PLS Committee News

House State Government

House State Government Committee
8/19/21, 10:00 a.m., Room G-50, Irvis Office Building
By Sheri Melnick and Jeff Cox, Pennsylvania Legislative Services

Committee(s):	House State Government Committee
Meeting type:	Public Hearing
Subject:	Public pension system trends and state policy considerations
Bills discussed:	Act 5 of 2017, Act 105 of 2019, Act 128 of 2020
Keyword(s):	pensions, improper payments, defined benefit plans, defined contribution plans
Testimony:	Matthew Knittel, director, Independent Fiscal Office (IFO) Brenda Warburton, deputy director, IFO Mathieu Taylor, fiscal analyst, IFO Dr. Mark Warshawsky, senior fellow, American Enterprise Institute (AEI) Terri Sanchez, executive director, State Employees' Retirement System (SERS) Sara McSurdy, chief financial officer, SERS Jim Nolan, chief investment officer, SERS Joe Marcucci, chief counsel, SERS Joe Torta, deputy executive director, member and participant services, SERS Chris Houston, deputy executive director, administration, SERS Ryan Frost, policy analyst, Reason Foundation Len Gilroy, vice president, government reform, Reason Foundation Arthur Steinberg, president, American Federation of Teachers (AFT) Pennsylvania Glen Grell, executive director, Public School Employees' Retirement System (PSERS)
Members Present:	Chairman Seth Grove (R-York) and Representatives Ben Sanchez (D-Montgomery), Brett Miller (R-Lancaster), Andrew Lewis (R-Dauphin), Dawn Keefer (R-York), Paul Schemel (R-Franklin), Joseph Webster (D-Montgomery), Frank Ryan (R-Lebanon), and Maureen Madden (D-Monroe)

The House State Government Subcommittee on Public Pensions, Benefits and Risk Management held a hearing on public pension system trends and state policy considerations.

Rep. Miller, chairman of the Subcommittee on Public Pensions, Benefits and Risk Management, noted that the Pennsylvania State Employees' Retirement System (SERS) and Public School Employees' Retirement System (PSERS) have approximately 357,000 active participants and 373,000 retirees. He stated that the financial impact affects nearly 14 percent of the General Fund budget for a combined cost of $4.8 billion. He said, "It is incumbent on us to ensure that we carefully review our pension systems with the best practices available."

Rep. Sanchez, minority chairman of the Subcommittee on Public Pensions, Benefits and Risk Management, said the information provided by the panel yesterday was interesting, and he is looking forward to hearing from today's panel.

Matthew Knittel, director, Independent Fiscal Office (IFO), provided information about legislation that made changes to the pension system, including Act 5 of 2017, Act 105 of 2019, and Act 128 of 2020.

Rep. Ryan noted his appreciation for the IFO's work and commented on PSERS's expected earnings rate drop to 7 percent. He asked about the cause of the decrease and why Pennsylvania is not in the higher rankings after meeting the required contribution. Knittel commented on the demographics' driven cause of the decrease. Mathieu Taylor, fiscal analyst, IFO, said the reason is because of the investment returns. Rep. Ryan asked if there would be a difference if investment returns were compared to those in other states. Taylor said he would need to check on that.

Rep. Ryan commented on the improvement in the equity and stock markets since 2009 and asked about tail risk calculations and the impact. Taylor said the IFO has not looked at that but will likely look at the vulnerability and stress testing next year. Rep. Ryan asked about the pension assumptions regarding the estimated $2 billion shortfall and if the 7 percent and 7.25 percent returns were used. Taylor said he uses a 30-year baseline and uses the projected 7.25 percent and employer contributions.

Rep. Ryan asked about the dangers of Pennsylvania's fiscal health relative to increasing General Fund revenues. Knittel said the IFO used 10 percent of General Fund revenues, noting that the largest risk is the investment risk, and the sensitivity analysis provides information about vulnerability. He stressed that the federal funding coming to Pennsylvania is temporary and that the structural deficit may still be present three or four years in the future.

Rep. Ryan commented on global monetary policies and asked about the associated risk related to pension funds in Pennsylvania. Knittel remarked on globalization and how financial systems are overlapping, stressing that globalization should be tracked. Rep. Ryan asked if Knittel would be concerned about funding Pennsylvania's pension funds if there were problems in the global financial market. Knittel said he would defer on answering the question as the IFO's review of fall reports will provide better risk information.

Rep. Sanchez asked about the pension system funding outlook, the system returns, and if they indicate actual market performance. Knittel said they indicate the return on investment for the prior year. Rep. Sanchez said it is impressive that there is only one red figure related to "volatile market conditions." He asked about the expectation of a similar return to be modeled on the SERS system. Knittel said he would defer to SERS, but his inclination is that it would be a "fairly solid return."

Rep. Sanchez commented on the 7 percent return for SERS and 7.25 percent for PSERS. He asked how that would affect the unfunded liability with a 25 percent system return. Knittel said the numbers would come down when considering the 25 percent for PSERS. He stated that once the 2018 data is updated, Pennsylvania may move up in the rankings. Rep. Sanchez asked how much that might push the unfunded liability if it is held at 25 percent. Knittel said he will defer on answering the questions until the release of the November 2021 report.

Chairman Grove noted his involvement in the former Public Employee Retirement Commission (PERC) issue. He asked about the internal process and timeline when sending requests to the IFO for the potential movement of legislation and the coordination of systems. Knittel said the coordination process is smooth and the amount of time needed could be a wide range. He commented on the helpful nature of a two-week turnaround with related systems.

Chairman Grove remarked on the projected drop in unfunded liability for SERS and the pre-funding used by Penn State University and the Pennsylvania State System of Higher Education (PASSHE). He asked about the bond payments versus savings within the system to see if costs have dropped. Knittel said the idea behind the pre-funding was to cut costs. He said the IFO has not checked to see if the cost-cutting materialized, but the IFO can check on that. Chairman Grove said that would be helpful and noted discussions by school districts to consider pre-funding.

