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VOLUME IV OF IV

PRESENTATION ON
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM
AND
STATE EMPLOYEES' RETIREMENT SYSTEM

BEFORE:
HONORABLE DWIGHT EVANS, CHAIRMAN
HONORABLE MARIO J. CIVERA, JR., CHAIRMAN
HONORABLE STEPHEN E. BARRAR
HONORABLE H. SCOTT CONKLIN
HONORABLE CRAIG A. DALLY
HONORABLE GORDON R. DENLINGER
HONORABLE BRIAN ELLIS
HONORABLE DAN B. FRANKEL
HONORABLE JOHN T. GALLOWAY
HONORABLE WILLIAM F. KELLER
HONORABLE THADDEUS KIRKLAND
HONORABLE BRYAN R. LENTZ
HONORABLE TIM MAHONEY
HONORABLE KATHY M. MANDERINO
HONORABLE MICHAEL P. McGEEHAN
HONORABLE FRED McILHATTAN
HONORABLE DAVID R. MILLARD
HONORABLE RON MILLER
HONORABLE JOHN MYERS

BEFORE: (cont'd.)
HONORABLE CHERELLE PARKER
HONORABLE JOSEPH A. PETRARCA
HONORABLE SCOTT A. PETRI
HONORABLE DAVE REED
HONORABLE DOUGLAS G. REICHLEY
HONORABLE DANTE SANTONI, JR.
HONORABLE MARIO M. SCAVELLO
HONORABLE JOHN SIPTROTH
HONORABLE MATTHEW SMITH
HONORABLE KATIE TRUE
HONORABLE GREGORY S. VITALI
HONORABLE DON WALKO
HONORABLE JAKE WHEATLEY, JR.

ALSO PRESENT:
MIRIAM FOX
EDWARD NOLAN

DEBRA B. MILLER
REPORTER

I N D E X

TESTIFIERS

CHAIRMAN EVANS: Good afternoon. I would like to welcome both funds before the House Appropriations Committee.

One, I would like for you to introduce yourselves, you know, tell us who is who, and then we will get right to the questions.

MS. VOGLER: I can start.

I'm Mel Vogler. I'm the Chair of PSERS, and I'm a teacher at Wallenpaupack Area, which is in the northeastern corner of the State.

I have with me Jeff Clay, who is our Executive Director, and Alan Van Noord, who is our Chief Investment Officer, and I will defer most of the questions to them, and I hope that we can answer all your questions. Thank you.

CHAIRMAN EVANS: Thank you very much.

MR. MAIALE: I'm Nick Maiale, Chairman Evans and Representative Civera. I have been Chair here for many years, working with both Mr. Evans and Mr. Civera over the years.

We have a good story to tell. I have Len Knepp, our new Executive Director, and John Winchester, our new Chief Investment Officer, who are prepared to answer any questions you may have.

CHAIRMAN EVANS: I guess the question that I would like to ask of both of you is, how are the funds doing? That's the main thing. Tell us, because we had PHEAA here yesterday, and you obviously may be somewhat aware of the credit-crunch issue that is going on. We had Global Insight that came in, obviously with the slowdown in the economy, recession, all kinds of things. Tell us, in both cases, how exactly are the funds doing relating to returns?

MR. MAIALE: Well, through 2007, our returns last year were 17.2 percent, which placed us in the top 3 percent in the nation. For the last 5 years, we were in the top 5 percent nationally. It's been an outstanding run, despite that we all talk about here in '02-03 what we thought was going to be over 23 percent for employer rates; we have it down to normal costs.

However, I caution you that the markets change, and the last 2 months so far have been turbulent. Who knows what will happen over the next 6 or 7.

I would like John Winchester, our Chief Investment Officer, to talk more particularly about some of the issues you have raised.

MR. WINCHESTER: Yes; we have heard that Chairman Bernanke is calling the economy in turmoil. Certainly things are in distress. You know, there have been prognostications from a slowdown to a recession to a deep recession. Only time will tell what is going to occur.

However, clearly inflation is wreaking havoc. It is not only impacting the cost of fuel and food; it is now also impacting rents, clothing, medicines. So clearly, I think we are going to see the consumer tighten up their budgets. As a consequence, that is going to impact corporate earnings to some degree.

We have seen a market correction in the equity markets actually between October and the end of January of a 17-percent decline. So whether that in fact is the bottom, we don't know yet, but we have seen a rally in February where we picked up about a 5-percent return.

