PUBLIC EMPLOYEE RETIREMENT COMMISSION

Date Prepared:	February 10, 2016
Agency Contact:	James L. McAneny
Telephone:	717-783-6100

ADVISORY NOTE

House Bill Number 1499, Printer's Number 2713

Prime Sponsor: Representative Mike Tobash

Committee: House Appropriations Committee

Retirement Systems Affected: Public School Employees' Retirement System and State Employees' Retirement System

Subject: Hybrid Retirement Benefit Plan

SYNOPSIS

House Bill Number 1499, Printer's Number 2713, would amend both the Public School Employees' Retirement Code and the State Employees' Retirement Code to implement a hybrid retirement benefit plan applicable to most new school and State employees. More specifically, the bill would amend the Codes in the following manner.

The Public School Employees' Retirement Code would be amended to:

1) Effective July 1, 2016, establish a hybrid benefit tier, which includes defined benefit and defined contribution components, applicable to all new school employees. Current members of PSERS would be ineligible to participate in the new hybrid tier. Members returning after a break in service may make a one-time election to become a member of the new benefit tier.

2) Under the defined benefit component, school employees would become members of "Class T-G" and would earn benefits at a 2% benefit accrual rate. A member would be vested in the defined benefit component after accumulating 10 years of service credit. The benefit formula would be equivalent to 2% multiplied by the member's years of service (maximum of 25 years), multiplied by the member's final average salary (highest five years), with an annual pay limit of $50,000 indexed at 1% per year. Class T-G

SYNOPSIS (CONT'D)

members would contribute 6% of compensation for the first $50,000 for the first 25 years of service.

3) Establish a defined contribution plan under a new chapter of the Code, called the School Employees' Defined Contribution Plan, for school employees to contribute 1% of compensation of the first $50,000 for the first 25 years of service, and 7% of compensation on pay above $50,000 or any service over 25 years. The employer contribution would be 0.5% of the member's first $50,000 of compensation for the first 25 years of service, and 4% of compensation on pay above $50,000 or any service over 25 years.

The State Employees' Retirement Code would be amended to:

1) Effective January 1, 2016, establish a hybrid benefit tier, which includes defined benefit and defined contribution components, applicable to most new State employees. Future State police officers would be exempt from membership in the new hybrid benefit tier and would instead continue to be eligible for membership in Class A-3 in SERS. Current members of SERS would be ineligible to participate in the new hybrid tier. Members returning after a break in service may make a one-time election to become a member of the new benefit tier.

2) For the defined benefit portion, most State employees would become members of "Class A-5" and would earn benefits at a 2% benefit accrual rate. A member would be vested in the defined benefit component after accumulating 10 years of service credit. The benefit formula would be equivalent to 2% multiplied by the member's years of service (maximum of 25 years), multiplied by the member's final average salary (highest five years), with an annual pay limit of $50,000 indexed at 1% per year. Class A-5 members would contribute 6% of compensation for the first $50,000 for the first 25 years of service.

3) Establish a defined contribution plan under a new chapter of the Code, known as the State Employees' Defined Contribution Plan, for most State employees to contribute 1% of compensation of the first $50,000 for the first 25 years of service, and 7% of compensation on pay above $50,000 or any service over 25 years. The employer contribution would be 0.5% of the member's first $50,000 of compensation for the first 25 years of service, and 4% of compensation on pay above $50,000 or any service over 25 years.

DISCUSSION

The Retirement Codes and Systems

Currently, most full-time public school and state employees are members of either the Public School Employees' Retirement System (PSERS) or the State Employees' Retirement System (SERS). Both PSERS and SERS are governmental, cost-sharing, multiple-employer defined benefit pension plans. The designated purpose of the Public School Employees' Retirement System and the State Employees' Retirement System is to provide retirement allowances and other benefits, including disability and death benefits to public school and state employees. As of June 30, 2014, there were approximately 789 participating employers, generally school districts, area vocational-technical schools, and intermediate units in PSERS, and as of December 31, 2014, approximately 104 Commonwealth and other employers participating in SERS.

Membership in PSERS and SERS is mandatory for most school and state employees. Certain other employees are not required but are given the option to participate. As of June 30, 2014, there were 263,312 active members and 213,900 annuitant members of PSERS, and as of December 31, 2014, there were 104,431 active members and 122,249 annuitant members of SERS.

