

Memo

From the House Appropriations Committee (D)



TO: House Democratic Members and Interested Parties

FROM: Rep. Joseph Markosek, Chairman

SUBJECT: SB 1071 (PN 1913) as amended by A#10803

DATE: October 25, 2016

We have worked very hard to get ahead of the Republican pension reform proposal that has been talked about. It's a bad idea, no matter its shape, and I am attaching a document that explains why and will help you talk about this important issue with stakeholders, constituents and reporters.

The first part of the document, a Memo from the Chair, explains the intricacies of the expected amendment to Senate Bill 1071. The second part of the document holds your talking points.

This document is fluid and we will continue to keep you updated as changes occur.

SB 1071 (PN 1913) as amended by A#10803

Overview of Proposal:

- **New Plan Design:** The complex plan design offers future (new) hires the option of three (3), newly established retirement plans. Two of the plan types are slightly different “side-by-side” defined benefit/defined contribution hybrid plans and the third plan type is a 401k-style defined contribution plan. The following table outlines the contributions made by the employer and employee as a percent of salary. It also reflects the benefit replacement relative to the current law for new hires.

	Current Law		Option A (default)		Option B		Option C	
	Act 120		Hybrid 1.25%		Hybrid 1%		DC Only	
	SERS	PSERS	SERS	PSERS	SERS	PSERS	SERS	PSERS
Employee -- Defined Benefit	6.25%	7.50%	5.00%	5.50%	4.00%	4.50%	-	-
Employee -- Defined Contribution	-	-	3.50%	3.00%	3.50%	3.00%	7.50%	7.50%
Employee -- Total Contribution	6.25%	7.50%	8.50%	8.50%	7.50%	7.50%	7.50%	7.50%
Employer -- Defined Benefit*	4.52%	2.97%	1.88%	0.68%	1.70%	0.62%	-	-
Employer -- Defined Contribution	-	-	2.00%	2.00%	2.00%	2.00%	3.50%	2.00%
Employer -- Total Contribution	4.52%	2.97%	3.88%	2.68%	3.70%	2.62%	3.50%	2.00%
Defined Benefit Accrual Rate	2.00%	2.00%	1.25%	1.25%	1.00%	1.00%	-	-
Benefit Replacement vs. Act 120	-	-	82%	76%	70%	65%	50%	37%

**Normal cost only*

- **Effective 2018:** January 1 for SERS; July 1 for PSERS.
- **Exemptions:** State Police, Corrections Officers and other hazardous duty personnel from participating in the new hybrid plan (approximately 30 percent of SERS active membership); however, the amount of voluntary overtime that may be included in the retirement benefit is limited to 10 percent of salary or wages earned.
 - Note that for State Police, they do not participate in Social Security and the DiLauro award still applies for PSP members accruing 20 or more years of service.
 - Future judges would be in the plan, however it would be expected that this aspect of the proposal could be challenged in court as an infringement of a unified judicial system.
- **Reduces Benefits:** The benefit for future employees is reduced by roughly 20 to 35 percent by the hybrid options and by 50 to 60 percent by the defined contribution option. This is in addition to a 20 percent reduction made by Act 120 (2010). Labor market experts indicate that implementing a private sector style retirement plan could have labor market implications and potentially put upward pressure on salary & wages.
- **Creates a 401(k):** Sharply reduces retirement benefits and adds a 401(k)-style component to the retirement plan. Satisfies the Republican majority's requirement that a portion of an employee's retirement benefit be funded in part with a defined contribution benefit.
- **Complicated.** Pension experts have indicated that this would be one of the more complicated plan designs in the country.

