

Write-up from PLS on December 16 Finance Committee Meeting

PSBA UNVEILS HYBRID PENSION PROPOSAL

By Matt Hess

The Pennsylvania School Boards Association (PSBA) was joined by Rep. Glen Grell (R-Cumberland) and Senator Gene Yaw (R-Bradford) for a press conference today to propose a long-term solution to the “looming crisis in the Pennsylvania School Employees’ Retirement System.”

Thomas Gentzel, PSBA Executive Director, said “Our association has studied this issue and has developed a plan that reduces the potentially devastating tax burden to local taxpayers while also creating a fair system for both employers and employees,” he stated.

Pam Markle, School Board Member in the Williamsport Area School District and Chairperson of the [Pension Study Committee](#), discussed how the committee crafted the plan. “Our

proposal combines the best features of a defined benefit and defined contribution pension systems,” she said, “It reduces the cost of the system over the next few decades while still honoring the importance of school employees.”

Rep. Grell, prime sponsor of the proposal in the House, said he hopes the plan with “jump start discussions to address the long-term need to reform PSERS.” He noted that the districts will be required to increase pension payments from the current 4.78 percent to 8.22 percent during the 2010-2011 school year and stated “in the next couple of years, school districts throughout Pennsylvania will realize sizeable increases in retirement costs, which are ultimately borne by school property taxpayers.” Rep. Grell stressed that the proposal “would not affect any current retiree or any current school district employee” and noted that the “reduction in benefits for future employees would, over the long-term, make the system more affordable for the Commonwealth, taxpayers and school districts.”

Senator Yaw said the proposal “will hold down the future costs of the Pennsylvania School Employees’ Retirement System.” He explained that the system currently utilizes a defined benefit system which means “school districts must pay their employer contribution rate no matter what the cost and the effect on their ability to pay” and said the proposal introduces a “defined contribution element to the system.” “This proposal reduces the employee contribution rate from the current 7.5 percent for most employees to 3.25 percent, and the multiplier would be reduced from 2.5 percent to 1 percent,” he stated, “The vesting time for the defined benefit portion of the plan would be increased from the current five years to ten years.”

Fred Botterbusch, School Director in the Dallastown Area School District and President of the PSBA, said the “projected high-water mark for the employer contribution rate is 2014-15” but pointed out that “next year’s rate of 8.22 percent is a 72 percent increase over the 2009-10 rates.” He emphasized the need for long-term reform and stated “the employer contribution will increase and will continue to exceed 20 percent until the year 2032.”

The participants then responded to questions from the media.

You’ve offered this as a long-term approach, what do you propose the state do in the short-term?

“The daunting reality here is that there is really no one or two things the Legislature can do to make this problem go away,” Gentzel responded, “What’s happened before is a re-amortization of the debt and some other machinations in terms of how PSERS could calculate some of the costs that could help a little bit.” “We’ll be supportive of any reasonable proposal to help mitigate the short-term cost, but our fear is that we don’t stop there. We have to do something so that we don’t face the prospect of this again.”

When do you estimate that this will save districts money and it’s my understanding that it’s putting more risk on school employees and making their plans smaller?

Gentzel stated, “A defined benefit plan puts all of the risk on the employer and we’re trying to come up with a hybrid plan that it would make this more balanced. The pension benefit that would be realized under this plan is still quite substantial.” Tim Allwein, Assistant Executive Director of Governmental and Member Relations for the PSBA, said “around 2020 you’ll see a separation, of what the employer contribution rate would be under the current system and what it would be under the hybrid system.”

So it will be significant lower in ten years?

“It’s maybe a percentage point lower but that will increase the longer we go,” Allwein stated.

Can you give us a brief background of how we got to this point?

Gentzel said "There were increases in employee benefits back in 2001 but the most significant factor has been declines in the market." "We can't earn our way out of this hole because there's a huge unfunded liability that needs to be paid for," he said.

Can you understand the frustration of taxpayers that are paying more money so that teachers can retire with a better deal than what they got in the private sector?

