HOUSE COMMITTEE ON APPROPRIATIONS

FISCAL NOTE

SENATE BILL NO. 1 **PRINTERS NO**. 902 **PRIME SPONSOR**: Corman

COST / (SAVINGS)

FUND	FY 2016/17	FY 2017/18
General Fund	**$0**	**See fiscal impact**
State Employees' Retirement Fund	**$0**	**See fiscal impact**
Public School Employees' Retirement Fund	**$0**	**See fiscal impact**

SUMMARY: Senate Bill 1, printer's number 902, amends Titles 24 (Education), 51 (Military Affairs) and 71 (State Government) of the Pennsylvania Consolidated Statutes to establish new pension plan design options for most future members of the State Employees' Retirement System (SERS) and Public School Employees' Retirement System (PSERS); and to make actuarial funding changes applicable to SERS. The bill also provides for the establishment of the Public Pension Management and Asset Investment Review Commission.

The effective date is immediately upon enactment.

ANALYSIS: The bill establishes three new pension plan design options effective for most state employees hired on or after January 1, 2019 and for all school employees hired on or after July 1, 2019. The new plan design options include two hybrid options, which have both a defined benefit (DB) component and a defined contribution (DC) component, as well as a stand-alone DC plan option. New Pennsylvania State Police officers, corrections officers and other hazardous duty personnel hired on or after January 1, 2019, are exempt from participation in the new plan options. New judges and legislators beginning State service after January 1, 2019, would be included under the new plan designs, which are described below.

<u>Hybrid Plan Option 1</u> (Default Option for employees not making affirmative selection of plan within 45 days for SERS and 90 days for PSERS) –

- Multiplier for DB plan is 1.25%.
- Employee contribution rate is 8.25% of compensation split between the DB and DC components as follows:
  - SERS employees – 5.0% contribution to DB plan and 3.25% contribution to DC plan.
  - PSERS employees - 5.5% contribution to DB plan and 2.75% contribution to DC plan.
- Employer contribution to DC plan is 2.25% of compensation.
- Employer contribution for DB component will be actuarially determined on an annual basis.

- Provides for "shared-risk" and "shared-gain" provisions to be calculated every 3 years comparing the actual and assumed rate of return for the past 10 years. For every percentage point in earnings realized in excess of or below the assumed rate of return, the employee contribution requirement will be increased or reduced by 0.75%, but no more than 3% above or below the initial contribution rate.
- Final average salary for DB annuity is highest 5 years. Voluntary overtime for SERS members is limited to 10% of base salary.
- Vesting is 10 years for DB component and 3 years for employer contribution to DC component (Employee contribution to DC plan vests immediately).
- Superannuation age is 67 with 3 years of service credit, or any combination of age and service that totals 97 with a minimum of 35 years of service ("Rule of 97").
- Allows for actuarially neutral "Option 4" withdrawal of member contributions and interest.
- Disability provisions same as current law.

<u>Hybrid Plan Option 2</u>

- Multiplier for DB plan is 1.0%.
- Employee contribution rate is 7.5% of compensation split between the DB and DC components as follows:
  - SERS employees – 4.0% contribution to DB plan and 3.5% contribution to DC plan.
  - PSERS employees - 4.5% contribution to DB plan and 3.0% contribution to DC plan.
- Employer contribution to DC plan is 2.0% of compensation.
- Employer contribution for DB component will be actuarially determined on an annual basis.
- Provides same "shared-risk" and "shared-gain" provisions as Default Hybrid Option.
- Final average salary for DB annuity is highest 5 years. Voluntary overtime for SERS members is limited to 10% of base salary.
- Superannuation age is 67 with 3 years of service credit or Rule of 97 for SERS members, and age 67 with 3 years of service credit for PSERS.
- Vesting provisions are the same as Default Hybrid Option.
- Allows for actuarially neutral "Option 4" withdrawal of member contributions and interest.
- Disability provisions same as current law.

<u>DC Only Option</u> -

- Each DC participant will have an individual investment account where all employee and employer contributions will accumulate and investment earnings/losses, fees and costs will be credited or charged.
- Employee contribution rate is 7.5% of compensation for both SERS and PSERS.
- Employer contribution to DC plan is 3.5% of compensation for SERS and 2.0% of compensation for PSERS.
- Vesting is immediate for employee contributions and interest and at 3 years for employer contributions.

