

State Pension Funding

Prepared by PSERS & SERS for the **Senate Finance Committee** - September 28, 2011



Jeffrey Clay
PSERS Executive Director



David Durbin
SERS Office of Member
Services Director

Table of Contents

Snapshot of the Systems	1
Funding Streams	2
Cost of Benefits Reduced in 2010	3
Remaining Budgetary Challenge -- The Debt	4
PSERS Graph	5
SERS Graph	6
Debt Built Over Decades	7
PSERS History of Employer Contributions Graph	8
SERS History of Employer Contributions Graph	9
Case Law on Contract Impairment	10
Popular Legislative Options	11
Cost of Closing Plans	12
A Combination of Solutions	13
The Good News	14
The Bad News	15
PSERS Investment Return Stress Test Data	15
SERS Investment Return Stress Test Data	16
Cash Infusion Projections	17
Other Issues to Consider	18

Snapshot



Public School Employees' Retirement System (as of 6/30/10)

579,000 members
 282,000 active
 185,000 retirees/beneficiaries
 112,000 vested inactive

749 employers

\$51.4 billion in assets (as of 6/30/11)

75.1% funded (actuarial value)
57.8% funded (market value)

\$19.7 billion unfunded liability



State Employees' Retirement System (as of 12/31/10)

227,000 members
 109,000 active
 112,000 retirees/beneficiaries
 6,000 vested inactive

106 employers

\$26.0 billion in assets

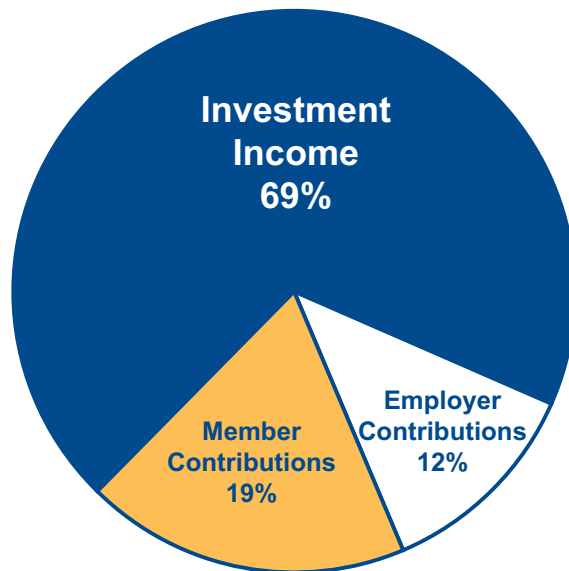
75.2% funded (actuarial value)
66.1% funded (market value)

\$9.7 billion unfunded liability

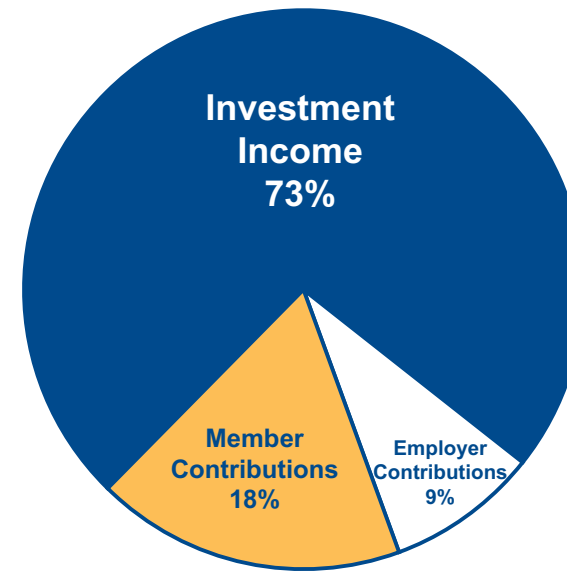
Pension systems are designed to remain solvent by receiving three regular funding streams—employee contributions, employer contributions, and investment earnings.



PSERS Funding
(10-Year History)



SERS Funding
(10-Year History)



Pennsylvania public pensions were reformed in 2010, reducing the cost of benefits for new employees hired after Jan. 1, 2011 to just 3% (PSERS) and 4% (SERS) of payroll.