Rep. Miller commented on the costs associated with pre-funding used by Penn State and PASSHE. He asked about the advantages and disadvantages of pre-funding. Knittel said, in theory, pre-funding provides for reducing costs but depends on the rate of return. He pointed out the fixed costs associated with pre-funding and said he would hold off on weighing in until he has been able to review the numbers. Rep. Miller asked what factors Knittel would look at to determine the pros or cons. Knittel said he would look at the pre-funded system and see what their costs were in the two scenarios with and without pre-funding. Rep. Miller said the chart provided by Knittel shows a consequence that is "notable." He stressed that if pre-funding is positive, it should be encouraged.

Rep. Miller commented on system returns from 2005 to 2020 with a 7 percent and 7.25 percent assumed rate of return. He referenced the market volatility and asked if 7 percent or 7.25 percent are valid measurements. Knittel emphasized his concerns that the current market may be "overvalued" but the rates being used are reasonable. Rep. Miller said the 25 percent return projected by PSERS is a positive return, noting that rates under 7 or 7.25 percent would have a "huge financial impact." Rep. Miller pointed out the 25 percent return projected by PSERS which shows an unfunded liability that increased after 2020. He asked for comments. Knittel said the 25 percent number is preliminary, and the unfunded liability should change. He continued that the movement in the unfunded liability is due to some "mechanical computations" that take a few years to play out. Rep. Miller said he looks forward to seeing the official numbers.

Rep. Miller asked Knittel about whether collars should be used to address financial problems. Knittel said collars are one "viable policy option to phase into the higher rate. He continued that they ended in 2016 and 2017. He stated that the collars would need to be set by policymakers but could be used to address unfunded liability. Rep. Miller asked if Knittel is aware of any studies showing extra costs related to collars. Knittel said he is not aware of any but has not researched the issue. Rep. Miller commented on Pennsylvania's rankings of 46 in 2014 and 45 in 2018. He asked about policies needed to improve that position related to Pennsylvania's pension funds. Knittel said stress testing and sensitivity analysis are powerful tools. He continued that those changes related to Act 5 are "beginning to ripple through the system." He stated that the unfunded liability will change when the changes are fully phased in, and the ranking will improve.

Rep. Miller asked about the overall market and the impact on the pension fund, the economy, and the General Fund with a downturn like in 2008. Knittel said a repeat of 2008 would be "very dramatic" and would affect all revenue sources, capital gains, and sales and use tax revenue. Rep. Miller said one of the worst things that could happen is if the pension system would need to pay off assets to meet obligations. He stressed the importance of improving the funded ratio and the need to plan on the possibility of a downturn like that in 2008.

Chairman Grove said Knittel mentioned the percentage of new employees going into different types of plans. He asked for feedback related to low employer contribution rates to the defined contribution plan "as an inhibitor" and the analysis of increasing that to a private-sector market average. Knittel said SERS and PSERS are assuming that 5 percent of new employees are enrolling in a defined contribution plan. He continued that an increased matching rate for employers would make the plan more attractive, but new employees may not be thinking about long-term pensions. He noted that he has not seen studies quantifying the responsiveness of the employer match rate but can search to see if there is any information.

Rep. Miller echoed Chairman Grove's comments about the referenced analysis since that could help legislators review the employer match. Knittel thanked the committee for the opportunity to testify and noted that his presentation is posted on the IFO website. Rep. Miller thanked Knittel for his testimony and the work provided by the IFO.

Dr. Mark Warshawsky, senior fellow, American Enterprise Institute (AEI), commented that his testimony focuses on the provisions of defined benefit plans and the funding of public and private sector plans and provides suggestions regarding Pennsylvania's plans.

Chairman Grove remarked on a course he recently completed for his master's degree in public financial management. He noted that the defined contribution plan is not comparable to plans offered in the private sector with a lower employer contribution. He asked about the average match regarding public and private sector defined contribution plans. Dr. Warshawsky said he cannot speak to the public sector, but there is a range in the private sector, and it has increased. He noted that the federal government is encouraging the increase. He stated that matching employer with employee contributions is "generally 3.5 to 4 percent, and many plans in addition to that have employer contributions of 2 to 3 percent." He stated that 6.5 to 7 percent is a "responsible defined employer contribution rate."

Chairman Grove asked about the Employee Retirement Income Security Act of 1974 (ERISA) and applying those standards to public pensions in Pennsylvania. Dr. Warshawsky said he was involved in the funding rules of ERISA when he worked at the U.S. Department of the Treasury in 2006. He stated that governmental entities have some risk of bankruptcy, noting that pensioners in Detroit and Puerto Rico lost their cost-of-living adjustment (COLA) adjustment. He stressed that defined benefit plans may promise more than states can afford. Dr. Warshawsky said, "Prudent rules of funding and a measurement of liability are needed in the private sector, and those reasons apply to the public sector as well."

Chairman Grove asked if Dr. Warshawsky reviewed how public pension plans structured their governance boards and his views on applying the recommendations of the Sarbanes-Oxley Act of 2002 to pension boards. Dr. Warshawsky said he would skip answering the question as he is not an expert on that matter. Chairman Grove asked about Dr. Warshawsky's work on global investment performance standards and applying those to pensions. Dr. Warshawsky responded that he would skip answering that question as well.

Rep. Sanchez asked about a 2012 study referenced by Dr. Warshawsky and how it has held up over time. Dr. Warshawsky said that study was conducted by researchers working at the U.S. Bureau of Labor Statistics and was based on direct surveys. He stressed that it was a "carefully done study," noting how the researchers had access to detailed data. He said the study showed that public sector workers are paid better than in the private sector when benefits are valued correctly. He pointed out the benefits of updating the study.

Rep. Sanchez noted that different people draw different conclusions from the same data. He continued that when looking at a holistic view, some government workers may have an overall better package over time. He noted how deferred compensation impacts how people can save for retirement. He said he would like to take a broader look at the economic impact of a future defined contribution plan compared to a defined benefit plan where most pensioners in Pennsylvania will continue to live in Pennsylvania after retirement. Rep. Sanchez asked for comments. Dr. Warshawsky said he is not familiar with the macro impact and noted the impact on the work and retention issues and turnover and retirement behavior of workers when comparing defined benefit plans with defined contribution plans. He continued that there is less turnover with defined benefit plans. He pointed out that employees like freedom which is the attraction of defined contribution plans.

