Pennsylvania House State Government Committee
Senate Bill 1
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Testimony of
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Chairman Metcalfe, Democratic Chair Cohen, and Members of the Committee - thank you for allowing me to submit written testimony on this important matter regarding retirement benefits for Pennsylvania state and school employees.

NASRA is an association whose members are the directors of the largest state, statewide, and territorial public employee retirement systems in the United States. Collectively NASRA members are responsible for the management of nearly 2/3 of the nearly $3.8 trillion held in trust to provide retirement benefits for 14 million working and 9 million retired employees of state and local governments.

The purpose of an employer sponsored retirement benefit is to meet the unique objectives of plan stakeholders, chiefly public employers, employees, and taxpayers. Generally, public employers want to be able to attract, retain, and provide for the orderly turnover of a skilled professional workforce while maintaining budget stability and predictability. Public employees want a competitive compensation package that includes secure, reliable retirement income. Taxpayers want public services delivered in a professional and cost-efficient manner.

These objectives can both conflict with and complement one another. A retirement plan design focused on one of these objectives, to the exclusion of others, is likely to produce unintended negative outcomes.

It is, however, possible to design a retirement plan that meets all desired objectives. While there have been an unprecedented number of changes to public retirement plans in recent years, nearly all state and local governments have retained key elements of plan design known to promote retirement security, assist in workforce management, and meet the unique objectives of their stakeholders. These key principles include:

- **Mandatory participation:** Most state and local employees are required, as a condition of their employment, to participate in their statewide retirement system.

- **Shared financing:** Nearly all public employee retirement systems require periodic contributions from both employees and participating employers. Public employees typically are required to contribute 5 to 10 percent of their wages on a tax-deferred basis to their state or local pension.

- **Assets that are pooled and professionally invested:** Employee and employer contributions are pooled and invested by professional staff to take advantage of lower fees, greater portfolio diversity and economies of scale to grow the fund from which benefits are distributed.

- **Targeted income replacement in retirement:** Retirement policies aim to replace a certain percentage of pre-retirement wages to better assure financial independence in retirement.

- **Mandatory annuitization:** Benefits are required to be distributed in installments over a member's retired lifetime, which ensures the benefit cannot be exhausted or outlived. Age and service requirements that must be met to begin distributions promote an orderly turnover of personnel.

Plans that include these elements provide greater certainty for employees and employers and in doing so promotes key human resources objectives including enhancing the ability of employers to plan for the management of a professional workforce. As such, NASRA has long supported these core, indispensable elements of public plan design as guiding principles to plan sustainability.

Every state is unique with respect to its public sector workforce needs and fiscal situation, but some overarching public pension issues have unfolded among all states in recent years. The effects of the two most recent economic recessions on state and local governments are well documented. Public employee retirement systems, like many large institutional investors, lost more than 20 percent of their value as a result of the sharp decline in the global equity market in 2008. Recent improvements in global equity markets have pushed assets above pre-recession levels, but this recovery is not reflected in aggregate funding levels due to the process of actuarial smoothing, a method that enhances contribution stability by recognizing investment gains and losses over a prescribed period of time.

The investment losses associated with sharp declines in capital markets that occurred in 2000-02 and 2008-09 increased the unfunded portion of pension liabilities in every state and caused pension contributions to rise, exacerbating the strain felt by state and local governments who were pressured to continue normal operations and delivery of core services in an environment of reduced tax revenues.

In Pennsylvania, PSERS and SERS additionally received far less than their required pension contribution for a number of years. The percentage of required contributions received has risen, gradually, for both systems. This represents a positive trend in restoration of full funding with a commitment to continue on this path.

In response to the drop in funding levels, between 2009 and 2014 nearly all states, including Pennsylvania, passed reforms to restore or preserve the sustainability of their public employee retirement plans. The most common changes were increases to required employee contributions, benefit reductions (including both the primary benefit and postemployment benefit increases, or COLAs), and increases in the eligibility requirements which must be met to qualify for normal (unreduced) retirement benefits. A handful of states passed reforms that included a hybrid plan design, which pertained to new hires only, in all but one case. These hybrid designs generally marry a diminished defined benefit with a defined contribution, or individual account component. So far only one state in this most recent period has adopted a defined contribution plan as the primary benefit for a broad employee group, which will apply to those hired after November 1 of this year.

