Memo

From the House Appropriations Committee (D)

TO: House Democratic Members and Interested Parties

FROM: Rep. Joseph Markosek, Chairman

SUBJECT: Side-by-Side Hybrid Pension Plan (Senate Bill 1071, PN1481)

DATE: December 19, 2015

As we have seen with previous GOP attempts to "reform" the pension systems, the side-by-side hybrid plan (Senate Bill 1071, PN1481) does not generate any savings in the short-term for the 2015/16 budget, nor does it pay off the pension debt any sooner than the current payment plan. Additionally, despite the pension changes, school districts' pension payments will continue to increase for the next 20 years.

The actuarial analysis indicates a net savings of $2.7 billion over the next 32 years. However, some of the plan's savings (about $5 billion) are derived from reducing benefits for current workers prospectively, which violates contract protections and is likely to be challenged and overturned in court. Thus, this plan could potentially cost about $2.3 billion. (Note: These estimates assume a drafting error identified by the actuaries is corrected.)

On Dec. 15, 2015, the House State Government Committee amended Senate Bill 1071 - a plan to overhaul the state's pension systems - to mirror the Senate-passed plan (Senate Bill 1082, PN1460), with a few notable changes. Senate Bill 1071, as amended in the committee:

- Requires a Public Employee Retirement Commission (PERC) actuarial note. The Senate-version would have by-passed the legally required actuarial analysis from PERC.
- Does not include payment "collars" in 2016/17. The Senate-version included borrowing from the pension systems to balance the budget by artificially reducing the required employer payment (i.e. "collars") in 2016/17. This move would have increased the pension debt for the systems over the long-term.
- Allows most current employees to opt-in to the new hybrid pension plan. The Senate-version moved current members of the General Assembly into the new plan upon re-election, with the option to opt-out of the new plan.

On Dec. 18, 2015, the House adopted three amendments to Senate Bill 1071: a technical correction and two troubling changes that will limit the pension boards' trustees. The first change will force the systems to reduce fees at the expense of investment returns – stressing cash flow even more. The second change will limit the boards' ability to select the best investment vehicles for the newly created defined contribution plan.

Attached is a summary of the plan. Basically, the plan:

- Creates a new side-by-side hybrid retirement plan for future workers, which includes a defined benefit and 401(k) component. Note: This change could be the first step toward eliminating the defined benefit plan and moving to a full 401(k)-style plan, as desired by the GOP.
- Reduces some aspects of current employees' benefits prospectively (i.e. anti-spiking, actuarially neutral option 4 lump sum withdrawal and shared risk/gain). Note: While the State Police, Corrections Officers and other hazardous duty personnel would be excluded from participating in the new hybrid plan, they would be subject to the benefit reductions applicable to current employees.
- Cuts retirement benefits by roughly 30 percent compared to employees hired after Act 120 of 2010. (Keep in mind, the cuts are in addition to the 20 percent benefit reduction in 2010.)

Summary of Side-by-Side Hybrid Retirement Plan (SB1071, PN1481)

Overview

- **New Plan Design**. Places future (new) hires in a newly created side-by-side hybrid (DB/DC) retirement plan.
    - Exempts State Police, Corrections Officers and other hazardous duty personnel from participating in the new hybrid plan (approximately 20 percent of SERS active membership); however, they are subject to benefit reductions applicable to current employees.
    - Provides most current employees the choice to irrevocably opt into the new hybrid plan.
    - Sitting judges will remain in their original class of service upon retention; however, first-time judges will be placed in the new hybrid plan.

Provision	Current Employees	Future Employees
Hybrid Plan	Optional*	Yes
Neutral Option 4	Yes	Yes
Shared Risk/Gain	Yes	Yes
Anti-spiking	Yes	Yes

*Excludes most hazardous duty personnel

See hybrid plan details on Page 8.

- **Reduces Current Benefits.** Reduces current employees' benefits prospectively (i.e. anti-spiking, actuarially neutral option 4 lump sum withdrawal and shared risk/gain). Note: State case law has determined that reducing benefits for current workers without consent violates contract protections and is likely to be challenged and risks being overturned in court.
- **Creates 401(k).** Reduces retirement benefits and adds a 401(k)-style component to the retirement plan. Meets the Republican majority's requirement that dollar one of an employee's retirement compensation be placed into a defined contribution plan. Please note: This change could be the first step toward eliminating the defined benefit plan and moving to a full defined contribution (401k-style) plan, as desired by the GOP.
- **No collars.** The plan does not include any provisions which artificially reduce the required employer payment (i.e. "collars" the pension payment) for 2016/17 as was included in the Senate-passed plan, making less than the required payment would have long-term impacts to the pension funds that would be much greater due to the lost revenues generated from investment income on these payments.

