HOUSE OF REPRESENTATIVES
COMMONWEALTH OF PENNSYLVANIA

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Pennsylvania's Public Pension Systems

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House Finance Committee

Irvis Office Building
Room G-50
Harrisburg, Pennsylvania

Tuesday, February 26, 2008 -- 10:00 a.m.

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BEFORE:

Honorable David Levdansky, Majority Chairperson
Honorable Jaret Gibbons
Honorable Chris Sainato
Honorable Tim Seip
Honorable Josh Shapiro
Honorable Scott W. Boyd
Honorable Adam Harris
Honorable William C. Kortz, II
Honorable Daryl D. Metcalfe
Honorable Dave Reed

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1 CHAIRPERSON LEVDANSKY: Good morning.
2 This morning we're going to take -- we can keep
3 this relatively informal given the small, intimate
4 nature of the group here.
5 I just wanted to invite Mr. Knepp and
6 Mr. Clay from the SERS and PSERS to appear before
7 the Committee to give us some background and
8 information on these two major state retirement
9 systems, to give some background and to help
10 Members gain a better understanding of how the two
11 retirement systems work and also the challenges
12 that you gentlemen see on the horizon that may
13 require us in the Legislature, you know, we need
14 to know what the potential problems are and the
15 issues that are out there before we seek to
16 address them.
17 So with that, let me have the Members
18 identify themselves starting from my extreme
19 right.
20 REPRESENTATIVE KORTZ: Good morning.
21 My name is Bill Kortz. I'm from the 37th
22 District, Allegheny County.
23 REPRESENTATIVE SAINATO: I'm
24 Representative Chris Sainato. I represent the 9th
25 Legislative District, which is Lawrence and a

1 small section of Beaver County.
2 REPRESENTATIVE SEIP: Tim Seip, the
3 Representative for the 125th Legislative District,
4 the Cabela's and Yeungling District.
5 REPRESENTATIVE METCALFE: State
6 Representative Daryl Metcalfe from Butler County,
7 the 12th District. Good morning.
8 REPRESENTATIVE BOYD: Scott Boyd from
9 the 43rd, which is a part of Lancaster.
10 CHAIRPERSON LEVDANSKY: With that, it's
11 yours.
12 MR. CLAY: Thank you very much. My
13 name is Jeffrey Clay. I'm the Executive Director
14 of Pennsylvania School Employees' Retirement
15 System. With me is Leonard Knepp from the State
16 Retirement System.
17 We have a actual presentation that we
18 have prepared. It's a joint presentation. I
19 believe you have copies of that. I'm going to
20 take the lead and walk down through that.
21 If you take a look at page 2, that's
22 sort of an outline of the agenda. And, again, as
23 the Chair had indicated, the purpose of this
24 presentation is to give the Committee sort of a
25 high level view of the operations of these two

1 systems.
2 The systems, we have a lot of -- areas
3 between the two; but there are some differences.
4 And as I go down through the presentation, I'll
5 make an attempt to point out some of those key
6 differences for you.
7 There are two issues that we will be
8 focusing. The bulk of our time will be on what is
9 known as the rate spike options funding issues for
10 the system. Also, as I'm sure you're aware, there
11 has been a lot of groundswell from state school
12 retirees for cost of living adjustments; so we'll
13 spend some time on that.
14 Turning to page 3, the State Employees'
15 Retirement System, the School Employees'
16 Retirement System, known as SERS and PSERS, are
17 what are known as governmental cautionary defined
18 benefit pension plans.
19 They are also mandatory pension plans.
20 The vast majority of the members that qualify for
21 this must be in the system. There are some
22 exceptions for both systems to that effect, but
23 typically for most state school employees it's
24 mandatory.
25 When we talk about school employees,

1 it's essentially all school employees, including
2 teachers, superintendent, bus drivers and things
3 of that nature. Same on the state side. It's
4 basically all state employees. And, again, there
5 are some that have optional membership.
6 Because they are governmental plans, in
7 the world of pensions, there's a series of types
8 of plans. There's the Private Pension Plans
9 typically subject to ERISA. There's the
10 Governmental Pension Plans, which are not subject
11 to ERISA. There's also what is known as Church
12 Plans, which generally are not subject to ERISA.
13 Our perspective, the two big
14 differences between us and ERISA covered plan,
15 ERISA plans have what is known as spousal consent.
16 So if a member wants to change his pension benefit
17 or her pension benefit, they need the consent of
18 the spouse before they do that.
19 In our plans, there is no spousal
20 consent; so there is no requirement that the
21 member get the spouse to sign off on those benefit
22 changes.
23 Second major difference, ERISA plans
24 typically participate in what is known as the
25 Pension Benefit Guarantee Corporation. This is a

1 governmental entity that is essentially the
2 insurance backup for defined benefit private
3 sector plans. So if they do go defunct, the
4 liability is shifted to that and it's paid out at
5 a premium pension plans pay.
6 That does not exist for either the
7 State or the School Retirement System. The
8 pension benefits for both systems are actually
9 guaranteed by the full faith and credit of the
10 Commonwealth per statute.
11 SERS was established in 1923. PSERS
12 was established in 1917. As a result, they are
13 basically some of two oldest defined government
14 benefit pension plans in the country.
15 What we call the plan document -- and
16 again, in pension vernacular, the plan document is
17 what establishes the pension benefits and the
18 structure of the retirement benefits.
19 So, for example, if I'm IBM, I have a
20 pension plan. It's going to define, you know,
21 what the contributions would be made in by the
22 employer and the employee and what type of benefit
23 would come out of the other side.
24 Our situation, that plan document is
25 actually state statute. So it's the respective

1 retirement code: The State Retirement Code and
2 the School Employees' Retirement Code. And as
3 I've indicated, they're very similar in nature;
4 but there are some differences there.
5 Page 4, one of the differences is the
6 structure of the board of trustees. In SERS, it
7 is an 11-person board that governs. And these are
8 trustees in the true sense of the word because the
9 pension benefits are held in trust with the
10 exclusive benefit of the members of the system.
11 As a result, the members of these
12 boards have these fiduciary duties of loyalty and
13 prudence. They have also have the fiduciary
14 liability that they are strictly liable for breach
15 of their fiduciary duty.
16 PSERS is governed by a 15-person board
17 of trustees. Basically serves over 730 school
18 employers. The SERS board serves 108 Commonwealth
19 employers. About 501 of the PSERS employers are
20 what you call traditional school districts, so
21 like a Cumberland Valley, for example.
22 We also have -- the largest growing
23 number of our new employers are charter schools.
24 They have the right to be in the system, but it's
25 at their discretion. Most of them have opted in

1 to the system to get coverage for their employees.
2 In addition to administrative-defined
3 benefit pension plan, PSERS also sponsors what is
4 known as the Health Options Plan. This is a
5 voluntary health insurance program for our
6 members. It's not mandated that we provide this
7 to them, but we have chosen to do so.
8 We currently -- the number here says
9 61,000; but the latest numbers would indicate
10 about 67,000 participants. And that's both
11 members and their spouses and dependents.
12 We get questions with respect to this.
13 Is there any what is know as OPEC liability?
14 That's the other postemployment benefits of
15 liability for the HOP Program.
16 The answer to that question is no,
17 because that program is essentially fully funded
18 by the members themselves. So all the premiums
19 are coming out of the members' pocket; there is no
20 direct funding by the employers or PSERS to that
21 program.
22 It is actually a separate trust,
23 separately accounted for, separate from the
24 pension system; pension assets cannot be used to
25 fund the health care trust.

1 We also run a Premium Assistance
2 Benefit. This is funded by the employers. This
3 is a pay-as-you-go system as a increment to the
4 employer contribution rate.
5 But it basically pays up to $100 a
6 month or actual out-of-pocket costs, whichever is
7 less, to a certain qualified group of individuals
8 based on age and service.
9 In this situation, there is an OPEC
10 liability that is essentially a $1 billion
11 liability over a 30-year time frame because this
12 is on a pay-as-you-go basis; however, the payment
13 that we make every year is what is known as 91
14 percent of the ARC, which is the Annual Required
15 Contribution.
16 If you have 100 percent, you're
17 basically paying it on a prefunded basis. If
18 you're below that ARC, there is some lesser amount
19 that's being paid.
20 If you were to basically increase that
21 to the full ARC and change the methodology of
22 that, it would basically result in a lot of
23 additional time and -- employer contributions. So
24 it's not a -- from pension perspective, it's not a
25 major issue for us.

1 SERS does not administer a health care
2 plan, although there's some misconception of that
3 in the press. But the majority of state employees
4 are basically, their retirement benefits are
5 provided through the Pennsylvania Employees'
6 Benefit Trust Fund.
7 Separate trust. That's a Tap-Hartley
8 Trust, which again is funded by contributions from
9 the Commonwealth and now from state employees.
10 SERS also uniquely administers what is
11 known as a defined contribution deferred
12 compensation plan. This is a 457 Plan. It's
13 available on a voluntary basis for state
14 employees. There's no employer associated with
15 that plan, so it's whatever the individuals
16 contribute up to the maximum limits allowed by
17 federal statute.
18 Over to page 5, just a quick snapshot.
19 Most of these numbers are either at the fiscal
20 year of June -- July 1 to June 30, which is PSERS'
21 fiscal year; or the calendar year, which is the
22 SERS fiscal year. One exception, the total assets
23 of the system as of 12/31/07, 35.5 billion for the
24 SERS system; 67.4 billion for the PSERS system.
25 When you look at the benefits payments

1 you'll, see that the annual benefits payment go
2 out the door from SERS is about $2 billion. For
3 PSERS, it's about $4 billion.
4 Interesting, we had an association,
5 national association look at our numbers at one
6 time. It's called the NASRA, National Association
7 of State Retirement Administrators.
8 They did a study and they noted that
9 that $4 billion that's paid out from PSERS
10 essentially exceeds the revenue generated by
11 mining and agriculture in this Commonwealth.
12 90 percent our employees, approximate
13 retirees actually reside in the Commonwealth. So
14 the bulk of those assets, those payments, are
15 actually going back to the Pennsylvania economy.
16 I would suspect there's a similar relationship on
17 the state side.
18 The next item is the funded ratio.
19 This is the status of the funds, the amount that
20 we have in the bank, so to speak, to pay the
21 benefits based on an actuarial value of the
22 assets. And I will go into more detail of that in
23 a little bit.
24 But currently as of the evaluation
25 dates of the two systems, essentially, SERS has 92

1 cents -- 92.7 cents for every dollar of liability.
2 PSERS has 85 cents -- 85.8 for every dollar of
3 liability that's owed if you were to shut those
4 systems down on those days.
5 Since our investment horizon is
6 essentially in perpetuity, these funding levels
7 are not a great concern to us. And I'll go into a
8 little more detail of that in a little bit.
9 The rest of the chart there gives the
10 number of active and retired members, the average
11 age of retirees, etc., the retirement by types.
12 We have normal retirement; that is, retiring at
13 the normal, what we call the normal retirement age
14 or superannuation age. Early retirement is any
15 retirement prior to that point in time.
16 Disability, of course, is some if
17 someone's disabled in their line of duty.
18 Notice there is a difference between the
19 disability number between SERS and PSERS.
20 That is to be expected. SERS, of
21 course, has correction officers, State Police,
22 other enforcement officers. They have a higher
23 level of disability and they're out of work.
24 If you look at the average monthly
25 Pennsylvania benefits, you can see that again for

1 someone that has reached full superannuation for
2 SERS it's about 1700 a month; for PSERS, it's
3 about $1,900 a month.
4 Turning over to the next page, both
5 systems are basically funded by three sources.
6 First is the employer contributions, second is the
7 employee contributions, and third is the
8 investment income.
9 One variation on the PSERS side of
10 that. On the SERS side, the Commonwealth
11 contributions, the employer contributions are
12 essentially coming from the Commonwealth of
13 Pennsylvania, the vast majority of those. On
14 PSERS, that is basically split between the
15 Commonwealth's contribution and school districts.
16 And as a consequence, one of the
17 reasons, one of the issues of when we talk about
18 the rate spike, if there's an escalation of the
19 employer contribution, it actually has an impact
20 on local taxes, which is the focus of the system.
21 But currently the opt-out has agreed
22 that they will reimburse the systems for not less
23 than 50 percent of the contribution. It can be
24 higher than that based on the income ratio. So
25 you could have a distressed district, those