"There's no question that's the biggest problem we have right now with the current situation," Gentzel said, "Our problem is that there are hundreds of thousands of people in the system that are entitled to the benefits and we can't adjust them." "Our *continued from previous page continued on next page* 3 plan is reasonable and one that will incent people to consider teaching as a profession but balances that interest on that of the taxpayers," he added. Rep. Grell said "For many years, the employer contribution has been kept artificially low, below what the actual cost of running the system is." "Once we deal with the long-term situation some of the short-term fixes make a little more sense," he stated. Senator Yaw added that the "defined benefit plan is a dinosaur in today's workforce, I don't know anywhere beyond the public sector that has it."

Senate Finance Committee 9:00 a.m., 12/16/09, 156 Main Capito/By Kimberly Collins

The committee held the first of a series of hearings on public pension issues.

Members in attendance included Chairman Pat Browne (R-Lehigh), Minority Chairman Jim Ferlo (D-Allegheny) and Senators Pat Vance (R-Cumberland), Gene Yaw (R-Bradford), LeAnna Washington (D-Philadelphia), John Eichelberger (R-Blair), Jane Earll (R-Erie), and Anthony Williams (D-Philadelphia).

Chairman Browne explained pension reform is a major issue for systems across the country, and if left unaddressed will result in a "serious reprioritization" of budgets. He said today is the first of several hearings he plans to hold to explore potential solutions.

Jeff Clay, Executive Director of the Public School Employees Retirement System (PSERS), and Leonard Knepp, Executive Director of the State Employees Retirement System (SERS), presented [joint testimony](#) on the history of the two systems, their current status, and options to mitigate the looming rate spike.

Clay explained PSERS is "a governmental, mandatory, multi-employer, defined benefit pension plan for Pennsylvania school employees" and as of June 30, its net assets were \$43.2 billion. PSERS is funded by three sources: employee contributions, employer (state and school districts) contributions, and investment earnings. Over the past ten years (2000-2009), investments have accounted for 59% of PSERS funding; during the period 1999-2008 investment earnings accounted for 77% of funding. The annual earnings assumption is 8%, which is a decrease from the previous rate of 8.5%. Over the past 25 years, PSERS' fund has earned an annualized rate of return of 9.23%. Noting the economic downturn of 2008, Clay said rebound began in the fourth quarter of fiscal year 2008-09 and the estimated fiscal year-to-date return is 9.18% (PSERS operates on a July 1-June 30 fiscal year). PSERS' employer contribution rate for FY 2009-10 is 4.78%, and the rate next year will be 8.22%. The state pays approximately 55% of employer contributions in PSERS. Clay explained the pension component of PSERS' employer contribution rate has been below the employer normal cost (the amount needed to fund the benefits earned by active members that year) for thirteen years, which adds additional unfunded liability. PSERS' normal cost is 7-8%.

Knepp explained SERS offers defined benefit plans to more than 219,000 state workers and has assets of \$23.7 billion as of September 30. He noted that the cost of benefits and expenses has doubled in the past ten years. SERS is also funded by employee and employer contributions and investment income, with investment income accounting for 85% of SERS funding from 1998-2007 and 72% of funding from 1999-2008. SERS also has an annual earnings assumption of 8%, down from 8.5%, which is considered more realistic in the current market environment. Knepp noted SERS had a rate of return of negative 28.7% in 2008, but over the past 25 years the fund has earned an annualized rate of return of 9.7%. SERS' fiscal year is the calendar year and its cumulative return for the first three quarters of this year is 4.5%. SERS has a 4% employer contribution rate; normal cost is 9.5%.

