INDEPENDENT FISCAL OFFICE

September 21, 2023

The Honorable Brad Roae
Minority Chairman
House State Government Committee
151 East Wing Capitol Building
Harrisburg, PA 17120

Re: Requested Actuarial Note for House Bill 1505, Printer's Number 1712, Amendment A01870

Dear Chairman Roae:

This letter responds to your September 11, 2023 request concerning an actuarial note for Amendment A01870 to House Bill 1505, Printer's Number 1712. The bill would amend Title 71 (State Government) of the Pennsylvania Consolidated Statutes to provide cost-of-living adjustments (COLAs) to certain annuitants of the State Employees' Retirement System (SERS) that served as State Police officers and retired prior to July 1, 2010. The COLAs range from $1,000 to $3,000 per annum depending on the year of retirement. The Independent Fiscal Office (IFO) determined that the bill would have a material cost impact and released an actuarial note on July 13, 2023. That note is available on the IFO's website, and a summary of the impacts is shown in the table below.

House Bill 1505, P.N. 1712 Impact Summary

	SERS
Individuals impacted	2,935
Lifetime increase in benefits	$69.9
Annual amortized costs (10 years)	$5.9
Initial change in:	
Unfunded Actuarial Liability	$41.8
Funded ratio	-0.05%
Employer contibution rate	0.08%

Notes: Dollars in millions. Data from SERS, calculations by the IFO.

Amendment A01870 would prohibit new members of the House of Representatives from electing to participate in the SERS Hybrid Defined Benefit (DB)/Defined Contribution (DC) plan beginning December 1, 2024. Legislators (Representatives and Senators combined) represent 0.2% of SERS payroll, and the system assumes that most members would elect to participate in the DC-only plan, and not forgo participation in the only plan option. Based on conversations with SERS, the system does not project a

material actuarial impact as a result of this amendment. Commentary from SERS is attached to this letter. The proposed legislation would not alter the COLAs as prescribed in the base bill.

Under section 615-B of the Administrative Code of 1929, the IFO reviews legislative changes that could affect public employee pension or retirement plans and provides actuarial notes for such legislation. Based on commentary from SERS, the IFO determined that there is no material actuarial cost impact associated with Amendment A01870 to House Bill 1505, Printer's Number 1712 and no further actuarial analysis is required. The office reviewed the legislation for actuarial cost impact only, and not for potential legal, administrative or policy implications.

If you have further questions regarding this response, please contact my office (contact@ifo.state.pa.us).

Sincerely,

Matthew J. Knittel
Director, Independent Fiscal Office

cc: Governor Josh Shapiro
Members of the General Assembly

pennsylvania
STATE EMPLOYEES' RETIREMENT SYSTEM

September 18, 2023

Mathieu Taylor
Independent Fiscal Office
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400 Market St.
Harrisburg, PA 17105

RE: Review of A01869, A01870, A01895, and A01896

Dear Mathieu,

We are responding to your request to provide additional insights concerning the amendments numbered **A01869, A01870, A01895 and A01896** which seek to amend H.B. 1505, which deals with a proposed Cost-Of-Living-Adjustments (COLA) for State Police Officers. In keeping with SERS' traditional posture, we are neutral on the substance of the proposed legislation, but we want to point out some technical aspects and implications that may be worth considering.

Upon review, each of these amendments mirror previous proposals that were offered to amend other pieces of COLA legislation, particularly H.B. 1415 and H.B. 1416. Our comments below, therefore, largely reflect what we have provided to you in the past concerning the issues that arise.

- **A01869:** Would delay second consideration on any bill that provides for a "supplemental annuity" until after SERS completes and submits its annual stress test report to the General Assembly during the calendar year in which the bill is introduced. Similar amendments (A01750 and A01751) were proposed for H.B. 1415 and H.B. 1416, respectively.

As noted earlier, from a financing perspective, delaying second consideration until after the stress test date should not have any significant actuarial cost.

One thing that is not clear is whether or not the COLA payments would be retroactive, necessarily. Typically, COLAs are drafted so that they are prospective only – this helps avoid constitutional and drafting issues involving annuitants who died during the retroactive period, for example. Of course, this is a policy issue that we would defer to the General Assembly to consider.

That said, we have several additional technical and practical aspects worth noting, in no particular order:

1. **Constitutional / Statutory Considerations:** We would defer to the legislation experts in the General Assembly as to whether this type of limited substantive issue statutory amendment of the operating rules of the Senate and the House is legally binding or constitutionally valid. We also would defer at this time to the experts in the General Assembly as to whether a supplemental annuity voted on and passed in violation of the new proposed 71 Pa. C.S. §5910 would be operative. If that happens, then SERS will need to make that determination as the results may depend on the precise fact pattern. We have not undertaken in-depth research or analysis for the purpose of this general review.

2. **SERS Fiscal / Calendar Year:** It is important to note that the SERS portions of these bills are geared to our calendar actuarial year and December 31 valuation dates, as opposed to the PSERS fiscal year based actuarial year.