1 contributions are going to be much higher than 50
2 percent.
3 If you take an average weighted amount
4 across the Commonwealth, it's basically the
5 Commonwealth is responsible for 52 percent of the
6 contributions of the school system and 48 percent
7 is coming from the local taxpayers.
8 One of the things you'll note is that
9 the investment income, as noted in this bullet
10 point, dwarfs substantially the contributions from
11 both the school employees and state employees.
12 Page 7 illustrates those vividly.
13 These are the numbers over the last ten years for
14 both systems. And you can see that the investment
15 income is the main driver for the funding of these
16 benefits.
17 If you look at the yellow slices, those
18 are the employer contribution pieces. They are,
19 again, below the employee contribution pieces.
20 The big debate about funding of the system tends
21 to be in this yellow area.
22 You'll also note, by the way, there is
23 a difference in the employee contributions numbers
24 between State and School. The School employees
25 actually pay a higher contribution rate than the

1 State employees: 7 and a half percent versus 6
2 and a half percent of compensation.
3 Over to page 9, we'll start with the
4 funding issues. There has been much in the news
5 about a projected large increase in the employer
6 contribution rate in fiscal year '012, '013. That
7 issue has been of much greater import in the past
8 years, but there's still an issue that needs to be
9 addressed.
10 A couple of factors have given rise to
11 this. The first three factors -- actually, the
12 first four factors are the ones that have created
13 the unfunded liability.
14 So if you look at the 2000 to 2002 or
15 2001 to 2003, depending on your fiscal year
16 approach, these are the bear market losses. That
17 was that recessionary time frame beginning of this
18 decade. Basically the greatest decline in the
19 market since the Great Depression.
20 Second was the Act 9 benefits. That
21 was the 25 percent enhancement of the pension
22 benefits. Third is the Act 38 COLA. That is the
23 last Cost of Living Adjustment that was granted to
24 both state and school employees.
25 And as a result of Act 40, which

1 changed the funding methodology, the employer
2 contributions of that time period, Act 40 to the
3 present time period and out to 2012, were being
4 paid below the normal cost. And I'll explain that
5 in a little more detail.
6 What I want you to get in your mind is
7 this: The first four items have created a balloon
8 of liability, a debt that needs to be paid. Act
9 40 basically squeezed that balloon and pushed off
10 the liability to the future. So that's why
11 there's a spike here.
12 And the reason that that has happened,
13 of course, they basically mismatched gains and
14 losses. And I'll go in to explain that in a
15 minute.
16 The original spike pre-Act 40 for the
17 school system was 32.1 percent. This would be the
18 employer contribution rate that would be required.
19 Original spike for SERS was 28.6 percent pre-Act
20 40. And, again, because of these losses were
21 piling up at that time, the rates were going to
22 skyrocket.
23 If you took a look at the next page, it
24 gives sort of the status of this both pre-Act 40,
25 post Act 40, and then where we currently stand.

1 This is the State Employees Retirement System.
2 You'll see that 28.6 percent. That's the black
3 line.
4 But if you'll notice, at 2003, look at
5 that steep increase of the contribution rates
6 outlined. That's what they were trying to avoid.
7 So they pushed that off. If you look at Act 40,
8 which is the orange line, you can see that a drop
9 to 28.6 dropped it to 24.2.
10 Okay, but you notice there was some
11 substantial decrease in the contributions from
12 2003 to 2012. That was to give the fiscal
13 breathing room. But you notice also, as with a
14 mortgage, if you push off payments, you're going
15 to actually pay more.
16 So for example, if I have a 15-year
17 mortgage and I decide to refinance it to 30 years,
18 my monthly payments drop but the overall cost of
19 the mortgage will increase because you're paying a
20 longer time of extended interest. You can see
21 that that's the impact of Act 40, the orange line.
22 Notice where SERS is at the present
23 time. It's 9.09 percent as of the last valuation
24 date. The reason for that is the system made
25 stellar returns and, as a result, there was a

1 surplus being created or excess actuarial gain
2 being created that's being used to prepay the
3 debt, if you want to think of it in that fashion.
4 If you take a look at the next slide,
5 this is the picture for the School Employees'
6 Retirement System. Again, same sort of picture.
7 Slightly different numbers, but the same net
8 effect of this.
9 The current rate for the projected rate
10 increase for the school system is 11.23 percent.
11 That is going to jump from 4.74 to 11.23. That's
12 that rate spike issue and, again, which causes a
13 particular school district's problem to have that,
14 you know, not quite the tripling, but almost the
15 tripling of the contribution rate.
16 But the net effect of what's happened
17 in the couple of years for both systems comes to
18 excellent returns, multiple billions of dollars
19 have been saved by taxpayers as a result.
20 On the school side, that drop from that
21 27.7 to 11.2 has essentially saved the taxpayers
22 $2.3 billion and still in excess of a billon
23 dollars on the school -- or state side.
24 The next page I want to talk a little
25 bit about what Act 40 did and why there was this

1 squeezing. I do apologize, because this will be a
2 little more on the technical side here. I do want
3 to go back to the concept of what is the actuarial
4 value of the assets.
5 When both systems calculate the
6 employer contribution rate, which is on a yearly
7 basis, the employer contribution rate is the rate
8 that, obviously, employers pay; but it's also,
9 because the employers bear the risk of investment
10 gain and loss, that is the rate that makes up the
11 difference in the systems.
12 If the systems have excellent returns,
13 that rate will fall. If the systems does not have
14 good returns or there's other bad experience, that
15 rate will go up. It's the safety valve to make
16 sure the systems are fully funded.
17 So what both systems do, instead of
18 recognizing all of the gains and losses
19 immediately in one year, they try to spread out
20 the impact. If you recognize all of the gains and
21 losses in one year, the employer contribution rate
22 would fluctuate greatly.
23 The people that do budgets do not like
24 to see that. It's a well-recognized method of
25 virtually every pension system across the country

1 does the same thing to smooth out the volatility.
2 For the two systems, it's basically
3 done in two fashions: First, if you have a
4 gain -- and I'll give you an example here -- they
5 do not recognize all of that gain in one year.
6 Both systems use what is know as five-year
7 smoothing.
8 So they basically only recognize 20
9 percent of that gain or, vice-versa, 20 percent of
10 that loss in a year for the calculation purposes.
11 Second, let's take a gain. They would
12 amortize it over a time period. So they're not
13 going to recognize all 20 percent of that in one
14 year; they're going to amortize it over a time
15 frame. That time frame post Act 40 is 30 years.
16 So, essentially, they're amortizing it over 30
17 years.
18 So let me give you an example here.
19 Let's say you have a $15 million gain, okay. If
20 I'm only going to recognize 20 percent of that,
21 that's $3 million. But I'm going to now amortize
22 that in over 30 years; so, roughly speaking,
23 that's a hundred thousand dollars a year.
24 Obviously, amortization would reduce
25 that as it goes forward. Same thing if it was a

1 loss. It would only come in as a debit as a
2 hundred thousand dollars a year.
3 What Act 40 did to basically push off
4 the liability, basically it said, Look, we're
5 going to basically take the position that any of
6 the gains and losses that were pre-Act 9 are going
7 to stay on a 10-year amortization schedule.
8 When they did that, there was only
9 gains. Those are the gains that came from the
10 1990s, the bull market of the 1990s. They then
11 also said bringing gains and losses post Act 9,
12 it's going to be on a 30-year basis. So the net
13 effect of this is they mismatched the gains and
14 losses for a 10-year time frame.
15 I want to go back to my same
16 illustration here. Let's say that pre-Act 9 the
17 gain was again $15 million. Again, we're going to
18 recognize 1/5th of that $3 million. But the
19 credit is not a hundred thousand dollars. It's
20 300,000. So I'm having my credits come in at
21 three times the rate of my gains and losses.
22 And the net effect of that is it pushes
23 down the rate dramatically for that 10-year
24 period. But I've used up all my reserves to
25 mitigate the rate by '012/'013; as a consequence,

1 the rate spikes up at that time frame. The next
2 slide basically illustrates this.
3 One of the other impacts of Act 40, if
4 you think about it, both systems have unfunded
5 accrued liability; but both systems were paying
6 what is below -- what is called below the normal
7 costs.
8 The normal costs for both systems is
9 the amount that needs to be paid to basically fund
10 the benefits that were earned in that year. So if
11 the systems were operating perfectly, all the
12 assumptions were perfectly met, the normal cost is
13 what would be contributed to the system.
14 If the systems have an unfunded
15 liability, you need to be paying more than the
16 normal cost because you need to gain the principle
17 that you're earning plus the principle towards the
18 debt plus interest.
19 Since we're going below normal cost at
20 this time, we're not even making the principle
21 payments on the debt, those unpaid principle is
22 then added to the debt which then causes -- it's a
23 negative arbitrage situation because, again, the
24 liability's being pushed off to the future.
25 Pension systems -- stands, pay me now

1 or you pay me later. If you pay me later, you pay
2 me more in the time frame.
3 Page 13, again, the question when I
4 explained this to a bunch of fiscal legislative
5 assistants one time, their question to me: Who
6 came up with this crazy scheme? My response was,
7 The school legislative assistants.
8 But, again, when it was being done at
9 this time frame, this was to give room to the
10 Commonwealth. This was the cash flow technique
11 that was put into play. Because to go back to
12 those time frames, 2000, 2001, 2002, tax revenues
13 to the Commonwealth were off.
14 We were in a recessionary time frame.
15 School districts were under pressure for their own
16 budgets, so they basically wanted to give some
17 breathing room to allow the markets to recover and
18 then basically address it in the future.
19 As I've already mentioned, partially
20 that has happened. The markets have recovered.
21 Those rate spikes have dropped significantly.
22 There's been significant savings to the taxpayers
23 because the funding is now coming from the
24 investment returns.
25 I've heard there is still this issue,

1 again, as I mentioned on the PSERS side of the
2 equation. The rate spike is projected to go from
3 4.76 over normal costs up to 11.23 in one year.
4 So something needs to be done.
5 On the SERS side, because they
6 basically have now gotten a fifth evaluation year
7 end, which would be another stellar year for them,
8 plus they had a lower unfunded accrual liability
9 to start with, there's not as much of the same
10 issue of urgency plus, of course, they're not
11 impacting local taxes as school system.
12 So the main focus of this tends to be
13 on the school side of the equation.
14 MR. KNEPP: If I may, Jeff, the rate
15 that you see here is 9.09. That was based on 2006
16 data. And as Jeff stated, we had a pretty solid
17 return this last year, 17.2. It's projected that
18 that rate will go below the normal cost, the 2012
19 spike. That was originally projected to be over
20 28 percent, will now be under 8 percent.
21 REPRESENTATIVE METCALFE: How you doing
22 the first two months of this year?
23 MR. KNEPP: The first month, we're down
24 four.
25 MR. CLAY: But for evaluation

1 purposes --

2 REPRESENTATIVE METCALFE: Understood.

3 But it's not a snapshot.

4 MR. CLAY: There's another side --

5 MR. KNEPP: -- constantly moving

6 target.

7 MR. CLAY: So now the question comes

8 up, we're at that time frame. There has been a

9 lot of debate about the rate spike, what to do.

10 I've got some potential alternative solutions that

11 have been discussed both in the press and the

12 General Assembly.

13 The first is basically Senate Bill 826.

14 There has been other variations of this introduced

15 in the General Assembly at various times. Both

16 systems have what is known as an employer

17 contribution rate floor. That floor is 4 percent.

18 So the employer contribution rate cannot go below

19 4 percent, even in a good year.

20 Again, that was an effort to try to

21 prevent the recurrence of what happened with the

22 pre-Act 40 to start to build extra reserves and as

23 you go forward. This proposal would basically

24 take the PSERS employer contribution rate floor

25 from 4 percent to 6.44.