For most members of both Systems, the basic benefit formula used to determine the normal retirement benefit is equivalent to the product of 2.5% multiplied by the member's years of accumulated service credit ("eligibility points") multiplied by the member's final average (highest three years) salary. Since the passage of Act 9 of 2001 (which increased the accrual rate for most members from 2.0% to 2.5%), most members of PSERS are Class T-D members and contribute 7.5% of compensation to PSERS, while most members of SERS are Class AA members and contribute 6.25% of compensation to SERS. Within both Systems, there are a number of additional membership classes with corresponding benefit accrual and employee contribution rates that differ from the majority of school and state employees.

Act 120 of 2010 implemented major pension benefit reforms, including the establishment of new benefit tiers applicable to most new members. Effective January 1, 2011, most new members (including members of the General Assembly), are required to become members of one of two membership classes, known as "Class A-3" and "Class A-4." Most new members of SERS, other than State Police officers or members employed in a position for which a class of service other than Class A or Class AA is credited or could be elected, become members of Class A-3 beginning January 1, 2011 (or if a member of the General Assembly, beginning December 1, 2010). Class A-3 members are eligible for an annuity based upon an annual benefit accrual rate of 2% and have a corresponding employee contribution requirement of 6.25% of compensation. As an alternative to Class A-3, an employee who becomes a member of SERS on or after January 1, 2011, may elect Class A-4 membership within 45 days of becoming a member of SERS. A Class A-4 member is eli-

DISCUSSION (CONT'D)

gible for an annuity based upon an annual benefit accrual rate of 2.5% with a corresponding employee contribution requirement equal to 9.3% of compensation.

Effective July 1, 2011, new members of PSERS are required to become members of one of two membership classes, known as "Class T-E" and "Class T-F." Most new members of PSERS are required to become members of Class T-E beginning July 1, 2011. Class T-E members are eligible for an annuity based upon an annual benefit accrual rate of 2% and have a corresponding employee contribution of 7.5% of compensation. As an alternative to Class T-E, an employee who becomes a member of PSERS on or after July 1, 2011, may elect Class T-F membership within 45 days of becoming a member of PSERS. A Class T-F member is eligible for an annuity based upon an annual benefit accrual rate of 2.5% with a corresponding employee contribution requirement equal to 10.3% of compensation.

Under the Codes of both Systems, superannuation or normal retirement age is that date on which a member may terminate service with the public employer and receive a full retirement benefit without reduction. Under the Public School Employees' Retirement Code, superannuation or normal retirement age for most members is age 62 with at least one full year of service, age 60 with 30 or more years of service, or any age with 35 years of service. Under the State Employees' Retirement Code, superannuation or normal retirement age for most members is age 60 with three years of service or any age with 35 years of service, while age 50 is the normal retirement age for members of the General Assembly and certain public safety employees. For most members of the Systems who first became members after the effective dates of Act 120, the superannuation requirement is age 65 with a minimum of three years of service credit, or any combination of age and service that totals 92 with at least 35 years of credited service, and age 55 for members of the General Assembly and certain public safety employees.

Defined Benefit and Defined Contribution Retirement Systems

In a "defined benefit" plan, such as PSERS and SERS, the pension benefit to be provided at retirement is defined, while the contributions to be made over the period of employment are variable based on the experience of the pension fund. Upon retirement, a defined benefit plan participant is entitled to receive a definitely determinable benefit that is calculated using a formulation that considers factors such as age, duration of service with the employer and compensation. Because the benefit is defined and calculated using a formula and is not dependent on an individual's account balance, members of defined benefit plans are largely insulated from both negative and positive fluctuations of the investment markets.

DISCUSSION (CONT'D)

By contrast, in a "defined contribution" pension plan, the contributions to be made over the period of employment are defined, while the pension benefit to be provided at retirement is variable based on the experience of the pension fund. Upon retirement or separation from the employer, a defined contribution plan participant is generally entitled only to the balance standing to the credit of the individual's retirement account. Market performance directly impacts the value of an individual's retirement account.