In 2010 the Pennsylvania legislature passed a package of pension reforms. Act 120 of 2010 established a new tier for newly hired teachers and state workers that included the following changes:

- An unchanged employee contribution rate with a reduced retirement multiplier, from 2.5% to 2%;

- An option to retain the 2.5% multiplier with an increased contribution rate;

- Increased eligibility for normal (unreduced) retirement.;

- Increased the vesting period from 5 years to 10 years;

- Eliminated the lump sum withdrawal “option 4”;

- Established a shared-risk provision which automatically increases employee contribution rates if actual investment returns do not meet the assumed rate over a three-year period.

The Pennsylvania reforms were among the most substantial and comprehensive in the nation during this period. Retirement system staff calculate that 18.6 percent of PSERS and 23 percent of SERS membership, respectively, are covered by Act 120.

Research from NASRA and the Center for State and Local Government Excellence measured the degree to which recent pension reforms reduced the initial retirement benefit expected to be received by newly hired workers. Reductions ranged from less than 1 percent to as much as 20 percent and new hires in Pennsylvania were among those whose expected retirement income was reduced by 20 percent relative to the pre-reform benefit terms. Using this same analysis, SB 1, would reduce expected retirement income by an additional 30 percent for SERS and 41 percent for PSERS, respectively, from Act 120 levels. This likely could have an impact on the ability of the pension to serve as a tool for hiring and retention, as well as place pressures on other expenditures, such as other forms of compensation and training costs.

Fully funding the pension system should be a requirement for any sponsoring government. The fact that some systems have accumulated significant unfunded liabilities should not be overlooked or repeated. However, pension benefits are paid out over many years, not all at once, and the restoration of full funding is a path that usually cannot be achieved all at once. For example, closing a defined benefit plan and replacing it with a defined contribution plan as the primary retirement benefit does not resolve the unfunded liabilities of the original plan. Research published by the National Institute on Retirement Security even suggests that an action such as this can sharply increase the associated employer costs, since a closed plan has very different liquidity needs and, as such, utilizes a much more conservative investment strategy, than a plan that is open to new participants. Research published by the Center for Retirement Research at Boston College has identified that plan administrative and investment costs are higher, to produce the same level of benefit, for a DC plan than for a DB plan. Without the ability to take advantage of pooled investment and longevity risks a likely scenario is a rise in employer costs or a significant reduction in benefits for new hires. These are just two of many implications that should all be considered as part of a measured approach to restore the pension funding stream in a manner that takes into consideration the needs of all stakeholders.

Also, retirement benefits should be only one consideration in the overall landscape of public employee compensation, which includes salary and other benefits. In a traditional pension plan, the ability of an employer to provide a secure retirement benefit attainable at a certain level of eligibility provides for the ability of the employer to replace older, more highly paid workers with younger, lower paid workers. This turnover can be anticipated and planned for to retain and transfer the institutional knowledge lost by those who elect to retire.

Crafting a retirement plan involves the consideration of multiple objectives. It is possible to design a plan to meet the objectives of all stakeholder groups. A plan that encompasses key principles of sound retirement plan design, namely mandatory participation, shared financing, pooled and professionally managed investments, targeted income replacement and required annuitization, is one that is likely to produce a more positive outcome for all involved.

As a final note, attached to this testimony please find the following resources:

- NASRA Resolution 2010-01: Guiding Principles for Retirement Security and Plan Sustainability
- NASRA Memo: Pennsylvania Pension Reform Supplemental Analysis

Again, I thank you for inviting me to testify on this important matter. If you are interested, NASRA can provide additional information and facts on strategies that have been utilized by retirement systems around the country. I would be pleased to address any questions.

RESOLUTION 2010-01 - GUIDING PRINCIPLES FOR RETIREMENT SECURITY AND PLAN SUSTAINABILITY

WHEREAS:

- State and local government employee retirement systems have demonstrated the ability to thrive in highly volatile market environments; and

- The resilience of public plans during periodic market declines is sustained through long-term investment and financing strategies; statutory, contractual, moral, and in some cases constitutional benefit protections; as well as the ability to adjust plan designs, financing structures, and governing statutes to accommodate changing needs and fiscal realities; and

- Needed periodic modifications, which have a history in state and local government retirement plans, require an open public legislative and regulatory process involving all stakeholders - governments, their plans, their employees (who typically share in the financing of their pension), and other taxpayers; and

- This open public process requires honest, unbiased and relevant information on public financing and long-term retirement policy objectives that should not be unduly influenced by projections that include unrelated healthcare liabilities or irrelevant corporate sector metrics, or that exclude relevant data regarding the inefficiencies and steep transition costs of closing, rather than adjusting existing plans; and