1 You asked the question, Why that
2 number? That's an attempt to get it as close as
3 possible to what the current certified rate is
4 today, which is 7.13 percent. Because on top of
5 this 6.44 is a premium assistance piece that gets
6 added. So this would bring it up to that 7.13
7 percent.
8 And the purpose of that is, again, we
9 have certified the rate that's currently in
10 effect, the 7.13 percent. The rate we have
11 certified next year is dropping to 4 and change.
12 The argument is, Why would you let that
13 rate drop if you're going to have a tremendous
14 increase going into the future? You want to try
15 to keep it because they're already accustomed to
16 paying that number.
17 That's what this bill seeks to do. On
18 the SERS side, they would take the rate floor from
19 4 to 5 percent. Similar time thought process.
20 Over to page 15, this proposal does
21 help, again, in the future as a greater impact for
22 the future underfunding. It does have some impact
23 on the rate spike for both SERS and PSERS, but it
24 does not have a significant impact partly because
25 it's not a lot of additional fund coming in;

1 second, there's a short time frame before that
2 rate spike takes place.
3 On the SERS side, the rate spike would
4 drop in at 9.09, 8.76 percent. Again, as Len has
5 indicated, if you factor in their latest valuation
6 number, which will be done in April sometime,
7 their rate spike, these numbers, will both
8 dramatically drop.
9 On the school side of the equation, if
10 you factor in our rate of return, our valuation
11 date, which is June 30 of 2007, which is 22.93
12 percent, rate spike would drop from that 11.23
13 percent to 10.5 percent.
14 The rate spike itself would be 7.18
15 percent to 10.5 percent because, again, you've
16 raised this rate floor; so you've closed that gap
17 to a certain extent.
18 Over to page 16, another option,
19 similar sort of concept. We have this outstanding
20 debt. What you want to do is gradually ratchet
21 yourself up to pay that. Sort of, in essence,
22 prepaying this outstanding debt.
23 Just a simple here. If we basically,
24 again, on the school side of the equation, just to
25 start to raise it up, raise that rate floor to

1 7.25, 7.7, 8.5 to 9 percent, just gradually raise
2 it up prior to that time frame, the rate spike
3 then would be 10.8 percent and the actual
4 difference between the two years will be 9.74 to
5 10.08 percent.
6 So essentially just smoothing it right
7 out. You're just prepaying. That's another way
8 to handle that. Those numbers I quoted, the 7.25
9 would then be a plus premium assistance on top of
10 that.
11 Again, this proposal would not
12 necessarily make the same sense as the SERS
13 because their gap is much, much smaller.
14 Okay. The next proposal that has been
15 discussed is what is known as the actuarial fresh
16 start. I want to take you back to my extended
17 discussion with respect to the actuarial value of
18 the assets.
19 Remember, we are not looking at the
20 market value of the assets when we make our
21 contribution calculations; we're looking at the
22 actuarial value.
23 When you have an up market, the
24 actuarial value of the assets tends to lag behind
25 the market value because you're not recognizing

1 all the gains. Vice-versa, in a down market the
2 actuarial value of the assets tends to be higher
3 than the market value because you're not
4 recognizing all the losses.
5 The last four or five years have been
6 stellar returns, so we have the actuarial value of
7 the assets are lagging the market value. So what
8 a fresh start suggests is two things: First, for
9 one time period -- this would be June 30th,
10 2007 -- we would recognize as we do the
11 calculation based on market value of the assets.
12 If you did that at that time frame,
13 instead of being 85.8 percent funded, it would be
14 a hundred and one percent fully funded. So that
15 shows you the difference between the two. You do
16 your calculation based on that.
17 Second, you would take all the unfunded
18 liabilities that are still out there that are
19 basically on either these 10- or 30-year time
20 frames; everything would get refinanced to a new
21 30-year period.
22 So, again, you're pushing out your
23 liabilities to a certain extent plus you're
24 marketing the two -- the market value.
25 If you were to do that as of the June

1 30, 2007 -- and that would have to take place
2 before the July 1st time frame this year -- the
3 rate spike is this year's rate: 7.13 percent.
4 The '012/'013 time frame, the rate would 6.65
5 percent.
6 Now, if you follow what I was
7 suggesting with the actuarial value, one of the
8 benefits of an actuarial value is you tamp down
9 volatility. So, in essence, this proposal is
10 accelerating all those gains and recognizing them
11 in one year to tamp down, take the credit.
12 One of the drawbacks of an actuarial or
13 fresh start would be if you start to have rocky
14 markets going forward. As Representative Boyd has
15 already noted, you don't have those gains to help
16 push in those losses. So there could be more
17 volatility takes place.
18 What you would start going back to
19 the -- methodology, you start going back to
20 actuarial value immediately; but, again, you would
21 have potentially more volatility with a fresh
22 start. So that's one of the drawbacks.
23 An analogy you can think about, when
24 Act 9 was done, both systems had tremendous
25 surpluses, excess to push and losses. Those were

1 essentially spent to pay the benefits. Markets
2 immediately turned the other direction and those
3 surpluses were not there to help push in those
4 losses.
5 I will mention when I go back to the
6 liability, I should note that when you look at
7 what drives the rate, Act 9 benefits did have an
8 impact; but they were dwarfed by the investment
9 losses. Both systems had much greater investment
10 losses than the end liability from Act 9.
11 And if you think of those charging, we
12 talked about the source of the funding. If you
13 shut off that 81 or 84 percent of funding and it's
14 below what's required, you can understand where
15 that liability's coming from. So that's the rate
16 spike.
17 There's a couple other options that
18 have been discussed. Briefly, we're just going to
19 walk down the defined benefit plan structure.
20 And, again, the chief difference: There's two
21 types of basic plans that are out there:
22 Defined benefit, in which the pension
23 benefit is determined by a formula. It is not
24 tied to the investment performance. So the net
25 effect of that is it gives the individuals a

1 downside protection; it gives 'em a upside
2 protection, upside benefit.
3 Contrast that to a defined
4 contribution. Defined contribution, the benefit
5 is essentially based on what is in the account and
6 the investment skill of the individual that
7 manages that account. They get potential upside
8 in a defined contribution; they get no downside
9 protection. Again, it's not tied to a formula.
10 I'll go through, but there is
11 fixed -- besides the benefit, another
12 characteristic of defined benefit, the benefit's
13 paid in an annuity; so it's a monthly benefit for
14 the life of the member. Allows them to
15 essentially not outlive their benefit, but they
16 can outlive their value of the benefit.
17 Defined contribution, of course, is
18 someone can take it, withdraw it all in one year,
19 if they're foolish enough to do that, buy a
20 Winnebago and be done. Hopefully, they're not
21 that foolish to do that.
22 Another difference -- another thing
23 mentioned about these pension systems, all the
24 benefits are prefunded. When an individual
25 retires, they actually have a hundred percent

1 fully-funded benefit for their expected life
2 expectancy.
3 Obviously, some people live that time
4 and beyond; others do not. The actuaries add that
5 to their calculation. So these are prefunded
6 benefits.
7 Initially when you set up a system like
8 this it tends to be a little bit more expensive.
9 In the long term, it's much cheaper because of the
10 source of funding is those investment returns.
11 Again, the taxpayers are only paying,
12 in our case, 7 percent of the cost of this system.
13 The vast majority is coming from either the
14 employees or from the investment returns.
15 Contrast this to social security,
16 social security is a pay-as-you-go system. It's
17 the cheapest way to start a retirement system.
18 And when it was started back in the '30s, the
19 number of active people contributing income tax
20 dollars was substantially greater than the number
21 of people retired.
22 Go to the present. Now it becomes a
23 very expensive system because the ratio is getting
24 much, much smaller. And as a result, the concern
25 is there that there's not going to be sufficient

1 funding; it just keeps escalating. That is not
2 the case in a defined benefit plan. Both systems
3 do offer disability benefits for their members.
4 Couple of things to again bring back
5 home again. Employers are expected to contribute
6 to these plans. There is no such thing that the
7 plans are fully funded, that there will be a zero
8 contribution.
9 The contribution that you would expect
10 is, again, as I mentioned, the normal cost of the
11 system. Again, that is the amount that the
12 employers have to contribute to cover the benefits
13 that are earned in that year.
14 Again, if the plan is functioning
15 perfectly, 8 and a half percent earnings
16 assumption, people live and die when they're
17 supposed to, etc., they should be paying the
18 normal cost, the employers.
19 That plan is generally considered
20 well-funded and the employer is basically paying
21 the normal cost, amortizing all unfunded liability
22 at a reasonable period of time. Typically, that
23 is not in excess of 30 years. Thirty years is the
24 max for most actuaries.
25 Again, the pension benefit is paid in

1 an annuity and, again, as I mentioned, this is
2 prefunded. The current normal cost for the state
3 system is 8.21 percent of contributions of the
4 payroll and for PSERS is 6.68 percent.
5 Ask why is there a difference between
6 the two since the structures are similar? SERS
7 has different classes of membership: The judges,
8 for example, the State Police, etc. They have
9 different formulas for the calculation of the
10 benefits.
11 Over to page 19, here is basically the
12 formula that applies to most individuals as the
13 multiplier times the final average salary. It's
14 the highest three years times years of service.
15 Over to page 20, this is just sort a
16 high-level snapshot of some of the key provisions
17 of the Government Defined Benefit plan. What I
18 would draw your attention to over on the
19 right-hand side, first, the option to withdraw the
20 lump sum.
21 This is the contributions that the
22 members are making themselves and they gain 4
23 percent interest. During the '90s, that was not a
24 good deal. During the first part of this decade,
25 that was a great deal. Nowadays, it's not quite

1 the same. CDs are running at 4 percent.
2 Notice also the next one, COLAs, they
3 are on an ad hoc basis. They are not prefunded;
4 they are postfunded. There is no entitlement in
5 retirement though for our members to get COLAs,
6 but we'll talk a little bit more about that.
7 Over to page 21, this is a little bit
8 on the benefits side. Talks about early
9 retirement. When I talk about early retirement in
10 this context, I'm not talking about a 30 and out.
11 These are individuals that retire prior to
12 superannuation, normal retirement age.
13 If you do that, there is an actuarial
14 reduction takes place into your pension benefit so
15 that keeps it actuarially equivalent. For
16 example, if your pension benefit, the present
17 value of that is $500,000, I'm going to pay that
18 to you over from age 65 to let's presume your life
19 expectancy is 85. That's gonna do the math as to
20 what that benefit's going to look like based on
21 your years of service.
22 However, if you decided to retire at
23 age 50 and I'm going to pay that over, there's
24 going to be a reduction that takes place to lower
25 that to basically make sure that's actuarially

1 equivalent during that time frame. You're not
2 going to get $500,000 twice, so to speak.
3 There is currently no what I call early
4 retirement incentive to give somebody the ability
5 to retire early with no actuarial reduction taking
6 place.
7 PSERS does have what is known as a
8 special retirement benefit. This is what is known
9 as a 55/25, age 55 with 25 years of service. You
10 can retire at that point and you get a reduced
11 actuarial reductions by half the normal cost.
12 Page 2 gives the various options that
13 members can select. -- single life annuity is,
14 essentially, that is your benefit. If you take
15 the simple formula, that's the maximum you're
16 going to be able to get out of the system.
17 Other options give you options to take
18 care of spouses and survivor annuitants or do some
19 other protection; but when you take those options,
20 your benefit is reduced from the maximum single
21 life annuity to pick up the cost of these.
22 So for example, under Option 2 you have
23 the ability to provide a benefit for yourself and
24 then your survivor annuitant, your spouse, can get
25 a hundred percent of your benefit for his or her

1 lifetime.
2 But it's not the maximum single life
3 annuity. It's going to be at a reduced number to
4 reflect that additional benefit payment that's
5 going out. Again, keeping everything actuarially
6 equivalent.
7 So again, if your benefit is a $500,000
8 present value, they're basically doing the
9 calculation that they spread that out to cover the
10 both lives.
11 If you take a look -- well, go a little
12 bit on the withdrawal option here on page 23.
13 Again, members can elect to pull that out. A vast
14 majority of the members in both systems do that,
15 all or a portion of that together with their 4
16 percent.
17 This is not a common feature in most
18 pensions systems across the country.
19 Pennsylvania's one of the few that does permit
20 this.
21 Over to page 24, this is sort of an
22 illustration of the effects of the reductions that
23 take place when you take out -- you go to another
24 option or you take out your contributions and
25 interest.