How retirement benefits are calculated under a side-by-side hybrid design:

Defined Benefit

Multiplier Rate (%)
x
Years of Service
x
Final Average Salary

+

401(k)-style Defined Contribution

Member contribution (% of salary)
+
Employer contribution (% of salary)
+
Investment Gains or Losses

=

Final Benefit

Noteworthy Provisions & Observations

Based on the actuarial analyses, the hybrid plan:

- **Current-Year Budget.** Provides no budgetary savings for 2015/16.
- **Pension Debt.** Does not pay off the debt (i.e. unfunded liability) any sooner than the current payment plan. (See Unfunded Liability chart on Page 4.)
- **Opt-in.** Provides an irrevocable opt-in provision for most current employees who would like to be enrolled in the hybrid plan.
- **Employer Contribution Rate.** Will not significantly reduce the employer contribution rate for school districts – the rate will remain above 30 percent of payroll for the next 20 years. (See Employer Contribution Rate chart on Page 4.)
- **Savings.** Will save $2.7 billion on a cash flow basis through 2048. (See table on Page 3.)
    - Savings of $27.7 billion: Approximately $23.9 billion from benefit cuts and $3.8 billion reflecting the amortization of plan changes over 30 years; and
    - Costs of $25 billion: Approximately $24.5 billion associated with the new hybrid plan and roughly $517 million in costs associated with financing assumption changes.
- **Risk to Savings.** Roughly $5 billion of the savings are at risk of being reversed if the benefit cuts to current employees are found to be unconstitutional and overturned in court. **Thus, this plan could potentially <u>cost</u> over $2.3 billion.** (See table on Page 3.)
- **Assets Compared to Liabilities.** The pension funds will reach the target 80 percent funded ratio – the healthy amount of assets possessed to pension liabilities owed – at roughly the same time as currently projected under Act 120 (see the Funded Ratio chart on Page 6).
- **Benefit Cuts.** The plan cuts retirement benefits by roughly 30 percent, relative to the benefits provided under Act 120. The hybrid benefit reduces the replacement income for retirees from approximately 68 percent to 49 percent of pay – not including social security. (See Benefit Estimate chart on Page 6.)
- **Benefit Cost Increase.** Using PSERS as an example, the cost of the benefit for employers (independent of the debt) will increase from 2.92 percent of payroll to 3.92 percent, a 34 percent increase. (See Employer Cost to Provide Pension Benefits chart on Page 5.)
- **Board Governance.** Prohibits systems' Board Trustees who represent current members or annuitants, or is a current member of the General Assembly, to serve as chairperson.
- **Creates Public Pension Management and Asset Investment Review Commission** consisting of five appointees to study the performance of current investment strategies and procedures; costs and benefits of both active and passive investment strategies; study alternative investment strategies that will optimize future rates of return net of fees; and make recommendations on how to improve within six months of its first meeting.
- **Costs of Implementation.** For PSERS the cost is estimated to be $9 million in the first year and $7 million each year thereafter. For SERS, the cost is estimated to be $11.5 million in the first year and $3.6 million each year thereafter. Total first year costs requiring an appropriation will be roughly $20.5 million.
- **Delinquent PSERS employers** will be charged interest at the assumed rate of return (currently 7.5%).
- **Legal counsel for both systems** will serve independently of the Governor's Chief Counsel, General Assembly or Attorney General.

Cost/(Savings)

The actuarial projection tables from the two pension systems are complicated because the reports are provided for each system separately. Thus, similar costs or savings are shown in separate reports. The table below combines data from these actuarial tables from both systems and reorganizes the costs and savings generated from changes to benefits for (1) current/active employees; (2) future employees; as well as (3) changes to how costs and savings are actuarially financed. The intent of this table is to help decision makers get a more comprehensive understanding of the fiscal impact.

NOTE: Costs are reflected as positive numbers because they are a net increase relative to the status quo, and similarly, savings are reflected as negative numbers because they are a net decrease relative to the status quo.