Rep. Schemel asserted that conventional pension programs force people to remain in their jobs to get benefits and asked if that is accurate. Dr. Warshawsky agreed. Rep. Schemel said those conventional programs disincentive mobility. Dr. Warshawsky said that is exactly right.

Rep. Schemel asked about the increased costs with a low-funded ratio. Dr. Warshawsky said a low-funded ratio is mechanical, and plans are cheaper with higher returns. He continued that the plans do not need to be "funded as richly," and the higher the discount rate, the lower the liability. He pointed out that the opposite is true with a lower discount rate. He stated that the discount rate is a measurement of true liability and should be presented to workers. Dr. Warshawsky stressed using a low-risk bond to value the benefits. He noted that the correct funding for a state and local government plan may not need to be as high in the private sector. He commented on the aging plan in Pennsylvania that cannot count on an influx of workers, noting that funding should be "on the conservative side."

Rep. Schemel said Pennsylvania has an aging plan and fewer employees paying into it. He asserted that the real cost of the pension benefit is demonstrated without having an "artificially inflated discount rate." He asked what other states do regarding employees choosing a defined benefit plan versus a defined contribution plan. Dr. Warshawsky said he will investigate that, noting that not many states make that offer. He stated that some private sector companies provide for that choice.

Rep. Schemel said both PSERS and SERS employ an outside consulting firm advising how to invest in a "socially responsible manner." He asked if Dr. Warshawsky is familiar with those types of firms and if the investment strategies fail in their fiduciary responsibility to maximize returns. Dr. Warshawsky said he is not familiar with firms or much of the issue. He asserted that there would be some loss in returns because of the constraints.

Rep. Miller reiterated that SERS and PSERS have about 357,000 active participants and 373,000 retirees.

Rep. Ryan noted that he is asking questions as a legislator and not as a board member of PSERS. Regarding the private sector's move away from defined benefit pension plans and the possibility of bankruptcy in the private sector, he asked if public sector defined benefit plans are sustainable. Dr. Warshawsky said the answer is no because of the competitiveness of the labor market. He continued that while defined benefit plans produce "very generous benefits," the trend is away from that, and those plans are not sustainable. He commented on the risks of defined benefit plans, asserting that they appeared to be "cheap at the start," there were loose funding rules, and the plans are no longer cheap.

Rep. Ryan commented on responsible investment, using environmental, social and governance (ESG), noting the risks attributed to the beneficiary in the private sector regarding bankruptcy. He pointed out that is not the case in the public sector, with the public will "pickup up the tab" if something goes wrong. He asked if that is a systemic weakness "in the overall concept of public sector pension funds." Dr. Warshawsky said it is a challenge and falls to the taxpayer who is "largely not aware of it."

Rep. Ryan commented on the challenge of convincing people that a state can go bankrupt, noting that a Pennsylvania school district is currently in receivership. He asked if a state can go bankrupt and what that looks like. Dr. Warshawsky said he is hesitant to answer because he is not a legal scholar. He pointed out that a professor at the University of Pennsylvania wrote about the topic and encouraged Rep. Ryan to talk to him. He asserted that the concept regarding pensions and that beneficiaries would not lose money in bankruptcy is not true. Dr. Warshawsky noted that pensioners in Detroit and Puerto Rico will lose money. He stressed that he would avoid answering whether a state can go bankrupt.

Rep. Ryan pointed out that municipalities can file for bankruptcy under the U.S. Bankruptcy Code and noted how Puerto Rico was permitted to file for bankruptcy as a commonwealth. He commented on looking at the actual discount rate that might reflect the need to solve a problem if the perception is that bankruptcy is not an option. He stressed the importance of fixing the funding issue. Rep. Ryan referenced legacy funding and asked for Dr. Warshawsky's thoughts. Dr. Warshawsky said that was recommended for Connecticut which has "very bad funding." He stated that he disagrees with legacy funding because of fairness, noting that taxpayers benefit from services provided by state workers. Rep. Ryan asked if insolvency is an issue and if a state can become insolvent, noting the possibility of a state not being able to access the credit markets. Dr. Warshawsky commented on the possibility of insolvency for states. He said Illinois is in a tough position because their pensions are contractual and constitutional obligations. Rep. Ryan said Pennsylvania has a constitutional pension obligation as well.

Rep. Miller noted that Dr. Warshawsky provided testimony about private defined benefit plans being mostly cash balance while public defined benefit plans are backloaded. He asked if the public pension cash balance plan is viable for most states. Dr. Warshawsky said the cash balance plans are common in the private sector but are not in the majority because they comprise about 40 percent. He stressed that the cash balance plan was designed to be more popular with the worker to get a decent benefit without needing to stay with an employer. He stated that the defined benefit plan still has funding and actuarial issues but is a more transparent benefit for the worker. He stressed that cash balance plans address the issue of being attractive to workers and have that advantage.

Rep. Miller commented on the application of ERISA standards referenced by Chairman Grove, noting the federal requirement of the issuance of a statement of risk to employees. He asked how the statement is provided. Dr. Warshawsky said the statement of risk is a periodic report addressing the funding of the plan and describes whether contribution requirements were met. He suggested the need for something comparable about funding, funding status, and the amount of contributions.

Rep. Miller commented on the 2.56 percent discount rate referenced for corporate bonds by Dr. Warshawsky as a true measure of costs. He asked if Dr. Warshawsky is suggesting using a side-by-side comparison of the 2.56 percent discount rate with a 7 percent return for the employee to look at. Dr. Warshawsky said the rate he provided for Pennsylvania would be 2.8 percent. He continued that the current yield of long-term bonds is 2.8 percent for Pennsylvania, which he would recommend for the discount rate for Pennsylvania's pension liability. Rep. Miller asked if Dr. Warshawsky is suggesting that PSERS or SERS provide their employees with a side-by-side comparison using the 2.8 percent and the 7 percent figures. Dr. Warshawsky said that might be confusing, and he recommends providing employees with the 2.8 percent data.

Rep. Miller noted that Dr. Warshawsky suggested calibrating the shared risk formula to external measures and asked for examples of states doing that. Dr. Warshawsky said he did not have examples of states doing that and pointed out that not many states use risk adjustment other than Connecticut. He expressed concern about the legislature controlling measures such as wages. He continued that the legislature decides on the asset allocations which may not be "clean." He stressed the importance for employees to experience the risks of the plan which come from the market and should not come from the choices regarding asset allocation by legislatures.