1 Because when you do take out your
2 contributions and interest, again, there is a
3 reduction in your pension benefit that is taken
4 into account because you actually are getting
5 essentially a lump sum payment as part of that
6 present value.
7 But you can see, depending upon the
8 options, the first set talks about it with the
9 contributions in; the second portion, the
10 contributions are withdrawn. It gives you some
11 idea of looking at reductions that take place.
12 Page 25 is sort of a comparison of both
13 SERS and PSERS to other systems, a very broad
14 basis. This is coming from a Joint State
15 Government Commission. I believe I have -- yes,
16 it's this report here. That's out there online.
17 But you can compare. It's not
18 surprising we're better than some plans, we're
19 worse off than other plans, and we're about the
20 same as other plans. The next couple slides are
21 going to highlight some of these issues.
22 Over to page 26, we tend to be more
23 favorable because we do have a higher accrual
24 rate. That's that 2 and a half percent
25 multiplier. That tends to be higher than other

1 systems around the country.

2 We also again have that ability to

3 withdraw the contributions and interest. Our

4 members are eligible to collect also social

5 security, so they have a social security benefit

6 plus our own pension benefit.

7 Other states, they have opted not to be

8 in the social security system; as a result, they

9 only get the pension benefit there. And that, by

10 the way -- some of the issues with respect to

11 COLAs in other states.

12 Some other states that have the

13 automatic COLAs, for example, it's because they're

14 nonsocial security states. It's because they're

15 trying to make up that difference between them not

16 having it. Because again, when you get social

17 security, there's a COLA that goes with that.

18 Go to page 27, there are some

19 characteristics that are less favorable. The

20 employee contributions tend to be higher than most

21 states. We actually contribute more into that as

22 State School Employees, plus there is no automatic

23 COLA or any sort of COLA entitlement here; so

24 there is no income protection going forward.

25 Page 28 is another look at the benefit

1 adequacy. Keep on that last bullet point, we do
2 tend to contribute, again, more than our median
3 towards our retirement benefit. So the employees
4 here tend to pay more than other states who do
5 that, particularly for the social security
6 eligible states.
7 That brings us up on page 29, the
8 COLAs. Again, as we've mentioned, COLAs are ad
9 hoc; they're granted at the discretion of the
10 General Assembly with the approval of the
11 Governor. They are postfunded; they are not
12 prefunded, which is what drives the cost.
13 If you are going to basically go for a
14 long-term policy to grant COLAs, I would ask you
15 to consider prefunding them. More expensive to
16 start. Long-term cheaper to do. Same
17 illustration as I mentioned with the pay-as-you-go
18 system and not a pay-as-you-go system.
19 What happens when a COLA is granted, it
20 creates an unfunded liability immediately. A
21 debt's established and then it's been amortized
22 off over some time frame. That period is
23 typically ten years for the end of Retirement
24 Code.
25 There has been a pattern in the past of

1 the General Assembly granting COLAs on usually a
2 four- to five-year cycle. We're at the edge of
3 that cycle at this point -- past that cycle at
4 this point.
5 Basically, COLAs are only permitted to
6 State School Employees based on the Constitutional
7 Amendment back in 1955 that basically exempted
8 from the prohibition of paying employees benefits
9 postemployment other than Cost of Living
10 Adjustment.
11 There is one exception to that. I'm
12 sure some of you have gotten letters from survivor
13 annuitants or spouses of members who are not
14 members themselves wanting a Cost of Living
15 Adjustment. The Constitutional provision only
16 applies to the members of the system; it does not
17 apply to the survivor annuitants.
18 So survivor annuitants that hit that,
19 for example, Option 3 or 2 benefit, they are not
20 eligible for a COLA if they're not a member of the
21 system. So they are totally on a fixed income for
22 the rest of their lives.
23 There was an effort to try to amend the
24 Constitution back in the '90s and it failed. It
25 was voted down by the -- it actually went through

1 the General Assembly twice and went to referendum
2 and failed.
3 So how are COLAs funded? As we
4 mentioned, there is a new unfunded liability.
5 There is no mechanism for us to prefund a COLA at
6 this point. We're not permitted to do by statute.
7 They cannot be paid from the existing
8 assets of the funds. If that happens -- again, if
9 you think about it, we're underfunded at this
10 point. We don't have enough assets to pay the
11 existing liabilities.
12 Probably another analogy to think about
13 this, someone could say, well, you can just dip in
14 the fund and pay the money out. I'll give an
15 analogy.
16 If I was running a business and I have
17 a reserve account to do building maintenance and I
18 have a new initiative I want to do, I'm going to
19 take the money out of my building reserve to fund
20 this new initiative, the building maintenance is
21 going to come due.
22 That bill's going to come due. You
23 have to pay that. There's a debt created here.
24 The money, you just can't take it out. And if you
25 do, it's just going to cause the contribution rate

1 to go up to bring it back to full funded.
2 So COLAs do require new funding.
3 Again, as I mentioned, those funding, it's a debt
4 that's over a ten-year time frame. It's a
5 considerable cost to these. But, again, the point
6 I want to get across is COLAs do cost money.
7 There is no such thing as a free COLA.
8 Well, there is if the percentage you
9 give everybody is zero.
10 If you take a look at 31, page 31,
11 here's some costs of COLAs. The last COLA that
12 was granted was the 2002/2003 COLA. If you look
13 at that, you can see the costs for both systems;
14 but the combined cost was about $1.75 billion.
15 That was only for what we call the
16 nonAct 9 people, or the single A and DC people.
17 That did not include that people got the Act 9
18 benefit.
19 You can see the annual cost of that
20 COLA was $307 million. Again, roughly speaking,
21 because this is a debt, that's the annual payment.
22 You can roughly take that times ten; that's the
23 actual full cost of the COLA.
24 Because as you're paying off the debt,
25 again, it's no different that you buy your house.

1 You bought your house for 50,000; you financed it;
2 by the time you get done for 30 years, it's more
3 than 50,000. Same thing for a COLA.
4 We did an estimate in 2006 of
5 what, if we were to replicate the 2002/2003 COLA,
6 those numbers on the other box. This would
7 include the DC members. So this is double 8 (sic)
8 members, the ones that got Act 9 benefits. You
9 can see that that number will be substantially
10 larger, $3 billion.
11 I did a quick calculation on this PSERS
12 side of the equation. If I were to exclude the DC
13 members, that number would drop to $2.1 billion
14 for a total for both SERS and PSERS, figuring that
15 the SERS costs are about roughly half the PSERS
16 costs.
17 Next page is an automatic COLA, which
18 would be a huge number. Almost $21 billion of
19 additional unfunded liability. Annual payment
20 would be close to $4 billion to pay that annual
21 automatic Cost of Living Adjustment.
22 And again, this is because you're
23 starting this brand new; you're not prefunding;
24 you're basically borrowing the money to pay this
25 off.

1 Over to page 33, again the Joint State
2 Government Commission did a study of this back in
3 2004, do some comparison to some other states.
4 There are 16 other states that do not grant ad hoc
5 COLAs.
6 The other states do it on a wide
7 variety of formulas. Some of it's tied to the
8 Consumer Price Index. Some of it's capped. Some
9 of it's just a flat percentage, for example.
10 There's a wide variety of ways to do it.
11 Some states have what are known as the
12 13th check. Just whatever -- your 12 checks a
13 year, you just get the equivalent of a 13th.
14 That's your COLA for that year.
15 Other states, even though they are
16 viewed as automatic, they will put in some
17 conditions subsequent only if there is favorable
18 investment return in the fund. So, for example,
19 if we're above our earnings assumption by "x"
20 percentages, then a COLA will be granted; if we're
21 below, it will not be granted at that time.
22 So this sort of gives a variation
23 description. Again, if you want the details of
24 that, that's in the Joint State Government
25 Commission Report.

1 Sort of the history of COLAs are on
2 page 34. Again, you can see the pattern. COLAs
3 have been granted for a considerable time frame;
4 as a result, the retirees have built up some sort
5 of expectation for 'em, which I'm sure you've
6 heard about already. But you can sort of see
7 that. Again, the last time a COLA was granted was
8 the 2002/2003.
9 That brings me to the end of my
10 remarks. I'd be happy to answer any questions,
11 and both us would be happy to respond.
12 CHAIRPERSON LEVDANSKY: Thank you for
13 your excellent and informative overview. Members
14 have any questions?
15 Representative Sainato.
16 Chris, before we get started with the
17 questionings, we've been joined by Representative
18 Jaret Gibbons and Representative Adam Harris. And
19 that's it.
20 Representative Sainato.
21 REPRESENTATIVE SAINATO: Thank you,
22 Mr. Chairman. Thank you, Mr. Knepp. You've given
23 us a lot to digest here. I think this has been
24 very helpful to all of us. Chairman Levdansky, I
25 thank you for doing this.

1 I have a question. Just hold on one
2 second. I'm trying to find the page with the
3 options.
4 Page 22, Option 3 where it says,
5 Provides a reduced monthly annuity for as long as
6 you live. Following your death, provides your
7 designated survivor with lifetime monthly annuity
8 approximately one-half of the monthly annuity.
9 So if the person was collecting a
10 thousand dollars a month and their designated
11 person after their death, the designated person
12 would get $500 a month?
13 MR. CLAY: Right.
14 REPRESENTATIVE SAINATO: Now, my
15 question is somewhat tied to the COLAs. Now, say
16 their benefit was a thousand dollars and that COLA
17 came in 2003, 2004, and the benefit went up to
18 eleven hundred dollars. When they die, their
19 designated person, would they get $500 or would
20 they get five-fifty?
21 MR. KNEPP: If the member was alive
22 when the COLA was passed, that additional COLA
23 would be passed to the bennie or, in this case,
24 the survivor.
25 The individual COLAs that do not get

1 passed to the bennie is if the member predeceased
2 the grantee or the enactment of that COLA.
3 REPRESENTATIVE SAINATO: Because I've
4 had this question asked of me and I've never
5 really had a chance to ask it till today. I could
6 never figure it out because, getting to what you
7 had said earlier, if you're collecting that as
8 that survivor, you can never, ever qualify for a
9 COLA; and that's because of the Constitution that
10 you've told us.
11 So the person who is that survivor now
12 would get half of what the benefit is now, not
13 what the original benefit was?
14 MR. CLAY: Right. Right.
15 REPRESENTATIVE SAINATO: So if they got
16 three COLAs in that lifetime, they would qualify
17 for those COLAs. But after they get this as that
18 survivor, they're done; that's their figure for
19 the rest of their life?
20 MR. CLAY: That's correct.
21 REPRESENTATIVE SAINATO: All right. I
22 think you've answered that question. That came up
23 a while back that someone asked me that and I
24 couldn't give an exact answer. So I thank you.
25 MR. CLAY: While we're at that page, I

1 should just -- that special option there, that
2 allows an individual to decide a benefit any way
3 they want subject to the actuarial equivalent.
4 So if you don't want a hundred percent
5 your survivor annuity, you want to make 33 percent
6 or 33.6 percent, you can do that. Trust me,
7 people do some interesting changes.
8 REPRESENTATIVE SAINATO: So it's just
9 not 50 percent?
10 MR. CLAY: Right.
11 REPRESENTATIVE SAINATO: I always
12 thought it -- okay.
13 MR. CLAY: You can do all sorts of
14 things as long as it's actuarially equivalent.
15 REPRESENTATIVE SAINATO: Let me follow
16 up. Okay, getting on these options, your first
17 option is you get the multiplier figure, say for a
18 state worker, 2 and a half percent times a number
19 of years times their high three years?
20 MR. CLAY: Correct. That would be your
21 maximum single life annuity. That's the maximum
22 you can get out of the system.
23 REPRESENTATIVE SAINATO: So that's what
24 you would get if you did that. Then the option
25 where you take out all your money.