This table clearly shows that **the total estimated cash flow savings of $27.7 billion is offset by $25 billion in costs**, yielding a $2.7 billion estimated net savings when the projection periods for both systems are the same. Note that approximately $5 billion of the savings from cuts to current employee benefits are at risk of being reversed if determined to be unconstitutional, if so the plan may actually cost $2.3 billion.

Allocation of Costs/(Savings): SERS & PSERS Combined

Side-by-Side Hybrid Plan with 1% DB accrual, 2.5% employer DC credit

Cash flow basis

$ billions

Costs/(Savings)	Current Benefits	Future Benefits	Financing	Total
Savings				
Reducing multiplier from 2% to 1%		($17.3)		($17.3)
Cost neutral Option 4	($5.0)			($5.0)
Spreading cost/savings of plan changes over 30 years			($3.5)	($3.5)
Calibrating SERS & PSERS projection period (thru 2048)			($0.4)	($0.4)
Final average salary from 3 to 5 years		($1.6)		($1.6)
Sub-total -- Savings	**($5.0)**	**($18.9)**	**($3.8)**	**($27.7)**
Costs				
401(k) benefit relative to current DB benefit		$14.4		$14.4
Diverting employee contributions from DB to DC		$9.2		$9.2
PSERS Disability Benefit (A05322)		$0.6		$0.6
Changing actuarial assumption for normal cost			$0.5	$0.5
Reducing vesting period from 10 to 5 years (PSERS only)		$0.1		$0.1
Cost neutral Option 4 for Act 120 employees		$0.02		$0.02
Sub-total -- Costs	**$0.0**	**$24.5**	**$0.5**	**$25.0**
Total	**($5.0)**	**$5.6**	**($3.3)**	**($2.7)**
Total without changes to current members	**$0.0**	**$5.6**	**($3.3)**	**$2.3**

Benefit cuts totaling $24 billion

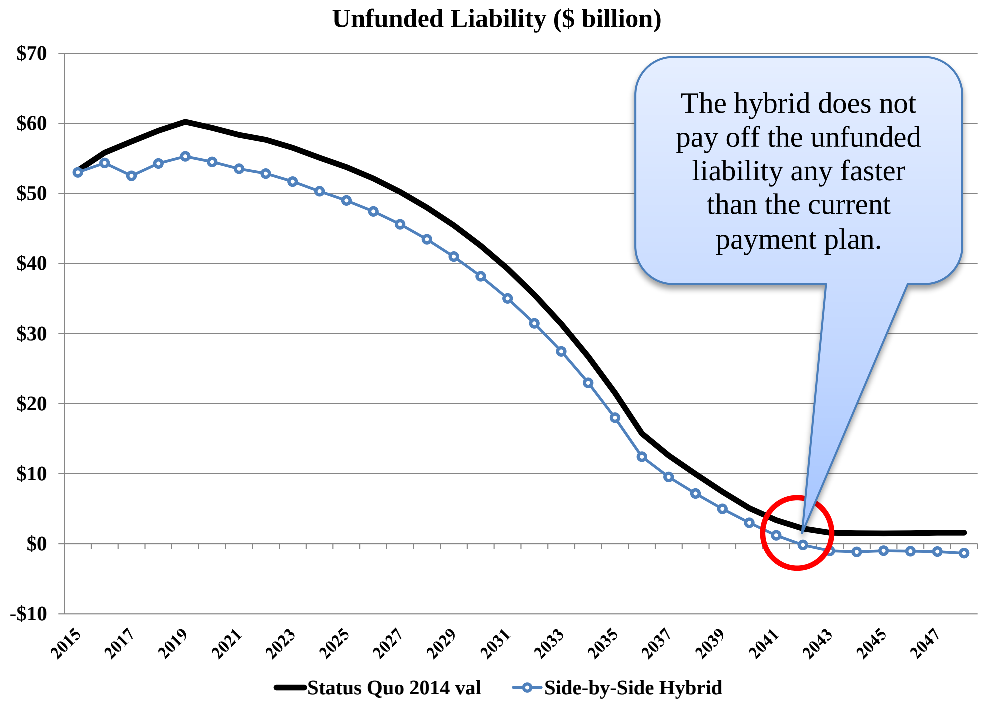
Cost of the New Changes

If cuts to current member benefits are determined by the courts to be unconstitutional, any savings from the plan changes will be lost and the new hybrid will actually cost roughly $2.3 billion.