The distinction between the defined benefit and defined contribution approaches is most significant in the placement of the risk associated with investment earnings over the period of employment. The fixed benefit in a defined benefit pension plan means that the investment experience impacts the contribution requirements, increasing them when investment earnings are lower than anticipated and decreasing them when earnings are greater than anticipated. The fixed contributions in a defined contribution pension plan mean that the investment experience impacts on the benefit amount, increasing it when earnings are higher and reducing it when earnings are lower. Therefore, the employer bears the investment risk in a defined benefit plan, and the employee bears the investment risk in a defined contribution pension plan.

For most employees, defined contribution plans are generally regarded as more valuable for those in the early stages of their careers or for those who are employed in careers that entail greater mobility. Defined contribution accounts are portable and can readily move with the employee as that employee moves from one employer to the next. In contrast, defined benefit plans are relatively more valuable for those employees who tend to remain with one employer and to long-service employees in the later stages of their careers, because the value and cost of the defined benefits earned each year increase as employees approach retirement age.

Hybrid Benefit Tiers for School and State Employees

The bill would establish two new "stacked" hybrid benefit tiers applicable to all new public employees who are hired by school or State employers within the Commonwealth after July 1, 2016, in the case of PSERS, and January 1, 2016, in the case of SERS. The hybrid benefit tiers would include both a defined benefit and defined contribution component. The bill would not affect the retirement benefits of current active members of the Systems. Instead, the bill seeks to create reduced benefit tiers within PSERS and SERS applicable only to new employees on or after the effective dates for each System. Current members of PSERS or SERS cannot elect to become members in the new hybrid plan. However, inactive members returning to service after 2016 may make a one-time election to become a member in the new benefit tiers.

DISCUSSION (CONT'D)

The following table illustrates the major benefit provisions of the new hybrid benefit tiers.

Table 1

Hybrid Benefit Tiers
Members of Class T-G in PSERS and Class A-5 in SERS

	Defined Benefit Component	Defined Contribution Component
Benefit Accrual	2% X Years of Service on first $50,000 of compensation (Max. first 25 years of service) X Final Average Salary (High 5 Years)	Balance of participant's account in form of annuity
Employee Contribution	• 6% contribution on first $50,000 of compensation for first 25 years of service [1] • 0% contribution above $50,000 or over 25 years of service	• 1% contribution on first $50,000 of compensation for first 25 years of service • 7% contribution above $50,000 or over 25 years of service
Employer Contribution	• Actuarially determined rate for compensation below $50,000 • 0% for compensation above $50,000	• 0.50% contribution on first $50,000 of compensation for first 25 years of service • 4% contribution above $50,000 or over 25 years
Vesting	10 years	Immediately for participant, 3 years for employer contributions
Superannuation Age	Age 65 (with 3 years of service for PSERS)	Not applicable
Death Benefit	If more than 10 but less than 25 years of service, eligible for annuity based on service	Payment of participant's account balance
Disability Benefit	If at least 5 years of service, eligible for annuity based on service and compensation	Payment of participant's account balance

[1] Subject to the shared-risk provisions of Act 120

Any employee who first becomes a member of PSERS on or after July 1, 2016, would become a mandatory member of the hybrid benefit tier and a member of a new membership class, known as "Class T-G." A Class T-G member would be entitled to a defined benefit equal to a 2% annual benefit accrual rate multiplied by the member's years of service (maximum of 25 years) multiplied by the member's final average salary (highest five years), with an annual pay limit of $50,000 indexed at 1% per year. Class T-G members would be required to make employee contributions equal to 6% of compensation for the first $50,000 for the first 25 years of service. Employer contributions on behalf of the member for the defined benefit plan would be an actuarially determined rate.

Likewise, any employee who first becomes a member of SERS on or after January 1, 2016, would become a mandatory member of the hybrid benefit tier and a member of a new membership class, known as "Class A-5." A Class A-5 member would be entitled to a defined benefit equal to a 2%

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annual benefit accrual rate multiplied by the member's years of service (maximum of 25 years) multiplied by the member's final average salary (highest five years), with an annual pay limit of $50,000 indexed at 1% per year. Class A-5 members would be required to make employee contributions equal to 6% of compensation for the first $50,000 for the first 25 years of service. In the case of employees in Act 111 collective bargaining units, the effective date is delayed until current agreements expire. Employer contributions on behalf of the member for the defined benefit plan would be an actuarially determined rate.