1 What is the -- a lot of people say they
2 take that option, taking their money out. Is that
3 such an advantage to do that, or is it based on
4 how old you are when you retired?
5 MR. KNEPP: Just to make sure you
6 understand that most of on these -- on all of
7 these options you can do both. In other words,
8 you could take an Option 1 and still take your
9 money out and then the Option 1 total benefit
10 would be totally state paid.
11 So a lot of people do what we call
12 Option 4 where they withdraw all their money they
13 contributed plus the interest it earned, take that
14 out; then the remaining benefit, which is totally
15 state funded, would go under the Option 1
16 calculation. So it's two different options.
17 REPRESENTATIVE SAINATO: Reduced?
18 MR. KNEPP: Yes, it would be actually
19 reduced by the amount of Option 4.
20 REPRESENTATIVE SAINATO: I understand
21 that. But my question is, Why do most people do
22 that? Is it better -- I know it's an individual
23 case, okay; but is it based on age?
24 I mean, if you are a state policeman
25 and they're 50 years old and they can retire,

1 would it be better to keep the money in if you're
2 50 as compared to being 60 or 65?
3 MR. KNEPP: I honestly think it's an
4 individual preference and I think they look at
5 it -- there's substantial sums of money for these
6 individuals and they just want to get to that
7 money instead of taking it out of their life
8 expectancy.
9 We're talking tens of thousands of
10 dollars potentially for these individuals. So
11 they get that in a lump sum again, pay off debt,
12 do the RV --
13 MR. CLAY: I think there are two things
14 that -- I think one is that they do need a lump
15 sum for whatever the cost may be. Maybe they're
16 paying for college costs or they're paying for
17 their kids or grandkids, whatever they're trying
18 to do.
19 REPRESENTATIVE SAINATO: But if you
20 don't need that lump sum --
21 MR. CLAY: But I agree, there are those
22 other circumstances. Maybe they'll take that
23 money out and invest that or buy an annuity and
24 have a better annuity.
25 So, for example, if their -- we're

1 going to reduce their annuity by a hundred dollars
2 a month, be able to take that money out and get
3 another annuity for a hundred and fifty dollars a
4 month. So they made $50.
5 But again, I think that depends on the
6 age and circumstances as to whether that makes
7 sense to do that. It's like with taxes. You have
8 to do the math. There are some financial advisors
9 that specialize in that that do the math for them.
10 REPRESENTATIVE SAINATO: I bring this
11 up because yesterday one of the speakers said
12 that, you know, we have this generous option here
13 and most people take this option. And I tried to
14 figure this thing out, and I keep thinking it's
15 gotta be based something on your age.
16 There's a big difference if you're
17 collecting it for 30 years versus if you're taking
18 it at 70. I mean --
19 MR. CLAY: An example of that, if
20 you're 95 years old and you would leave, your life
21 expectancy is zero; so your annuity, it's not
22 going to work for you. So there is going to be a
23 place where it isn't going to work, you know, the
24 younger you are.
25 REPRESENTATIVE SAINATO: You may have

1 some problems at that age. All right. Thank you
2 very much. It's very helpful.
3 CHAIRPERSON LEVDANSKY: Before I
4 recognize Representative Seip, we've been joined
5 by Representative Dave Reed from Indiana County
6 and Representative Josh Shapiro from Montgomery
7 County.
8 Representative Tim Seip.
9 REPRESENTATIVE SEIP: Thank you,
10 Mr. Chairman. I have to tell you, as a licensed
11 social worker, I probably have a different view of
12 the whole retirement system than some other
13 people.
14 But I have to ask you to make sure I
15 understand this correctly. I've been told by some
16 constituents that there are participants in PSERS
17 Program that did not participate in social
18 security. Is that true?
19 MR. CLAY: Yes, there are a very, very
20 few that have not. They made a choice some time
21 in the past not to do it. Very few individuals of
22 that status anymore.
23 And really, from their perspective, the
24 real harm for them when it comes to Medicare, we
25 see it more on the Medicare side. I think the

1 last we looked at it was, like, 114 of our
2 retirees that could not participate in Medicare
3 because they were not eligible for social
4 security.
5 This was one of those choices they made
6 years and years and years ago which was not a good
7 choice.
8 REPRESENTATIVE SEIP: They're in a
9 terrible position at this point.
10 MR. CLAY: Right. One of the
11 initiatives we did with our -- we actually got
12 them into Medicare, worked out an arrangement that
13 they are now eligible for Medicare. They had to
14 pay a penalty to do that, but we've offset that.
15 From our perspective, we're offering
16 our Medicare Supplement Plan for free because
17 Medicare is picking up the primary costs of the
18 coverage. It was actually to our economic
19 advantage to do that, plus it benefitted them.
20 REPRESENTATIVE SEIP: One other quick
21 question. I guess because I'm a social worker,
22 not so much an accountant or anything like that;
23 but when we looked at the fund, one way to improve
24 the fund would be to try and increase that return.
25 Is there anything that we could do? Is

1 there anything that's handcuffing this fund from
2 trying to maximize that increase?
3 MR. CLAY: Both systems have what is
4 called full prudent investment --
5 REPRESENTATIVE SEIP: We don't want to
6 invest in ENRON, but --
7 MR. CLAY: Right, right, right. Back
8 in the early '90s we had what was known as a legal
9 list; we could only invest in certain categories
10 of investment. Back in the early '90s, the NASDAQ
11 Stock Market was not considered a safe investment.
12 When you think about what happened in
13 the '90s, the General Assembly changed that to
14 allow us to have the ability to invest basically
15 in any assets that's out there. So that's, again,
16 prudent to do something.
17 That effect, both systems are very
18 heavily diversified both in foreign and domestic
19 stock in all different types of asset classes,
20 which is the reason we've had the returns that
21 we've had. I'm not sure at this point there is
22 anything else you can do to make it better.
23 REPRESENTATIVE SEIP: -- boost.
24 MR. CLAY: Unless you can predict what
25 the market's going to do and tell us in advance.

1 We can invest it.
2 CHAIRPERSON LEVDANSKY: Representative
3 Harris.
4 REPRESENTATIVE HARRIS: Thank you,
5 Mr. Chairman.
6 A quick follow up to Representative
7 Sainato's comment. On page 5, I see a pretty
8 significant disparity between percentage of
9 retirees enrolling their accumulated deductions
10 for SERS members and PSERS members.
11 It looks like about the 91 percent of
12 the SERS members are taking all their money out
13 and only about 80 percent of PSERS.
14 Any idea why the difference? I would
15 assume that they would be very close.
16 MR. CLAY: Actually, there is a
17 difference in the demographics of the system. The
18 PSERS system is, about 60 percent are women versus
19 I think it's the reverse -- it's 60/40 in the SERS
20 system and it's the reverse of that in the State
21 System. That may have some aspect of that, make
22 different choices as they choose to go forward.
23 We'd have to take a survey of every one
24 of them --
25 REPRESENTATIVE HARRIS: Sure, personal

1 choices. I think the demographic issue will speak
2 to it as well, because we tend to not live as
3 long, fortunately or unfortunately. Thanks.
4 CHAIRPERSON LEVDANSKY: Representative
5 Boyd.
6 REPRESENTATIVE BOYD: Thank you,
7 Mr. Chairman. Thank you for an excellent
8 presentation. It's extremely thorough. I got
9 lots of questions. I'll try and sort through 'em.
10 First thing I want to talk about is the
11 spike issue that you referred to. The charts that
12 you show demonstrate that the returns over the
13 last, say, probably three years in the market have
14 really currently mitigated the impact of the
15 spike.
16 However, correct me if I'm wrong, but
17 the charts that you're showing us are really
18 snapshots --
19 MR. CLAY: Right.
20 MR. KNEPP: Right.
21 REPRESENTATIVE BOYD: -- as of really
22 December 31st, 2007. Is that the snapshot?
23 MR. CLAY: For --
24 MR. KNEPP: Ours, the SERS side, would
25 be as of 12/31, 2006. They do not factor in 2007

1 yet.
2 MR. CLAY: Ours would be as of June 30,
3 2007.
4 REPRESENTATIVE BOYD: Okay. So it's
5 important I think for the Committee to understand
6 that the spike issue is not dead. The current
7 anomaly that was created by Act 40 still exists.
8 And if the market performs poorly throughout the
9 2008/2009 time frame, these numbers will be
10 quickly reversed.
11 Can you comment on what will happen
12 based on what we did in Act 40, which was really
13 kind of playing games with gains and losses, what
14 happens -- it was assumed the market would do
15 well. We've seen that for the last three years.
16 What happens if the market reverses
17 itself?
18 MR. CLAY: I gave you an illustration
19 of that. And this is, again, doing sort of a rate
20 projection. If I were to indicate that we made a
21 zero rate return for this fiscal year, the '08/'09
22 time frame, you -- currently is forecast to go
23 from 11.23 percent. So it's 4.74 to 11.23. That
24 would go from 4.74 to 15.02.
25 REPRESENTATIVE BOYD: Okay. So --

1 MR. CLAY: Notice what I said: The
2 rate for the year before the rate spike doesn't
3 change, because of that suppression that's taking
4 place.
5 REPRESENTATIVE BOYD: Right. Okay.
6 And on that spike issue you identified some
7 proposals that are out there to mitigate that.
8 Can you comment a little bit more on
9 this Fresh Start concept and the risks of doing
10 that? A year and a half ago the Fresh Start may
11 have looked pretty good.
12 Starting Fresh now with markets that
13 are -- I've talked to my analyst and he said he's
14 never in his entire 25-year history seen the
15 market more volatile than it is right now, swings
16 that are just obscene in a day.
17 MR. CLAY: You're right. I mean, if
18 You were to take a look at the June 30 time frame,
19 our actual asset value was about 67.7 billion or 8
20 billion, give or take a little bit.
21 We're now currently about 64.5 billion
22 from a market value perspective, so we've
23 obviously lost some ground here. So if you were
24 literally to Fresh Start us as of the end of June
25 of this year, not get that same effect here. It's

1 going to be difficult for us to make our 8 and a
2 half percent rate of return.
3 At this point, we're currently negative
4 for the fiscal year.
5 REPRESENTATIVE BOYD: And you commented
6 a little bit further a question on Representative
7 Seip's question. Your returns are pretty good. I
8 mean, when you -- do you compare yourself -- what
9 benchmarks do you compare yourself with regarding
10 the private sector?
11 MR. CLAY: We typically do it for other
12 large public pension plans. There's a fairly
13 large universe of that. When we do that, our
14 returns typically are in the top decile. They
15 have the net weight of the top, minus four or
16 five -- and even the top 1 percent.
17 If you'd expand that out to private
18 sector plans and -- we would still be probably in
19 the top decile.
20 REPRESENTATIVE BOYD: Okay. It'd be
21 kind of nice for me sometime to see how you
22 compare particularly to the S&P, you know, Russell
23 Index, some of those indexes that typically our
24 investments might, you know, if we're in a
25 deferred comp, how those comparisons would be.

1 MR. CLAY: Actually, PSERS has what is
2 know as the Policy Index, which, again, not all of
3 our assets are invested in the S&P. We basically
4 have, depending on what the benchmarks for each of
5 these asset classes, if it's rolled up on a
6 weighted basis, there's a policy number index as
7 to what you want to beat.
8 We typically have been beating that by
9 a substantial number of basis points for the last
10 four years.
11 REPRESENTATIVE BOYD: Good. That's one
12 of the advantages of a DB plan is you can keep an
13 aggressive investment structure ongoingly.
14 I want to comment a little bit on
15 normal cost, or question. If a layman like
16 myself, your normal cost is really -- should be
17 defined as what the average employer contribution
18 should be over the life of the plan, correct?
19 MR. KNEPP: Right.
20 MR. CLAY: Yes.
21 REPRESENTATIVE BOYD: To keep the plan
22 fully funded. So if yours is eight-two --
23 MR. KNEPP: Ours, SERS, is 8.21 right
24 now.
25 REPRESENTATIVE BOYD: SERS is 8.21,

1 yours is --
2 MR. CLAY: 6.68
3 REPRESENTATIVE BOYD: Yeah, so close to
4 7. So theoretically -- and, again, I'm really
5 grateful that Chairman Levdansky did this.
6 Theoretically, if we were to keep the
7 fund in its purest sense actuarially sound -- not
8 actuarially sound -- in its purest sense fully
9 funded, the employer should be making anywhere
10 from an 8.2 to close to 7 percent annual
11 contribution on a regular basis?
12 MR. CLAY: That is correct.
13 REPRESENTATIVE BOYD: When's the last
14 time we made those kinds of contributions?
15 MR. CLAY: For the last ten years
16 you've been actually below the normal cost,
17 substantially below the normal cost.
18 REPRESENTATIVE BOYD: Okay. Thank you
19 very much. I'll yield to further Members. This
20 is a great presentation. Thanks, Dave. This is
21 super.
22 CHAIRPERSON LEVDANSKY: Representative
23 Metcalfe.
24 REPRESENTATIVE METCALFE: Thank you,
25 Mr. Chairman.