- Reduced benefit accrual for new employees by **20%** -- from 2.5% to 2% of salary for each year of service
- **Retained employee contributions** at pre-reform levels
- Created “shared risk” to allow **increased employee contributions** in certain circumstances
- Increased normal **retirement age**
- **Eliminated lump sum withdrawal** of contributions and interest at retirement
- Rolled back the vesting period to **ten years**
- Required that members purchase prior nonstate service at **full actuarial cost**
- **Reamortized existing liabilities** through an actuarial “fresh start”
- Capped **growth** of employer contributions:
 - 3% in FY 11/12
 - 3.5% in FY 12/13
 - 4.5% thereafter until no longer needed

The Employee Benefit Research Institute found that retirement funding for private employers amounts to about 3.5% of employee compensation.

In May 2010, the Wisconsin Legislative Council found that major public employee retirement systems provided employer contributions ranging from 1.95% (MA) to 17.01% (ME), with a median in the 8% range.

Some recent legislative proposals in Pennsylvania attempt to achieve savings by closing the existing defined benefit plans and replacing them with 401(k)-style defined contribution plans, including a 6% employer match.

Despite the \$2.9 billion in savings achieved by pension reforms, a significant budgetary challenge remains.

A \$29.4 billion debt has already been incurred.

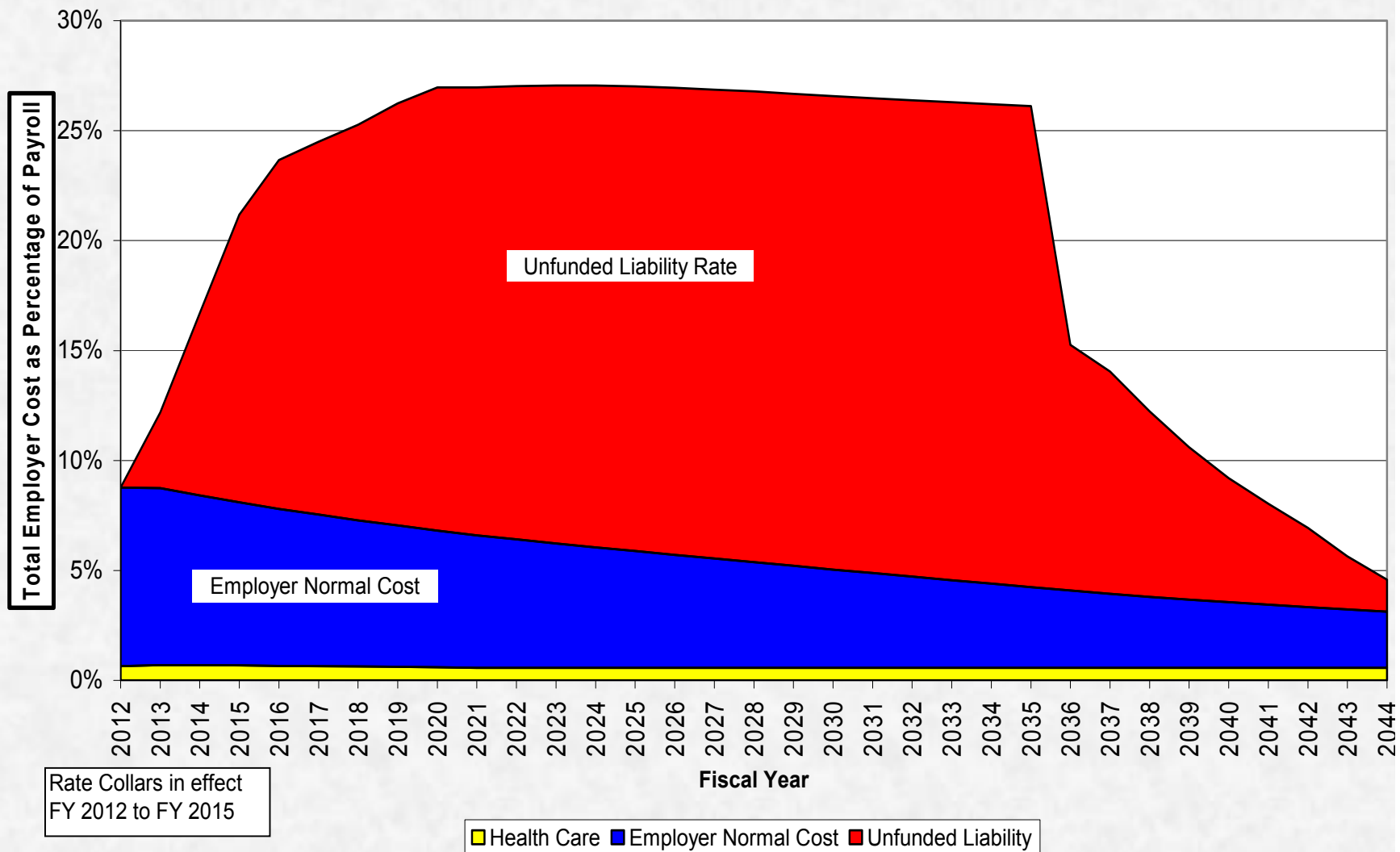
\$19.7 PSERS \$9.7 SERS

**A debt of the Commonwealth, backed by the
full faith and credit of the Commonwealth**

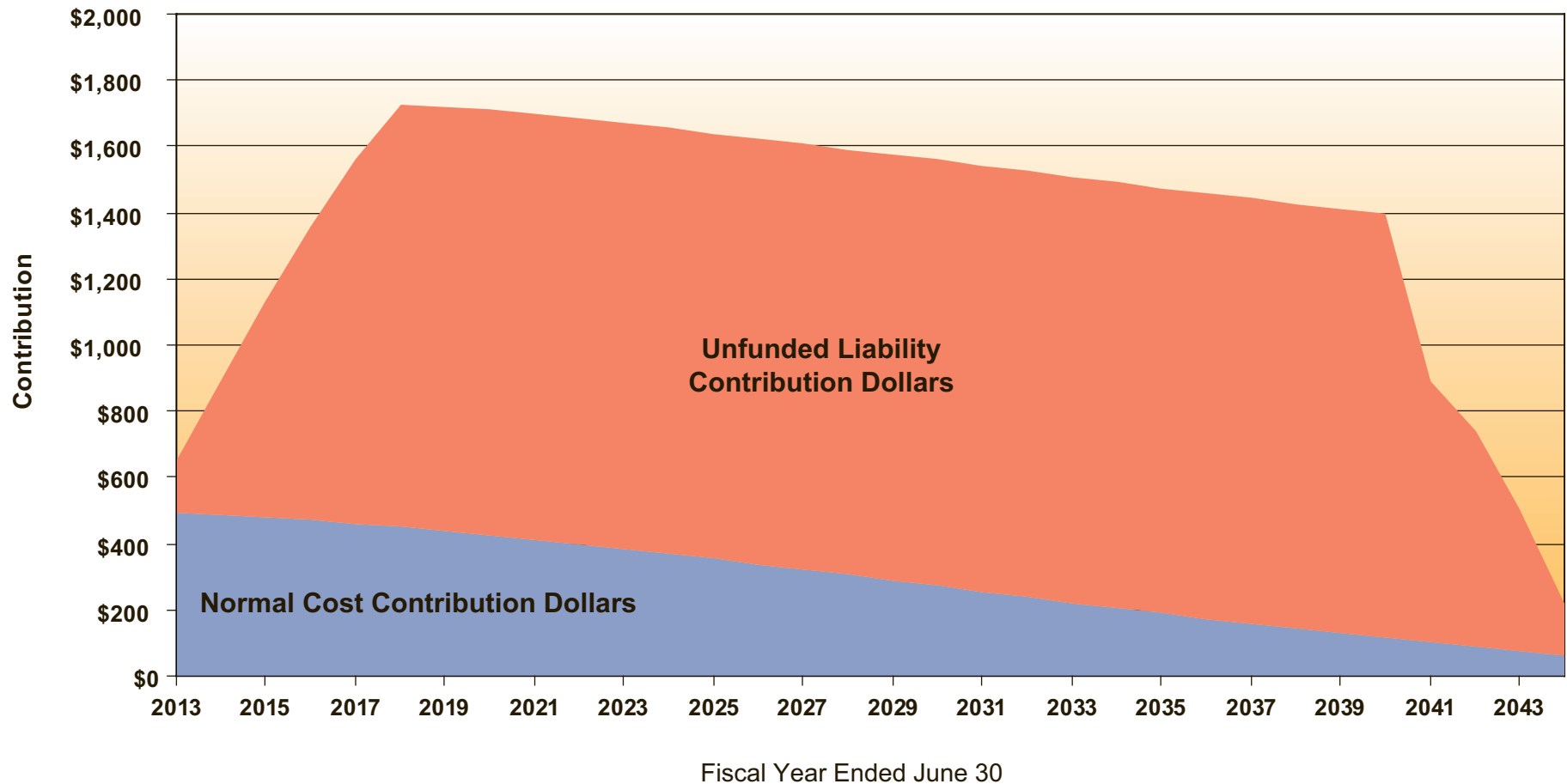
“Statutory interest charges payable, the maintenance of reserves in the fund, and the payment of all annuities and other benefits granted by the board under the provisions of this part are hereby made obligations of the Commonwealth. All income, interest, and dividends derived from deposits and investments authorized by this part shall be used for the payment of the said obligations of the Commonwealth.”