After becoming a participant in one of the Plans, an employee would be prohibited from purchasing any previous school or creditable nonschool service, in the case of PSERS, or any previous State or creditable nonstate service, in the case of SERS, except to reinstate previously credited Class T-G or A-5 service credit or for non-intervening military service.

In addition to the defined benefit portion of the hybrid tiers, the bill would amend the PSERS Code by adding Chapter 84, effectively integrating into the Code a defined contribution benefit component, known as the "School Employees' Defined Contribution Plan." Similarly, under the SERS Code, a new chapter, Chapter 58, would be added to incorporate a defined contribution benefit component, known as the "State Employees' Defined Contribution Plan." Participation in the respective defined contribution plans would be mandatory for all Class T-G and Class A-5 members. After the first 25 years of service, benefits would cease to accrue in the defined benefit plan and the defined contribution component would exist in lieu of a defined benefit, but with significantly larger contributions.

Vesting

Whereas the defined benefit component of the hybrid plan does not entitle new members to vesting of retirement benefits until 10 years of service, the defined contribution plan provides 100% vesting from the first day of membership. For both Class T-G and Class A-5, superannuation age is age 65, with 3 years of service required for PSERS. Vested members may not withdraw contributions and interest in lieu of receiving a benefit. Vested members are eligible to receive an early retirement benefit after completing 25 years of service. To receive an unreduced retirement benefit, however, members must attain age 65.

DISCUSSION (CONT'D)

Defined Contribution Plans

The hybrid benefit tiers also contain a defined contribution component. For the purposes of the Commission's discussion, the major issues of the new defined contribution portion of the hybrid benefit tier have been divided into the following four categories: 1) establishment, organization and operation; 2) coverage, benefits and contributions; 3) investments; and 4) ancillary issues.

Establishment, Organization and Operation

The bill mandates that the School Employees' Retirement Board and the State Employees' Retirement Board administer or ensure the administration of the respective Plans, and sets forth the Boards' powers and duties. Most of the details governing the actual operation of the new Plans are delegated to the Boards which will be responsible for establishing the rules and regulations governing the Plans. These rules and regulations will presumably address the many specific details involved in the operation of a public pension plan. It also appears that most of the new Plans' investment and administrative functions may be handled by third-party administrators contracted by the Boards to provide the necessary services.

Coverage, Benefits and Contributions

School and State employees who participate in the new defined contribution plans would contribute 1% of the first $50,000 of compensation for the first 25 years of service, and 7% on pay above $50,000 and for service over 25 years. Employers will contribute 0.5% of the member's first $50,000 of compensation for the first 25 years of service, and 4% of compensation above $50,000 and for service over 25 years. Future Pennsylvania State Police Officers would be exempt from joining the new defined contribution plan, with new employees of this group continuing to be eligible for membership in Class A-3 of SERS after 2016.

Participants in the Plans may make additional contributions to the Plans up to the limits imposed by federal law. Contributions on behalf of the participant and the employer would be credited to an "individual investment account" for each participant of the new Plans, along with all interest and investment gains or losses. For investment purposes, the Boards may pool the assets of the participants in the Plans.

Participants in the Plans would become fully vested in the employer-matching contributions after three years of employment. The participant's contributions would vest immediately.

DISCUSSION (CONT'D)

Investments

While the bill does not specifically mention the type of investments that will be offered to the participants, governmental defined contribution plans typically offer a variety of investment options, including lifestyle funds that are based upon age and projected retirement date. The Plans will most likely also make available investment options that represent a broad cross-section of asset classes and risk profiles. The bill states that the PSERS and SERS Boards will not be held responsible for any investment losses incurred by participants in the Plans or for the failure of any investment to earn a specific or expected return. The Boards will bear the expenses arising from the establishment of the Plans, but all other expenses, fees and costs of the administration of the Plans will be assessed against the accounts created on behalf of participants.

Ancillary Issues

Death and Disability Benefits. Beyond payment of the participant's account balance to the designated beneficiary upon the death of an active participant, there are no special death benefit provisions to provide for the surviving spouse or children of a Plan participant.

Holding Vehicle Trust. The bill creates a temporary "holding vehicle" for each of the Systems in the event that the defined contribution plans are not ready to accept contributions by the effective dates. All employee and employer contributions would be held in a qualified holding vehicle trust until the Boards certify that the defined contribution plans are operational and able to accept the employee and employer contributions. Contributions in the holding vehicle would earn annual interest at a rate of 4%, increased or decreased by any investment earnings or losses.