1 Question on the defined benefit versus
2 the defined contribution. When I first started
3 working for DuPont many, many years ago before
4 coming to the Legislature, we had a defined
5 benefit plan and over the ten years I was with
6 DuPont they moved it to a defined contribution
7 plan and forced to supplement on the side a 401(k)
8 also.
9 So how much -- do either of you know
10 how much we could actually save the taxpayers by
11 moving both systems to defined contributions
12 rather than defined benefits?
13 MR. CLAY: Is this in the context of
14 resolving the rate spike issue?
15 REPRESENTATIVE METCALFE: No. Just
16 overall moving both retirement systems to a
17 defined contribution versus defined benefit and --
18 MR. CLAY: All right.
19 REPRESENTATIVE METCALFE: -- meeting
20 for the most part --
21 MR. CLAY: First off, one issue is
22 there's a short-term or mid-term issue, then
23 there's a long-term issue.
24 From a short-term, mid-term
25 perspective, because the benefits, the pension

1 benefits currently are protected by the
2 Constitution -- of contract, any change to a DC
3 plan is prospective only.
4 So the system members would have a
5 right to remain in the current plan and then
6 there's going to be some significant off of those
7 benefits.
8 You'll be still funding the DB plan,
9 plus you'd be funding the defined contribution
10 plan. And typically they do have some sort of a
11 match. So you're basically, the way I always like
12 to explain it, you're going to two houses with two
13 mortgages.
14 I guess from a long-term perspective,
15 probably 25, 30 years out, you will start to see
16 some savings because your liability's going to be
17 capped, your contribution under the defined
18 contribution plan.
19 Now the other side to that equation is
20 you're giving up all the upsides in the markets.
21 And the employers that benefitted from the upside
22 over some time frame, in the '90s, for example,
23 contribution rates plummeted dramatically, you
24 know, and a billion dollars plus was basically
25 back to the employers to do whatever they needed

1 to do.
2 So it's sort of a complicated
3 calculation. When you look at the long term of
4 the markets, the long term of the markets tend to
5 be more up than down. This is a question of
6 what's your level of volatility. So you're going
7 to give up the more up markets if you go for
8 your -- liability.
9 REPRESENTATIVE METCALFE: So when you
10 give that up, then you wouldn't be able to
11 increase your own contribution rate because of the
12 savings that you have from the investments?
13 MR. CLAY: Correct, your contributions
14 would stay fixed under a defined contribution
15 plan; that's correct. The ones that get the
16 benefit is gonna be the employees at that point in
17 time.
18 It's something you really need to look
19 at carefully because there is a trade-off that
20 takes place there.
21 REPRESENTATIVE METCALFE: Thank you
22 very much. Thank you, Mr. Chairman.
23 CHAIRPERSON LEVDANSKY: Executive
24 Director Ritter.
25 MINORITY EXECUTIVE DIRECTOR RITTER:

1 Thank you. And on behalf of Chairman Nickol,
2 thank you guys for being here. I do have just a
3 couple quick questions.
4 First, on page 18 you guys stated that,
5 A plan is considered well-funded when the
6 employers pay the normal cost and amortizes the
7 unfunded actuarial liability over a reasonable
8 period of years.
9 Is that PSERS' and/or SERS'
10 consideration of a well-funded plan or is that an
11 industry standard or who considers --
12 MR. CLAY: That would be an industry
13 standard for that.
14 MINORITY EXECUTIVE DIRECTOR RITTER: So
15 it has nothing to with the ratio of assets to
16 liabilities?
17 MR. CLAY: Correct, I mean, in this
18 sense: The fact that a system is underfunded does
19 not necessarily make it bad, per se. It's, is
20 there a mechanism in place too bring it back to
21 full funding?
22 Again, the way the Retirement Code is
23 set, if you're overfunded, you'll start to shut
24 off the employer contributions, bring it back to
25 full funded. If you're underfunded, they'll

1 increase that to bring it back to full funded.
2 What you do not want to see happen is a
3 situation over an extended time period that the
4 system is intentionally underfunded. So for
5 example, West Virginia's had that issue; Illinois
6 has had that issue.
7 So instead of the funding slowly going
8 up or sort of going up like this (indicating),
9 it's going like this (indicating) in I guess of a
10 point that you could have what is known as a death
11 spiral for the pension system: The benefits are
12 just going so fast and not enough money's coming
13 in that there's not enough money to undo the
14 damage that's being done.
15 That is not the situation in
16 Pennsylvania though.
17 MINORITY EXECUTIVE DIRECTOR RITTER:
18 You also talked about the impairment of the
19 benefit issue and we've talked about the lump sum
20 withdrawal option.
21 If there was legislation enacted that
22 removed the lump sum withdrawal option, would that
23 violate that impairment of benefit?
24 MR. CLAY: I believe that probably
25 would violate that part of the contract.

1 MINORITY EXECUTIVE DIRECTOR RITTER:
2 Even though, in essence, you're not really
3 changing the amount of their benefits, are you?
4 because they're still getting the same benefit;
5 it's just when they're getting it?
6 MR. CLAY: Correct. However, I would
7 suspect there would be a challenge, a
8 Constitutional challenge.
9 MINORITY EXECUTIVE DIRECTOR RITTER:
10 Okay. And the last set of questions apply
11 specifically to PSERS.
12 Jeff, what, if any, role did PSERS have
13 in the decision that was made -- I think the
14 Administration ultimately was who made the
15 decision to direct school districts to prepare
16 their budgets with an employer contribution rate I
17 think of what Senate Bill 826 provides and not
18 what PSERS has certified for the upcoming '08/'09
19 school year?
20 MR. CLAY: That's correct. Basically,
21 the Department of Education, for the rest of the
22 Members of the Committee, did issue a statement to
23 all school districts that suggested they do not
24 reduce from a budgeting perspective their
25 contributions because of the anticipation of

1 trying to resolve the rate spike by the end of
2 this legislative or fiscal year.
3 PSERS, on that, we provided some
4 language to support that when they told us what
5 they wanted to do. We did include that in our
6 press release so that would get out to the
7 districts. We did work with the constituent
8 groups to get the news out as much as possible.
9 And, again, it's that issue. It
10 doesn't make sense to let the rate fall if you're
11 going to basically rise it up for budgeting
12 purposes.
13 MINORITY EXECUTIVE DIRECTOR RITTER:
14 And the reason I ask -- and I understand that and
15 I know there was significant interest in Senate
16 Bill 826.
17 But here we are, it's one month after
18 schools have sent in their preliminary budgets,
19 three weeks before they have to certify I think
20 any backend referendum questions, and Senate Bill
21 826 to my knowledge is still in the House
22 Education Committee.
23 So I guess my question then, my
24 ultimate question would be, Are you aware
25 of -- first I guess, are you -- and you may not

1 be. But are you aware of what school districts
2 budgeted for? Have all school districts budgeted
3 at 6.46 or have some done --
4 MR. CLAY: We've not done a survey of
5 the school districts. Anecdotally we know that
6 some have gone ahead and done that, that they've
7 basically retained it within their budget. Other
8 districts for other reasons probably have not done
9 that.
10 Districts have their own pressure at
11 the local level. If they are perceived as having
12 a surplus at the local level, the local taxpayers
13 are upset about that. So it probably depends on
14 the district, or a district basis.
15 MINORITY EXECUTIVE DIRECTOR RITTER:
16 Are you aware of any plans or discussions or have
17 you had any discussions with PDE about any
18 directive that will be given to school districts
19 going into the '08/'09 budget if Senate Bill 826
20 is not enacted?
21 MR. CLAY: No, not at this point.
22 MINORITY EXECUTIVE DIRECTOR RITTER:
23 Thanks. Thank you.
24 CHAIRPERSON LEVDANSKY: Representative
25 Bill Kortz.

1 REPRESENTATIVE KORTZ: Thank you,
2 Mr. Chairman. Thank you, Mr. Knepp, Mr. Clay for
3 your information. It's been very informative.
4 Back on page 5 we talked about the
5 retired members currently: A hundred and two
6 thousand in SERS and a hundred and sixty-eight
7 thousand in PSERS. But as we go forward, the
8 baby-boomers are going to start exiting in droves.
9 Have you looked at where we're going to
10 be four years from now at the 2012 spike, 2013,
11 2015? because, obviously, there's going to be a
12 drain on your total assets.
13 What's going to be the negative impact
14 for the amount of people that are going to be --
15 MR. CLAY: I don't have those numbers
16 with me at this time, but we do forecast out.
17 Remember when I had indicated that when they get
18 to retirement they will be fully funded? It's
19 already baked into the equation.
20 So notwithstanding there is a
21 tremendous increase of people leaving the system,
22 they would have the benefit fully funded by the
23 time they leave. That's the benefit of our
24 current system. It is a prefunded. It's the way
25 we fully fund it.

1 If you think about what I said though
2 about the funding ratio, that means the active
3 members are not fully funded, okay? But that's
4 okay because they're not retired yet. That's all
5 built into the calculations, what's needed to fund
6 the system.
7 REPRESENTATIVE KORTZ: Thank you.
8 CHAIRPERSON LEVDANSKY: Representative
9 Seip.
10 REPRESENTATIVE SEIP: Thank you,
11 Mr. Chairman.
12 You talked about the advantage of
13 prefunding. Let me just kind of go over that
14 again. What kind of investment would we have to
15 identify as a Legislature to prefund a reasonable
16 COLA for PSERS and SERS?
17 MR. CLAY: Yeah, I mean, part of what
18 drives that is what you think is a rational COLA
19 that you want to provide people. Do you want to
20 do an annual COLA, which you've seen the numbers.
21 That's a large number, okay.
22 Do you want to do a one every four or
23 five years? You can do something along that line.
24 But if you're going to do it, you may want to
25 start on a small basis and say we're going to tack

1 on top of the employer contribution rate a number
2 that's reasonable and slowly build up that reserve
3 to basically prefund a COLA. I mean, a lot of it
4 depends on what the size of the COLA's going to
5 be.
6 The other thing I caution, there has
7 been discussion about prefunding COLAs in the
8 past. Once you build that COLA in, as we are
9 going to grant the COLA, it becomes an entitlement
10 and it becomes protected by the -- statute.
11 So one of the things that people have
12 talked about, about prefunding is to say, we're
13 going to put the money aside; but we're not
14 promising your COLA. And then at the five-year
15 time frame, we'll look to see what the status of
16 the fund is.
17 If the money's needed to go back to
18 take care of unfunded liability, we'll go back to
19 that. If not, we can go ahead and add a COLA.
20 That's one way to do it.
21 But once you say the COLA is granted
22 and they're entitled to that forever, that rate is
23 going to skyrocket because now with the way the
24 system is set it prefunds that.
25 CHAIRPERSON LEVDANSKY: Representative

1 Boyd for a second question.
2 REPRESENTATIVE BOYD: Just actually,
3 with what Representative Kortz brought up, when
4 you say it's a prefunded system, there's certain
5 assumptions though that are built into that
6 prefunding. And those certain assumptions are, is
7 that the employer normal cost is being met and/or
8 the 8.5 percent average return is satisfied.
9 And one of the tricks of this issue is,
10 is that if the market returned 17 percent like it
11 has, the employer contribution drops and it keeps
12 it actuarially sound.
13 But if the market drops to a negative
14 return like we saw in the year 2000 and 2001 and
15 2002, the employer contribution needs to spike way
16 up; it needs to go well above the 8 and a half
17 percent. And that's tax dollars. That's money
18 that we all got to put up votes for and the school
19 districts' got to come up through property taxes.
20 So to say it's prefunded, it's
21 prefunded if there's the Legislative fortitude to
22 vote for those budget numbers and have those
23 annual assumptions met. And that's the tricky
24 part of this.
25 MR. CLAY: Right. And just to expand

1 the assumptions, there's more than just what these
2 economic assumptions are. There's the demographic
3 assumptions.
4 Another economic assumption is what's
5 the salary growth that takes place that drives the
6 liability, for example. Inflation assumption.
7 Again, what the life expectancies in individuals.
8 All that drives that calculation.
9 With respect to the rising and falling
10 of the employer contribution rates, you're correct
11 that, obviously, if the assumptions are not met,
12 it does have an impact. But, there is that
13 smoothing methodology that takes place that helps
14 mitigate that over the years.
15 So again, we look long term for an 8
16 and a half percent rate of return. That's a
17 long-term over 35, 40, 50 years. You ever hit
18 that rate on the number? Generally not.
19 But I think, at least in our numbers,
20 our last ten year numbers for -- I think we're
21 above 8 and a half percent. 9, 10 percent is our
22 number for our average rate of return. So, you
23 know, we are essentially making what we need to do
24 at this point; however, obviously, that can all
25 change in the future.