3. **Stress Test Timing:** The draft amendments are written on the assumption that SERS' annual stress tests are prepared and submitted according to the statutory time frame in 71 Pa. C.S. §5909 (July 1 for SERS, September 1 for the IFO). SERS actually released its first comprehensive Stress Test Report (which is more comprehensive than required by statute) in September 2019. This was prior to the passage of Act 2020-128. Each year, these Stress Tests utilize the freshest data available, drawn from our Annual Comprehensive Financial Report, which is produced in June. Each year since 2020, SERS and the IFO have requested, and received, a 90-day extension to their respective Stress Test submission deadlines – the key point being that we need the additional time to provide the most current and useful information available.

   The fact that there may be a delay in the submission of the Stress Tests by up to 90 days to allow the data to be collected and the testing to be performed could raise operational issues in regard to the proposed amendments. It could be interpreted that if the deadline for submitting the Stress Tests is waived or extended, then the cooling off period before the second consideration also is extended. However, such a decision is not ours to make. Legislative sponsors may well want, and decide, to have second consideration during the extension period. In such a case, it could then be a point of contention between those who would grant the extension, versus those seeking an expedited vote, with SERS stuck in the middle. It also raises the concern that our extension requests are not granted because legislative leaders want to move a supplemental annuity more quickly.

4. **Clarification of Intent:** It is not entirely clear what is being addressed in the following sentence paragraph (shorter paraphrasing in brackets):

   > [A bill implementing a supplemental annuity may not be given second consideration] until after the deadline to submit the results of the stress test of the system to the General Assembly under [§5909], which is conducted and completed by the board after the annual actuarial valuation required by [§5902(j)] for the calendar year in which the bill is introduced.

   Our question focuses on what is being referred to in the last prepositional phase "for the calendar year in which the bill is introduced." If the reference is to apply to the annual actuarial valuation, then it means that that 2nd consideration could be delayed a full year. It would seem to be more logical that the reference is to the stress test occurring during the calendar year in which the bill is introduced. But we can't be sure. We would therefore suggest the following language changes to help clarify the intent (which are shown in all caps for additions and strikethroughs for deletions):

   > A bill implementing a supplemental annuity under this part may not be given second consideration by the Senate or House of Representatives until after the COMPLETION AND SUBMISSION ~~deadline to submit the results~~ of the stress test REPORT of the system to the General Assembly AS DESCRIBED IN ~~under~~ section 5909(a) (relating to stress test of system) which is conducted and completed by the board after the MOST RECENT annual actuarial valuation required by section 5902(j)(relating to administrative duties of the board) ~~for~~ DURING the calendar year in which the bill is introduced."

5. **Terminology (COLAs vs. Supplemental Annuity):** All retroactive benefit increases applicable to SERS annuitants are "COLAs" constitutionally. We have used the term "supplemental annuity" as a general term to cover retroactive benefit increases that are not traditional and generally applicable COLAs. Two examples are found in:

    a. **§5708.4** which granted retroactive benefit increases as a "special supplemental postretirement adjustment" to employees who retired after the 1974 Retirement Code was enacted and the implementation of court decisions allowing "double dipping" nonstate service credit for active military duty, which is part of the member's eligibility for a federal reserve/national guard military pension.

    b. **§5708.8** which granted as a "special supplemental postretirement adjustment" retroactive benefits to correction educators who retired before the enactment of 71 Pa. C.S. §5303.2.

    Both provisions were funded under the "supplemental annuity" funding provisions and ledger accounts in the Retirement Code, not as part of the standard unfunded liability provisions applicable when benefit increases are given to active members.

    The point of raising this issue is that if the legislation is enacted "as is" then there could be questions as to whether the term "supplemental annuity" applies generally and broadly to all post-retirement benefit increases enacted by legislation, as has been the historical practice, to use the term this way since at least since the 1974 Retirement Code? Or is "supplemental annuity" as used in proposed §5910 a more limited term that needs the "magic words" of "supplemental annuity" or at least be recognizable as a traditional COLA and not some other form of retroactive benefit increase that is only a COLA due to constitutional reasons?

- **A01870:** Would limit newly elected members to the House of Representative to opting to be participants in the Defined Contribution Plan, unless the new member is a state employee with a previous footprint. This amendment is similar to two amendments (A01770 and A01771) that were offered for H.B. 1415 and H.B. 1416, respectively.

SERS Observation: This amendment also mirrors a proposal (S.B. 699, P.N. 781) that was introduced on the Senate side. SERS worked with the sponsor(s) to review proposed language and made suggestions that appear to have been incorporated.

- **A01895:** COLAs shall not be funded by alternative investments or alternative investment vehicles acquired after the effective date unless the investment was approved by 2/3 of the board. This amendment is similar to two amendments (A01790 and A01791) that were proposed recently for House Bills 1415 and 1416.

SERS Observation #1: SERS investments and their earnings are considered one large, commingled pot of funds for actuarial purposes. The overall earnings on the total portfolio help to pay down the plan's overall UAL (there is no contingency for delineating a specific component such as a COLA). The actuarial valuation does not require the consideration of the breakdown of total portfolio earnings into further asset class, sub-asset class, or investment manager.