Pension Forfeiture Act. Under Act 140 of 1978, known as the Public Employee Pension Forfeiture Act (43 P.S. § § 1311-1315), a public official or public employee who is convicted or pleads guilty or no defense to a crime related to public office or public employment is disqualified to receive a retirement or other benefit or payment of any kind except a return without interest of the contributions paid into a retirement system. Under the bill, the accumulated contributions of a participant shall not be forfeited, but will be made available for payment of any fines or restitution.

Limitations on Compensation and Final Average Salary

The bill proposes two new changes to the limits on compensation that may be used for purposes of calculating the retirement benefits of prospective members of PSERS and SERS. The two changes are: 1) increasing the period over which the member's final average salary may be calculated from three years to five years; and 2) imposing an "annual compensation limit" to limit the amount of

DISCUSSION (CONT'D)

compensation eligible to be calculated under the defined benefit plan for retirement benefits to \$50,000. The limit will be indexed at 1% per year. The overall impact will be to reduce from current benefit levels the potential future retirement benefits of the affected members.

The Systems currently employ a member's "final average salary" as one of the components of the statutory formula that is used to compute a member's retirement benefit entitlement. Currently, a member's final average salary is calculated as the average of the highest three years of compensation. The bill would amend the Codes to change the final average salary calculation from the average of the highest three to the average of the highest five years of compensation for all prospective employees affected by the bill.

The bill would also apply a new limit on the level of compensation that may be used for final average salary determination purposes. Under this provision, the compensation calculated for the defined benefit component cannot exceed \$50,000. All pay above the \$50,000 limit (indexed at 1% per year) would not be included in the calculations for employee and employer contributions to the defined benefit plan, but would count toward the employee and employer contributions for the defined contribution plan.

Shared-Risk Provision

One of the major changes to Act 120 was the implementation of a variable employee contribution rate, known as the "shared risk contribution rate" which was applicable to new members (Classes A-3, A-4, T-E, and T-F) of both Systems. The shared risk contribution rate is tied to the investment performance of each System's pension fund and would be added to the basic contribution rate of each membership class under certain conditions. Every three years, each System will compare the actual investment rate of return, net of fees, to the actuarial assumed rate of return for the previous 10-year period. If the actual rate of return is less than the assumed rate by 1% or more, the total member contribution rate will increase by ½% per year, up to a maximum total increase of 2.0%. If the actual rate is equal to or more than the assumed rate, the total member contribution rate will decrease by ½%. New hires contribute at the rate in effect when they are hired. The additional shared risk contributions are used to reduce the unfunded accrued liabilities of the Systems. If the System is fully funded at the time of the comparison, then the shared- risk rate will be zero for that period. For any year in which the employer contribution rate is lower than the final contribution rate, the employee contribution rate would be the basic contribution rate. There would be no increase in the employee contribution rate where there has not been an equivalent increase to the employer contribution rate over the previous three-year period. Until there is a full 10-year "look back" period, the look back period will begin as of the effective date of the act. The bill would

DISCUSSION (CONT'D)

make members of Class T-G and Class A-5 subject to the shared-risk provision as well, with a maximum employee contribution of 8% of compensation.

Premium Assistance

Section 8509 of the PSERS Code governs administration of the Health Insurance Premium Assistance Program. Through the program, health insurance premium assistance payments are provided to a retired member who is receiving postretirement healthcare benefits through either the PSERS-sponsored Health Options Program (HOP) or through a healthcare provider approved by the retired member's former school employer. To be eligible for premium assistance, a member must have: 1) accumulated at least 24½ years of credited service; 2) be a disability annuitant; or 3) have at least 15 years of service and have both terminated school service and retired after attaining superannuation age (age 65 for members of Class T-E and T-F).

Under current program provisions, participating eligible annuitants receive health insurance premium assistance payments from the Health Insurance Account equal to the lesser of $100 a month or the amount of the actual monthly premium. As of June 30, 2012, there were approximately 87,977 retirees receiving premium assistance benefits from the program. An additional 45,321 retirees were eligible to participate but were either enrolled in non-approved plans or did not purchase healthcare coverage, and so were not eligible to receive premium assistance payments.

