

9:00 a.m., 1/27/10, 8E-A East Wing
By Kimberly Collins-- PLS

The committee held a hearing 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), John Wozniak (D-Cambria), John Eichelberger (r-Blair), LeAnna Washington (D-Philadelphia), and Jane Earll (R-Erie).

Chairman Browne explained this hearing is the second in a series of hearings on the pension systems and the issues they are facing. He noted that at the [first hearing](#) the committee heard from the state's two largest public pension systems (SERS and PSERS) on the status of the plans, from the public school teachers who said they are willing to work. He noted that the teachers have been meeting their contribution obligations, unlike employers, and from the school board directors who offered a plan for new members that would address the deficiencies of the system. Today's meeting, he said, is to hear from the experts.

Roderick Crane, Director of ID&S, Government Market, and Richard Hiller, VP of ID&S, Government Market, for [TIAA-CREF](#) provided the committee with an overview of the national landscape for state and local government public pension benefits, what other states are doing, and of their own point of view.

Crane described the bleak status of the current economy and of pension systems. He noted that "revenues for governments are in poor shape with no immediate light at the end of the tunnel." Meanwhile, he continued, public pension costs are increasing due to market losses, traditional long term pension investment risk controls were overwhelmed by non-diversifiable risks, and most asset categories did not hold value during the market downturn. This is further compounded by delayed funding, cost volatility magnified by the size of pension liabilities, and unfunded benefit improvements. He noted benefit manipulations are not significant components of the problem. Crane then discussed options to improve the situation, noting that solutions are hampered by rules limiting changes to future employees only, stakeholder resistance, and limited financial resources. He said some states are reducing benefits for new hires, increasing contribution rates, delaying funding, issuing pension obligation bonds, and/or conducting legislative studies.

Offering their point of view on the subject, Crane recommended that the legislature develop a plan for funding past-service liabilities, reduce pension funding risks, and act sooner rather than later. He said options for reducing pension funding risks include reducing defined benefit (DB) promises for new hires, refinancing pension liabilities (possibly with bonds), exploring immunizing current liabilities and new accruals, and considering a risk-managed defined contribution (DC) pension plan. Hiller suggested that the legislature needs to ensure that both employees' and employers' objectives are being met and recommended a first step should be to develop a retirement benefits policy, which can be used as a base for making future pension-related decisions, and assess and manage risks. He suggested that a lack of consideration of risks led to the downfall of many private plans. Hiller discussed the various risks that face standard DC plans, and reviewed best practices to mitigate those risks while realizing the benefits of the risks. He also recommended shifting the risk to a third part pooled risk taker (an insurance company). Hiller commented that risk cannot be eliminated, but it can be managed effectively.

Senator Vance asked for clarification of her understanding that utilizing a smoothing period is "an easy way out" that prolongs and exacerbates the problem. Crane said using smoothing techniques does stretch out costs overtime, and agreed that they can lead to issues being handed to the next generation. However, he argued that they are good strategies in certain instances. Senator Vance also asked if Hiller was suggesting that retirees should leave a part of their contributions in the system, whereas currently retirees can withdraw their entire contributions. Hiller said he suggested that part of the contribution should be received as a lifetime income, noting there are several options to accomplish this. He said the goal is to guarantee a stream of income that the retiree will not outlive.

Senator Wozniak asked if private plans typically provide cost of living adjustments (COLAs). Crane said mostly they do not, noting private plans "tend to be plain vanilla." Senator Wozniak asked if Pennsylvania is unique in that it allows employees to withdraw their entire contribution. Hiller said PA is not unique, but reiterated the importance of defining a plan and ensuring that some of the money is available for a lifetime.

Senator Wozniak then asked what TIAA-CREF did that its plans weathered the downturn so well. Hiller said TIAA-CREF is a DC system with DB-like features. He noted TIAA-CREF has an investment philosophy geared toward plan objectives and by design DC plans have no unfunded liability.