Side-by-Side Hybrid Plan Compared to the Status Quo

In order to make sense of a proposal, it must be compared to what's currently in place. Below are charts reflecting some of the key metrics used to assess the impact of the hybrid plan relative to the status quo.

*Definition: The **unfunded liability** is the difference between assets and liabilities.*



Unfunded Liability
(PSERS & SERS Combined)

Relative to the status quo, the Side-by-Side Hybrid Plan does not appreciably reduce the state pension systems' combined unfunded liability in terms of magnitude nor does it pay it off any quicker.

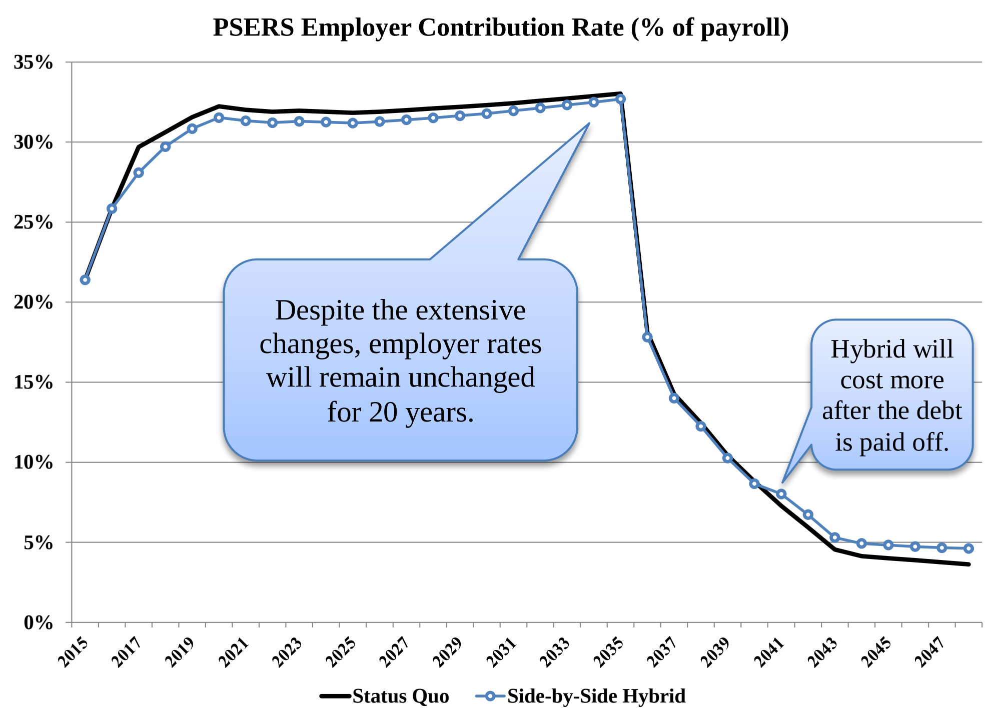
Projections indicate that the hybrid plan and the status quo will achieve a funded ratio of 80 percent in 2030 (15 years), for PSERS. The hybrid plan is expected to achieve 80 percent funded status in 2028 – 2 years before it would under current law.

*Definition: The **employer contribution rate** is calculated by actuaries and includes the cost of the benefit plus the cost of the unfunded liability. For PSERS only, the ECR also includes the cost associated with the premium assistance program.*