So for the 12 months, we had a 17.2-percent calendar year return net of all fees. We are estimating that the 12 months ended February, at yesterday's close, our return is about 11.4 percent at this point. So we are still well ahead of our actuarial assumed return of 8 1/2 percent at this point.

MR. VAN NOORD: PSERS, likewise---

CHAIRMAN EVANS: Make sure you introduce yourself for the purposes of the record.

MR. VAN NOORD: Yes. Alan Van Noord, Chief Investment Officer for PSERS.

The fund experienced an exceptional fiscal year. Our fiscal year is different than SERS. It is a June 30 fiscal year. We are up 22.93 percent.

The last 6 months, though, have been very, very challenging, and for the 12-month period ending 12/31, we are up about 13.2 percent.

I will echo what John had mentioned about the economy. The subprime issue came to the forefront in July of last year, and it sort of has now spread to other parts of the fixed-income market.

And you mentioned PHEAA in here. We have seen a shutdown of the auction rate market the last couple of weeks. That is another one of these fallouts from what is happening with the fixed-income market.

Investment banks are looking to shore up their balance sheets, and as a result, they are not extending the credit the way they once did. They are looking to reduce their leverage and increase their capital requirements.

CHAIRMAN EVANS: Chairman Civera.

CHAIRMAN CIVERA: Thank you, Mr. Chairman, and welcome.

I am very happy to see that there was a news release by you, Nick, that came out, and it is impressive. But I just want to read one paragraph, and maybe you could explain it.

It says, "Five years ago, the pension officials projected the taxpayers would have to kick in 28 percent of the State government's massive payroll to keep the system afloat in 2012. As a result of a strong investment performance, the system now expects the taxpayers' share to be less than 8.2 percent," which is impressive. But with some of the issues that are not because of you or your board and what you people do, and you do a good job, how does that play with all this bad news that we are hearing?

MR. MAIALE: Past performance is no indication of what is going to happen the rest of the year and future years. We use a rolling 5-year average that melts in gains or losses.

So in terms of that spike reemerging, if we had another 3 bad years in a row, 2000, 2001, 2002, those 3 years were the worst bear market since the Great Depression. Something like that could always rear its ugly head again. But the 5 years after that could be like the 5 years we just had. That is why we always like to look as far out as we can.

Our returns for the past 10 years had been like over 10 percent. So that is the kind of long-term range we like to keep our eye on.

But you are right. I mean, if the markets go that far south and it is a big hit for 2 years, that employer contribution rate would spike up again. I mean, keeping it down is premised on beating 8.5 each year.

CHAIRMAN CIVERA: Is there anything that the Legislature can do to help that situation?

MR. MAIALE: Well, you did last year, thanks to Chairman Evans's initiative, where you enacted that we get at least a 4-percent floor in employer contributions every year.

There had been 2 or 3 years earlier this decade when the employer rate was zero because of our great returns at the end of the nineties. So that was one big step.

The next big step you could do, and this isn't politically popular, is not to enhance any benefits, which you admirably have refrained from doing since 2002-2003. But I'm sure there will be more questions about that as we go on.

CHAIRMAN CIVERA: And could you respond to that also?

MR. CLAY: Right. You know, a rate spike for the School Employees' Retirement System is projected to be 11.23 percent, jumping from 4.76 to 11.23 at this point.

We've had 4 good investment years to get us down to that rate, and essentially our original rate was projected at 27.73. That reduction to 11.23 percent results in about a $2.3 billion savings for the taxpayers.

Again, it is projected that that rate spike is based on an 8 1/2-percent rate of return going forward. As Nick has mentioned, obviously if the markets turn the other direction, that rate will start to go back in the other direction.

CHAIRMAN CIVERA: What could we -- could we do anything?

MR. CLAY: One of the things that is happening, our current contribution rate is 7.13 percent. We have recently in December certified the rate for next year at, I believe, 4.76 percent.

As a consequence, the rate is actually going to decrease prior to the time of the rate spike taking place. In essence, that is like digging a trench before you climb the mountain.

Probably the way to help resolve that would be to raise our rate floor. There is a bill out there, I believe it is Senate Bill 826, that basically takes our current rate floor of 4 percent to 6.44 percent to at least hold it at the level that we are currently at so that there's not a decrease taking place, because again, it doesn't make sense to dig a trench that you have to go through the trench and then go up the mountain on the other side of that trench.