Minority Chairman Ferlo asked how many participants want to leave for a DB plan. Crane did not know, but offered to look into the question.

Chairman Browne noted the challenges nationwide with unfunded liability. He said part of the question is how to change the approach going forward to ensure this situation does not occur again, noting that TIAA-CREF's approach has lower downside risk. He said maybe it is worthwhile to go with the approach based on plan objectives instead of an assumed rate of return. He asked if that question is being discussed nationwide. Crane said it is a great debate and currently there is no consensus. He said a lot of the private sector has gone that way and it is a worthy question for PA to ask. Chairman Browne asked if market value funding drives the discussion. Crane said not just market value funding, but also the fact that pension liabilities go to the bottom line in the private sector, whereas they are merely a disclosure in the public sector.

Chairman Browne asked about Hiller's suggestion for 12% of payroll to be contributed in instructing a DC plan to match a DB annuity. Hiller said 12-15% needs to be contributed, assuming that employees also participate in Social Security. Chairman Browne asked what the percentage of salary as income replacement would be with a 6%/6% split. Hiller said it is 70-80%; Crane added it is 40-45% without Social Security. Chairman Browne noted the current percentage is 120-125% for commonwealth employees. Hiller said best practice is 70-90% to maintain the standard of living from retirement to death.

Chairman Browne also asked about pension obligation bonds, questioning how the proceeds should be used. Hiller said the proceeds could be used to purchase bulk annuities and lock in guaranteed benefits instead of putting the money back into the investment pool. Crane said however the proceeds are used, they should not be put at higher risk.

Minority Chairman Ferlo asked if references to insurance refer to those such as GIC, which he indicated is concerning. Crane indicated this is the case, noting that there are all sorts of immunization strategies that can be considered.

[Donald Mayer](#), Chairman of the COLA Coalition, a coalition of public employee retiree organizations advocating for a COLA, testified on the need for a COLA for retirees. He noted PA typically enacts a COLA every five years, but it has been eight years since the last COLA. Mayer acknowledged it is unlikely retirees will see a COLA before the looming 2012 rate plateau is addressed and offered his coalition's assistance in solving that issue. He offered the following proposed solutions:

- Raise the employer contribution rates gradually over several years
- Consider extending the smoothing period to ten years and implementing temporary caps on annual rate hikes or decreases
- Restore equal 30 year amortization periods for the recognition of annual investment gains and losses and for the funding of active member liabilities
- Authorize pension obligation bonds
- Establish a speaker's commission, or similar entity, to study the issue and make recommendations.

Mayer noted the coalition does not specifically support any of these solutions, but reiterated its willingness to work with the legislature towards a solution. He also made the case for a COLA for retirees, noting that retirees contribute billions to the economy.

[Sue Houghton](#), Vice President of Southern Region PSEA-Retired and member of the COLA Coalition, also spoke of the need for a COLA. She discussed the current economic climate and said inflation has eroded the value of retirees' pensions. Houghton reviewed the history of COLAs in PA and acknowledged the issues facing the legislature, but, she stated, "We want you to also be aware that many of our older retirees have seen a great reduction in the purchasing power of their benefit and they feel that the legislature's delay in addressing the funding situation has also delayed any hope they have of getting a COLA in the future." She urged the committee to "push forward to enact responsible solutions to the pension spike, assessing them all, and taking appropriate action...During this process, we ask that you remember the plight of state and public school retirees and consider granting a COLA."

[Lynn Herman](#), of the PA Association of Retired State Employees and a former House member, briefly read from an actuarial note issued by the Public Employee Retirement Commission last session on a bill that would have authorized a COLA. The actuarial note indicated that COLAs are typically granted to maintain adequacy of benefits, as without them the power of the benefits diminishes. It is a goal of the system to adequately meet the needs of retirees, thus providing a COLA is a logical extension of this goal.