1 REPRESENTATIVE BOYD: In reference to
2 the question on the COLA Representative Seip left,
3 a 13th check model for preAct 9 retirees, that
4 number could be quantified pretty easy?
5 MR. CLAY: Yes.
6 REPRESENTATIVE BOYD: And to -- it
7 wouldn't be a bad number to have. And the way to
8 do that would be to fully fund it in that year
9 that it's paid?
10 MR. CLAY: Yes, that would be one way
11 to do that or --
12 REPRESENTATIVE BOYD: Actually, just
13 fully fund it not out of the -- or whether it's
14 out of the system or through the employer --
15 MR. CLAY: A graduating --
16 REPRESENTATIVE BOYD: -- contribution
17 --
18 MR. CLAY: That could be a graduated
19 way. Let's say it's, okay, we're going to do a
20 13th check 2010. That's going to cost whatever
21 it's going to cost over the next three years,
22 basically two years. We'll start to put the money
23 into the system and prefund that.
24 REPRESENTATIVE BOYD: Makes sense.
25 MR. CLAY: That's the way to do it.

1 CHAIRPERSON LEVDANSKY: Representative
2 Sainato.
3 REPRESENTATIVE SAINATO: Thank you,
4 Mr. Chairman.
5 Just going back to -- actually,
6 Representative Boyd just made an interesting
7 concept and made me think. When it comes to
8 COLAs, okay, are we prohibited from using the
9 money in the system to give them any?
10 MR. CLAY: Yeah, I mean, that was the
11 illustration I used before. The money that's
12 currently in the system is promised for the
13 existing benefits. It is not for any future
14 COLAs.
15 And essentially what you do when you
16 grant a COLA, since it's not prefunded, you are
17 borrowing from a system the money to pay that
18 COLA. That sets up a debt that's an -- over a
19 ten-year time frame, you're paying that debt off
20 and also increases the employer contributions.
21 REPRESENTATIVE SAINATO: Is there a law
22 that says we can't do that? Or is that a federal
23 law, a state law? Is it --
24 MR. CLAY: That's, in effect, what you
25 do since you're not prefunding. But if you took

1 the money out -- you can say, I'm going to take
2 the money out of the system, okay, and reduce the
3 funding level and I'm not going to allow you to
4 increase the employer contribution.
5 At that point, you're intentionally
6 underfunding the system and you're going to
7 cause -- I mean, that's that issue of there are
8 states that have done that in the past where they
9 say we can't afford to make these payments.
10 Forget COLAs. We're just not going to pay into
11 the system.
12 And at some point if you keep taking
13 the money out of the system for other purposes
14 it's not intended for, the system will spiral out
15 of control.
16 REPRESENTATIVE SAINATO: Is there a
17 federal law that says you can't do that? I heard
18 that rumor years back somewhere.
19 MR. CLAY: Well, there is a tax
20 qualification also. For example -- this would be
21 the grossest example of this. Let's say you
22 wanted to repair all the roads and bridges in
23 Pennsylvania, not that they need to.
24 You say, That's gonna cost $10 billion.
25 I'm just going to take $10 billion out of the

1 pension system and pay that. That would be a
2 violation of the tax qualification and violate the
3 Rules of Trust and there would be penalties as a
4 result of that.
5 REPRESENTATIVE SAINATO: So if you
6 would do the same thing with a COLA, that would
7 fall under that guideline --
8 MR. CLAY: Well, no. I mean,
9 essentially you do that anyway. No, that's not
10 because it's a pension benefit. It's an
11 enhancement, but it will cause the contribution
12 rate to go up.
13 It's not -- there's not free money
14 sitting in the pension system. This is no free
15 money in the pension system. You cannot
16 grant COLA for free. It costs money. And you're
17 either going to take it way from the existing
18 benefits, which needs to be replaced; or you're
19 going to have to, you know, fund it.
20 REPRESENTATIVE SAINATO: In this talk
21 of coming up with something to have an automatic
22 COLA, and a suggestion was brought up earlier
23 about leaving the money in the system, you know,
24 taking away the option of taking your money out.
25 Would it be doable if it was an option

1 to retirees to say, okay, if I leave my money in,
2 I could get a COLA? Or would you -- would it not
3 be allowed because everyone would have to get it?
4 MR. CLAY: You could --
5 MR. KNEPP: Based on the discussion we
6 had just yesterday regarding this very issue, it
7 sounds like that if it's an elected option, that
8 you would not have this contract impairment
9 problem that we were talking about earlier.
10 So if you allowed a member to make the
11 election to leave the money in for the COLA, we
12 believe that would work.
13 REPRESENTATIVE SAINATO: But you could
14 only use that money for those who took that
15 option; you wouldn't be able to say, okay, the
16 people left their money in, now we can pay a COLA
17 throughout the whole system?
18 MR. CLAY: That's correct.
19 REPRESENTATIVE SAINATO: It would be
20 put into, like, a separate fund or something to
21 pay this?
22 MR. CLAY: If you think about what's
23 happening, they're essentially using their own
24 contributions and interest on their own Cost of
25 Living Adjustment.

1 Think of the other side of this
2 equation. They can take that money out and invest
3 it themselves for their own Cost of Living
4 Adjustments.
5 REPRESENTATIVE SAINATO: Right.
6 MR. CLAY: I will mention, again, as we
7 mentioned, State employees have available to them
8 a 457 Deferred Compensation Plan. School
9 employees have what is known as 403(b) Deferred
10 Compensation Plan, their defined contribution
11 plans.
12 Which the assets of having both of
13 those, the advantage to doing that, you have a
14 fixed event that gives you downside protection;
15 you can have a defined contribution which gives
16 you upside protection.
17 When a pension -- when defined
18 contribution plans were first brought into play,
19 basically they were coming into a defined benefit
20 plans and they were set up to provide that upside
21 protection. They were basically supplemental to
22 defined benefit plans.
23 What's happened, because companies have
24 gotten rid of defined benefit, they've left people
25 just with defined contribution. And so the

1 retirement structure has changed dramatically.
2 Unfortunately, what you're finding in
3 the private sector, defined contribution plans do
4 not provide sufficient retirement security. In
5 essence, you need both.
6 REPRESENTATIVE SAINATO: So you think
7 the structure we have here in Pennsylvania is
8 actually good with the --
9 MR. CLAY: Yes.
10 REPRESENTATIVE SAINATO: -- deferred
11 comp option and defined --
12 MR. CLAY: Yes.
13 REPRESENTATIVE SAINATO: I think the
14 federal government has a very similar Thrift
15 Savings Plan with pension, social security, and
16 Thrift Savings, a three-pronged like we have here
17 in Pennsylvania.
18 But you're saying actually that
19 is -- if an employee actually takes advantage of
20 everything they should be taking advantage for,
21 they should have a good retirement?
22 MR. CLAY: Right. Just again to be a
23 contrast between private and public sector, in the
24 private sector if they cannot afford a defined
25 benefit plan, they offload that liability to the

1 federal government.
2 If you do not provide adequate
3 retirement security, the ultimate payer is going
4 to be the state because they're going to fall back
5 on federal Medicare/Medicaid. The big issue the
6 country faces today is what is adequate retirement
7 security?
8 Remember, there was a criticism leveled
9 about the pension systems a couple years ago. A
10 newspaper made the comment that the benefits for
11 the public pension system were too lavish, that
12 they should be reduced, essentially, to the
13 average benefit in the private sector under the
14 defined contribution.
15 That average benefit was $7,000 a year.
16 So the argument that's being made is that people
17 should live on $7,000 a year. That just is not
18 rationale or reasonable.
19 REPRESENTATIVE SAINATO: When you say
20 about the constitutional protections, if the
21 system would change, say, January 1st and we
22 eliminated the combined contribution to
23 Pennsylvania and went to the fund --
24 MR. CLAY: The defined benefit --
25 REPRESENTATIVE SAINATO: Yeah. Okay,

1 all the employees that are here now would be
2 protected?
3 MR. CLAY: That's correct.
4 REPRESENTATIVE SAINATO: And the rules
5 that they're under today would be protected?
6 MR. CLAY: That is correct.
7 REPRESENTATIVE SAINATO: So if we want
8 to change the retirement age for our pension
9 system to, say, 70, that everyone who's working
10 now will be under the rules which are in effect
11 now.
12 MR. CLAY: Correct.
13 REPRESENTATIVE SAINATO: I mean, these
14 things come up and sometimes those questions are
15 asked. And I think a lot of people don't
16 realize -- I mean, so every employee school,
17 employee state worker that's part of this system
18 now is protected?
19 MR. CLAY: That is correct.
20 REPRESENTATIVE SAINATO: So any changes
21 would be for new hirees?
22 MR. CLAY: Yeah, it's only
23 prospectively. And typically when you do have a
24 change that takes place in other states -- and
25 there are states that have gone, they typically

1 offer sweeteners or incentives to get the DB
2 people to move to the DC plan.
3 And again, it depends on the
4 circumstances of the individuals. But the vast
5 majority of them do not make that move. They tend
6 to stay on their defined benefits plan.
7 REPRESENTATIVE SAINATO: Okay. Thank
8 you, Mr. Chairman.
9 CHAIRPERSON LEVDANSKY: Okay. My
10 Executive Director, Bob Kassoway.
11 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
12 Thank you.
13 Getting back to the concept of the
14 benefits of the systems assets versus current and
15 future earnings, would it be possible -- and I
16 guess the 13th check. Most of the problem that I
17 see in cost of livings, whether they're continual
18 or not, is that you have this additional cost
19 every single year.
20 Would it be possible to designate a
21 percentage of their earnings each year or in a
22 particular year for a bonus 13th check just for
23 that year, recognizing you have to take in
24 consideration that the earnings are not only to
25 meet the 8 and a half percent assumed rate this

1 year, but to meet down year in the future?
2 But realizing that, but to designate
3 just a certain portion of an earnings that could
4 result in a one-time-only check for a particular
5 year?
6 MR. CLAY: Yeah, there have been some
7 states that have gone in this perspective. And
8 this is what is viewed as what's called excess,
9 if you want to think of it in that way.
10 So if you have a situation where
11 earnings assumption's 8 and a half percent, if you
12 make over the 8 and a half percent, that gives you
13 this excess. Now, technically in pension there is
14 no such thing as excess interest because,
15 remember, the 8 and a half percent is the
16 long-term assumed rate of a 30-, 35-year return.
17 If you're always going to be shaving
18 some portion of that excess off for another
19 purpose, it's no longer an 8 and a half percent
20 assumed rate of return; it's something less than
21 that because it's essentially the long-term
22 average of all those numbers.
23 But some states have done that and
24 they'll typically take the position if you've made
25 10 and a half, 11, 12 percent, some percentage

1 substantially above that we will rebate that back.
2 But that actually does cost ultimately
3 the taxpayers something because, again, the ones
4 that benefit from the excess return is the
5 taxpayers. So you're -- it's just another way of
6 doing it and somewhat camouflages the cost of it;
7 but it still costs the taxpayers money.
8 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
9 And in essence, in the past ten years or so,
10 haven't we actually done something like that by
11 reduced -- instead of giving it back to the
12 retirees as a additional sum, we've reduced the
13 state funding down to lower than it would
14 otherwise be --
15 MR. CLAY: That is correct. In
16 essence -- like I said, the actuary was
17 essentially a cash flow technique. But again,
18 anytime you have a cash pushoff in the future it
19 becomes expensive because that debt is earning an
20 8 and a half percent rate of return for us, which
21 has to be paid.
22 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
23 So if we went to a fixed obligation on the part of
24 the employer, we'd be at least in a little better
25 position to know what our funding status would be?