CHAIRMAN CIVERA: Okay. Thank you.

CHAIRMAN EVANS: Representative Barrar.

REPRESENTATIVE BARRAR: Thank you, Mr. Chairman.

The good news is that the fund is doing very well. This year, both our funds are doing well. The bad news is that when the press releases go out like this telling us how great the funds are doing, of course we get the winter letter from the retired groups in here, and about three-quarters of the newsletter is dedicated to a COLA.

There are six bills right now introduced by different legislators that would give our retirees a COLA. I think they pay for them -- every one of them pays for them in a different way.

At this point in time, especially with 2012 still looming out there, would you recommend that the Legislature give a COLA?

MR. MAIALE: I'll have Len Knepp respond.

MR. KNEPP: What we can do is, right now we are about 92-percent funded. That is before this year's return. As of 2006, we were 92-percent funded.

Our last COLA that we granted in 2002-2003 cost us, cost everyone over $650 million. So with the markets the way they are right now, we have had 5 great years, as we did prior to Act 9. Passage of benefit enhancements could present a problem, but that is really your call.

REPRESENTATIVE BARRAR: Is there a way -- I think the most popular way to pay for the COLA that has been expressed in these bills, which I have not signed on to one of them; I get beat up pretty bad by my retirees for not cosponsoring them, but I'm not convinced that any of them actually pay for it in a proper way.

But I think most of the methodology used to pay for the COLA is based upon taking the surplus, everything that is made above the 8 1/2 percent that you need to make per year, right? To keep the funds solvent---

MR. KNEPP: Right.

REPRESENTATIVE BARRAR: 8 1/2 percent; okay.

If you have made 17 percent this year, of that, how much of that surplus would be needed then to deliver a COLA to the retirees of the surplus?

MR. KNEPP: Well, you have to understand, that whole return is a moving target. So even though we are making 17, our average is still holding at 8 1/2. So I don't know if it's a fair statement to say how much of that surplus.

What they were talking about, I believe, in that letter was the "fresh start" concept, where they would take us immediately -- we use the 5-year average, and we have an actuarial value of assets. Right now as of 2006, that was about $28 billion. Our market value is 32. So bringing all those gains in at one time, it would appear to be overfunded.

REPRESENTATIVE BARRAR: Okay.

MR. KNEPP: However, I caution you again, it is at a time when the markets are volatile. You are working your way out of this problem with Act 9, you are starting to catch the 100, and all of a sudden you are taking on new benefit enhancements. So that is one thing.

The other thing is, in this type of market you are taking away this cushion. So you have got a cushion somewhat built for a market that is not as solid as the last 5 years, and all of a sudden your rates will go back up.

So taking on additional debt right now will increase the employer rate. I can guarantee you that.

REPRESENTATIVE BARRAR: If we did a COLA similar to the 2002 COLA, I'm sure -- I guess, hopefully, someone has looked at this to say, how would it impact the employer rate at that point?

MR. KNEPP: On our number, if we replicate -- and these numbers came as of, I believe it was 2006 -- if we replicate the 2002-2003 COLA, the cost of that COLA was, I believe it was $650 million. If we replicate it today or as of 2006, it would be over a million dollars. I'm sorry; a billion dollars. That would result in about a 2.9-percent increase to the employer rate.

REPRESENTATIVE BARRAR: And that's from the State employees. How about on the school?

MR. CLAY: Yes. On the School Employees' Retirement System, the last COLA that was granted was the Act 38 COLA. That was a $1.1 billion COLA. Yet, again, if we are to replicate that, again based on 2006 numbers, it is going to be about a $2 billion COLA.

So between the two systems, it is about a $3 billion cost to the taxpayers. That is going to translate out to about a $505 million annual payment.

REPRESENTATIVE BARRAR: Wow.

Have you looked at any way or is there a suggested way that either fund has looked at to provide a semiannual COLA, either through -- I mean, is it possible to increase the employee contribution rate to cover a future COLA, or is there any other way than just this, basically it seems like every time we do it, we create an unfunded liability, and that is just huge and it is having a huge impact.

I think on one hand we give our retirees a pay raise, and on the other hand we take it away from them by having to raise their school taxes so high that it wipes out any gain that they had. And I tried to explain that to my retirees, and a lot of them, especially since it has been so long, they just don't want to hear it. They are convinced that the fund is doing well and we are lying to them and telling them that we can't afford to give a COLA at this point in time.