- Differing plan designs, financial conditions, and fiscal frameworks across the country do not lend themselves to one-size-fits all solutions, but rather, require a range of tailored approaches, agreed to by the relevant stakeholders, in order to best secure the viability of each state and local retirement system for the very long-term; and

- Core elements of public pension plan design – which include mandatory participation, benefit adequacy, shared financial responsibility, pooled assets invested by professionals over long time frames, and benefits that cannot be outlived – are the most reliable and economical means of providing retirement security, while also assisting in the retention of qualified workers needed to perform essential public services and providing economic stability to local communities; and

- These core components of public pension plan design are indispensable to sound retirement policy and not only should be retained in current and future benefit designs in the public sector, but also should be cultivated in the design of retirement plans for employees outside the public sector; and

- Federal policy should be supportive of these central features of public pension design and the flexibility of state and local governments to meet local needs and concerns, and should also encourage the development of similar design characteristics in retirement plans beyond the public sector;

NOW, THEREFORE, BE IT RESOLVED, that the National Association of State Retirement Administrators:
Supports the following guiding principles to retirement security and public plan sustainability:

- Participation of all relevant stakeholders, including government employers, their plans, their employees, plan beneficiaries and retirees, and other taxpayers in discussions and processes pertaining to the design and financing arrangements of public retirement plans

- Policy-driven decision making based on objective and pertinent information that fairly reflects the long-term time horizon and economic effects of public plan financing, benefit adequacy and benefit distributions

- Tailored solutions, achieved by affected stakeholders working through the state and local legislative and regulatory processes

- Retention of core, indispensable elements of public plan design, namely mandatory participation, shared financing, benefit adequacy, pooled investment and longevity risks, and lifetime benefit payouts

- Removal of federal policy barriers to the preservation of these central retirement plan design features in the public sector and adoption of federal policies that encourage their inclusion in the private sector.

Adopted August 11, 2010

NASRA
MEMORANDUM

PENNSYLVANIA PENSION REFORM SUPPLEMENTAL ANALYSIS

Since 2009 nearly every state has passed significant reforms to their pension plans for major public employee groups. These actions have generally taken the form of increased contributions, benefit reductions, or both. In a handful of cases states have closed their existing pension plan and replaced it with a different plan design, generally a hybrid plan taking the form of either a cash balance plan or a combination hybrid which marries a diminished defined benefit plan with a defined contribution plan.

In 2010 the Pennsylvania legislature passed a package of pension reforms affecting new participants in the State Employees Retirement System and the Public School Employees Retirement System. These reforms included the following provisions:

- An unchanged employee contribution rate with a reduced retirement multiplier, from 2.5% to 2%.
- An option to retain the 2.5% multiplier with an increased contribution rate.
- Increased eligibility for normal (unreduced) retirement.
- Increased the vesting period from 5 years to 10 years;
- Eliminated the lump sum withdrawal "option 4";
- Established a shared-risk provision which automatically increases employee contribution rates if actual investment returns do not meet the assumed rate over a three-year period.

A 2013 study by NASRA and the Center for State & Local Government Excellence examined the impact of recent state pension reforms on newly hired workers[1]. The study included an analysis which evaluated the benefit produced under post-reform conditions with the original, pre-reform benefit. The study found that, if new state and school employees in Pennsylvania elected to retain the pre-reform contribution rate, they would experience a 20 percent reduction in their benefit vis-à-vis the benefit available to existing workers. This reduction was the most significant of any observed in this analysis. Retirement system staff calculate that 18.6 percent of PSERS and 23 percent of SERS staff, respectively, are covered by Act 120.

The changes for new hires proposed in Senate Bill 1 would make further reductions in benefits for new hires. The aforementioned NASRA/SLGE study included an evaluation of new hybrid plans, with benefit levels determined using a set of reasonable assumptions to project benefits.

The chart below compares the benefit levels produced under the plan provisions pre-Act 120, Act 120, and Senate Bill 1for SERS and PSERS as proposed, as we understand the legislation. For comparison, an "average" hybrid benefit is included, the product of which is the plans included in the NASRA/SLGE study. Solid bars represent guaranteed levels of benefits provided by defined benefit or cash balance plans, and patterned bars represent variable benefit levels provided by defined contribution plans.