1 MR. CLAY: That's right. If you went
2 to a pure DC plan and you basically --
3 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
4 I mean with a fixed employer contribution under
5 the defined benefits plan. Currently, we seem to
6 establish the rate -- the employer rate each year;
7 but now we've taken steps to establish I think
8 fixed rate for 4 percent for SERS --
9 MR. KNEPP: That's the floor --
10 MR. CLAY: The rate would still be for
11 example, would not let --
12 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
13 The floor. And we've not had a floor in the past.
14 That's what made us --
15 MR. CLAY: That is one of the issues.
16 And that actually -- because the pension rates for
17 both systems actually became a negative number at
18 the end of -- I think it's because of the stellar
19 returns.
20 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
21 Thank you.
22 CHAIRPERSON LEVDANSKY: I just wanted
23 to follow up just briefly to what Representative
24 Sainato covered.
25 Looking at this whole issue of COLA and

1 people wanting the COLA, I just wanted to make
2 clear that legally we could set up a system
3 whereby people that are going to retire could
4 decide to leave all or a part of their lump sum in
5 the system and then use that to fund a COLA for
6 them as they retire. I mean --
7 MR. CLAY: That's right.
8 CHAIRPERSON LEVDANSKY: --
9 constitutionally, we could do that, correct?
10 MR. CLAY: Correct. Because as Len had
11 indicated, they'd be making the election to make
12 that change. Similar to what happened in Act 9.
13 If you remember Act 9, their employee
14 contributions were increased under Act 9. The
15 only way they got that is to elect the benefit.
16 CHAIRPERSON LEVDANSKY: Correct. Okay.
17 And I don't know if you have this or not, but I
18 wanted to -- Representative Harris pointed out
19 that in one of your systems, I think in PSERS
20 about 80 percent of the retirees elect to withdraw
21 their lump sum and about 90 percent with the
22 state.
23 What's the average amount of a lump sum
24 that's pulled out for those majority --
25 MR. CLAY: We don't have those numbers

1 with us, but we can provide that.
2 CHAIRPERSON LEVDANSKY: If you can
3 provide that, that would be insightful.
4 MR. CLAY: Do you want it with or
5 without Joe Paterno's pension calculated?
6 REPRESENTATIVE BOYD: Oh, man.
7 CHAIRPERSON LEVDANSKY: In terms
8 of -- your expertise is in public pensions. But
9 I'm just trying to look for -- a lot of people
10 look at the public pension system and they want to
11 compare it with the private side.
12 My knowledge -- my limited knowledge of
13 the private sector pension system, for those that
14 have defined benefits programs, is that they don't
15 get regular COLAs for the most part. It seems to
16 be on an ad hoc basis as well.
17 MR. CLAY: Yeah, that is generally
18 true. In the private sector there's generally
19 no -- in most defined benefit plans would not be a
20 COLA.
21 CHAIRPERSON LEVDANSKY: May dad is a
22 retired steel worker and I think he retired in,
23 like, 1983 --
24 MR. CLAY: My father's pension from
25 Text (phonetic) ran the same way.

1 CHAIRPERSON LEVDANSKY: And I think
2 only maybe one time did they actually, you know,
3 give him a COLA. And that was because that has to
4 be -- those benefits are negotiated as part of the
5 contractual relationship between the employers and
6 the collective bargaining agents.
7 So it tends to be -- in the private
8 sector, it tends to be ad hoc and even on a, at
9 least my experience, is a more irregular basis.
10 MR. CLAY: Well, what's happened -- in
11 the old days of pensions, they used to say people
12 should rely on what is known as a three-legged
13 stool for pensions.
14 It's their savings, it's a defined
15 benefit pension plan or a pension from some
16 company, and social security. The savings rate in
17 the country is abysmal. So people are coming into
18 retirement with massive debt and very little
19 savings.
20 In the private sector, the DB plans are
21 under attack and it's basically the DC plans.
22 Social security has its own funding issues. So
23 all three are in trouble at this stage.
24 Now, again, for public governmental
25 defined benefits plans, at least, you know, one of

1 those stools is still -- spokes are still fairly
2 solid.
3 CHAIRPERSON LEVDANSKY: My final
4 question, just let me turn to page 31 of your
5 presentation, which by the way was really
6 excellent and very informative and comprehensive.
7 You know that the cost of the 2002/2003
8 COLA, an initial cost of roughly 1.7 billion,
9 okay, and then an annual cost of 307 million.
10 MR. KNEPP: Right.
11 CHAIRPERSON LEVDANSKY: Now, shift down
12 to the estimated cost of replicating that today.
13 I want to make sure I understand this. So there
14 would be an initial cost, an upfront cost of
15 roughly $3 billion and then an annual cost of
16 roughly 505 million thereafter.
17 And that would be, correct me if I'm
18 wrong, would be laid over top of the 307 million
19 that you have to continue to fund?
20 MR. CLAY: That is correct. Again, the
21 2002/2003's being amortized over a 10-year period.
22 So there would be some overlap between the two.
23 CHAIRPERSON LEVDANSKY: So if we did
24 this, this -- I want to be clear about this. If
25 we replicated the '02/'03 COLA today, we would

1 have to pay -- the first year cost of that would
2 be 307 million plus 505 million plus 3.02 billion;
3 and then in year two, it would just be 307 million
4 plus 505 million?
5 MR. CLAY: The $300 million is the
6 total unfunded liability created by the COLA.
7 It's not that you're actually coming out of pocket
8 3 billion that year. That 500 million is what's
9 being paid in that.
10 So, again, if you want to do the quick
11 math -- this is not quite right. But just times
12 ten, because that's the payment over ten years,
13 it's about $5 billion you're paying over a
14 ten-year time period.
15 CHAIRPERSON LEVDANSKY: But you would
16 also have to continue to pay the $307 million --
17 MR. CLAY: That's correct.
18 CHAIRPERSON LEVDANSKY: -- times ten or
19 wherever we are and there's an overlap there --
20 MR. CLAY: Right, overlap.
21 CHAIRPERSON LEVDANSKY: -- and you have
22 to come up with the first year cost of 3.02
23 billion?
24 MR. CLAY: No. The first year cost is
25 that 500 million. The total cost is 3.2. Again,

1 you're paying it over ten years. So another way
2 to look at it, that 3 billion is the present cost
3 of the COLA.
4 MR. KNEPP: That increases your
5 liability. Your liability will go up $3 billion
6 in total. The annual cost to fund that liability
7 would just be -- not just -- the five hundred
8 million.
9 CHAIRPERSON LEVDANSKY: Okay. So the
10 real cost then if we did it would be 307 plus 505?
11 MR. CLAY: Correct. Another way to
12 look at it, the 3 billion is your mortgage; the
13 500 million is your mortgage payment.
14 CHAIRPERSON LEVDANSKY: Got it. Got
15 it.
16 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
17 Could I just interject?
18 CHAIRPERSON LEVDANSKY: Sure.
19 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
20 You keep saying 307. That's just because you're
21 continuing to pay the 307 million under the
22 existing COLA?
23 MR. CLAY: Right.
24 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
25 That has nothing to do with extending this new

1 COLA?
2 MR. CLAY: That's correct. Again, that
3 is the mortgage payment for the first mortgage.
4 So you're going to have two mortgages for some
5 time --
6 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
7 -- replicated, you're just paying 505?
8 MR. CLAY: Right.
9 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
10 The cost for giving this COLA would increase from
11 the 307 that it was back then to 505 now?
12 MR. CLAY: No. Again, the mortgage
13 that you're paying under the first rule is 1.7
14 billion. The mortgage --
15 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
16 I'm just trying to separate cost for --
17 MR. CLAY: Agreed. Agreed.
18 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
19 -- what was given before and costs for what's
20 being given now to the future.
21 MR. CLAY: Agreed. That's a separate
22 mortgage and has a separate mortgage payment of
23 307.
24 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
25 And you could then add about seven or eight other

1 costs to that for every other COLA that's been
2 given in the past; is that correct?
3 MR. CLAY: Most of those have been
4 funded --
5 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
6 So whatever outstanding obligations from COLAs
7 would have to be added to it?
8 MR. CLAY: Right.
9 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
10 What I just wanted to make clear was that the cost
11 of doing something today is 505?
12 MR. CLAY: Right.
13 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
14 Okay. Thank you.
15 CHAIRPERSON LEVDANSKY: No other
16 questions? No Round 3s for anybody?
17 Representative Boyd.
18 REPRESENTATIVE BOYD: Chairman
19 Levdansky, I couldn't let this slide without at
20 least making an editorial comment. There's been a
21 lot of conversation about defined contribution
22 versus defined benefit.
23 And I think our presenters here made
24 some comments, which I respect their opinion
25 regarding the comparison between DC and DB.

1 I personally believe there's tremendous
2 advantages to defined contribution plans and I
3 think they're for both the employer and the
4 employee.
5 And we've run some actuarial analysis
6 that on a 4 percent annual increase in salary over
7 a 25-year period of time with a 6 percent
8 contribution by the employee, 6 percent by the
9 employer, that an employee could retire at a
10 hundred and seventeen percent of their last year's
11 wage for twenty years and not eliminate their
12 annuity.
13 So I think it's worth a conversation.
14 I respect the gentlemen's opinion; I surely do.
15 But I would at least want to put an editorial plug
16 in that I think defined contributions are at least
17 worth a look for the Commonwealth.
18 MR. CLAY: Actually, we have offered
19 that at some point if you want to have a
20 discussion just on the merits and demerits of this
21 debate we'd be happy to come back and have that
22 conversation. Because it is an interesting
23 discussion and it goes right to the heart --
24 CHAIRPERSON LEVDANSKY: Just so we're
25 all clear, if you wanted to change and go in that

1 direction, it could only be for new hires --
2 MR. CLAY: Correct.
3 CHAIRPERSON LEVDANSKY: -- all the
4 existing people in the state? So anybody looking
5 for a short-term solution, you know, it's not
6 going to be there.
7 One final thing, one final question I
8 forgot to ask. So if we did, you know,
9 this -- going back to page 31, if we replicated
10 the '02/'03 COLA, you know, I understand, you
11 know, 307 million for the first mortgage, an
12 additional 505 million for the second, what would
13 that do?
14 If we did that COLA, what would the
15 impact be on the projected rate spike?
16 MR. CLAY: It would increase that rate
17 spike. It would increase it by whatever the
18 percentage of the contribution is. And I forget
19 what that percentage is.
20 MR. KNEPP: Just on the SERS side
21 alone, the employer rate would go up 2.9 percent.
22 CHAIRPERSON LEVDANSKY: 2.9?
23 MR. KNEPP: Just 2.9.
24 CHAIRPERSON LEVDANSKY: And right now
25 we're projecting the SERS what?

1 MR. KNEPP: Well, on the original I
2 believe it was 9. So it would go up an additional
3 almost 3 percent just to fund that.
4 CHAIRPERSON LEVDANSKY: Okay. And --
5 MR. CLAY: PSERS, 2.73 percent
6 additional rate.
7 CHAIRPERSON LEVDANSKY: 2.73 on the?
8 MR. CLAY: Just on top. Just put it
9 right on top.
10 CHAIRPERSON LEVDANSKY: Added to
11 the -- what is the anticipated --
12 MR. CLAY: 11.23.
13 CHAIRPERSON LEVDANSKY: 11.23. That's
14 important to note.
15 MR. KNEPP: Yes.
16 CHAIRPERSON LEVDANSKY: I mean,
17 everything that I -- all the requests I get for
18 COLAs, you know, it doesn't -- nobody really
19 thinks about what the real impact is on the rate
20 spike that -- while I think what we've -- some of
21 the changes we've done in terms of the moving
22 forward with normal costs and the floor 4 percent,
23 I think we've made some inroads.
24 But I'm fearful that that could be all
25 for naught, you know, if we do this and don't

1 figure out another way to pay for it. Okay?
2 One final question from my Executive
3 Director, Bob Kassoway.
4 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
5 Just for frame of reference, what would your
6 earnings have been on the fund last year?
7 MR. CLAY: With respect to the school
8 system, it was the 22.93 percent for fiscal
9 year --
10 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
11 Can you translate that into a dollar figure?
12 MR. CLAY: We've added about $10
13 billion to the system.
14 MAJORITY EXECUTIVE DIRECTOR KASSOWAY:
15 10 billion?
16 MR. CLAY: Give or take a little bit.
17 CHAIRPERSON LEVDANSKY: Thank you.
18 One from Representative Gibbons.
19 REPRESENTATIVE GIBBONS: You mentioned
20 that your estimated costs for replicating the
21 COLA, that's for doing everyone. And the number
22 you said for just doing it for pre-Act 9 would be
23 about 2.1?
24 MR. CLAY: One billion, that's correct.
25 REPRESENTATIVE GIBBONS: Okay. Thank

1 you.

2 CHAIRPERSON LEVDANSKY: That's it.

3 Thank you, gentlemen, so much.

4 (The proceedings concluded at 11:57

5 a.m.)

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