Rep. Miller said the asset allocation was delegated to the PSERS's and SERS's boards. He asked about the processes in other states regarding making those policy decisions. Dr. Warshawsky said he is speaking "very broadly" when he said "you," noting that from the employees' point of view, the person making the decision is either the legislature or a board.

Rep. Miller thanked Dr. Warshawsky for his testimony, noting he wants to see Pennsylvania "be as strong as possible."

Terri Sanchez, executive director, SERS, provided an overview of SERS's governance. She told lawmakers, "We come here today to assure you that our goal is to manage our investments, costs and expenses the best way possible, and to thank you for the past five years of fully funding the commonwealth's share of actuarially required contributions."

Jim Nolan, chief investment officer, SERS, discussed SERS's investment program, managers' fees and expenses, and transparency. He told lawmakers, "The objectives of the Defined Benefit Plan Fund are to provide benefit payments." Nolan explained, "SERS seeks to provide investment earnings that meet, or preferably exceed, the assumed rate of return over complete economic cycles and strives to meet this objective by applying acceptable risk parameters and allocations to investments that are diversified by type, industry, quality and geography." According to Nolan, SERS's current target is 7 percent. He then discussed manager fees and expenses. Nolan reported SERS strives to engage the highest quality investment managers for the most cost-effective price and reports its performance net of fees and expenses for its private market managers. He noted that since 2008 SERS has reduced investment manager fees and expenses from $304 million in 2008 to $146 million in 2020. Nolan also discussed SERS's ongoing commitment to demonstrate transparency while working within its legal and fiduciary framework.

Sanchez reported that SERS's current unfunded actuarial liability is $22.4 billion and the funded ratio is 59.4 percent. She explained that the factors influencing that liability include: sustained periods of employer contributions below normal costs, losses that neutralized investment gains, benefit increases that were not pre-funded, legislatively mandated actuarial changes that extended the time over which liabilities are paid or artificially suppressed employer contribution rates, and gradual reductions in assumed rates of return over the past several years. Sanchez concluded her presentation with a discussion regarding pension forfeiture.

Rep. Sanchez wanted to know if there is a "sweet spot" when it comes to balancing the fees and expenses of the top-quality managers and trying to reduce the costs over time. Nolan explained that it is not an exact science so there is not a perfect target that SERS is moving towards but they think they are moving in the right direction. He pointed out that one of the largest contributors to SERS's fees is the private structures, which generate higher returns for SERS but are more expensive. Rep. Sanchez asked if part of the SERS plan for being nimble enough is getting into the higher-performing investments. Nolan said it is definitely a component.

Pointing out he is a legislative member of the SERS board, Rep. Schemel asked Nolan about his experience in working with a board in the private sector. Nolan explained in his experience on the corporate side ultimately the pension board is reporting to the corporation's board of directors and that board would delegate specific responsibilities for the benefit plans. He said human resources, finance and manufacturing would be represented.

Rep. Ryan asked if employers are adding all of the correct unfunded obligations so it is consistent across the system. Sara McSurdy, chief financial officer, SERS, explained the Governmental Accounting Standards Board (GASB) takes SERS's unfunded liability and reports it out to SERS's employers using a proportionate methodology so they can take the information and the employer can record it on their financial statement. She said SERS does that report every year and provides their employers with more information than they need so they do not have to do the calculations on their own. McSurdy pointed out SERS's auditors audit the report. She said she is not sure if SERS has done a reconciliation to obtain the financial statements for all of their employers.

Rep. Ryan wanted to know the criteria for a "high-quality manager" that could be determined in advance rather than based upon historical performance. Nolan said that would be a number of metrics that the team looks at. Rep. Ryan asked if SERS sees any structural changes in commercial real estate that could cause them to hit reset to see where the market may go. Nolan explained that it is just one more variable that gets added to an already complex set of variables SERS is looking at.

Chairman Grove wanted to know how long it takes for SERS to generally produce an actuarial note on pension legislation. Sanchez said it would depend on the legislation. McSurdy added that SERS's actuary is very responsive to all of SERS's requests. She explained that the time varies depending on the type of request and the length of the legislation. Chairman Grove requested the contribution rates that SERS has regarding the employees of the General Assembly and the legislative service agencies. Sanchez said they have contribution rates by membership class and she will provide that information.

Chairman Grove asked if SERS would have that information by agency. Sanchez said they could but typically they don't to that level. McSurdy reported they have employer contribution rates by membership class and category which are percentages of payroll. She explained SERS provides the rates to the governor's budget office. Chairman Grove wanted to know why the employer contribution increases in 2027 while the unfunded liability rate and the employer contribution rate appear to decrease. Sanchez said she would have to look into it and get back to the committee.

Chairman Grove noted that in the testimony SERS reported the Pennsylvania Supreme Court has not ruled on the applicability of Act 140 for crimes of attempt, conspiracy or solicitation and the Commonwealth Court decision on Act 140 crimes has been challenged. He wanted to know the status of that challenge. Joe Marcucci, chief counsel, SERS, reported that none of the challenges have been successful so far. He explained one of the challenges won but it was on a different issue. Marcucci said there are a couple of appeals in the appellate courts. He said he will provide a status on those appeals to Chairman Grove.

Chairman Grove pointed out there are some discrepancies between Act 140 and the Judicial Code. He asked if there is a clear definition of what misconduct is and how the court's disciplinary board interprets it when deciding a case. Marcucci said he does not know how the disciplinary board interprets the term. He explained, "We basically take the opinion of the court and if it has the words that the individual is being removed for misconduct in office and bringing the judicial office into disrepute then SERS will do the forfeitures.

Rep. Keefer wanted to know what incentive is there for people to join the Defined Contribution plan when they only have a 3.5 salary match and they are being charged $668 per year to manage the retirement fund. Sanchez explained that at this point in time the participants are not being charged those particular fees but they are paying for the investment fees and no administrative fees. She added that beyond that she doesn't have any comment.

Rep. Miller asked Nolan about his views on non-disclosure agreements with investment managers and whether they are needed and to what extent they are needed. Nolan explained that on occasion SERS has used them but not frequently. Rep. Miller asked if you need such agreements to get the high-performance managers. Chris Houston, deputy executive director, administration, SERS, said he could not speak to it right now but he will get back to the committee after speaking with SERS's investment counsel.