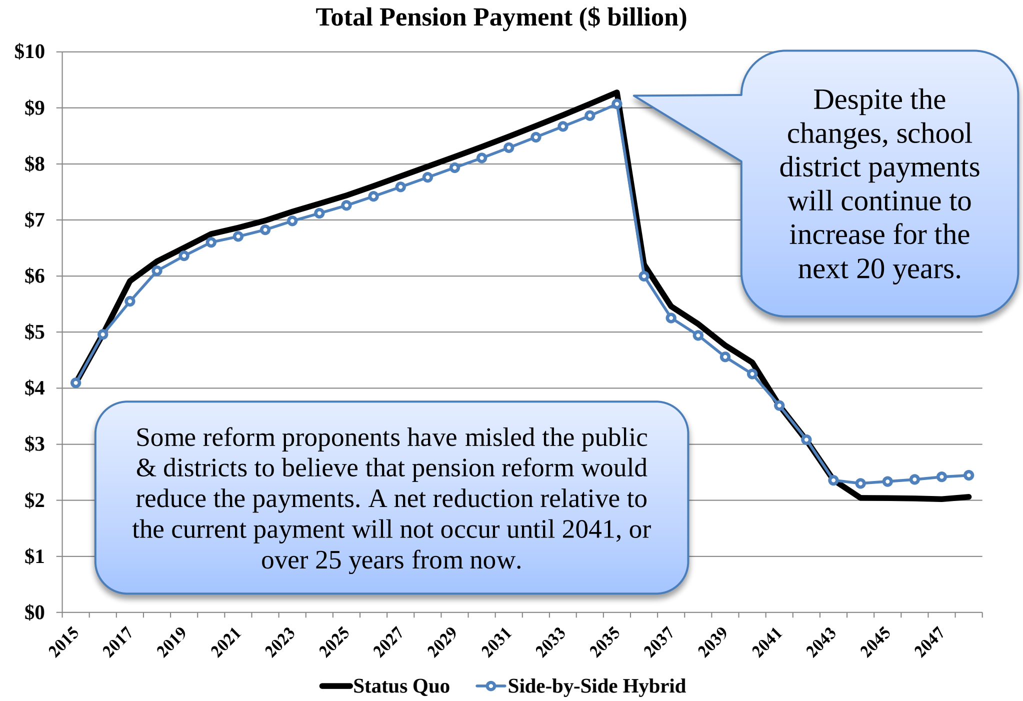
Employer Contribution Rate

School districts' employer contribution rates are expected to level-out at roughly 30% of payroll beginning in 2018 and remain at this level for approximately 20 years until the debt (principal and interest) is largely amortized.

The Side-by-Side Hybrid Plan reduces the employer contribution rate only modestly in the near-term and then will begin to cost more in the long-term.



*Definition: The **total pension payment** is the projected dollar amount that employers must pay per year.*



PSERS Total Pension Payment (All Employers)

In either case, going with the status quo or with a side-by-side hybrid plan, the total pension payment made by all of PSERS' employers will increase for the next 20 years from $4 billion (2015) to about $9 billion (2035). For the next 25 years, districts will pay more than they pay today - in terms of dollars spent.

*Definition: The **employer cost to provide pension benefits** is calculated by actuaries and is the cost today to provide an earned pension benefit in the future and is also called the "employer normal cost". This value does not include the cost of paying down the unfunded liability (debt).*

Employer Cost to Provide Pension Benefits

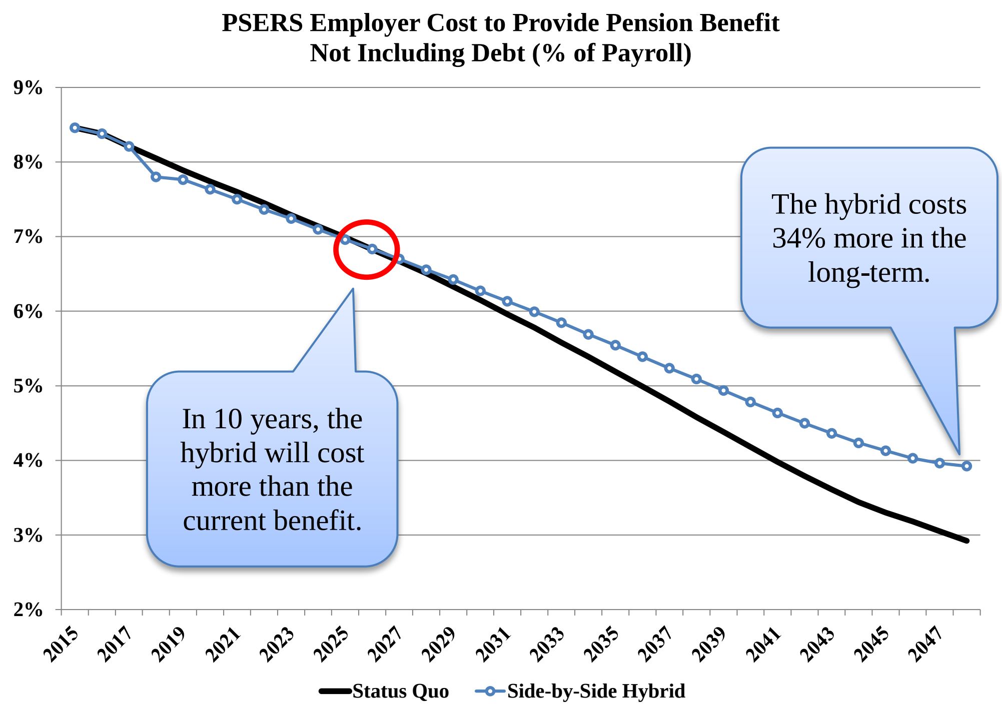
The cost for PSERS' employers, the school districts, to provide a pension benefit for its employees (i.e. the normal cost), is less than 3 percent (2.92 percent).