And maybe just a follow-up question: What would the impact be, if we were to do a COLA similar to 2002, would that set us back from where the projected gain that we just made on possibly a much lower rate than 2012, when we were told that that was kind of like a doomsday date for the fund?

MR. KNEPP: Right. It will increase the employer cost. I mean, it will; it has to.

So you are taking on the additional liabilities of, I think between the two funds, of over $3 billion. There is only one way to pay for that: You either increase the employer cost or you hope you can earn your way out of that, as we have in the last 5 years with great returns. Those are the two.

The only other funding -- there are three primary funding sources: the employer rate, the employee rate, and investment earnings. So it has to be one of those two that we talked about.

REPRESENTATIVE BARRAR: Is it possible at this point to legislatively raise the employee contribution rate to cover the cost of a COLA and make it a system where they would pay into in order for future retirees now to start receiving some type of COLA?

I mean, the pressure put on the Legislature to do this I think is kind of unfair in a sense, because we continue not to pay for it, for the COLA, but then again the employees keep retiring and they are getting bigger and bigger retirements.

But they still come here and every 2 years they want a COLA from us, and I think it is unfair for the Legislature -- it's a policy decision, but not necessarily all yours, but I think we need a recommendation from you to somehow solve this problem either through a permanent fix, or I think you are going to see, because, you know, we want to be popular with these people, that every so many years we are going to do a COLA whether we can afford it or not.

So just a comment. That is all I have, Mr. Chairman. Thank you.

CHAIRMAN EVANS: Representative Bill Keller.

REPRESENTATIVE KELLER: Thank you, Chairman Evans.

As you mentioned, we had PHEAA in here yesterday, and I said the room went silent when they were testifying because of, you know, the impact that the subprime crisis had on their funds.

I was just wondering, I know you are a lot bigger and more divested, but I was just wondering what kind of impact that crisis has also had on the funds?

MR. VAN NOORD: The PSERS portfolio had very, very, very little subprime exposure.

What is happening to PHEAA, though, however, is a ramification of what happened in the subprime market, and you are seeing investment banks reduce their risk exposure. They are de-leveraging their balance sheet, trying to increase liquidity. So basically the auction market has been shut down.

And it is happening to other markets. It is like things are moving through the system, but they are moving through the system slowly. And it will come back, but it will take some time.

One of the things that we have seen of late is a big spike in the commercial-backed mortgage market, and these securities at one time might have sold for $300 or $400 over Treasury's. They have spiked to about $1,500 over Treasury's. It is a whole different ball game than a residential mortgage in that a commercial-backed mortgage, you have a down payment and you have a lot of cash-flow backing, let's say an apartment complex or an office building, but there are some surprises that we are going to see because of the subprime fallout, I'm sure of it.

REPRESENTATIVE KELLER: Thank you.

MR. WINCHESTER: Within the SERS portfolio, you are clearly seeing some sympathetic pricing through various asset classes, and of course they are driving them up above liquidity by the money center banks. Therefore, the leveraging of some real estate investments or some alternative investments, it is going to get a lot tighter. But big deals will be impacted significantly, medium-sized and smaller deals not so much.

But as far as the impact that we had on the portfolio when this broke back in July, we had a net short position in subprime, so in fact the fund made money. But I will tell you, it was a de minimis exposure. It was a mere $60 million. At year end, that had declined to short of $6 million.

Although some of the funds are looking at these investments opportunistically, to the extent that they can get them at deep discounts with the opportunity of making some money in the longer term.

REPRESENTATIVE KELLER: Thank you.

And Mr. Maiale mentioned briefly -- I just wanted to see if you could go into more detail, because that was something everyone was concerned about -- the contribution rate spike in the out-years, and that has been mitigated a little bit?

MR. KNEPP: Well, the original projection was over 28 percent for SERS. At last valuation, 2006, it was projected to be at just over 9 percent.

Now, with the return that we are experiencing or we did experience in 2007, that contribution spike at 2012 should be under the normal cost. So it should be in the 7s.

REPRESENTATIVE KELLER: Good job.

Thank you very much, Mr. Chairman.

CHAIRMAN EVANS: Representative Petri.

REPRESENTATIVE PETRI: Thank you, Mr. Chairman.

I want to follow up on a couple of areas that have been already touched upon, and I'm going to ask questions, and I'm hoping we can get kind of some simpler answers. I know that people who listen to this and watch don't always understand what we're talking about. Quite frankly, I don't always understand what we're talking about when we are talking about retirement benefits.