Rep. Miller noted Penn State and PASSHE prefunded their liability. He wanted to know what other groups would qualify to do that and if there has been any more motion towards that. Sanchez said she has not seen any more motion towards that. She explained that technically speaking there are a number of agencies that would be able. Sanchez commented that the challenge would be to have the funding to do it without a pension obligation bond which is currently prohibited.

Ryan Frost, policy analyst, Reason Foundation, first discussed pension garnishment and forfeiture in Pennsylvania. According to Frost, Pennsylvania is one of just 13 states that has what is organization refers to as a "comprehensive policy." He noted, "Pennsylvania has possibly the most clear-cut policy on this issue in the country." Regarding the outlook on Pennsylvania's pension systems, Frost commented, "Luckily for Pennsylvania, you have two brand new pension tiers still in the asset accumulation phase, making the process of matching the plans assumed rates of return to a new-term investment outlook much easier than a plan that has been open for longer." He went on to provide some possible additional reform recommendations. Frost told lawmakers, "Building resilient retirement systems that create a pathway to lifetime income for all employees while avoiding intergenerational disparities and the need to constantly mitigate financial challenges threatening the basic obligations of state and local governments should be the North Star that guides this committee." He suggested, "This legislative body should look to additional phases of reform in the arenas of improved funding policy, amortization of unfunded liabilities, and governance, given the good work done so far to start de-risking SERS and PSERS for the future via the introduction of risk-managed plan designs for new hires the last several years."

Rep. Miller wanted to know if there are any states that have provisions where a person can lose their pension for a crime less than a felony. Frost said he has not seen anything under a felony that has triggered forfeiture in another state. Rep. Miller commented it would appear now is the optimal time to make a potential reduction in the assumed rate of return. He asked about reducing it further than it already is. Frost said that now is the best time because it doesn't raise costs. Rep. Miller asked about the recent actions of the California Public Employees' Retirement System (CalPERS). Frost reported CalPERS lowered their assumed rate of return down to 6.8 percent last month due to this past year's investment returns. He also reported that CalPERS has a policy that automatically triggers a drawdown on its assumed rate of return if returns are above a certain percentage.

Rep. Miller asked about Wisconsin's system having auto-correcting features. Frost explained that Wisconsin has auto-correcting around their benefits package so when returns are down their benefits are actually lowered. Rep. Miller wanted to know Frost's thoughts on the direct involvement of the General Assembly in dictating policy to a pension board such as the ones in Pennsylvania. Frost responded that every state does it a little differently. He said it could be a good thing in some places and it is going to backfire in some other places.

Chairman Grove asked about Frost's testimony about resilient systems that rely on a governance structure designed to minimize the role of politics. He wanted to know how that would work. Frost suggested the best governance structure for a public pension plan is to have appointed employee groups and appointed employers. He mentioned Pennsylvania's boards seem to follow the ERISA structures.

Rep. Ryan asked if there will be a shift away from the more traditional types of mixes. Frost reported there has been a rapid shift from active management towards passive management across the country. He noted CalPERS got rid of most of their active management a couple of years ago and went in-house and rapidly increased their allocation to passive income.

Rep. Miller asked about Penn State prefunding $1.1 billion and PASSHE prefunding $8.25 million and whether that type of prefunding is taking place in any other part of the nation. Frost reported that quite a few states including Arizona have put up one-time massive infusions but not have used bonding like Penn State and PASSHE. Rep. Miller wanted to know some of the cons to bonding. Frost said the very top concern is it is just another way to take on risk.

The following provided written testimony:

- Glen Grell, executive director, PSERS;
- Arthur Steinberg, president, American Federation of Teachers (AFT) Pennsylvania

Committee Member Contact Information (click or mouse over): Grove, Seth (R) / Schmitt, Lou (R) / Mackenzie, Ryan (R) / Ortitay, Jason (R) / Diamond, Russ (R) / Schemel, Paul (R) / Miller, Brett (R) / Dowling, Matthew (R) / Keefer, Dawn (R) / Lewis, Andrew (R) / Nelson, Eric (R) / Owlett, Clint (R) / Ryan, Frank (R) / Staats, Craig (R) / Wheeland, Jeff (R) / Conklin, Scott (D) / Kenyatta, Malcolm (D) / Young, Regina (F) (D) / Webster, Joseph (D) / Madden, Maureen (D) / Sanchez, Ben (D) / Fitzgerald, Isabella (D) / Howard, Kristine (D) / Sims, Brian (D) / Solomon, Jared (D)

PLS Committee News

House State Government

House State Government Committee
8/18/21, 10:00 a.m., Room G-50, Irvis Office Building
By Derek Danneker and Maggie Doldt, Pennsylvania Legislative Services

Committee(s):	House State Government Committee
Meeting type:	Public Hearing
Subject:	Public Pension System Trends and State Policy Considerations
Bills discussed:	Act 120
Keyword(s):	legacy liability, legacy debt, pension, actuarial
Testimony:	Anna Petrini, senior policy specialist, National Conference of State Legislatures (NCSL) Keith Brainard, research director, National Association of State Retirement Administrators (NASRA) Alex Brown research manager, NASRA Jean-Pierre Aubry, director of state and local research, Center for Retirement Research at Boston College Richard Vague, secretary, Department of Banking and Securities (DOBS)
Members Present:	Chairman Seth Grove (R-York), Minority Chairman Scott Conklin (D-Centre), and Representatives Brett Miller (R-Lancaster), Ben Sanchez (D-Montgomery) Frank Ryan (R-Lebanon), Dawn Keefer (R-York), Paul Schemel (R-Franklin), Matthew Dowling (R-Fayette), Clint Owlett (R-Tioga), Russ Diamond (R-Lebanon), and Joseph Webster (D-Montgomery)

The House State Government Subcommittee on Public Pensions, Benefits and Risk Management held a hearing on public pension system trends and state policy considerations.

