

**PUBLIC EMPLOYEE RETIREMENT COMMISSION****ACTUARIAL NOTE TRANSMITTAL**

Bill ID: Senate Bill Number 686, Printer's Number 789

System: State Employees' Retirement System

Subject: Purchase of Credit for Nonstate Service as a Municipal or Federal Employee

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**SYNOPSIS**

Senate Bill Number 686, Printer's Number 789, would amend sections 5304 and 5505 of the State Employees' Retirement Code (Code) to permit an active member or an active multiple service member to purchase service credit in the State Employees' Retirement System (SERS) for previous nonstate service as an employee of a Pennsylvania municipality or as an employee of the federal government, provided that:

The election is made from July 1, 2003, through June 30, 2005;

The member was a member of or was eligible to join as a member of a Pennsylvania municipal (county, city, borough, incorporated town or township) retirement system; or the member was a member of or was eligible to join as a member of a federal retirement system;

The member could not, upon leaving municipal or federal service, have drawn any type of retirement benefit, excluding the return of employee contributions and interest;

The nonstate service credit purchased does not exceed the lesser of five years or one-half of the member's state service at the time of application for the credit; and

The member's purchase contribution for the service credit is determined in the same manner as nonintervening military service under section 5505(b).

**DISCUSSION**

The State Employees' Retirement Code (Code) is a governmental, cost-sharing, multiple-employer, contributory, defined benefit pension plan. The designated purpose of the State Employees' Retirement System (SERS) is to provide retirement allowances and other benefits, including disability and death benefits, to employees of the Commonwealth and certain

## **DISCUSSION (CONT'D)**

independent agencies. As of December 31, 2002, there were approximately 106 participating state and independent agencies in SERS. Membership in SERS is mandatory for most state employees. Certain other employees are not required but are given the option to participate. As of December 31, 2002, there were 111,059 active members and 91,228 annuitant members of SERS.

Under the Code, most members are eligible to retire and receive full, unreduced retirement benefits at age 60 with three years of service credit, or at any age with 35 years of service credit. The pension benefit is equivalent to 2.5 percent multiplied by the number of years of service credit multiplied by the member's final average (highest three years) salary. The number of years of credited service has a direct impact on the benefit amount for both regular and early retirement. Public employee defined benefit pension plan provisions that permit a member to receive additional service credits are of value to the member because they enhance the retirement benefit and also may accelerate retirement eligibility.

The bill would expand the list of purchasable nonstate service to include service as an employee of a Pennsylvania municipality or employee of the federal government, subject to certain restrictions. A member could not purchase more nonstate service than one-half of the credited state service that the member has at the time of purchase, and in no event could the member purchase more than five years. The effect of the additional service credit would be to increase the member's SERS annuity by an amount equal to 2.0 percent of the member's final average salary for every year of service credit purchased.

The bill requires that, in order to be eligible to purchase credit for the nonstate service, the member must either have been a member of the former employer's retirement system or been eligible to join the former employer's retirement system. Many Pennsylvania municipalities have no retirement system for nonuniformed employees. Under the bill, a member who had worked in such a municipality would not be eligible to purchase credit for the municipal service, while a member who elected not to join a municipal retirement system would be eligible to purchase credit for the municipal service.

Under section 5304 of the Code, a member cannot purchase credit for nonstate service for which the member is entitled to receive, eligible to receive now or in the future, or is receiving retirement benefits under a retirement system administered and wholly or partially paid for by any other governmental agency. In order to be eligible to purchase credit for nonstate service under the bill, a member would have already surrendered, or would be required to surrender, retirement system rights in the municipal or federal retirement system. Granting the purchase option to a SERS member who could have been a member of a municipal or

## DISCUSSION (CONT'D)

federal retirement system may necessitate a difficult, after-the-fact determination by SERS of whether the individual could have joined the former retirement system.

The bill limits the exercise of the proposed purchase option to the two-year period of July 1, 2003, through June 30, 2005. The bill also proposes to use the section 5505(b) method to compute the member's purchase contribution, which means that in order to exercise the proposed purchase option, a member will have to have become a member of SERS before July 1, 2002, because the purchase contribution must be based on the member's average annual rate of compensation over the first three years of state service subsequent to the service purchase. In public employee retirement systems, purchase of service credit options normally are available to any member who joins the system with the permitted prior service regardless of the date of entering the system. The public policy rationale for limiting the purchase option to individuals who became members prior to July 1, 2002, is not evident.