*State Employees’ Retirement Code, Title 71, Pa.C.S. §5951
Public School Employees’ Retirement Code, Title 24, Pa.C.S. §8531*

PA Public School Employees' Retirement System
Components of Projected Total Employer Contribution Rate - Act 120
Based on June 30, 2010 Actuarial Valuation - Assumes 8% Rate of Return



**SERS Employer Contribution Projections
Presuming Plan is Closed to New Members**
(\$ millions)



Factors influencing the \$29.4 billion debt have been building over decades.

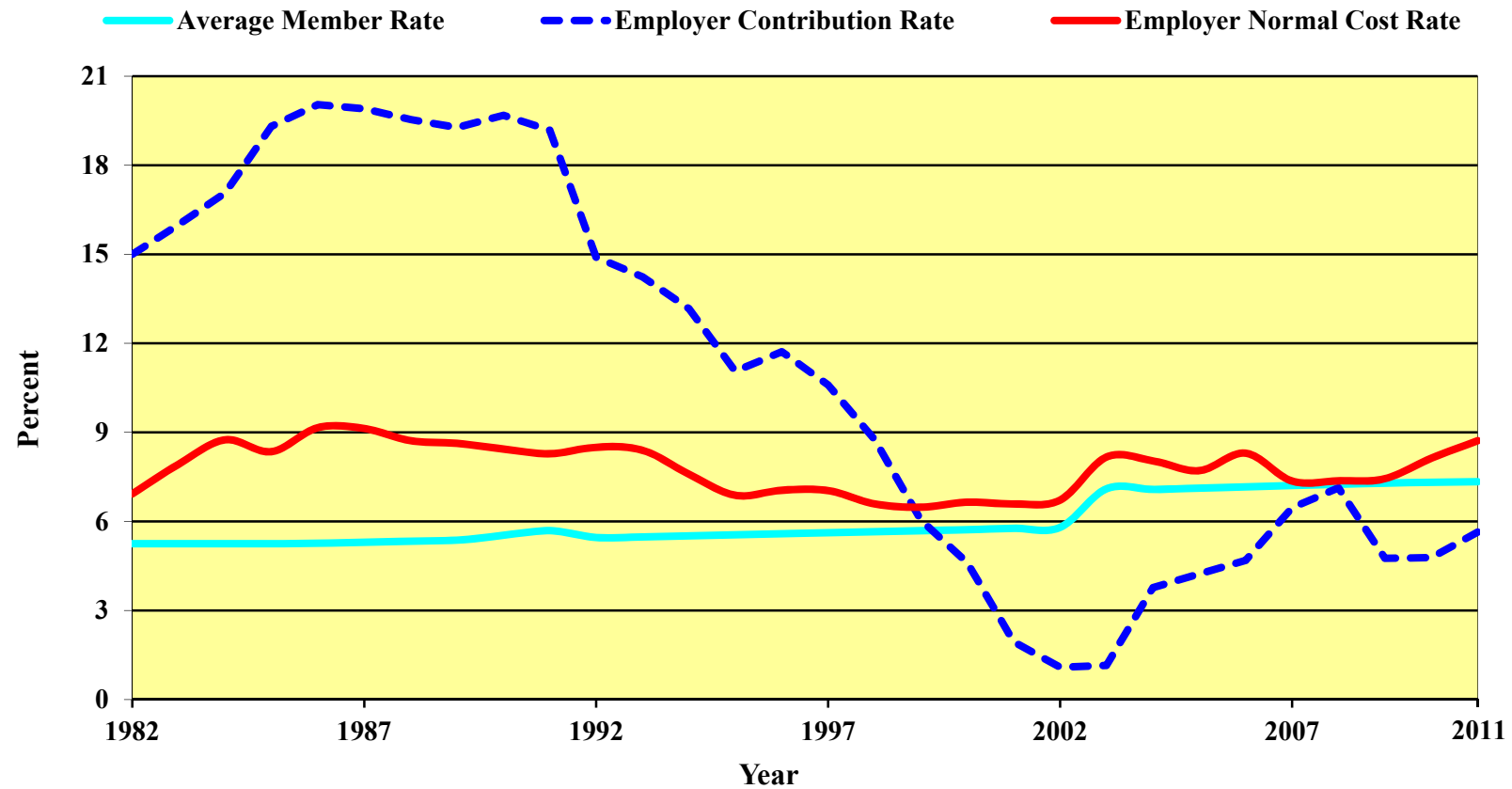
The \$29.4 billion debt is largely the result of:

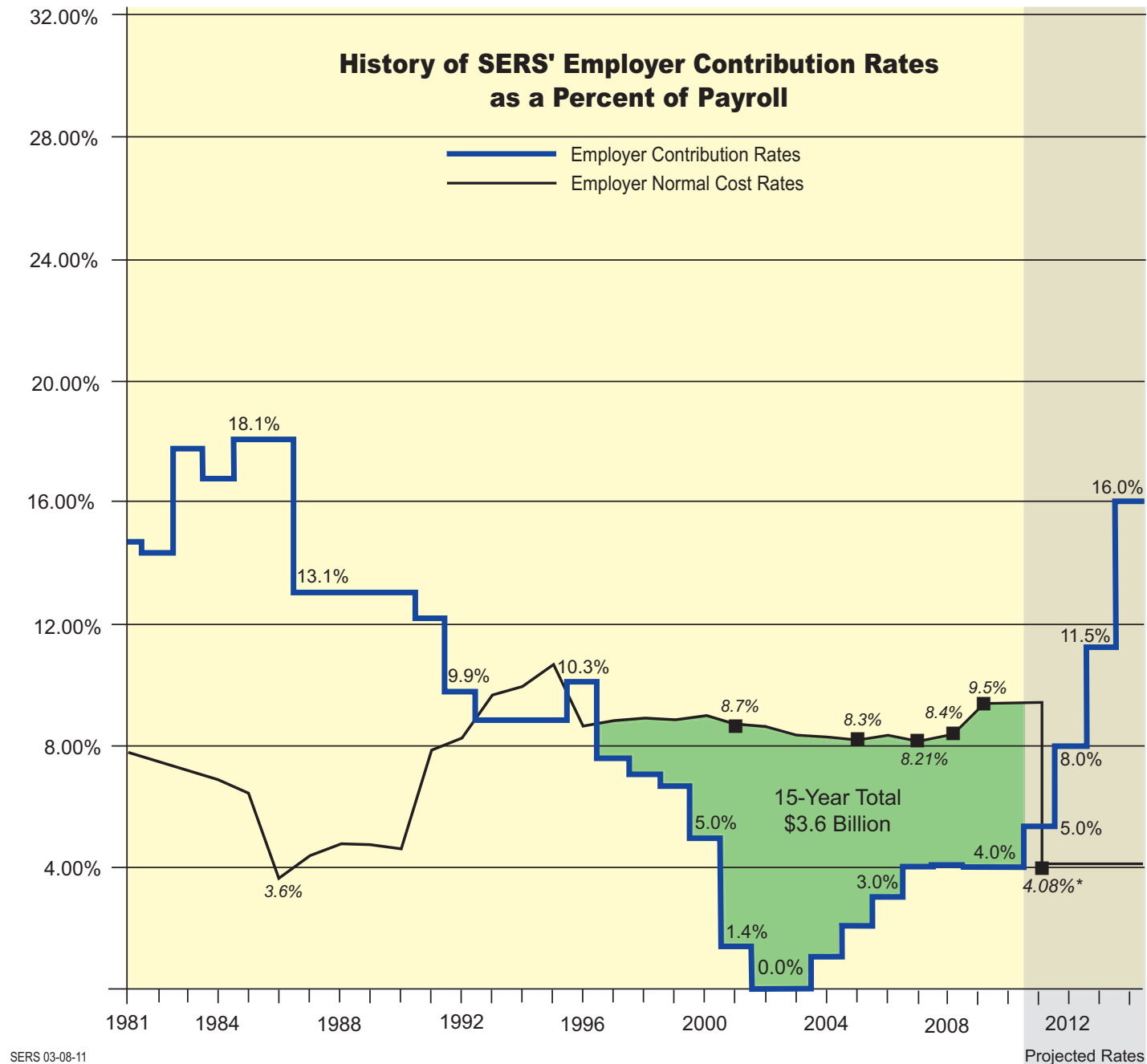
- employer contributions below normal costs
- losses that neutralized the past investment gains used to justify low employer contributions
- benefit increases without increased funding streams
- funding changes to extend time to pay down liabilities
- cumulative negative impact of the above on investment returns