After reviewing the status of the two funds, Clay and Knepp addressed the contribution rate spike. Employer contribution rates for both systems are expected to jump substantially in 2012 and remain high in subsequent years. Clay explained the increase is primarily the result of unfunded liabilities created by down markets, earnings assumption changes, cost of deferral techniques, Act 9 of 2001, Act 38 of 2002, and Act 40 of 2003. Act 38 and Act 40 have been artificially suppressing the employer contribution rate, he stated. PSERS' contribution rate is projected to jump to 29.22% in FY 2012-13 and peak at 33.6% in FY 2014-15. SERS' employer contribution rate is projected to jump to 28.3% in FY 2012-13 and peak the following year at 31.4%. In recent years the projected spike had been decreasing, to as low as 11.23% for PSERS in 2007, but the market crash in 2008 caused the projection to spike back up. Clay stated there are three fundamental options to mitigate these spikes: increase the funding of the systems, decrease or cut costs and liabilities, or defer liabilities.

Clay explained there are three ways to achieve the first option of increasing funding: increase employer contributions, increase employee contributions, or increase investment returns. He opined all three of these are unlikely to occur to any significant degree. He suggested other sources of funding could be pursued, such as utilizing federal funds or floating a bond, but again Clay opined these are unlikely to occur to any significant degree and there are also potential legal issues *continued from previous page*
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with these options. Clay next discussed options to decrease the costs and liabilities of the system, include converting to a defined contribution or hybrid plan or reducing benefits, but he pointed out these changes would have minimal effect in the immediate future because they could only be applied to new employees. The third option to mitigate the spike is to defer liabilities, which Clay noted the governor has a proposal on to use “legislatively prescribed employer contribution rate collars and floors that are tied to the funding status of the systems.”

Clay concluded “there is no silver bullet to resolve the systems’ funding issues” and suggested the solution likely lies in a combination of several approaches. He stated converting to a defined contribution or hybrid plan will not affect current liabilities or resolve the immediate funding concerns, and in fact, “may aggravate the employers’ cash flow problems as each employer will be supporting two pension plans.”

Minority Chairman Ferlo remarked on his lack of faith in the legislature to resolve the pension issues, noting his recent efforts to address issues in Pittsburgh. He then asked that the percentages be equated to real numbers. Knepp said SERS’ employer contribution amount is \$220 million now, which will be over \$2 billion with the spike. Clay said PSERS expects \$4.2 billion more at the spike, of which the Commonwealth would be responsible for about half and the school districts the rest. Minority Chairman Ferlo reiterated his doubts that the legislature is “up to the task.” He said the legislature needs to determine what is sustainable for the commonwealth and the school districts, and commented the outlook is not good.

Senator Eichelberger asked if the contribution rates are too low or if contributors are not meeting their obligations. Clay said the employee contribution rate is set by statute and the obligations are being met. He said the funding methodology suppressed the rate to provide funding relief. Knepp concurred, stating Act 40 is the problem. Senator Eichelberger asked about the possibility of creating a defined contribution tier. Clay said any such changes would be prospective and would complicate the administration of the plans, but he said this is not insurmountable. Senator Eichelberger asked about the possibility of a third party administrator, to which Clay responded that is permissible but may cost more.

Chairman Browne commented on the need to increase awareness of the unfunded liability as a part of the process to address those issues. He asked for a breakdown of the biggest issues that contribute to the unfunded liability. Knepp said the two biggest components are the investment losses last year and the drop in the assumed rate of return. Clay agreed “there is no question” the investment losses are the main driver. He then identified deferral techniques and the Act 9 multiplier as the next biggest contributors. Chairman Browne asked if the assumed rate of return, plus normal cost, plus the employee contribution is adequate to fund the system post-Act 9. Clay confirmed this.

Chairman Browne concluded changes to the employer contribution would not have to be made to deal with Act 9; just to deal with the unfunded liability. Clay agreed. Chairman Browne asked if the breakdown of funding sources for the two systems is typical to other systems. Clay said the percentages are different, but confirmed that most see more than half their funding come from returns. Chairman Browne asked if this distribution and the current benefit structure can be maintained. Clay conceded that is a big question, noting confidence in the market is needed. Knepp suggested the employer contribution rate would have to go up. The chairman asked what is being done to address this. Knepp explained SERS’ five-year investment plan lowers exposure in public equity and moves into fixed income in order to meet liquidity needs. When asked about pressure on the system, Knepp opined this is still an acceptable range and 8% is achievable. Clay said it will be more difficult to meet 8%.