The bill would limit the time during which the proposed purchase option could be exercised to the two-year period from July 1, 2003, through June 30, 2005. Limiting the time during which a purchase of service credit option may be exercised in a public employee retirement system is not uncommon because it reduces the actuarial loss to the system caused by the purchases. However, the most appropriate means of specifying a time limit for a purchase of nonstate service credit is to require that the purchase option be exercised within a period of time after the member first becomes eligible to purchase the service credit. Unless the service for which credit is to be purchased was rendered previously during a finite period of time, the time limit usually is not implemented through specification of a termination date for the purchase option. Specification of a termination date where the type of service to be purchased is ongoing, as proposed in the bill, serves to restrict the purchasable service to service rendered prior to the specified termination date. Although this approach to a time limit for the service credit purchases reduces the costs of the proposal, there is a high probability that increased costs will be incurred through future extensions of the specified termination date because there is no apparent public pension policy rationale for the artificial distinction between prior and future service of the type being purchased.

Under section 5505(b) of the Code, the statutory method for calculating the member contribution to purchase service credit for prior nonstate service will be to apply the member's basic contribution rate, plus the Commonwealth normal contribution rate for active members at the time of entry of the member into state service to the member's average annual rate of compensation over the first three years of subsequent state service and multiplying the result by the years of service being purchased plus interest at the statutory interest rate of four

## **DISCUSSION (CONT'D)**

percent during all periods of subsequent state and school service up to the actual date of purchase.

In addition to the direct actuarial cost to the Commonwealth for the increased SERS benefits under the bill, there may be other retirement benefit costs incurred by the Commonwealth. By purchasing service credit in SERS for nonstate service, a member either may become eligible for other postretirement benefits sooner than otherwise or may achieve eligibility for those benefits when the member could not otherwise do so.

Under the Code, a member under age 60 must have 35 years of service credit to retire and receive a full pension. The bill, therefore, would permit a 57-year-old member with 30 years of Commonwealth service to purchase five years of service credit for the proposed type of nonstate service and immediately retire with a full pension, although the member would not be eligible for full retirement under standard Code provisions.

Under certain current Executive Board actions and collective bargaining agreements, total years of service credit in SERS are used to determine eligibility for some ancillary retirement benefits that are not provided for in the Code. Examples of the ancillary retirement benefits include payment by the Commonwealth to the employee at retirement for a portion of earned, unused sick leave and payment by the Commonwealth throughout retirement for the retiree's medical insurance.

## **SUMMARY OF ACTUARIAL COST IMPACT**

The following table illustrates the estimated percentage of the full actuarial cost paid by the member for selected age and service combinations. The estimates are based on average career salary increases of 6.0% from time of entry to time at purchase. The consulting actuary of the Commission has estimated this percentage for a range of Commonwealth normal contribution rates at time of entry. These rates have ranged from a low of 3.60% to a high of 10.73%. As the Commonwealth normal contribution rate at time of entry increases, the percentage of the total cost paid by the member also increases.

**SUMMARY OF ACTUARIAL COST IMPACT (CONT'D)**

<b>Estimated Percentage of Total Cost Paid by the Member</b>				
<b>Current Age</b>	<b>Current Service with SERS</b>	<b>Normal Contribution Rate = 3.60%</b>	<b>Normal Contribution Rate = 7.00%</b>	<b>Normal Contribution Rate = 10.73%</b>
30	5	41%	57%	75%
40	10	76	105	138
50	20	49	69	90
60	30	32	45	59

The consulting actuary of the Commission also examined the effect of alternative average career salary growth rates on the estimated percentage paid by the member. The following table illustrates the effect of average career salary growth of 4.0%, 6.0%, and 8.0%, and assumes a Commonwealth normal contribution rate of 7.0% at time of entry. As the average career salary scale increases, the percentage of total cost paid by the member decreases.

<b>Estimated Percentage of Total Cost Paid by the Member</b>				
<b>Current Age</b>	<b>Current Service with SERS</b>	<b>Average Salary Increase of 4%</b>	<b>Average Salary Increase of 6%</b>	<b>Average Salary Increase of 8%</b>
30	5	62%	57%	53%
40	10	125	105	89
50	20	99	69	48
60	30	78	45	26

The consulting actuary of the Commission has estimated the increase in the unfunded actuarial accrued liability due to these possible service purchases based on an average current annual salary of \$43,000, average past salary growth of 6.0%, and a Commonwealth normal contribution rate of 7.0% at time of entry. The consulting actuary also assumed that, on average, members would purchase 2.5 years of service and that the members who purchase service would be those who advance their superannuation age. The consulting actuary has

**SUMMARY OF ACTUARIAL COST IMPACT (CONT'D)**

estimated the first year amortization payment attributable to the service purchase authorization both as a dollar amount and as a percentage of total payroll. These estimates are summarized in the following table.