Key Takeaways:

- **Unfunded Liability:** The proposal will not pay down the unfunded liability any faster than the status quo (Act 120). Approximately 70 percent of today's unfunded liability resulted from policy decisions (Acts 9 & 40).
- **Long-Term Savings:** All savings are generated from cuts to benefits and are estimated to save \$1.9 billion over 30 years on a cash flow basis and these savings are largely generated twenty years from now, when the unfunded liability is fully paid. Over the next 10 years, the proposal will cost \$337 million more than under current law.
- **Short-Term Budget:** The proposal will not generate any savings in 2018, however will generate \$22 million in budgetary savings for employers through 2022. These savings are quickly eliminated by the immediate, up-front agency costs of roughly \$19 million (\$7 million PSERS and \$12 million for SERS) and second year costs of \$9 million (\$5 million PSERS and \$4 million SERS).
- **Retirement Benefits Reduced by roughly 20 to 60 percent, as compared to Act 120:**

Hybrid 1.25%		Hybrid 1%		DC Only	
PSERS	SERS	PSERS	SERS	PSERS	SERS
-24%	-18%	-35%	-30%	-63%	-50%

- **Employee Contributions are Significantly Increased**

Hybrid 1.25%		Hybrid 1%		DC Only	
PSERS	SERS	PSERS	SERS	PSERS	SERS
13%	36%	0%	20%	0%	20%

- **Constitutional Implications:** The proposal permits current, post-Act 120 members to receive an actuarially neutral Option 4 benefit as well as participate in the shared-gain risk provision. Because these benefits are an improvement upon the current benefit, contract impairment issues are unlikely to be a major issue.
- **School District Impacted:** It is expected that each school district will incur significant up-front costs to implement the changes, but have not yet been estimated.
- **Newly Created Commission:** Five party commission intended to perform and publish a study. A10803 provides this authority to majority and minority leaders.

Plan Details:

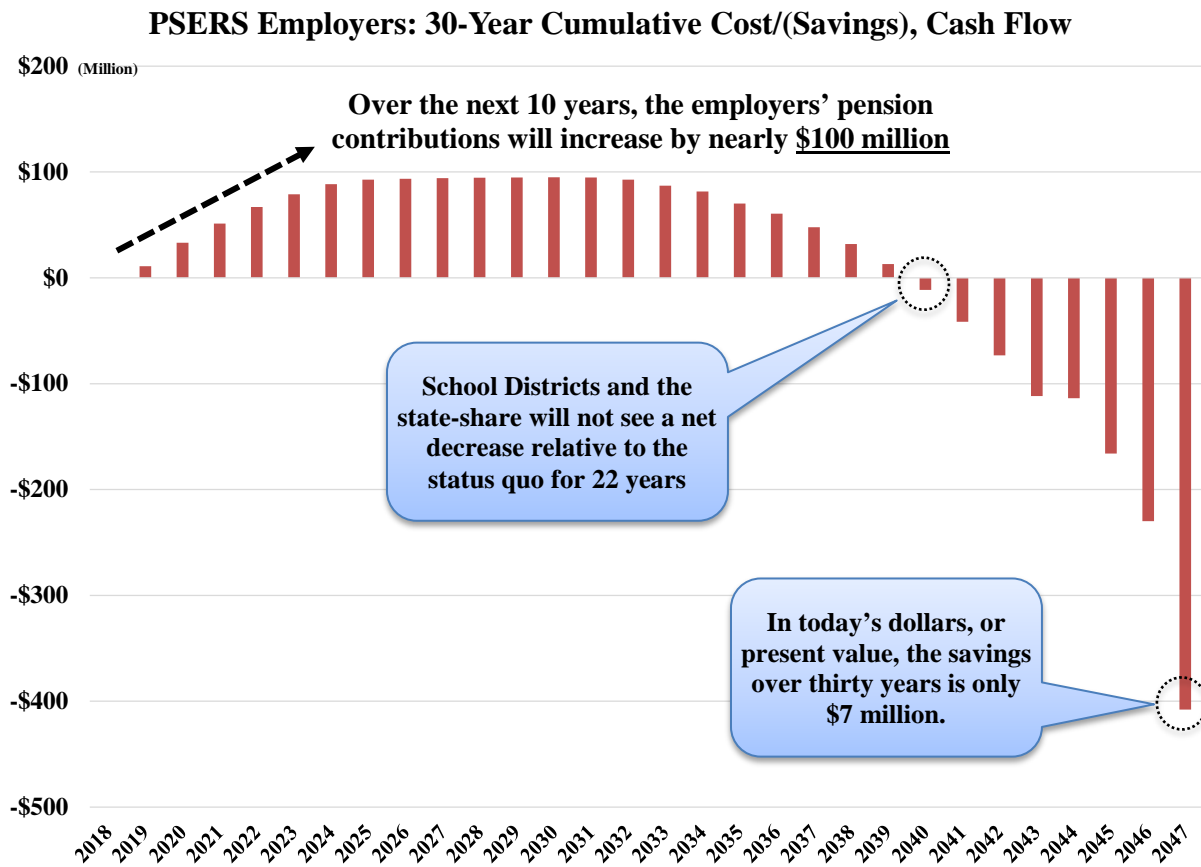
Retirement Age	Age 67 for both systems. "Rule of 92" eliminated.