The proposed side-by-side hybrid plan cost to provide a benefit will be roughly 4 percent (3.92 percent), which is a cost increase of 34 percent.

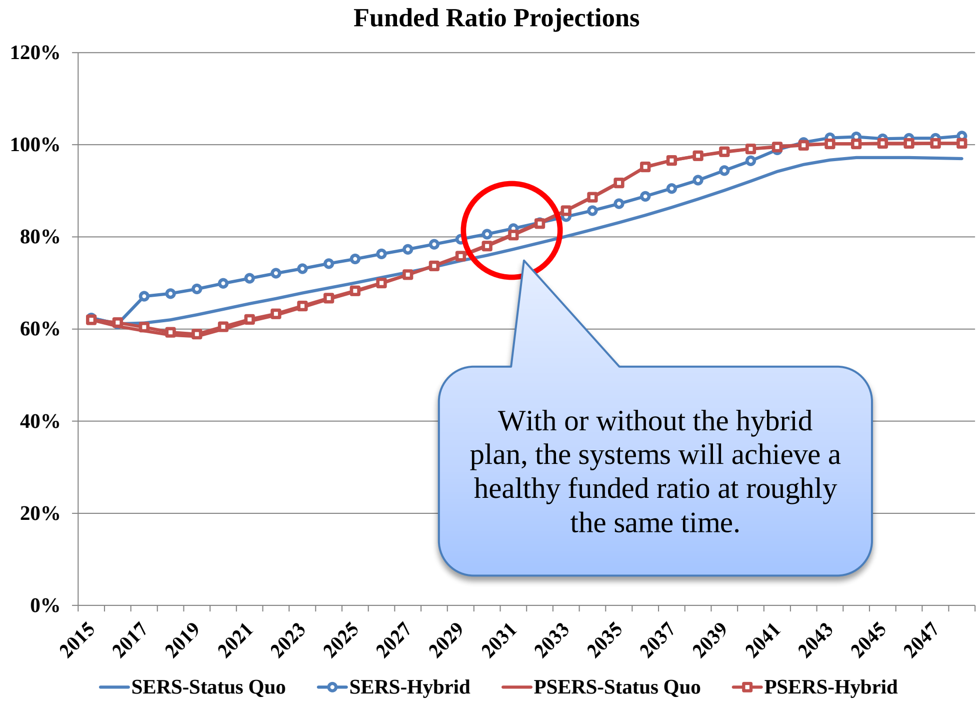
Comparing Status Quo to Hybrid

As a percent of payroll

Plan	DB	DC	Total
Status Quo	2.92	0.00	2.92
Hybrid	1.48	2.44	3.92
Variance	-1.44	2.44	1.00
Variance %	-49%	100%	34%



Definition: Expressed as a percentage of a system's liabilities, the ***funded ratio*** *is calculated by dividing assets by its liabilities. A ratio above 80 percent is considered "healthy" for state government pension plans which operate in perpetuity. Compared to private companies (which can be dissolved at any time) that have pension plans, ERISA requires any shortfall be paid off in 7 years.*



Funded Ratio

Most pension experts agree that for public pension funds that operate in perpetuity, that 80 percent funded status is a sustainable target for systems to achieve, but always recognizing that 100 percent funding is ideal.

As is shown in the chart to the left, both systems will achieve an 80 percent funded ratio at approximately the same time with no reform as it would with the hybrid plan – in about 15 years.