Rep. Miller, chairman of the Subcommittee on Public Pensions, Benefits and Risk Management, announced the start of two days of hearings to receive testimony that will be considered as lawmakers seek to strengthen the statewide and local pension systems. He reported that the state's two pension systems, the Public School Employees' Retirement System (PSERS) and State Employees' Retirement System (SERS), serve 357,000 active participants and 373,000 retirees. Rep. Miller detailed that the retirement systems impact 14 percent of the state's General Fund, or $4.8 billion in payments. He added that lawmakers must also consider taxpayers, who contribute to the funds through property taxes. "It is incumbent on us to ensure that we carefully review our pension systems and remain current with the best practices," he said. "It is hoped that today and tomorrow's hearings will both educate and inform us on how we can all work together to have the strongest possible pension systems to benefit all Pennsylvanians."

Anna Petrini, senior policy specialist, National Conference of State Legislatures (NCSL), provided a review of other state's pension systems and how many are working through a variety of funding issues. She also examined different types of pension design considerations and trends in state government legislation.

Rep. Ryan asked if larger government contributions to an individual early in their career causes an underfunding issue when that individual eventually begins earning a larger wage. Petrini answered that it is possible, however it is heavily dependent on when that person retires.

Rep. Ryan noted that Pennsylvania has a dual-pension system and asked if that design is considered normal. Petrini responded that a number of states have "major plans" for their teachers, public safety workers, state employees, and municipal employees, which result in a variety of different systems. She noted that states usually combine all of those plans into a single department, however she was unaware of how many states use a dual-pension model.

Rep. Ryan asked if Petrini saw any particularly strange methods of handling pensions in Pennsylvania. Petrini said she could not point out anything in particular but would be happy to examine particular aspects of the state's policy. Rep. Ryan thanked her and added that he would appreciate a comparison with other states with multi-employer plans.

Rep. Ryan noted that Maine is using an environmental, social and governance (ESG) concept and asked if that would cause any kind of long-term policy implications related to funding. Petrini explained that she was unaware if state-level conversations regarding ESG and fiduciary responsibility have been resolved, but they certainly have not been determined at the federal level. "I think there's a lot of uncertainty about risk plans, the private sector and how fiduciary responsibility plays into ESG decision-making and investments," she said.

Rep. Webster commented that although legislators often use the word reform, they really mean improvements. He asked if Petrini saw anywhere that Pennsylvania could make improvements to their pension system. Petrini stated that NCSL does not attempt to make policy prescriptions but works to provide for greater information and intercommunications between states that are looking to pursue similar policy goals. She added it's important to recognize that each state is different and there is no single decision that would interchangeably work.

Chairman Grove stated that he was interested in how states develop their system of governance and noted that Pennsylvania has both legislative and executive appointees. He asked if most states operate using the same board governance system. Petrini remarked that she would like to do more investigation on the topic but did not have a state-by-state breakdown on that subject.

Rep. Keefer asked if NCSL had any statistics involving the retention of employees as states move into defined contribution plans. Petrini commented that her organization has not looked closely at that information but opined it may be too soon to determine the future of states with defined contribution plans.

Rep. Keefer asked if states that eliminated cost-of-living adjustments (COLAs) saw savings. Petrini said she could not remember any useful analyses that have been done but would search for them and return to the representative.

Rep. Sanchez, minority chairman of the Subcommittee on Public Pensions, Benefits and Risk Management, said he was curious to know how states can make changes to their pension system to make public jobs more attractive to employees.

Rep. Miller asked if there were any other states like Pennsylvania that had a defined benefit, hybrid and cash balance plan. Petrini said she was unaware of any other state that institutes all of those methods.

Rep. Miller questioned if the cash balance formula was gaining in popularity throughout the states. Petrini stated that the method had gained visibility through court decisions to overturn them based on procedural grounds.

Rep. Miller stated that he was surprised to learn that some states have attempted to change the pension system for current employees rather than only allowing new employees to use new pension systems. He noted that PSERS and SERS are 60-percent funded and asked how other states have increased benefits for new or particular groups when it increases liability and future costs. Petrini answered that she did not have a general impression of states and would need to do more investigation on the topic.

Keith Brainard, research director, National Association of State Retirement Administrators (NASRA), pointed out that the Pennsylvania pension systems are more mature than other states in that they have more individuals receiving their benefits than active working members. He reviewed the funding condition in the commonwealth and remarked that the state also has more liabilities than assets. Alex Brown research manager, NASRA, described the large number of municipal pension plans and further explained the difficulties of funding pension plans during market declines and recessions. He continued to describe other trends in the country.

Rep. Schemel asked if the actuarially required contribution (ARC) was a legislative formulation, rather than one furnished by actuaries. Brainard answered that ARC is a technical term that was originally called annual required contribution and does not change the underlining definition or methodology. He continued that ARC is a cost of benefits that are accrued by active workers each year as added upon by the cost to pay off the unfunded liability. He remarked that some states have a statutorily defined payment but was unaware if Pennsylvania fell into that category. Rep. Schemel confirmed that Pennsylvania is among those states.

Rep. Schemel noted that NASRA compared Pennsylvania's pension plan to other states and asked why it is not the case that Pennsylvania's pension plan was compared to private plans. "It seems to me that comparing us with other states is like a rogue's gallery of states that end to underfund other plans," he said. Brainard commented that the private and public sectors' pension plans operate under separate federal mandates such as Employee Retirement Income Security Act (ERISA) where the private sector is required to be fully funded. He explained that only 15 percent of today's workforce is enrolled in a private pension plan, likely due to the federal mandates, and that percentage is decreasing each year.

Rep. Schemel questioned if there is any difference between states that engage in passive or active investment strategies in terms of performance. Brainard stated that he was not in a position to identify which states have outperformed or underperformed, but passive investments tend to range between 25 to 50 percent of their assets.

Rep. Keefer remarked that the expected earnings rate for pension plans in Pennsylvania is about 7 percent. She asked if this was consistent with the national average. Brainard responded that 7 percent is the median and the average is 7.1 percent, but the actuarial assumption for investment return has been consistently reduced.

Rep. Ryan asked if NASRA had determined how much of today's employee contribution is repayment for underfunding Pennsylvania's pension system for 10 years. Brainard explained that actuaries conduct an attribution analysis where the unfunded liability is attributed to various factors. He continued that the primary factors are typically the investment performance and the actuarial experience of the plan, such as in the event that the enrolled individuals live longer than expected. He estimated that the lower contributions combined with the length of time that they were in place had a material effect on the unfunded liabilities of PSERS and SERS. Brainard remarked that the retirement systems would likely have that information.