Vesting	<u>Defined Benefit Component:</u> SERS will remain the same at 10 years and reduced to 5 years for PSERS members. <u>Defined Contribution Component:</u> 3 years for the employer contribution and immediately for employee contributions
Option 4	If participants in the hybrid plans withdraw contributions, the benefit offered will be actuarially neutral. Provides this option to current post-Act 120 members.
Final Average Salary	Calculated using five years of salary including overtime, increased from the current three years final average salary calculation. Volunteer PSP overtime compensation for new hires is capped at 10% of salary when calculating the member's annuity.
Disability & Death Benefits	Eligibility and benefits would generally be consistent with Act 120 provisions applicable to members of the same class and category.
PSERS' Healthcare Premium Assistance	No change.
Shared-Risk / Shared-Gain	In the event of under investment performance, employee contributions are increased by a maximum of 2%; conversely, in the event of over investment performance, provides that employee contributions are decreased by no more than 2%.
Footprint Rule	If there is a break in service, current members would retain their pre-reform benefit.
Independent Legal Counsel	Permits the legal counsel to the systems' boards shall serve independently from the Governor's Office of General Counsel, the Attorney General and the General Assembly.
Boards	Both systems' boards will expand to include the Secretary of Banking and Securities, replacing one of the Governor's current appointees.
Newly created commission	The Public Pension Management and Asset Investment Review Commission that will be composed of five members appointed by: the Senate President, House Speaker, Senate Minority Leader, House Minority Leader, and Governor.
Investment Restrictions	The provisions in the bill constrain the systems' independent boards from optimizing benefits offered to its members. This provision could add layers of duplicative or unnecessary fees.
Higher Education	May continue to offer TIAA-CREF as an option to its employees.