<b>Estimated Actuarial Cost to the Commonwealth</b>			
<b>Number of Eligible Members who Purchase Service</b>	<b>Estimated Increase in Unfunded Actuarial Accrued Liability</b>	<b>First Year Amortization Payment</b>	
		<b>Amount</b>	<b>% of Payroll</b>
200	\$ 3,000,000	\$ 500,000	0.01%
600	9,000,000	1,400,000	0.03
1,000	15,000,000	2,300,000	0.05
2,000	30,000,000	4,600,000	0.09

**POLICY CONSIDERATIONS**

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

Departure from Policy Guidelines. (-) In March of 1997, the Public Employee Retirement Commission published *Service Purchase Authorizations for Pennsylvania Public Employee Retirement Systems*, a report recommending policy guidelines for authorizing, funding, and structuring service purchases. The bill conforms in part to some of the recommendations and does not conform to other recommendations in the report concerned with authorizing, funding, and structuring service purchases.

*Inequity of Certain Service Purchase Authorizations.* The Commission recommended that service purchase authorizations not be employed as a means of recognizing past education, training, or work experience of public employees based on the public policy determination that the recognition of these activities represents a departure from the conventional role of a public employee retirement system as an employment-related benefit maintained principally in the interest of those devoting a substantial career to service for the public employer. The use of service purchase authorizations on an ad hoc basis to recognize past education, training, or experience requires policy makers to

## POLICY CONSIDERATIONS (CONT'D)

make arbitrary determinations concerning what types of past service should be purchasable results in inequitable treatment of public employees.

*Appropriateness of Credit for Municipal/Federal Service.* The specific situations for which the Commission considered the use of service purchase authorizations to be appropriate were limited to those involving military service, transfers of governmental function, the reinstatement of service credits following a break in service, and remedying inequalities caused by employer actions. The service for which credit is to be made purchasable under the bill does not occur under any of these situations. For the Commonwealth, the service credit authorization would represent permission to purchase credit for service with another government, a government that enjoyed an actuarial gain when the member terminated service or will enjoy an actuarial gain when the employee surrenders retirement system rights in order to purchase this service credit in SERS. The SERS fund will suffer an actuarial loss in permitting these purchases unless the bill is amended to require an employee to pay the full actuarial cost.

*Adequacy of Purchase Payments.* The statutory method for calculating the member contributions to purchase service credit for nonstate service proposed in the bill may result in a member paying less than the full actuarial cost of the increased benefit acquired through the service credit purchase. This service credit purchase price will result in an increase in the unfunded actuarial accrued liability of SERS and increased amortization payments by the Commonwealth. A service purchase transaction that favors a member at the expense of the retirement system is viewed by the Commission as being appropriate only where necessary for the purpose of equity. If the bill were to be amended to require payment by the member of the full actuarial cost of the increased benefit obtained by virtue of the service credit purchase, there would be no actuarial cost to the Commonwealth.

*Cost Effective Technical Provisions.* For service purchase authorizations of this type, the Commission recommended that employees be required to exercise the purchase option within three years of becoming eligible to do so. The bill proposes a specific two-year period during which the purchase option may be exercised. Unless the service credit to be purchased was rendered during a previous, finite period of time, the time limit is not usually implemented through specification of a termination date for the purchase option. Specification of a termination date where the type of service for which credit is to be

## **POLICY CONSIDERATIONS (CONT'D)**

purchased is ongoing, as proposed in the bill, serves to restrict the purchasable service to only service rendered prior to the specified termination date. The Commission also recommended that, in cases where the service purchase amount required to be paid by an employee includes amounts representing both employer and employee costs attributable to the purchased service, the portion of the payment representing employer cost be precluded from withdrawal by a member upon retirement. Unless the bill is amended to exclude the employer portion of the purchase payment from Option 4 lump sum withdrawal, it will enable an eligible member to receive the service credit and have the entire purchase amount returned upon retirement as part of the Option 4 withdrawal. The absence of a restriction on withdrawal of the purchase amount under Option 4 will increase the cost to SERS associated with the authorization to purchase credit for this nonstate service.

Unequal Treatment of Similarly Situated Individuals. (-) The bill limits eligibility to purchase credit for the Pennsylvania municipal service to those individuals who were either members of or eligible to join the former employer's retirement system, thereby preventing an individual who worked for a Pennsylvania municipality with no retirement system coverage from purchasing the service credit.

Documentation Problems. (-) In the case of a member applying to purchase credit for municipal or federal service that occurred many years prior to the purchase, the member, the municipal or federal entity, and SERS may encounter difficulty in documenting that the prior nonstate service was rendered and that the member joined, or was eligible to join, the municipal/federal government retirement system.

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## **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.

## **ATTACHMENTS**

Actuarial Note prepared by Katherine A. Warren of Milliman USA.

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