Assets to pay premium assistance benefits from the Health Insurance Premium Assistance Program are held in the Health Insurance Account, which is a separate fund within the pension plan trust. The Health Insurance Account is credited with the contributions of the Commonwealth and school employers and is funded on a pay-as-you-go basis, with the required contributions calculated by the consulting actuary as part of the valuation process based upon expected annual disbursements and funded for one year in advance of the actual disbursements. A review of the most recent actuarial valuation report for the Public School Employees' Retirement System (June 30, 2013) reveals contributions to the program equal to 0.90% of total payroll.

The bill would amend the definition of "eligible annuitants" in Section 8102 of the PSERS Code to exclude Class T-G members from participating in the Health Insurance Premium Assistance Program.

Discussion (Cont'd)

Membership Exemption for Pennsylvania State Police Officers

Special retirement coverage for various public safety employees often is provided in public employee retirement systems. The enhanced benefits are premised on the hazardous nature of public safety employment and the physical and psychological demands of public safety work. Under the State Employees' Retirement Code, the special retirement benefit for most Commonwealth public safety employees, including correction and enforcement officers, is the eligibility to retire at age 50 with full retirement benefits. For public safety employees who first became members of SERS after the effective date of Act 120, retirement age is age 55. Because the death benefit for any Commonwealth employee is dependent on the retirement age, the special public safety employees' retirement coverage also increases the death benefit.

The benefits of State Police officers are affected by the DiLauro arbitration award. The award provided that officers with 20 years of service are eligible to receive a retirement benefit of 50% of the officer's highest full year's salary, and those with 25 years of service shall receive 75% of the highest full year's salary. Years of service between 20 and 25 or after 25 do not produce incremental benefit increases. The award applies to officers who retire on or after July 1, 1989. (Class A members with less than 20 years of service are not affected by the award and are eligible for the statutory Class A benefit at a 2.0% benefit accrual rate. No State Police officer is entitled to the Act 9 benefit accrual rate of 2.5% because members of the State Police were specifically excluded from coverage by that statute). By the act of August 5, 1991 [P. L. 183, No. 23], 71 Pa. C. S. § 5955 was amended to provide that SERS retirement benefits are exclusively statutory and cannot be changed by collective bargaining agreements or arbitration awards under such agreements. That section grandfathered pre-existing awards, including DiLauro, but the amendment does not foreclose the legislature from prospectively altering benefits for new State Police officers by statute.

The bill would exempt a sworn officer of the Pennsylvania State Police from membership in the new hybrid benefit tier. All prospective employees of this group would continue to be eligible for membership in Class A-3 in SERS until they become eligible for the enhanced State Trooper retirement benefits upon attaining 20 years of credited service. The bill would also amend the bill to limit overtime compensation for new State Police officers hired on or after July 1, 2017, to 10% of base salary.

DISCUSSION (CONT'D)

Special Membership Classes

Within SERS, there are a number of special membership classes entitled to enhanced retirement benefits, reduced superannuation requirements or both. These include all members of the judiciary, members of the General Assembly, certain enforcement officers and Pennsylvania State Police Officers. Additionally, certain highly compensated employees would be entitled to enhanced retirement benefits by virtue of their higher than normal final average salary calculations. Under the bill, except for Pennsylvania State Police Officers, there would be no special benefit provisions for these groups of employees in the new hybrid benefit tier.

In 1974, an attempt was made to reform and make uniform the benefit provisions of the SERS Code. This attempt at reform prompted a series of lawsuits brought by members of the judiciary challenging the benefit changes as applied to members of the judicial branch. These court cases ultimately resulted in the preservation of the judiciary's entitlement to special membership status and enhanced benefits. The most salient of these cases were the "Goodheart" Supreme Court decisions (See *Goodheart v. Casey*, 521 Pa. 316 (1989); 523 Pa. 188 (1989), and *Klein v. State Employees' Retirement System*, 521 Pa. 330, 555 A.2d 1216, 1221 (1989)). Essentially, the Supreme Court of Pennsylvania ruled that the 1974 amendments to the Code, which eliminated the option to elect special class membership, were unconstitutional as applied to members of the judiciary. The Supreme Court ruled that, in order to preserve an independent judiciary, judges must be adequately compensated, pension benefits are part of compensation, and all members of a single-level court performing similar functions and exercising similar authority must be compensated at the same rate. As a result, all individuals who became members of the judiciary following the 1974 amendments to the SERS Code must be permitted to elect special class (Class E-1 or E-2) membership, make the required higher member contributions, and receive the higher pension benefit attributable to their membership class.