Provisions that apply to DC participant accounts in all plan design options

- The trust fund for participants' individual defined contribution investment accounts will be separate from the SERS and PSERS defined benefit trust funds.
- Additional voluntary employee contributions are permitted; although these contributions will not be considered pickup contributions so there is no tax deferral on the contributions.
- DC disability and death benefits would be based on participants' vested account balances.
- At retirement or separation, employees may elect a full or partial lump sum payment or a single life annuity based on the actuarial value of employee account.
- Language is included to specify that the SERS and PSERS boards would not be liable for any plan participants' investment losses.
- At least 10 investment options, through at least 3 providers, are to be available to DC plan participants.
- School districts that establish or maintain a 403(b) plan or a 457 plan must select a minimum of four financial institutions or pension management organizations, in addition to the financial institution or pension management organizations that entered into an agreement with the PSERS board.
- Individuals electing a distribution of vested employer defined contributions may purchase an annuity that must be provided as an option in the DC plan document.
- Loans from the plan to active employees are not permitted, unless required by law.
- All expenses, fees and costs of administering the plan and the trust and investing assets of the trust shall be borne by the participants and paid from assessments against the balances of the individual participant's investment accounts. There is an exception for fiscal years ending on or before June 30, 2020 when the expenses, fees and costs of establishing and administering the DC Plan and trust shall be paid by the Commonwealth through annual appropriations from the General Fund.

Current Post-Act 120 Member Benefit Provisions -

- Provides for actuarially neutral "Option 4" withdrawal of member contributions and interest. Option 4 is currently not available to post-Act 120 members.
- Provides for "shared gain" provisions that would mirror the currently imposed "shared risk" provisions. For post-Act 120 members, for every percentage point in earnings realized in excess of or below the assumed rate of return, the employee contribution requirement will be increased or reduced by 0. 5%, but no more than 2% above or below the initial contribution rate.

Exempt Groups – the following SERS groups of public safety and enforcement officers are exempt from participating in the new hybrid and DC plans:

- Pennsylvania State Police Officers (DiLauro award still applies for members accruing 20 or more years of service as a State Police Officer)
- Enforcement Officers
- Corrections Officers
- Wildlife Conservation Officers
- Other Commissioned Game Commission law enforcement personnel
- Delaware River Port Authority Police officers
- Park Rangers

- Capitol Police Officers
- Campus Police Officers employed at State-owned Educational Institutions and Community Colleges
- Campus Police Officers at the Pennsylvania State University
- Police Officers employed at Ft. Indiantown Gap and other designated military installations & facilities

The 'footprint rule" is applicable to current state and school employees who return to active service after a break in state or school employment. Such employees will remain in the DB plan for future service unless they opt in to one of the new plan designs within specified timelines.

Current SERS and PSERS members will be eligible to opt in to one of the new plan designs. For SERS, the election period would last from January 1, 2019 through March 31, 2019. For PSERS, the election period would last for 90 days after notification by the PSERS board that members are eligible to make such election. Employees who opt in to the new plans would receive benefits on a prospective basis applicable to all future service beginning July 1, 2019 for SERS and January 1, 2020 for PSERS. Employees opting in to a new plan design would retain the same employee contribution rate in effect at the time of their election. Any post-election adjustment necessary to maintain prior employee contribution rate would be made in DC plan contribution rate (e.g. Class A-3 member electing new Default Hybrid Plan Option 1 would retain 6.25% employee contribution rate, with 5% going to DB plan and 1.25%, rather than 3.25%, going to DC plan).

Funding Provisions –

- PSERS and SERS employer contribution rates related to existing unfunded accrued liabilities would be based upon the entire payroll - both defined benefit and defined contribution.
- Changes the actuarial cost method for determining SERS normal cost from a "new entrant" method to a "blended" traditional entry-age actual cost method. The new method bases the normal cost on the benefits and contributions for all covered employees from their date of entry.
- Language is included in the bill to provide that savings realized by SERS as a result of the enactment of the new plan designs are to be "plowed back" into the SERS fund to pay down unfunded accrued liabilities.

Other Provisions

PSERS Premium Assistance – New school employees hired after July 1, 2019 will continue to be eligible for premium assistance payments (a $100 per month payment to eligible annuitants, who participate in approved health care plans, to help pay health insurance premiums).

Public Pension Management and Asset Investment Review Commission is established to make recommendations regarding active and passive investment performance and strategies. The Commission will include 5 members appointed by the following: the Governor, the President Pro Tem of the Senate, the Minority Leader of the Senate, the Speaker of the House, and the Minority

Leader of the House. The appointees to the Commission shall be investment professionals and retirement advisors and shall be appointed within 90 days of the effective date of the act. The Joint State Government Commission (JSGC) shall provide logistical and other support. The Commission is to submit findings and recommendations to the General Assembly and Governor within six months of their first organizational meeting. The Commission is specifically tasked with recommending the lowest amount of investment fees to be paid by the SERS and PSERS boards to achieve the boards' anticipated annual rates of return and to develop recommendations to reduce expenditures to generate actuarial savings of $1,500,000,000 over 30 years. Temporary staff may also be employed as needed. The Commission shall expire within 60 days of submitting the required report.

Mandatory Training - Board members of both SERS and PSERS will be required to obtain eight hours of mandatory training in investment strategies, actuarial cost analysis and retirement portfolio management on an annual basis.

Legal counsel to the SERS and PSERS boards shall serve independently of the Governor's Office of Chief Counsel, the General Assembly and the Attorney General.