One of the questions, following up on the direction Steve Barrar was headed, Representative Barrar asked about what would the cost be to replicate the COLA in 2002, and I think you explained that.

One subset of the retirees that I hear from is the group that kind of got caught in the middle and they didn't qualify for Act 9, and they say, well, wait a minute, you know, I had already announced my retirement and I didn't get any benefit. Has anyone ever analyzed what it would cost to give them the same COLA everybody else got, just that small group within the State and the school system that got caught in the mix and didn't qualify?

MR. MAIALE: I'm not sure I understand.

REPRESENTATIVE PETRI: Well, they may have announced their retirement, so they didn't get the

Act 9 benefit. They were excluded.

MR. MAIALE: They were at 2 percent rather than the 2.5, and you want to try to find them---

REPRESENTATIVE PETRI: They believe it is unfair, if you talk to them, and that they have been cheated, and they want to know how much would it cost to fix that, how many employees would be involved, and are we going to fix it for them? That is what they want to know.

MR. KNEPP: Well, if what you are talking about, we have about, I think it is 107,000 members or annuitants. Approximately 60 percent, I believe it is, of those members are pre-Act 9 retirees. So is that the number you are looking for?

REPRESENTATIVE PETRI: Yes.

MR. KNEPP: Okay. And I believe the cost -- and we will get back to you with a definite answer -- I think the cost on just the pre-Act 9 individuals was over $700 million.

REPRESENTATIVE PETRI: Okay.

MR. CLAY: And for the school side, typically between the two pension systems, PSERS is generally about twice the cost of the State system, so it is about $1.4 billion.

REPRESENTATIVE PETRI: $1.4 billion?

MR. CLAY: Yes.

REPRESENTATIVE PETRI: Okay. If you could get those specific numbers and calculations to the Chair, I think that will be helpful, because this is information people really want to know and understand.

The next question I have, one of the things we have to decide as policymakers is, what should the retirement benefits be going forward and how should that work?

Now, as I understand it, when you retire from either the State system or the school system, that you can select what they call option 4, which is the option where you can take your portion and reinvest it and take it out of the system. Does anyone know the approximate percentage of employees who opt to do that?

MR. KNEPP: From the State side, approximately 90 percent of the members leaving the system option 4 their money. They withdraw it.

REPRESENTATIVE PETRI: How many percent?

MR. KNEPP: 90.

REPRESENTATIVE PETRI: 90. I thought you said 9, and I thought that was low. Okay; 90.

MR. KNEPP: No; I'm sorry. It's approximately 90 percent, and from the PSERS side it would be approximately 88.

MR. CLAY: That is correct.

REPRESENTATIVE PETRI: Okay.

One other -- and I know you don't have this calculation with you -- one other calculation I would like to see is, if in 2002 when Act 9 was enacted, those retirees and subsequent retirees had not pulled out their money. Would we now be able to do a COLA or could we do a COLA each and every year?

In other words, we have got the benefit of hindsight. Maybe this is an option that we can't afford, that if people want COLAs, we cannot give them the right to take their retirement money out and invest it.

We now have the opportunity to look backward and say, would the retiree be better off than they are now, and would the State system be better off if we had given COLAs each and every year? Could we have afforded to do it? So if there's a way you can get to an empirical situation.

Now, the last area of questioning, and I will be real quick.

As I understand it, the teachers'

association, PSERS, is suggesting that we need to have a floor for this year and that there is Senate Bill 826, you mentioned Senate Bill 826, which, I understand, is sitting over in the House. It could be voted at any point in time.

MR. CLAY: Yes; that is my understanding.

REPRESENTATIVE PETRI: And you testified that that would create the floor at 6.44. Otherwise, the contribution rate, as I understand it -- and you can correct me if I am wrong -- under law has to be 4.76. Somebody can't put in more money, you know, to kind of hedge their bet and say, well, I want to contribute more. You wouldn't accept it.

MR. CLAY: Yes; that is absolutely correct. And again, what happened, the rate was certified by our board back in December at the 4.76 percent. That is the actual rate that we can charge the school employers at that point.

The Department of Education did issue a notice to the school districts suggesting that they budget for that number, the 7.13 number, in the event something takes place in the December time frame and July 1 in case Senate Bill 826 is passed.