Despite 2008's unprecedented investment losses, PSERS' and SERS' long-term investment performance has exceeded actuarial return objectives.

	PSERS	SERS
Current Actuarial Return Objective	7.5%	8.0%
One-Year Return (ending June 30, 2011)	20.4%	18.8%
25-Year Rate of Return (annualized, net of fees)	8.8%	9.0%

History of PSERS' Contribution Rates as a Percent of Payroll





SERS 03-08-11

Case law has held that contract clauses prohibit benefit changes for existing employees.

A significant body of case law establishes that the contract clauses of the United States and Pennsylvania constitutions protect public retirement benefits from being retroactively changed in any way that may be interpreted as a **“net detriment”** to employees. This prohibits not only reductions in already earned benefits but also reductions in the rate of future benefit accrual.

A “net detriment” has been found in both **reductions in benefits** agreed-to at the time of hire and in **increases in employee contributions** in order to maintain the same level of agreed-to benefits.

Although the General Assembly can change the employment contract of new employees to allow future reductions—as occurred with recent reforms—**even a constitutional amendment is unlikely to allow the reduction of already earned benefits** and may not allow the reduction of future accruals for existing employees.

Many seemingly sensible attempts to further reduce costs do not actually cost less and may well exacerbate the debt issue to potentially insurmountable proportions.

Some of the more popular legislative options seem to be:

- creating a “**cash balance**” tier to the current defined benefit plan
- developing a “**hybrid**” plan that includes both defined benefit and defined contribution components
- closing the defined benefit plan in favor of a 401(k)-style **defined contribution** plan

Any proposal that includes closing the current defined benefit plans would exacerbate the debt issue to potentially insurmountable proportions.

The commonwealth would have to pay off the existing debt **while also paying** for whatever new retirement benefit is put in its place.

Pension plans must be **fully funded** as of the date the last member is eligible to retire. Thus — because there would be no new members joining the plan — the clock would start ticking and the \$29.4 billion debt would be due within about 35 years.

As the plans wind down fewer people would be paying in, the employer share would be spread over fewer employees, and there would be less time to make up for market fluctuations. The commonwealth's share of the existing debt would become **intolerably volatile**.

The most likely way to deal with a debt of this size is
a combination of solutions
including substantial funding infusions and consistently
higher levels of employer funding over time.

The Good News

Pension reform benefit reductions have helped create *proportionately* **higher levels** of funding.

Higher levels of funding may possibly be achieved by reallocating **dedicated funding streams**.

The Bad News

The funds **cannot “earn” their way out of this debt** through existing investments.

PSERS Stress Test Summary

	Baseline	Early Decade Recession	Last Decade	Great Recession	4 Great Years
Projected Return by Fiscal Year (FY) Ending June 30th	Current w/Act 2010-120	Stress 1 FY 2001 - 2003 returns for FY 2012 - 2014	Stress 2 FY 2002 - 2011 returns for FY 2012 -2021	Stress 3 FY 2008 - 2009 returns for FY 2012 - 2013	Stress 4 FY 2004 - 2007 returns for FY 2012 - 2015
2012	7.50%	-7.40%	-5.26%	-2.82%	19.67%
2013	7.50%	-5.26%	2.74%	-26.54%	12.87%
2014	7.50%	2.74%	19.67%	7.50%	15.26%
2015	7.50%	7.50%	12.87%	7.50%	22.93%
2016	7.50%	7.50%	15.26%	7.50%	7.50%
2017	7.50%	7.50%	22.93%	7.50%	7.50%
2018	7.50%	7.50%	-2.82%	7.50%	7.50%
2019	7.50%	7.50%	-26.54%	7.50%	7.50%
2020	7.50%	7.50%	14.59%	7.50%	7.50%
2021	7.50%	7.50%	20.37%	7.50%	7.50%
2022 and there after	7.50%	7.50%	7.50%	7.50%	7.50%
Results					
Max Employer Contribution Rate*	27.72%	34.93%	30.70%	38.10%	23.98%
Dollars at Max Rate, in millions**	4,930.2	8,244.1	7,778.1	9,652.9	3,755.8
Max Rate Fiscal Year	FY 2020	FY 2028	FY 2030	FY 2030	FY 2016