Based upon the independent status of the judiciary in Pennsylvania, the case law regarding the special status of its members and the exclusion of State Police officers and educational employees (as noted below) as the only exemptions from the new benefit tier, if enacted, the bill is likely to be challenged in the courts.

Treatment of Educational Employees

Under current law, "school employees" (employees of the Pennsylvania State System of Higher Education [PASSHE] institutions, most employees of the Pennsylvania State University, and community college employees) are eligible to choose coverage in an employer-approved, defined contribution "alternative retirement program" as an alternative option to membership in either

DISCUSSION (CONT'D)

the State Employees' Retirement System or the Public School Employees' Retirement System. Of the school employees who are eligible to choose membership in an alternative retirement program, approximately 50% elect membership in SERS, 45% elect membership in an alternative retirement program and 5% elect membership in PSERS. Section 5301(a)(12) of the SERS Code allows employers to contribute up to 9.29% of pay into the independent retirement program, and all affected employers currently contribute at that rate.

Under the bill, eligible employees would continue to have the option of electing the alternative retirement plan rather than the new hybrid benefit tiers offered by either of the Systems. Since the alternative defined contribution plan offered to school employees would have an employer contribution rate more than twice the amount of what would be offered under the new defined contribution plans and a lower employee contribution rate, it is likely that a majority of future eligible employees would choose the more attractive alternative plan.

Funding Methodology

The funding methodology used by SERS for the defined benefit plan is a variation of the entry age normal cost method. Under the traditional entry age normal cost method (as used by PSERS), a contribution rate is determined for all employees such that if that rate is applied to the member's salary, from date of entry into the plan until the member retires, it will be sufficient to fund the member's lifetime retirement benefit. The method used by SERS (which is set in statute) bases the normal contribution rate only on the benefits and contributions for new employees, rather than for all current members. Since new Act 120 members are entitled to benefits of a lesser value than members hired prior to the effective date of Act 120, the employer normal contribution is artificially low. The difference between the actual normal contribution rate and the rate determined under the SERS methodology becomes a component of the unfunded accrued liability, which is then funded over 30 years. The 30-year amortization period is a longer period than what is considered the average future working lifetime of the member. In other words, the methodology used by SERS funds the cost of the plan over a longer period of time resulting in an artificially low employer contribution rate. If enacted, the bill would serve to further compound this issue by reducing the normal cost calculation even more, since it would be based on new entrants of Class A-5 which has a lower normal cost than Class A-3 and A-4 members.

Miscellaneous Provisions

Contractual Benefit Rights of Defined Contribution Plan Participants. Section 402 of Article 4 in the bill explicitly states that a member in either of the Systems or a participant in either the School Employees' Defined Contribution Plan or the State Employees' Defined Contribution Plan

DISCUSSION (CONT'D)

shall not have "an express or implied contractual right" in relation to requirements for any of the following provisions: 1) qualification of the Plans as a qualified plan(s) under the Internal Revenue Code; 2) compliance with the Uniformed Services Employment and Reemployment Rights Act (USERRA); 3) contributions to, participation in, or benefits from the Plans or Systems; and 4) domestic relations orders regarding alternate payees of participants in the Plans.

Amortization Periods. Currently, changes in the unfunded accrued liability, except those due to legislative action, are amortized on a level-percentage of compensation over 24 years for PSERS and on a level-dollar basis over a 30-year period for SERS. Changes due to legislative action are to be amortized over a ten-year period.

Under the bill, for fiscal years beginning on or after July 1, 2015, for PSERS, any increase or decrease in the unfunded accrued liability will be amortized on a level-percentage of compensation of all active members and participants over a period of 24 years. Changes in the accrued liability of PSERS as a result of legislation will be amortized on a level-percentage of compensation over a ten-year period. In the case of SERS, for the fiscal year beginning July 1, 2016, any increase or decrease in the unfunded accrued liability will be amortized on a level-dollar basis as a percentage of compensation of all active members and participants over a period of 30 years. Beginning July 1, 2015, changes in the accrued liability of SERS due to benefit changes under the bill will be amortized on a level-dollar basis over a period of 20 years.