Nor does the Retirement Code differentiate in the funding of most benefits. To the extent that it does, those differences are ledger account balances and not separate investment pools, except for the Benefits Completion Plan assets, which are in a different trust and managed and invested separately from the State Employees' Retirement Fund. Thus, what seems to be envisioned – a

separate investment pool managed separately to fund the COLA created by H.B. 1505 – probably would not work statutorily or practically. SERS is unable at this time to ascertain how investment monies from specific investments would be allocated to COLAs. Setting up such a system/process would incur administrative and operational costs requiring additional study.

SERS Observation #2: Because the fund is a single pot of money, undifferentiated and unallocated to how it is used, the practical impact of AO1895 as written would be to impose the new restrictions on the entire State Employees' Retirement Fund and all new alternative investments or alternative investment vehicles. The likely result of enacting A01895 would be to place the entire Fund under a supermajority requirement for any investments in the alternative investment class or using alternative investment vehicles. The amendments "work" to prohibit the funding of the COLAs through alternative investments and alternative investment vehicles – not in the way the amendment language seems to suggest – but rather by prohibiting the entire Fund from using these types of investments unless approved by a supermajority of the Board.

Also, from a technical drafting perspective, there are a number of issues that SERS will need to deal with if these amendments are enacted.

"Alternative investment" and "Alternative investment vehicle" are defined terms in the Retirement Code, specifically 71 Pa. C.S §5102:

> **"Alternative investment."** An investment in a private equity fund, private debt fund, venture fund, real estate fund, hedge fund or absolute return fund.
>
> **"Alternative investment vehicle."** A limited partnership, limited liability company or any other legal vehicle for authorized investments under section 5931(i) (relating to management of fund and accounts) through which the system makes an alternative investment.

These are the definitions that would be applicable to A01895. In most cases it is obvious what investments fall into these categories and to which the supermajority vote rule would apply. SERS may need to make an investment-by-investment decision, however, if the matter is not clear.

SERS Observation #3: Placing a 2/3 requirement on the ability of the Board to approve an alternative investment or alternative investment vehicle (for it to be considered worthy of funding a COLA), possibly enters a gray area relating to the fiduciary duty of the SERS Board (working with its Investment staff and consultants) to determine the efficacy and viability of a proposed investment.

In short, there is a rollback of fiduciary flexibility inherent in A01895. In a sense, these amendments are a minor reversion back to a "legal list" approach to investment authority. It has been SERS' position that the General Assembly can impose these sorts of restrictions on the Board and that the Board (as a creature of legislation) has only those powers granted to it by the General Assembly. It also is worth noting that alternative investments are qualitatively different under the Retirement Code than other types of investments and the Board needs specific investment authority from the General Assembly to make alternative investments or use alternative investment vehicles. The general "prudent expert" standard or "basket clause" approach does not authorize alternative investments or alternative investment vehicles. When the General Assembly grants alternative investment authority, it can put whatever constitutionally

appropriate restrictions it wants on that authority. In a sense, this is no different than limiting alternative investments to a percentage of the total fund.

We also note that this is not necessarily an absolute prohibition on alternative investments and alternative investment vehicles.

- **A01896:** Would require SERS to identify eligible benefit recipients and provide notice that they are eligible for a supplemental annuity as a result of a State law adopted by the General Assembly, as well as a calculation of the additional monthly annuity payments attributable to this law. The notice would also include a calculation of the unfunded liability and actuarial funded ratio of the system and the first notice would be issued no less than 45 days after the effective date of the law's enactment. Future notices would be issued no later than January of each year thereafter and note that any future supplemental annuity would depend on the funded status of the system and would require the adoption of a new State law. Again, this amendment is along the lines of two amendments (A01802 and A01805) that were offered for H.B. 1415 and H.B. 1416, respectively.

SERS Observation: SERS' fiscal year is based on the calendar year. Each year, SERS assimilates data from investments returns and other sources to produce an annual comprehensive financial report, which is typically finalized in June. The process takes several months to complete. Thus, an annual end-of-January deadline for providing up-to-date notices of unfunded liability and actuarial ratio is extremely ambitious, if not unrealistic. In addition, we would note that the proposed legislation establishes new process and programming requirements, all of which will create significant additional operational (e.g., mailing costs, process and system development and testing) and administrative costs to the system.

In addition, as noted earlier, SERS maintains a neutral stance on topics relating to policy, but we are very much aware of the keen interest among retirees concerning the general issue of Cost-of-Living-Adjustments (COLAs). This amendment essentially may be requiring SERS to spend significant amounts of money on an annual basis to inform potential COLA recipients that the system's funded ratio is such that a new COLA is not affordable. We anticipate it would provide retirees and the media with a ready topic for debate.

We hope these observations are useful to you. Please feel free to reach out if you have any questions or concerns.

Thank you,

Thomas Derr
Director, Communications & Policy