School Districts Will Pay More

Below is a chart reflecting the cumulative cost or (savings) relative to the status quo that is projected to be generated for PSERS employers (school districts and state-share) over 30 years by the proposal, on a cash flow basis.

The following observations can be made, relative to the status quo:

- PSERS employers will see an increase in their annual employer contribution over the next 22 years.
- Within the first 10 years of the projection period, employers will have a net cumulative cost of approximately \$95 million. Of this amount, \$53 million is state-share and \$42 million from school districts.
- Using today's dollars, or present value, the total cumulative savings for PSERS will be \$7 million.

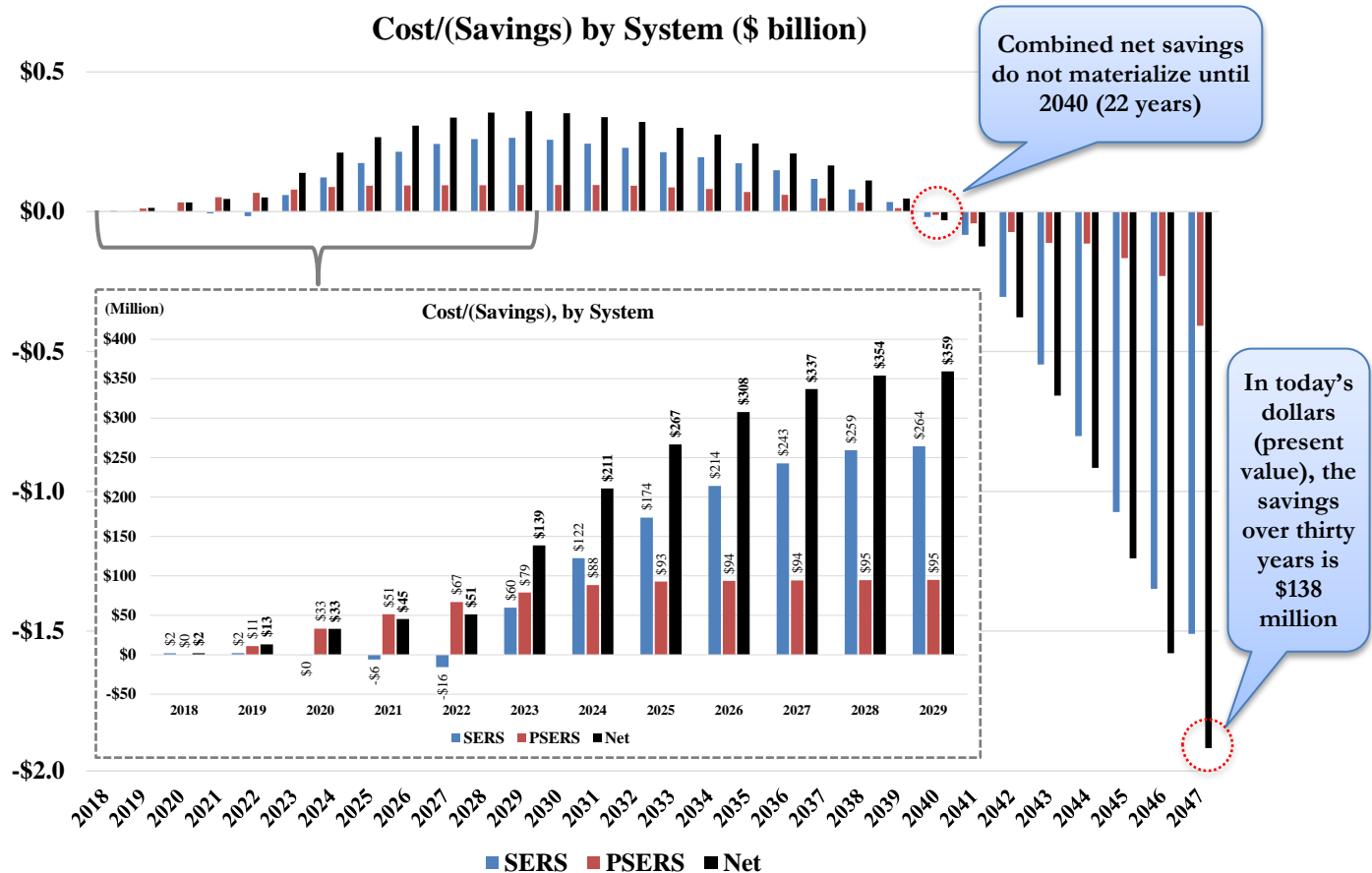


Time Period Analysis

Below is a chart reflecting the cumulative cost or (savings) relative to the status quo that is projected to be generated over the course of 30 years by the proposal, on a cash flow basis.

The following observations can be made, relative to the status quo:

- Cumulative net savings from the proposal do not materialize until 2040, or 22 years after implementation.
- Years 0-10 (2018-2027) of the projection period reflects a net cumulative cost of \$337 million (see inset chart for details). This reflects \$243 million of SERS costs and \$94 million of PSERS costs.
- Years 11-20 (2028-2037) of the projection period we see the costs peak at \$359 million then a gradual decline in the annual employer contribution occurs. By 2037, the proposal's cumulative costs are estimated to be \$165 million more than the status quo. This includes \$117 million of SERS costs and \$48 million of PSERS costs.
- Years 21-30 (2038-2047) of the projection period costs begin to decline once the unfunded liabilities are fully amortized and as the majority of pre-reform members retire and are replaced, reducing employer costs.
- Over the thirty year period, of the \$1.9 billion in net cash flow savings, \$1.5 billion (79 percent) is borne by the SERS system and \$0.4 billion (21 percent) by the PSERS system.
- The unfunded liability is approximately \$65 billion, this plan offers a miniscule 3 percent reduction to the debt.
- In today's dollars, or present value, the savings is dramatically put into perspective, with a total savings of \$138 million over thirty years (\$130 million for SERS and only \$7 million for PSERS), an annual savings of \$5 million.