If 826 is not passed and one employer tries to provide that money to us and another employer does not, that employer is actually paying an unfair share for the balance, and we really can't charge them that and accept that money.

REPRESENTATIVE PETRI: Okay.

Now, so that I understand what the implication is, number one, when should we pass 826? That's the first question.

And number two is, who gets hurt if we make a contribution of 4.76 instead of 6.44? Who ultimately gets hurt?

MR. CLAY: All right. To answer your first question, you would need to pass 826 prior to the end of this fiscal year, June 30.

The second question, if you do not pass that, that effect is the rate is going to continue at a much lower number than what we currently need to fund the system. As a result, ultimately the taxpayers will be putting in more money down the road.

REPRESENTATIVE PETRI: Okay. So the taxpayer gets hurt if we don't do this.

MR. CLAY: That is correct.

REPRESENTATIVE PETRI: It is more property taxes.

MR. CLAY: Correct.

REPRESENTATIVE PETRI: Okay.

Last question: If we establish legislation where there is a floor at some sort of rate, like a 6.44 each and every year, does that make it easier or harder for school boards to budget their budget?

MR. CLAY: In talking to school business officials, one thing business officials do not like to see is volatility in their budget numbers. So if they have a predictable number going forward in the future, they are going to be much happier about that.

REPRESENTATIVE PETRI: Well, Mr. Chairman, I'm done, but I urge us to move that Senate bill right away.

REPRESENTATIVE KELLER: Thank you.

Representative John Siptroth.

REPRESENTATIVE SIPTROTH: Thank you very much, Mr. Chairman.

Thank you, board panelists, for joining us today.

I would hope that, you know, you have done an excellent job in trying to fill that void that we all anticipated that we would have to even put some dollars into or have the employer-based contribution go up so significantly that it would have a terrific impact on our school systems, especially on our school property taxes, so I thank you for doing that. And I would hope that the investments are in a suitable fund short term so that you have the flexibility to move that around with the unstable market that we have today.

I just want to ask a couple of questions recording COLA, because as Representative Barrar and Representative Petri indicated, you know, when there appears to be a closing of the gap, both retiree units come after us for a COLA.

Has there ever been a projection done so that we would be comparable, like the State of New Jersey, where an automatic COLA not to exceed 3 percent per year would be built in to our retirement programs? That is my first question. And how much would that cost us?

Secondly, has there ever been any consideration for an optional plan whereas the employee portion of the contribution was kept in the system and that those individuals that opted to do that would be eligible or could be eligible for a COLA, reinvesting their portion? And as you indicated, about 90 percent of the folks take theirs out. If that was, you know, as an option left in, reinvesting, would that be sustainable for a COLA?

MR. CLAY: I will answer that first.

With respect to your first question about having some sort of an automatic 3-percent COLA, capped at 3 percent, that was actually costed out in a report by the Legislative Budget and Finance Committee back in 2006. If you were to add that to the system, that would increase the unfunded liability of both systems by about $21 billion. That would require an annual payment in the employer contribution rate of about $4 billion.

REPRESENTATIVE SIPTROTH: Okay. And that is combined, that $21 billion?

MR. CLAY: That is a combined between the two systems.

With respect to your other question about essentially retaining the members or the employee contributions, their interest, that has been looked at in the past, but I don't know whether that has actually made it to legislation or if it has been seriously considered, but I drew numbers on that. I don't have them with me here.

REPRESENTATIVE SIPTROTH: If you would

provide them to the Chair so they can be distributed---

MR. CLAY: Yes; I would be happy to do that.

REPRESENTATIVE SIPTROTH: ---I think that would be somewhat helpful.

And I thank you very much for the answers, and thank you, Mr. Chairman.

REPRESENTATIVE KELLER: Thank you.

Representative Gordon Denlinger.

REPRESENTATIVE DENLINGER: Thank you, Mr. Chairman, and good afternoon, everyone.

An accounting compliance question, if I may.

Of course the accounting profession, under the provisions of GAAP, is pushing each private sector to full recording of liabilities and in fact full reserving of those liabilities and funding them, and under provisions of GASB 45, public entities are also to move forward with proper recording of liabilities and funding them.

And obviously we have the dialogue every year about your numbers, and obviously we congratulate you on the return, but I'm wondering, what are your plans to fully comply with GASB 45, the provisions of it, as we move through this year and into the future.

MR. KNEPP: GASB 45 would pertain to what they call an OPEB, which is not pension; it is post-employment benefits other than pensions.