POLICY CONSIDERATIONS

In reviewing the bill, the Commission staff identified the following policy considerations.

> <u>Fundamental Shift in Risk Sharing</u>. The benefit reforms proposed in the bill will take several years to modify the risk profile of the Systems. Over time, as defined benefit plan participation decreases and defined contribution plan participation increases, the Commonwealth and school employers will assume less risk and more risk will be shifted to members of the Systems.
>
> <u>Cost Containment</u>. The bill provides a measurable increase in savings over existing law, which will serve to contain employer costs in future years. These cost savings result because new employees participating in the Systems will accrue benefits that are less costly to the Commonwealth and school employers.
>
> <u>Benefit Value and Security</u>. The hybrid benefit tiers proposed in the bill would provide new school and State employees with a retirement benefit that is likely to be less valuable, pre-

POLICY CONSIDERATIONS (CONT'D)

dictable and secure than that provided by the current, traditional defined benefit pension plans. Retirement planning based on projected defined contribution account balances is likely to be less predictable and involve greater individual attention to risk management than participation in a traditional defined benefit plan.

<u>Special Membership Classes</u>. Under the SERS Code, there are a number of special categories of public employees entitled to enhanced benefits, reduced superannuation requirements, or both. These include members of the General Assembly, the judiciary, Pennsylvania State Police officers and certain other hazardous duty personnel. Under the bill, except for Pennsylvania State Police officers, there are no special benefit provisions for these groups of employees. The uniform benefit level under the bill would result in a major reduction in the value of employer-provided benefits for these groups of employees in the future and would result in significant benefit disparities between similarly situated employees.

<u>Treatment of Educational Employees</u>. Under current law, "school employees" (employees of PASSHE institutions, most employees of the Pennsylvania State University, and community college employees) are eligible to choose coverage in an employer-approved, defined contribution "alternative retirement program" as an alternative option to default membership in SERS or optional membership in PSERS. Under the bill, new employees of these educational institutions would continue to have the option to select membership in an alternative retirement program such as the Teachers' Insurance Annuity Association – College Retirement Equity Fund (TIAA-CREF) rather than joining one of the new hybrid benefit ers. The rationale for maintaining the status quo for this subgroup of educational employees while imposing a reduced benefit tier upon most future members of SERS is not apparent.

<u>Annual Compensation Limit</u>. The $50,000 annual compensation limit proposed in the bill would be increased (indexed) by 1% each year from the prior year's limit. Because the 1% index is, and can be expected to be, significantly less than either the cost-of-living index or inflation, the effect will be to cause a gradual erosion in the value of the defined benefit component of the hybrid plan over time.

<u>Delegation of Legislative Authority</u>. The bill empowers the Boards of the Systems to develop the details of major defined contribution plan design elements and administrative details by rule or regulation. Policymakers must determine if the broad powers afforded the Boards constitutes an appropriate delegation of legislative authority.

POLICY CONSIDERATIONS (CONT'D)

Technical Operational Issues. In reviewing the bill, the Commission staff noted the following technical operational issues.

Risk Sharing. Under the defined benefit structure of PSERS and SERS, all of the longevity risk (the risk of members outliving their retirement income) and most of the investment risk is borne by the retirement system. Under current law, only those members subject to Act 120 of 2010 (Classes T-E and T-F, Classes A-3 and A-4) share in the investment risk of the Systems through the shared-risk contribution requirement imposed by Act 120. All pre-Act 120 members of the Systems are exempt from the shared-risk contribution requirement. Under the bill, all new employees would be enrolled in a hybrid benefit tier and would be required to bear all of the investment risk and longevity risk associated with managing their defined contribution accounts. This situation creates significant risk-sharing disparities among the various classes of public employees.

Employee Contributions. Traditionally, school employees have contributed a higher employee contribution amount, while receiving the same level of benefits as most State employees. The bill would mandate employee contribution requirements that are consistent between the two Systems, resulting in members of PSERS and SERS contributing an equal percentage of compensation for the same level of benefits.

ATTACHMENTS

House Bill Number 1499, Printer's Number 2713. (Due to the size of the bill, it is not attached to this advisory note, but may be viewed at the link.)