[1] See full report on NASRA.org http://www.nasra.org/content.asp?admin=Y&contentid=210

Figure 1. Benefits as a percent of final average salary: Pre-Act 120, Act 120, SB 1

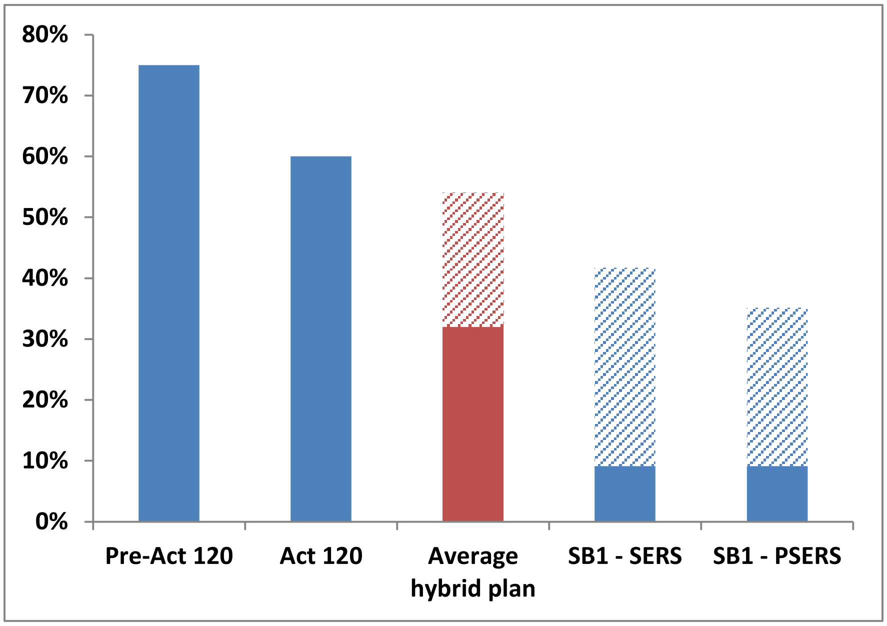

Figure 1. Assumptions

Pre-Act 120: Benefits calculated for state and school employees hired before 7/1/11 are calculated using a 2.5% multiplier.

Act 120: State and school employees hired as of 7/1/11 will elect to retain their contribution rate and accept a reduced multiplier of 2%.

SB 1: Cash balance benefits are projected using employee contributions of 3% and an interest crediting rate of 4%, compounded over 30 years. The benefit is annuitized for a 25-year term. Defined contribution benefits are projected using default contributions (5.59% for PSERS, 7% for SERS) and an annual return of 6.50%, compounded over 30 years. The balance is annuitized for a 25-year term.

Cost-of-living adjustments (COLAs) are not included in this analysis

The benefits produced by the Pennsylvania plans using the NASRA/SLGE model are below those provided by the Act 120 benefit and the average hybrid plan. Specifically, the defined benefit component of the SB 1 plan is much smaller than the average defined benefit plan of the other hybrid plans examined. This is primarily due to a relatively modest cash balance benefit.

As the NASRA/SLGE study found, one of the most important factors in the ability of a cash balance or defined contribution plan to deliver adequate retirement income is the level of contributions made to the plan. The cash balance plan proposed by SB 1 for new SERS and PSERS participants requires employees to contribute 3 percent of pay; there are no employer contributions to this plan. This rate is below that which is required for all other statewide cash balance plans which serve as a primary or supplemental benefit option; total contribution rates in other plans generally range from 4 percent to 10 percent, depending on many factors[2].

The ultimate level of retirement income from a hybrid plan with a diminished defined benefit component relies heavily on the investment performance of assets in members' individual defined contribution accounts. With such a large percentage of the retirement benefit variable, subject to fluctuations in the capital market, replacing a targeted level of income in retirement becomes more difficult. Moreover, the risk of a market downturn shortly before retirement, which could eliminate a significant portion of retirement assets in individual accounts, becomes a major factor in determining the level of retirement income.

Our research shows, and many states exemplify the idea, that any type of retirement plan—defined benefit, defined contribution, or cash balance-- can be crafted to meet the diverse objectives of stakeholders, including recruitment and retention of a qualified public sector workforce, stable and predictable employer costs, and a secure, lifetime income in retirement for public employees. The more important factors in determining the level and reliability of retirement income are the presence or absence of core retirement plan design features known to promote retirement security, including mandatory participation, pooled assets that are invested professionally, employee-employer cost-sharing, targeted income replacement, and required annuitization.

[2] NASRA Issue Brief: State Hybrid Retirement Plans http://www.nasra.org/hybridbrief