REPRESENTATIVE DENLINGER: Yes.

MR. KNEPP: So it really wouldn't be relevant to us.

REPRESENTATIVE DENLINGER: So as far as medical benefits---

MR. KNEPP: We would not be booking that as a liability other than our portion of the payment that the Commonwealth would come down with.

REPRESENTATIVE DENLINGER: Okay.

MR. KNEPP: So 43 and 45 are both applicable to the same type of issue, but they would not be applicable to SERS.

MR. CLAY: With respect to PSERS, PSERS actually does run two health-care programs. We do run an insurance program for our retirees. It is on a voluntary basis. The entire cost of the premiums are borne by the members. There is no direct funding by the Commonwealth. So the net effect is, there is no OPEB liability for our system as a result of that.

The second program we offer is what is known as a premium assistance benefit. This reimburses a certain number of people that meet certain age and service requirements up to $100 a month or their out-of-pocket expense, whichever is less.

There is an OPEB liability associated with that. That is approximately a $1 billion liability over a 30-year time frame.

The big issue with respect to that, that is a pay-as-you-go system, and currently it is an add-on to the employer contribution, where basically you pay into the OPEB liability at about 91 percent of the annual required contribution. If you are going to increase that to 100 percent, it would be about a $9 million increase in the employer contribution.

REPRESENTATIVE DENLINGER: Can you give me that again?

MR. CLAY: Yeah; it would be about a $9 million increase in the employer contribution.

REPRESENTATIVE DENLINGER: Okay. So we do have a bit of an issue there.

MR. CLAY: Yeah, there is a little, but given that we are paying the ARC at 91 percent, it is not a significant number.

REPRESENTATIVE DENLINGER: Okay.

MR. CLAY: And if I could, that is disclosed in our actuarial evaluations.

REPRESENTATIVE DENLINGER: Okay.

What is your understanding of the penalties of noncompliance on that accounting issue?

MR. CLAY: There are no penalties as long as you disclose the liability. The GASB 45 basically requires you to make the disclosure, and it has been disclosed.

REPRESENTATIVE DENLINGER: Okay. That does not match my understanding of the obligations there. I'm not sure---

MR. CLAY: GASB 45 doesn't require to fund it at the ARC.

REPRESENTATIVE DENLINGER: Just reporting.

MR. CLAY: It just says you need to disclose it.

REPRESENTATIVE DENLINGER: Okay.

That may be something that we would want to have as a dialogue outside of this meeting.

MR. CLAY: Okay.

REPRESENTATIVE DENLINGER: My understanding is that it also covers full funding, so.

Thank you, Mr. Chairman.

REPRESENTATIVE KELLER: Thank you.

Vice-Chair Craig Dally, please.

REPRESENTATIVE DALLY: Thank you, Mr. Chairman, and good afternoon, panel.

Senate Bill 826 was mentioned earlier about the employer floor, and I think that is a good idea, a good concept, as far as leveling the peaks and the valleys.

The one concern I have about legislation like that though is, what happens when the funds start to develop a surplus? It seems like then there is an urge to, you know, enhance benefits and the like, and if I could just have your comments on that scenario.

MR. CLAY: There is that potential, if you continue to have the rate floor at a significant number close to the normal cost. If you have a prolonged period of good returns, you could be building up a surplus.

Two things can happen to that surplus. It can obviously be used to cushion any downturns, or it could be a tempting target for enhancing benefits. Or it could be a means to pre-fund COLAs; that's another way to look at it.

REPRESENTATIVE DALLY: Okay.

MR. CLAY: It depends on what the benefits policy of the General Assembly will be. But there is a risk that that will happen.

MR. KNEPP: And I agree with what Jeff was saying. I mean, we are at the 4 percent, and the reason we were there is because the rates would have dropped so low, and that is one of the reasons that we got in trouble with Act 9, you know, in the early part of 2000.

So this is a good preventative method right now. However, a few years down the road, if we do start to generate surpluses, we would have to address it at that point.

REPRESENTATIVE DALLY: All right.

And Jeff, you mentioned the issue about pre-funding. That was something that came up, and as you are aware, I was part of a working group that looked at this issue last session. And as far as benefit enhancements, that was one of the things that we considered, was that if you are going to have benefit enhancements, have them pre-funded, and I guess that reduces the likelihood of that happening, but also you have less of a hit to your plan.