Chairman Browne commented the investment mix is structured to meet the assumed rate of return, but opined this is difficult. He suggested an alternative goal of setting the mix to meet the liability instead of the assumed rate of return. He remarked the volatility of the systems is not sustainable overtime. Clay said that is something to be looked at. He agreed there has been dramatic volatility this decade and questioned whether that is the new “normal” or if the market will return to the previous normal. He agreed a more stable way to fund the system is needed.

[James Testerman](#), President of the Pennsylvania State Education Association (PSEA), shared “four important truths that are motivating our members to speak out.” They include:

- The current defined benefit pension plan is critical for recruiting and retaining quality public school employees, which benefits students, their families, and their communities.
- The pending spike in employer payments is primarily the result of significant losses in investment returns and a lack of *continued from previous page continued on next page 17*

state and district funding.

- School employees have never stopped making their pension contributions. But because of decisions made in previous legislative sessions, school districts and the state have not paid their fair share in any of the last 10 years.
- Many of the “solutions” being discussed make for good sound bites but will do nothing to lessen the projected payment increase, and are actually long-term problems that will hurt the ability to attract and retain quality education professionals over the long term.

Testerman emphasized the importance of pension benefits, stating “the PSERS benefit plan encourages individuals to become and remain educators, thereby ensuring a stable and highly qualified workforce in our public schools.” He discussed the problems facing the system and discussed the option to abandon the current system for a defined contribution plan, or slash benefits in the current plan, or defer liabilities. He said changing the current system “would have absolutely no impact on the pension spike” and urged the members to consider the negative consequences this would have. He argued in support of defined benefit plans. Regarding options to defer liabilities, Testerman, urged the committee to look at changes to reduce the level of contributions necessary in 2012. These options, he stated, “range from extending the smoothing period used to determine the actuarial value of assets to the reamortization of PSERS unfunded liabilities, which would be much like refinancing your home to get some cost savings by extending the terms of payment.” He opined a combination of these options can substantially lower the level of the 2012 spike. In conclusion, Testerman asked that the committee keep in mind that employees have paid in nearly twice as much as the state and school districts in the past ten years and stated “the state and the school districts have to step up to the plate and begin to pay their share.”

Senator Eichelberger asked Testerman if he understands that any changes made to PSERS’ benefits would not affect any current PSERS members. Testerman confirmed he understands this, and explained his concerns with preserving the benefits is to ensure that Pennsylvania attracts and retains the most qualified professionals. Senator Eichelberger argued that schools were the biggest winner in the budget this year, and said the state cannot fulfill requests to fund education and requests to fund the systems. He said cuts have to be made, and argued there is room for cuts in the Department of Education’s budget. Testerman praised the legislature’s investments in education, stating they pay off in the long term. He said PSEA is ready to work with the legislature to find solutions to the pension problem.

Minority Chairman Ferlo noted an earlier reference that Nebraska, Alaska, and West Virginia have defined contribution plans. He asked if these are the only such states. Former State Representative Steve Nickol, who joined Testerman, confirmed these are the only states with closed defined contribution plans.

Senator Williams asked for specific suggestions, noting there is only so much money and the financial outlook for FY 2010-11 is poor as well. He said difficult decisions are going to have to be made if no one is willing to raise taxes. Testerman assured the senator that PSEA is “in the pool” and working with the legislature to find solutions.

Chairman Browne asked if there are any actuarial components that PSEA is more concerned about than others, specifically asking about the governor’s proposal to use collars. Testerman said PSEA looked at collars a few years ago. He commented that it will take a combination of options to accomplish the goal, noting that collars start to increase funding status but are a matter of risk tolerance while they are in place. He said collars have to help ease funding while other components are looked at.