* - Include Healthcare Premium Assist.

** - Includes Commonwealth and School Share

The Bad News

The funds **cannot “earn” their way out of this debt** through existing investments.

SERS Stress Test Summary

	Baseline	Early Decade Recession	Last Decade	Great Recession	3 Great Years
Projected Return by Year	Current w/Act 2010-120	Stress 1 2000 - 2002 returns for 2011 - 2013	Stress 2 2001 - 2010 returns for 2011 - 2020	Stress 3 2008 returns for 2011	Stress 4 2004 - 2006 returns for 2011 - 2013
2011	8.00%	2.20%	-7.90%	-28.70%	15.10%
2012	8.00%	-7.90%	-10.90%	8.00%	14.50%
2013	8.00%	-10.90%	24.30%	8.00%	16.40%
2014	8.00%	8.00%	15.10%	8.00%	8.00%
2015	8.00%	8.00%	14.50%	8.00%	8.00%
2016	8.00%	8.00%	16.40%	8.00%	8.00%
2017	8.00%	8.00%	17.20%	8.00%	8.00%
2018	8.00%	8.00%	-28.70%	8.00%	8.00%
2019	8.00%	8.00%	9.10%	8.00%	8.00%
2020	8.00%	8.00%	11.90%	8.00%	8.00%
2021 and there after	8.00%	8.00%	8.00%	8.00%	8.00%
Results					
Max Employer Contribution Rate	25.9%	38.9%	33.4%	41.2%	20.8%
Dollars at Max Rate, in millions	1,757.9	2,894.3	2,804.4	3,065.7	1,370.3
Max Rate Fiscal Year	2016/2017	2019/2020	2023/2024	2019/2020	2015/2016

More Bad News

Funding infusions have to be **massive** to “move the needle.” They are important as part of the combination of solutions necessary to deal with the debt but they are **not likely a viable solution on their own.**

Cash Infusion Projections

Additional Infusion Required as of July 1, 2011 to Reduce PSERS Contributions Below Target
(\$ In billions)

Target Percent of Payroll	Amount Needed (30 yr Amortization)	Amount Needed (10 yr Amortization)
	To Keep all Future Contribution Rates Below Target	To Keep all Future Contribution Rates Below Target
< 20%	\$15.23	\$27.29
< 15%	\$26.71	\$34.17
< 10%	\$37.39	\$41.04

Rates assume a 1% collar on FY 11, 3% on FY 12, 3.5% on FY 13, and 4.5% on FY 14 and above until collars are no longer needed. (Act 120 collars)
Rates projected based upon PSERS June 30, 2010 actuarial valuation.

Cash Infusion Projections

Additional Infusion Required In 2011 To Reduce SERS Contributions Below Target
(\$ in billions)

Target Percent of Payroll	Amount Needed (30-Yr Amortization)	Amount Needed (10-Yr Amortization)
	To Keep All Future Contribution Rates Below Target	To Keep All Future Contribution Rates Below Target
<20%	\$3.8	\$9.4
<15%	\$7.4	\$11.7
<10%	\$10.9	\$14.1

NOTE: Per current law, rates assume collars of 1% in FY11, 3% in FY 12, 3.5% in FY13 and 4.5% in FY14+ until no longer needed.

SERS 09-12-11

Aside from the budgetary concerns, there are some other issues to consider:

- Bond ratings
- GASB exposure draft
- Employee recruitment and retention
- Benefit adequacy

We're in this together. As your partners and technical experts, we are ready to do whatever it takes to help.



Jeffrey Clay
PSERS Executive Director
jclay@pa.gov
717-720-4734



David Durbin
SERS Office of Member
Services Director