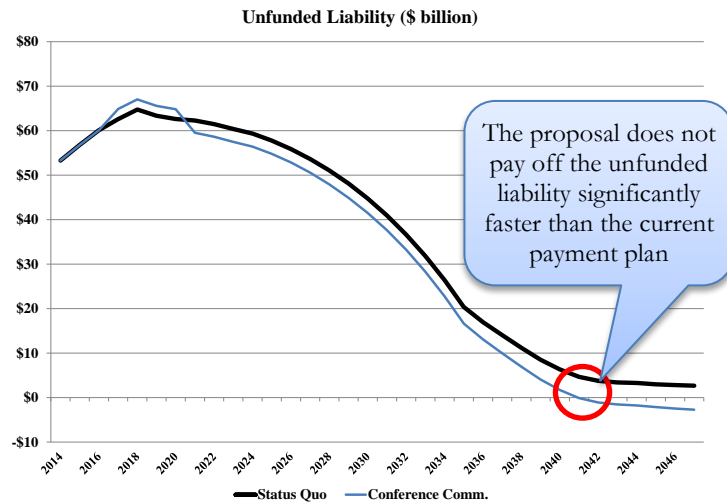


Useful Performance Metrics to Assess the Impact of the Proposal vs. Status Quo

Performance Metric

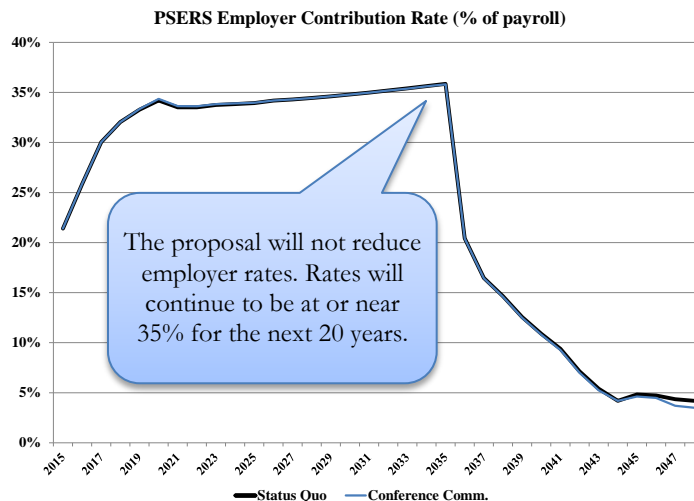
Chart

The **Unfunded Liability** is the difference between assets and liabilities. Currently, 70 percent of the employer payment is used to pay down the pension debt.



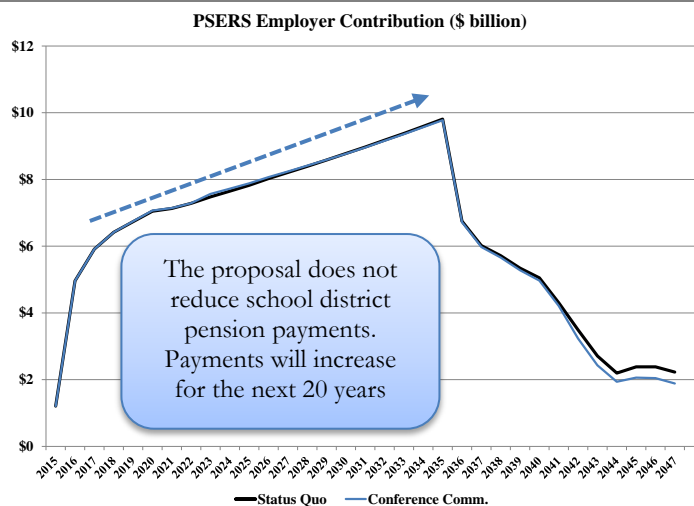
The **employer contribution rate** is calculated by actuaries and includes the cost of the benefit plus the cost of the unfunded liability.

School districts' employer contribution rates are expected to level-out at roughly 34 percent of payroll beginning in 2018 and remain at this level for approximately 20 years until the debt (principal and interest) is largely amortized.



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

In either case, going with the status quo or with a stacked hybrid plan, the total pension payment made by all of PSERS' employers will increase for the next 20 years from \$5 billion (2016) to about \$9.7 billion (2035). For the next 22 years, districts will pay more than they pay today - in terms of dollars spent.