Secretary of Banking and Securities is added to the SERS and PSERS boards as an ex officio member. The Secretary shall be added to each of the boards when a position currently appointed by the Governor becomes vacant or an incumbent member's term expires.

PSERS Specific – The bill adds provisions to address delinquent school entity payments to PSERS. A subsection is added to the School Employees' Retirement Code to provide that a school entity is still expected to make full payment to the PSERS fund in the event the receipt of the Commonwealth's portion of the employer liability is delayed because of delinquent salary reporting or other conduct by the school entity. Language is also added to provide that employers whose payments to the PSERS Fund are delinquent shall be charged interest at the annual interest rate adopted by the board based on the assumed rate of return in effect in the fiscal year in which the payments are required to be paid.

FISCAL IMPACT: Based on an actuarial note prepared by the Independent Fiscal Office, the enactment of this legislation is projected to result in the savings shown below for the pension funds over the 32-year projection period. The estimates shown below only represent savings to be realized from benefit changes for SERS and PSERS and actuarial funding changes for SERS. Potential future savings from risk transfers are not reflected in the numbers that follow. The present values of the expected cash flow savings as of June 30, 2018 are also shown.

	(Dollars in Thousands)		
	SERS	PSERS	Total
Projected Cash Flow Savings	($1,180,000)	($217,000)	($1,396,000)
Present Value of Cash Flow Savings at 3.6%	($303,000)	($16,000)	($319,000)
Present Value of Cash Flow Savings at 7.25% for PSERS / 7.5% for SERS	$9,000	$48,000	$57,000

According to the IFO, a discount rate of 3.6% was used to calculate the present value of the cash flow savings because it reflects the Commonwealth's long-term revenue/budget growth rate. The IFO deems the 3.6% discount rate appropriate to use when assessing the impact of savings from a budgetary perspective. The cash flow savings are also shown at discount rates which reflect assumed rates of return for SERS (7.5%) and PSERS (7.25%).

The majority of the projected cash flow savings result from future benefit reforms ($1.175 billion or 84.2%) for new SERS and PSERS members. Savings are not evident in the first several years because the benefit reforms impact future members. The first actuarial valuation for the DB plans that will reflect the benefit changes is December 31, 2018 for SERS, which impacts the contributions to be paid during the 2019-20 fiscal year, and the June 30, 2020 valuation for PSERS, which impacts the contributions to be paid during the 2021-22. Savings will grow in the later years of the projection period as current state and school employees are replaced by employees eligible for the new plan designs.

In addition to the savings from the benefit reforms, the risk transfer from the Commonwealth and school districts as employers to the plan members has the potential to reduce future costs to the Commonwealth if investment rates of return are not achieved. The IFO ran a simulation for all new employees who become members in one of the new plan designs. The simulation analysis determined that risk shifts in the new plan designs that would occur if there was a 100 basis point (1%) reduction in the assumed rate of return could mitigate increases in employer normal cost contributions by approximately 58 percent for SERS and 53 percent for PSERS. The IFO estimated employer cost reductions in this simulation totaled $6.5 billion over the 32 year projection period ($2.3 billion for SERS and $4.2 billion for PSERS).

To the extent the Public Pension and Asset Investment Review Commission is successful in providing achievable recommendations for investment fee reductions paid by both SERS and PSERS an additional $3 billion in actuarial savings may be realized by the pension systems.

Senate Bill 1 provides that the expenses, fees and costs of establishing and administering the DC plan and trust shall be paid by the Commonwealth through annual appropriations. After the DC plan is established (projected to be in 2020-21) expenses and fees of administering the DC plan shall be paid from assessments against the participants' individual accounts.

There will be costs incurred by SERS and PSERS for the implementation of the new pension plans. Costs will be incurred to develop IT systems necessary for the new pension plan design. Both systems will need to secure additional legal counsel and consulting services to make system changes on a relatively short timeline. Implementation costs for the new DB plan components can be paid from DB trust assets. Implementation costs for the new DC components cannot be paid from DB plan assets per Section 401(a) of the Internal Revenue Code which provides that trust assets must be used for the "exclusive benefit" of DB employees and beneficiaries. These costs will need to be appropriated from the General Fund.

Costs will also be incurred for the Public Pension and Asset Investment Review Commission. The Joint State Government Commission (JSGC) estimates that they will incur costs of $102,000 for two 9-month temporary positions (analyst and administrative assistant) to provide administrative and operational support to the Public Pension and Asset Investment Review Commission. Costs for a consultant to gather and review investment data from both SERS and PSERS in order to help the Commission develop and report recommendations for investment fee reductions within six months of its first organizational meeting is estimated to result in additional costs for the JSGC.

Costs could be incurred by school employers to implement the reporting mechanisms needed for the new hybrid and DC pension plans.

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House Appropriations Committee (R)

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Estimates are calculated using the best information available. Actual costs and revenue impact incurred may vary from estimates.