Minority Chairman Ferlo asked about the cost of a COLA. Herman said the bill last session was projected to cost \$3.36 billion for PSERS and \$1.56 for SERS over twenty years. He noted it mirrored the last COLA that was granted, Act 38 of 2002. Minority Chairman Ferlo asked if legislative or voter approval is needed for a bond. Herman was not confident, but speculated the legislature would pass enabling legislation but the bond would need voter approval.

Minority Chairman Ferlo then asked about the suggestion to form a commission to study the issue. Herman said it is not unusual for the legislature to establish such a commission. He argued action needs to be taken this year, preferably as a part of the budget, and said it makes sense for a commission to assist. Minority Chairman Ferlo commented on the "harsh reality" of this year's budget, agreeing with the moral imperative for a COLA but stating it is highly unlikely. He remarked he has no faith in the legislature to actually take up the recommendations of a commission. Herman continued to advocate toward utilizing the many options to find a solution, to which Minority Chairman Ferlo continued to emphasize the harsh reality of the situation. Herman countered the harsh reality is that any benefit changes would only apply to new hires and thus would not affect the projected rate increase. He pointed out that COLAs have been enacted during recessions in the past and suggested the employer contribution rate be adjusted to more properly align with costs.

Senator Earll asked for information regarding the age of retirement in granting COLAs. She also concurred with Minority Chairman Ferlo's skepticism about "punting" to a commission.

Chairman Browne noted there is a class of retirees who served when the system did not pay Social Security. He further commented there is a need for a larger discussion on expectations for new workers and standards for COLAs so they are funded and not enacted on an ad hoc basis.

[Jay Himes](#), Executive Director of the PA Association of School Business Officials, decried the looming pension rate spike, characterizing it as a "launch" because it will increase dramatically above 20% and stay there for the next 20 years. He stated that every 1% increase in the employer contribution rate amounts to \$120 million from schools and the commonwealth. Himes posited that the "massive draining of resources" due to the rate increase will detrimentally affect educational quality. On the subject of COLAs, he stated the return of employee contributions "provides a buffer for cost-of-living increases if utilized in the proper fashion," and suggested that the elimination of this option is one of many remedies that need to be fashioned into a relief package.

Himes recommended a "multi-dimensional approach" that spreads the burden among schools, the state, and employees to address the pension crisis and offered the following recommendations:

For Schools

- Mandate an employer contribution rate of 11% for FY 2011-12
- Create a series of gradual increases in the rate to reach the maximum level required to sustain a viable and stable PSERS

For the State

- Consider asset sales
- Use any tax revenue from the Marcellus Shale gas extraction tax for reducing contribution rates
- Reamortize the existing gains and losses of the system
- Look at pension bonds

For Plan Design

- Reduce the multiplier of 2.5 for new school employees to the pre-Act 9 rate of 2
- Eliminate return of employee contributions at retirement
- Use the highest five, instead of three, years of salary to calculate retirement benefits
- Return to the ten year vesting provision
- Increase the retirement age
- Consider changed to a hybrid structure of DB and DC

Minority Chairman Ferlo asked what the idea rate would be in the FY 2010-11 budget. Himes said somewhere around 11 or 12, so schools have something to plan for. He said it is a good idea to start increasing the rate now to make the increase manageable. Minority Chairman Ferlo asked about the fund balance that school districts are encouraged to hold. Himes said state law has a scale of eight to twelve.

Chairman Browne noted that the testifiers from TIAA-CREF painted a scary national picture and asked what will happen on the local level if the situation is allowed to run its course. Himes couldn't answer the question because he said he doesn't see how a school district could "get there." He explained schools simply do not have enough revenue to offset the spike; cuts and massive tax increases are the only option, he stated. Chairman Browne asked if reserves are a standard policy. Himes said no, they began to be utilized when it became apparent that rates would go back up. Chairman Browne said that is a conversation worth having; how obligations meet cash flow and establish reserves accordingly.