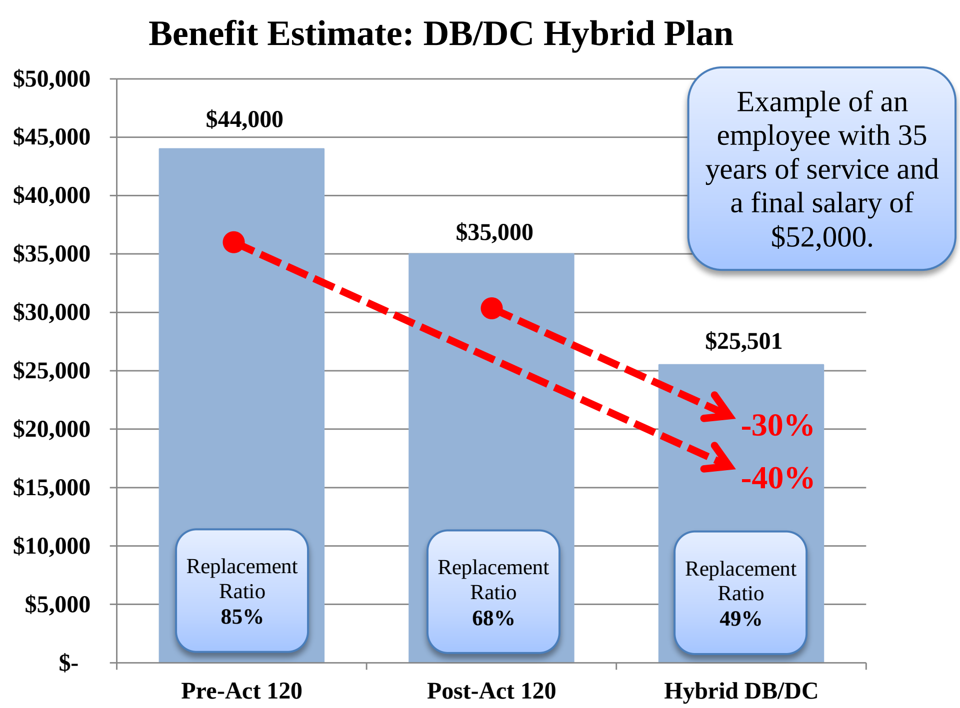
Definition: The ***estimated benefit*** *provides a calculated estimate of what a typical employee benefit will be under the hybrid plan relative to a comparable benefit being currently earned. The* ***replacement rate*** *is a term that is used to provide a number to help individuals plan for retirement and is expressed as a percentage that is calculated by dividing the estimated pension benefit by their pre-retirement income. A target replacement rate is roughly between 75-80%.*

Estimated Benefit

The estimated benefits under the hybrid DB/DC plan will be roughly 30 percent less than what Act 120 employees receive and approximately 40 percent less than pre-Act 120 employees.

In terms of replacement rate, assuming the employee works 35 years, the hybrid plan will provide a replacement income of roughly 50 percent of their final salary – not including social security.

Changes may create significant benefit disparities between similarly situated employees, likely to place upward pressure on future employee salaries.



Background

Over the last two sessions, there have been numerous pension reform proposals considered by the General Assembly. Some proposals have sought to convert the commonwealth's current defined benefit (DB) plan completely to a 401k-style defined contribution (DC) plan, other proposals have sought to make cost savings changes within the current plan, and several proposals sought to combine elements of a defined benefit plan and a defined contribution plan.

"Hybrid" is a general term often used to refer to any retirement plan that combines some elements of a traditional defined benefit pension plan and a defined contribution plan with an individual retirement savings account to which the employee and employer contribute money.

The most recent plan design is known as a **side-by-side hybrid plan**. In this plan, employees and employers contribute to (1) a smaller defined benefit plan and (2) a defined contribution plan - under the assumption that both plans together will provide a suitable level of retirement benefits.

Side-by-Side Retirement Plans in Other States

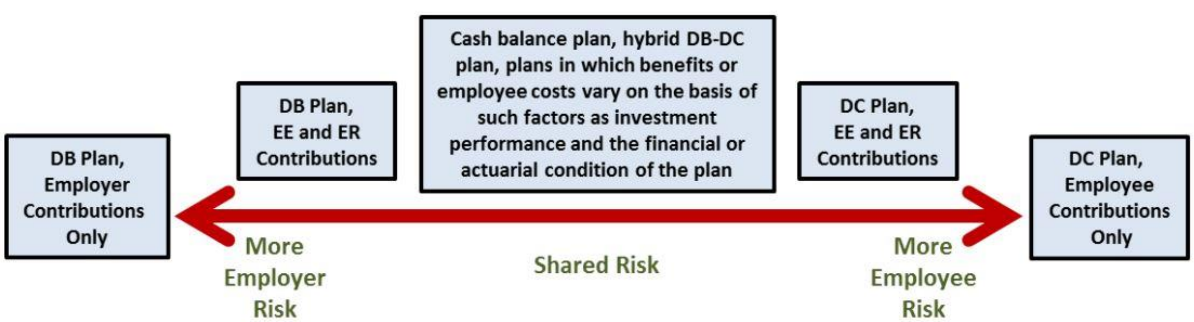
According to a recent report from the National Association of State Retirement Administrators (NASRA), there are 12 states with side-by-side hybrid retirement plans. The following table reflects how other states either include or exclude various components of a side-by-side hybrid plan:

Attribute	Inclusion/Exclusion
Mandatory Participation	Eight states require participation for new employees
Defined Benefit Multiplier (accrual rate)	Most states have a 1% multiplier; three states have a 1.5%, and the other states have a multiplier in between.
Defined Benefit Funding	Most employers fund all or a significant portion.
Employer Contributions to DC plan	Employers are split on funding - some will match (up to 4%) or not at all. Often there are other trade-offs if a higher or lower match is provided.
Employee Contributions to DC plan	These vary, ranging from 2% to 15% of salary; with trade-offs.
Investment Options in DC Plans	Most have between 7 and 19 options.
Default DC Plan Investment Option	Most include an age-appropriate target date fund.
Withdrawals from DC Plan	Most provide several options, including lump sum, partial lump sum, or annuity.

Plan Design and Risk

According to NASRA, in a retirement plan, risk manifests itself primarily in three forms: investment risk, longevity risk, and inflation risk. The degree to which risk is shared between employees and employers varies across differing plan designs.

Retirement Plan Risk Continuum



Hybrid Plan Details

Effective Dates	New Hires:	PSERS: 7/1/17 SERS: 1/1/18
	Current Members:	- Neutral Option 4: 7/1/16 – both systems - Shared Risk/Shared Gain: 7/1/16 – both systems - Anti-spiking: 1/1/17 SERS only - Opt-in Deadline: PSERS 6/30/17, SERS 12/31/17
<u>Hybrid</u> Defined Benefit (DB)	Multiplier:	1% accrual rate (currently 2% for Act 120 employees)
	Employee Contribution:	SERS: 3% PSERS: 4%
	Employer Contribution:	Actuarially determined.
	Final Average Salary (i.e. anti-spiking):	SERS: Any 5 highest consecutive calendar years for those with overtime or any 3 highest consecutive for those without overtime. PSERS: Any 5 highest calendar years.
	Vesting:	SERS: 10 years (no change) PSERS: 5 years (currently 10 years)
	Disability:	Current provisions are maintained (after adoption of A05322)
<u>Hybrid</u> Defined Contribution (DC)	Employer contribution:	2.5%
	Employee contribution:	SERS: 3.25% PSERS: 3.5%
	Vesting:	Employee + Employer contributions: 3 years Employee contributions only: immediately vested.
Exemptions	Elected Officials:	Members elected and sworn into office after the effective date will go into the hybrid. Current elected officers may opt-into the hybrid plan.
	Judges:	Sitting judges retained will remain in original class of service. Those who were never judges before will be in the new hybrid plan.
	Guns & Badges:	State Police, Corrections Officers and all other hazardous duty employees (except psychiatric security aides) are exempted. However, these classes of service are not exempt from anti-spiking, shared risk/gain, or actuarially neutral option 4.
Other Provisions	Board of Trustees:	- Prohibits systems' Board Trustees who represent current members or annuitants, or is a current member of the General Assembly, to serve as chairperson. - Increases the membership of both boards to include the Secretary of Banking and Securities. - Requires 8 hours of board education each year.
	Independent Board Counsel:	Authorizes the Board's legal counsel to serve independently from the Office of Chief Counsel, the General Assembly or the Attorney General.
	Funding Mandate:	Failure of the employer to make the annually required contribution will be deemed an impairment of contract.
	Retirement Age:	No changes.
	Footprint Rule:	No changes.
	Shared Risk/Gain:	Determined every three years. <u>Shared Risk</u>: If systems' actual rate of return is 1% less than assumed rate of return, employees contribute 0.5% more - maximum increase of 2%. <u>Shared Gain</u>: If systems' actual rate of return is 1% greater than assumed rate of return, employees' contribution is reduced 0.5% - minimum decrease of 2%.
	Lump Sum Withdrawals	Act 120 classes of service and future employees will have the choice of selecting an actuarially neutral lump sum withdrawal, a choice they currently do not possess.
	Commission Created	Public Pension Management and Asset Investment Review Commission consisting of five appointees to study the performance and make recommendations on how to improve within six months of its first meeting.