Chairman Browne asked for recommendations to change the portfolio. Testerman, noting he is not an expert in this field, said riskier returns are need to grow out of this situation and once out, the systems should seek to reduce volatility. Nickol added that if the earning assumption had been reduced sooner, the employer contribution rates would have been higher. Chairman Browne said this “begs discussion” of whether efforts to exceed the assumed rate should be abandoned and instead allocations should be made in order to ensure that the assumed rate is achieved.

The chairman then asked about participation by higher education employees in TIAA-CREF’s defined contribution plans, which primary and secondary school employees do not have the option to participate in. Testerman could not speak for higher education, but he suggested that people ultimately regret decisions to join defined contribution plans.

[Thomas Gentzel](#), Executive Director of the PA School Boards Association (PSBA), discussed a proposal by PSBA to address the pension problems. He argued that a short term and long term solution is needed and stated “PSBA believes that a short *continued from previous page continued on next page* 18

term solution begins with a re-amortization of the system's liabilities over a longer period of time, combined with changes to the benefit package will have the greatest desired effect." He suggested changes should include increasing the vesting time back to ten years, reducing the multiplier, changing the terms of retirement, and examining options that are currently available to retirees that are costly. For the long term, PSBA recommends changed the PSERS system from a total defined benefit system to a hybrid defined benefits/defined contribution system.

Tim Allwein, Assistant Executive Director at PSBA, added that PSBA's proposal is a short term and long term fix. Gentzel noted that now is the time to implement it because there are a lot of retirements and the volume of new members means it will have more impact.

Senator Williams asked if PSBA's proposal has been introduced as a bill. Allwein said Rep. Glen Grell (R-Cumberland) will be introducing it as House Bill 2135 and Senator Gene Yaw (R-Bradford) will introduce it in the Senate. Allwein explained PSBA wants to be actively working on the pension problem, not just complaining about it, which prompted the association to study the issue and craft this proposal.

Minority Chairman Ferlo asked if Pittsburgh and Philadelphia are part of the proposal. Gentzel confirmed they are, noting that it has not been discussed fully with them. Allwein commented that management of a defined contribution plan will be by PSERS, under the proposal, and speculated that employers would develop a service to help employees make decisions. Minority Chairman Ferlo commented that he has heard a lot of horror stories relating to decisions made in defined contribution plans. Gentzel commented on the importance of guidance.

Senator Williams asked how many school districts are members of PSBA. Allwein reported 498 of the 501 total districts. Senator Williams asked if all 498 members have signed off on the proposal. Gentzel explained PSBA membership voted on the proposal as a part of its platform, but conceded this does not mean each individual district supports the plan. Senator Williams asked if votes are proportional or if one district represents one vote at PSBA. Gentzel said they are proportional, noting he does not recall how the Philadelphia School Reform Commission voted. Senator Williams questioned if the commission is familiar with the proposal.

Chairman Browne commented that if the legislature does not fully address this problem it will be "kicking the can down the road," yet he surmised that the scope of the problem makes that inevitable to some degree. He questioned the normal cost estimate of PSBA's proposal. Allwein did not have an estimate, but noted most provisions remain unchanged. He noted the proposal provides for a defined contribution benefit plan with an employee contribution rate of 3% and an employer contribution rate of 2%, which cannot be changed or bargained. Chairman Browne asked about the challenge of maintaining two separate systems. Allwein estimate the cost would be about the same, though somewhat higher in the initial years. Gentzel said the legislature needs to find a solution, adding that hoping this never happens again is not a responsible decision.

Lastly, Chairman Browne asked if PSBA has made any effort to encourage its members to build a reserve balance in anticipation of the spike. Gentzel said that has been approached, but it is difficult to do and any money set aside will be eaten up quickly.

Minority Chairman Ferlo asked if PSBA has a position on legislation moving through the Senate providing for a two year moratorium on property tax assessment. Gentzel indicated that a moratorium could exacerbate problems.