Rep. Ryan questioned if there should be a difference between private and public pensions. Brainard stated that they should because the federal regulations tie the private sector's pensions to interest rates and require those businesses to keep their pensions funded in case of bankruptcy. In contrast, he expounded that states will not go out of business and are able to provide a higher level of stability and predictability on long-term investments.

Rep. Ryan asked if Pennsylvania should consider tail-risk events that may have an implication for state policies, in regard to world equity markets or fixed-rate bond markets. Brainard answered that he is not an investment expert but noted that many have prognosticated lower expected returns from major asset classes, private equities and fixed income in the coming years. "I think that tail risk is always out there, but perhaps it's a little bit more pronounced given what's happened in recent months," he said.

Rep. Miller asked if some states are adopting similar policies to those that the private sector is mandated to provide. Brainard explained that there were some states, which take the form of funding policies. He stated that he would provide some examples at a later date.

Chairman Grove asked how many states would be out of compliance if the federal government instituted ERISA standards. Brainard stated that "almost all" would be out of compliance.

Chairman Grove asked if any states had instituted Sarbanes-Oxley Compliance standards. Brainard answered that some states have moved in that direction, but none have implemented them.

Rep. Miller questioned the average national percentage of total investments in alternative investments. Brainard replied that his organization has seen alternative investments in hedge funds, commodities ad private equity, as well as a general movement into real estate. He stated that about 20 percent of public pension fund assets are in alternative investments, which has risen in recent years.

Jean-Pierre Aubry, director of state and local research, Center for Retirement Research at Boston College, opened by noting the history of SERS and how they evolved into the program it is today. He explained over a third of SERS's unfunded liabilities are from legacy liabilities and their focus now must be on how to deal with the existing unfunded actuarial accrued liabilities (UAAL). He noted that SERS could continue with the current actuarial approach but it is not well-suited for legacy costs. He suggested separating legacy liabilities from the current pension system and pay them over a longer period of time.

Rep. Sanchez asked Aubry if projections have taken into account underfunding at the time or if they run models without the underfunding. Aubry responded that they have not run these models because they are focused on actuary projections that presume no other liabilities. He explained that these projections have shown that there will be "shocks" along the way that will require constant adjustments. He noted they have not thought about how legacy-funded liabilities will be incorporated and if the actuary of 2001 separated out the legacy cost, which would cause the legacy cost to be underfunded while the current system is slightly overfunded. Rep. Sanchez stated that it seemed that there are no overarching policies other than to fund each year's ARC. Aubry explained that under the current framework, the best thing for a client to do is fund the annual contribution presented. He continued they are trying to find another reason for the rise in cost other than paying out liabilities through opportunities they have to modernize actuary funding.

Rep. Ryan noted that the legacy cost is an issue in the automotive and steel industry that led to the bankruptcy of these industries. He asked if the Governmental Accounting Standards Board would give them any problems if they attempted an activity-based cost approach. Aubry responded that he is not an expert on the board's opinion but noted other organizations that may be able to provide guidance on this. Rep. Ryan asked if Aubry had legacy information on PSERS. Aubry responded they do have this information and noted their unfunded liabilities are similar to SERS.

Rep. Ryan requested a copy of PSERS's legacy information and transitioned to mention Aubry's testimony that stated six percent of the employee contribution rate reflects normal costs of pension and 29 to 30 percent represents the underfunded obligation and they plan to spread that amount over a longer period of time. He asked what the market interest rate is currently and if there is a benchmark rate. Aubry responded that the proposition of municipal bond rates that could be used for crossover dates could work as a model that has already been tested in the field. Rep. Ryan asked what rate was used for the SERS analysis. Aubry explained that they used 4.5 percent as their rate for SERS. Rep. Ryan clarified that this analysis is compared to the 7 percent SERS currently uses. Aubry clarified this is correct.

Rep. Ryan stated that from his understanding the legacy debt is more advanced than a "pay-as-you-go model" and is a smoother process. He expressed his agreement with this as to not burden one generation more than another. He asked if Aubry expected any secondary or tertiary effects from spreading this expense over a longer period of time in Pennsylvania. Aubry responded that legacy debt allows for the focus to move to proposals of actuarial funding and how to incorporate inter-generational risk assessment.

Rep. Schemel referenced page nine in Aubry's testimony that the budget allocated is not the actual cost, so they will run into a "collision course" to pay money every year and asked if that was correct. Aubry clarified this is not correct and they will not run money as contributions and audits come in that are enough to pay back their output. He explained that this risk is small as long as there are new employees continuing to come in and buy contributions. Rep. Schemel noted the number of state employees is decreasing in Pennsylvania and asked if this means they will rely on state contributions to increase. Aubry responded that the rising arc keeps the amount of money paid and will eventually close and shut down. Rep. Schemel noted that Aubry demonstrated the actual arc and the arc calculated in 2001 and stated they are basing allocations on arcs calculated in 2001. Aubry explained that they re-calculated the actuary from 2001 with their new technology and noted the state is typically looking for the actual arc required every year as a benchmark for what should be allocated each year.

Chairman Grove asked what the optimum fee reporting criteria Aubry would advise for investors and internal investments. Aubry replied that he did not have information on best practices but noted there are organizations working on providing this information and some that specialize in private investments. Chairman Grove referenced Aubry's discussion on shifting legacy liability to a trust fund and explained this would likely create another legacy liability. He asked if this legacy liability would shift over. Aubry responded that their hope in separating legacy debt is to work in frameworks, so if payments are loosened for legacy liabilities, liabilities are valued at an "appropriate market rate."

Chairman Grove clarified that legacy debt is the "hardened debt" and the market rate would be used for investments that stay in the trust fund while actual payments for employees can get "riskier for higher rates and have less risk exposure because it is a smaller portion of money put out there." Aubry responded Chairman Grove's explanation is one way of approaching this and another way is to pay the legacy portion in a pay-as-you-go format. He continued that the legacy would start with zero assets and the state would be required an amount of money into the trust fund that is equal to the liability which would go towards paying people back.

