remedy the problems of ineffective and inefficient administration, lack of portability, and disparity in benefit structure. Additionally, a statewide system would, when fully implemented, significantly reduce employers' municipal police pension costs, provide for reliable actuarial funding, enhance membership services, and provide equitable retirement benefits to the Commonwealth’s municipal police officers.

[5] The projected increase in employee contributions over projected local police pension plan contribution levels results in a corresponding decrease in future employer contribution requirements.

[6] Based on an estimated average 2.4% increase in investment return over municipal return rates resulting, in part, from the consolidation of assets made possible in a statewide plan.

POLICY CONSIDERATIONS (CONT'D)

Gradual Implementation. **(+)** The extended transition period for implementation of the statewide local government police employees' retirement system is provided to prevent the disruptive effects that would most likely occur with immediate implementation. The long transition period will also facilitate the administrative changes needed to accommodate implementation of the new system.

Administrative Efficiency. **(+)** Implementation of a statewide retirement system for local government police employees will enable the consolidation of administrative functions, increasing efficiency and significantly reducing costs associated with providing employee retirement benefits.

Determination of Actuarial Funding Requirements. **(+)** The bill resolves the present difficulties in the application of actuarial cost methods in numerous small plans by consolidating the membership of the approximately 970 police pension plans into a single retirement system.

Centralized Investment Management. **(+)** The consolidation of assets and centralization of investment management functions provided for in the bill will serve to maximize potential investment earnings and reduce the risks of adverse investment experience.

Benefit Portability. **(+)** A statewide retirement system for local government police employees will ensure pension benefit portability for police employees. The transfer of retirement service credits between local governments will eliminate a substantial impediment to police employee mobility, facilitating recruitment, and providing more equitable retirement benefits when a public safety career involves service with more than one government entity.

Benefit Uniformity. **(+)** Because local governments will provide more uniform benefits within the parameters provided by a statewide system, the competitive pressure on police employees to achieve higher benefits will diminish, and the benefit provisions will be more widely understood and accessible.

Enhanced Member Services. **(+)** The statewide system provided for in the bill will ensure an adequate and consistent level of retirement-related services to police employees.

Provision for Cost Sharing. **(+)** The provision in the bill requiring increased member contribution rates consistent with the enhanced benefit structure appears to be a reasonable public pension policy approach.

Commission Recommendation

The Commission voted to attach the actuarial note to the bill, recommending that the General Assembly and the Governor consider the policy issues identified above and favorably consider enactment of the bill.

Attachments

Actuarial note prepared by Mr. David H. Killick of Conrad Siegel Actuaries.

Supplemental letter prepared by Mr. David H. Killick of Conrad Siegel Actuaries.

Senate Bill Number 606, Printer's Number 672.