MR. CLAY: That would make it consistent to the existing pension benefits, which are all pre-funded. When you first start a system under pre-funding, it is more expensive in the long run. It is always cheaper to do that.

If you post-fund benefits, like most COLAs, you are essentially borrowing the money from the retirement system and paying an 8 1/2-percent rate of return for a 10-year time frame. It gets to be very expensive cash flow.

REPRESENTATIVE DALLY: On the issue of unfunded status of the funds, I believe that SERS, you mentioned that it was 94 percent?

MR. KNEPP: Approximately 92 percent.

REPRESENTATIVE DALLY: 92 percent; okay.

And what is PSERS at present?

MR. CLAY: We are 85.8 or almost 86 percent.

REPRESENTATIVE DALLY: Okay.

Another question on option 4 withdrawals, and that issue has come up earlier, too. Would it be possible for you to get information for the committee as to those withdrawals, an average withdrawal, say for the last 5 years?

MR. KNEPP: Yeah; we don't have that readily available, but we can see that you get that. That wouldn't be a problem.

REPRESENTATIVE DALLY: If you could do that.

MR. CLAY: Yeah; it was actually, it was pointed out. That question was asked. We had our Senate budget hearing earlier today, and it was the same question.

REPRESENTATIVE DALLY: Oh, okay. I didn't hear that hearing, so I didn't copy the question.

MR. CLAY: I wanted to point out, in our comprehensive financial report, we do have in the back the deductions, and, for example, for fiscal year 2007, the lump-sum payments that are being made out is about $855 million. We can do a quick averaging of that to find out.

REPRESENTATIVE DALLY: Yeah; I would just be curious what that average amount is, because I think that also comes into play when you look at, you know, the argument about COLAs and you get to look at what is being withdrawn from the system and how that money is invested, which obviously is providing earnings to the annuitant also.

MR. CLAY: Right.

REPRESENTATIVE DALLY: Now, your expense ratio, how do your plans compare, say, with the other top three public pension funds in the country in terms of expense ratio?

MR. CLAY: I guess the question, there are two ways to look at expenses. There is what they call the investment expenses and then the administrative expenses.

My recollection is that the investment expenses are about 42 basis points. If you add on top of that are what I call administrative expenses, which is the cost to operate the system. That is probably another 7 or 8 basis points. So say about 50 basis points as a round number.

REPRESENTATIVE DALLY: Okay.

MR. CLAY: And that would compare very favorably to other pension systems.

MR. WINCHESTER: Yeah; SERS's expenses are slightly higher than that. The nature of the type of investments that we are in, we have a lot of limited partnerships, and there are alternatives, which are private equity and venture capital. We also have a lot of limited partnerships because of real estate.

In 2002, we installed a Fund of Hedge Funds program, and those fees initially were rather high, but we aggressively negotiated them back to more normal rates.

So consequently, relative to our peers, we are probably slightly higher than our peers, but I think our performance has borne out that it has been well worth the cost.

REPRESENTATIVE DALLY: Okay. Thank you.

Thank you very much.

Oh; did you just get that number, Jeff?

MR. CLAY: Yes. It is $685 million over the last 5 years. That's the average for the option 4 withdrawals.

REPRESENTATIVE DALLY: Average?

MR. CLAY: That's the total average in a year's time.

REPRESENTATIVE DALLY: Yeah; I was looking at it on a per annuitant average.

MR. CLAY: Okay. Well, we can come up with that.

REPRESENTATIVE DALLY: Okay. Thank you.

REPRESENTATIVE KELLER: Thank you.

I know I express the feelings of Chairman Evans and the whole committee when I thank you for coming here today and for testifying. It is always good that we have people who deal in the financial markets who aren't coming here with their coats over their heads saying that we are in bad shape.

So all of us that are in your funds express a great deal of thanks for how you have handled this over the number of years and the great job you have done in that, so thank you.

We are going to adjourn this committee

hearing, but tomorrow we are going to have a Subcommittee on Economic Impact and Infrastructure, chaired by Subcommittee Chairman Mike McGeehan. That will be on the municipal water, sewer, and natural gas infrastructure. That will start at 10 a.m. to 1 p.m., and that will be in Bucks County in Langhorne, Pennsylvania.

Thank you.

(The hearing concluded at 2:18 p.m.)

I hereby certify that the proceedings and evidence are contained fully and accurately in the notes taken by me on the within proceedings and that this is a correct transcript of the same.

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Debra B. Miller, Reporter