Rep. Keefer referenced expired statutory language for contribution collars and asked if this is factored into Aubry's graph because they are "technically suppressed arcs that we have had for at least five years." Aubry replied that he believes they used the pre-collared contribution in their graphs but was unsure. Rep. Keefer asked if any other states have a similar practice in place. Aubry stated he was unaware of any states that used this practice.

Rep. Miller noted the presentation on legacy debt is a "legacy debt of people who are no longer there that the current folks are paying for." He asked if there are any states addressing a legacy trust or a pension trust. Aubry stated there are no states currently doing this and this is an idea they are still working on. He explained that they are looking at the six states that are the worst-funded in the country, including Pennsylvania and Massachusetts, to understand how underfunding impacts the legacy liability.

Rep. Miller noted the committee often gets requests for benefit enhancements and asked what Aubry thought about Pennsylvania requiring a pre-payment for future requested enhancements. Aubry responded that many states did this before 2001 by providing pre-paid benefit enhancements. He commented that it is more based on predicted costs of enhancements and to understand the risks. He emphasized that their approach does not prevent pension funds from investing in risky actions, but they must evaluate risk before they take action. Rep. Miller added that they cannot control if they achieve investment expectations, which needs to be considered when choosing rates. Aubry mentioned they asked their participants about legacy costs that do not have much debt because their plans were started when pre-funding began and they were incentivized through tax advantages compared to public plans. He explained their concern is they will not be able to get gains over the market interest rate that will lower the contribution costs in future periods.

Richard Vague, secretary, Department of Banking and Securities (DOBS), mentioned his history within the banking industry and studying systematic analysis of private and public sector debt. He emphasized the consequences of public pension funds falling short and noted his focus on issues related to transparency and cost.

Rep. Miller referenced the DOBS website that shows all the opportunities their staff offers, including educational seminars such as "How to Hire an Investment Professional" and "How to Choose an Investment Fund." He asked Sec. Vague what the key elements he felt were most important when hiring investment fund managers and professionals. Sec. Vague stated that they offer educational services to military personnel, incarcerated individuals, students, and senior citizens. He explained that selecting an investment manager is "of incredible importance" and noted that Pennsylvania has "the luxury of choosing from the best managers out there." However, he expressed that there are decisions more important than choosing an investment manager, such as deciding on an allocation, and described this as having "the biggest impact on the ultimate results of the fund." He continued that there is also a decision on how much of the fund should be "passively managed" in which there is no manager actively managing the investment assets and charging fees.

Rep. Ryan asked if Sec. Vague is concerned about debt levels currently existing and if there are risk factors the General Assembly should be aware of. Sec. Vague responded that when looking at debt, an individual can focus on the debt across all categories which would show that there are "very high levels" of debt in comparison to history. He continued that within all this debt there are equities, margin debt and derivatives based on debt that need to be considered and it shows equity-linked derivatives are at an all-time high. Rep. Ryan asked if alternative investments and long-term investments would be a challenge. Sec. Vague responded that this information means people should be cautious of all investments and stated that private investments have greater fees and are riskier during times such as these. Rep. Ryan noted that throughout history a normal asset allocation was 60 percent equity and 40 percent bond. He asked if they should be concerned about this due to current debt levels. Sec. Vague responded that there "is still merit in 60-40" but new innovations and investing allow individuals to diversify beyond two categories. He emphasized the need to be cautious across the board and expect returns to be lower. Rep. Ryan asked if some of the decision is based on the "financial strength of the commonwealth's ability to continue making payments during an economic downturn." Sec. Vague agreed with the statement and stated that understanding the liquidity of the portfolio has to be central to the asset allocation.

Rep. Keefer asked if Sec. Vague could quantify the financial impacts of Act 120 on PSERS funds. Sec. Vague stated he did not have this information with him but could provide it at a later time. Rep. Keefer asked Sec. Vague about his opinion on a policy like this. Sec. Vague responded that he is cautious about synthetic policies with high fees. Rep. Keefer asked if Sec. Vague could discuss the financial impact of lowering the rate of return assumptions. Sec. Vague noted that return assumptions mean the state has to increase their contribution which leads to them not having funds to spend on other resources.

Chairman Grove asked how ERISA plans in the private sector compare to the public sector. Sec. Vague explained that ERISA increased the flexibility corporations had to make contributions which he described as a "healthy thing." He commented that state governments would have more flexibility and would be unable to avoid making contributions due to requirements under ERISA. He stated that anything that would require the government to step up when they need to is something he supports. Chairman Grove asked how many governance requirements have been implemented in the pension systems and what else can the General Assembly do to bring more structure to pension funds. Sec. Vague responded that some components of governance requirements may not be necessary, but most aspects are necessary to keep strict audit standards for companies. Chairman Grove asked how benefit structures in the private sector compare to the public sector. Sec. Vague responded that providing options to those with pensions is always a positive and encourages modest introduction of contribution plans.

Rep. Schemel asked if Sec. Vague believes that not making adjustments to returns would cause the pension system to make increasingly risky investments. Sec. Vague responded that this could cause potential risk in any state due to the pressure of being underfunded while return rates go down globally.

Rep. Miller asked Sec. Vague about his view on non-disclosure agreements. Sec. Vague stated his belief in transparency and commented that it is typically better to have more disclosure. He added that he believes this model should be used throughout the financial world and not just in Pennsylvania. Rep. Miller noted Sec. Vague's mention of active versus passive management and asked if he has an opinion on how much of the funds should be active versus passive. Sec. Vague replied that he did not have a specific number, but generally it should be on the low end of what is done across the public industry. Rep. Miller noted discussions on public pension management and the fees associated with alternative investments. He asked if Sec. Vague had a suggestion on a number for Pennsylvania systems for alternative investments. Sec. Vague responded that he does not have a specific number but noted this subject is often discussed. He stated his belief that they should be in the lower-to-middle end of the fee range. Rep. Miller emphasized the need for transparency when using public dollars and asked if Sec. Vague could elaborate on transparency related to fees. Sec. Vague responded that one of the main things a manager needs to be is transparent with what they are doing with the fee structure.

Rep. Miller announced that the follow-up hearing will be tomorrow at 10 a.m. and adjourned the meeting.

Additional testimony was provided by the Center for Retirement Research.

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