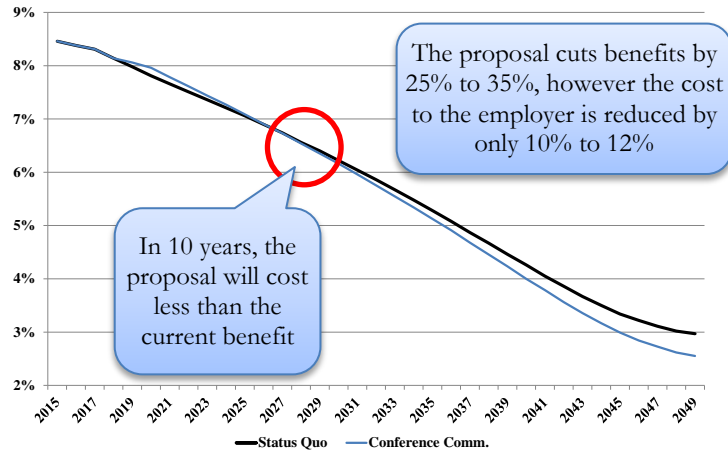
Performance Metric

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. Also called the “employer normal cost”.

Currently the cost for PSERS’ employers and the school districts to provide a pension benefit for its employees (i.e. the normal cost), is less than 3 percent (2.97 percent). The proposed stacked hybrid plan cost to provide a benefit will be 2.68 percent, which is a cost reduction of 10 percent.

Chart

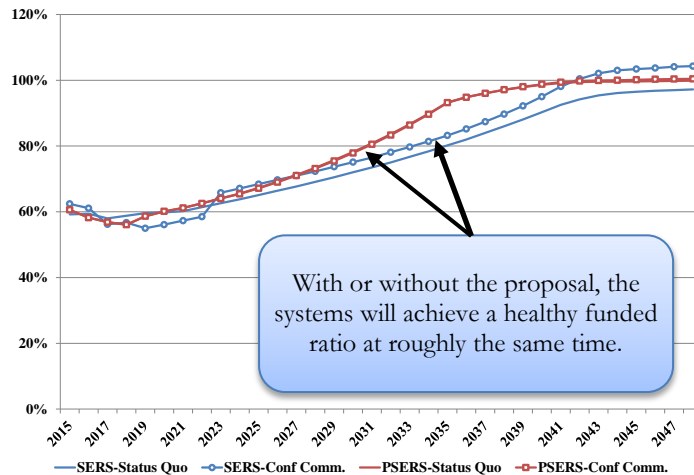
PSERS Employer Cost to Provide Pension Benefit
Not Including Debt (% of Payroll)



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.

As is shown in the chart to the right, both systems will achieve an 80 percent funded ratio at the same time with or without the proposal.

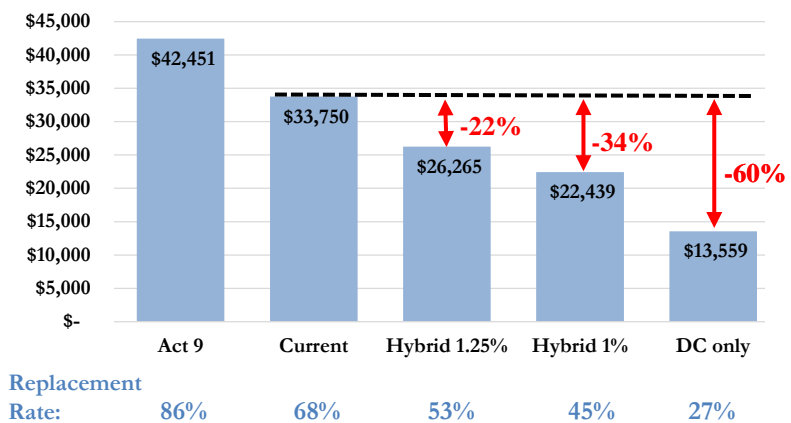
Funded Ratio Projections



The **estimated benefit** provides a calculated estimate of what a typical employee benefit will be under the proposal 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 percent. The replacement rates shown do not include Social Security.

Benefit Estimate



Example: PSERS member with 35 years of service and a final average salary of \$50,000.

House Appropriations Committee (D)

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