Testimony of

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Good afternoon Chairman Salomone, members of the Commission, Executive Director McAneny, staff and guests. I am Jeffrey Clay, Executive Director of the Public School Employees' Retirement System (PSERS). Thank you for the opportunity today to provide brief comments about the pension issue and also for your sponsorship of these hearings.

As previous speakers at these hearings have noted, the pension issue is a significant fiscal issue currently facing the Commonwealth, its public schools and their taxpayers. That said it also involves very important and vital policy decisions.

As you are aware, I have been intimately involved with PSERS' funding challenges for more than ten years. During this time I have met with various groups and individuals and heard their concerns and diverse viewpoints on addressing the pension issue; just like you have heard throughout your own hearings.

From PSERS' perspective, however, the "pension issue", can be broken into two separate issues; a pension funding issue and a pension design/reform issue. Neither issue has a quick, clean or easy answer to it.

The first issue, and I would suggest, the primary one of the two, is the proper funding of PSERS and specifically the significant unfunded liability that PSERS has incurred for benefits already earned. In essence, it is a debt that has to be paid and, unfortunately, is growing due to the continued intentional underfunding of the System. It is this issue that is driving the rising employer contribution rates, which are causing the budgetary stress for both the Commonwealth, school employers and their taxpayers. In short, the question is how to pay the pension bill that is due in both a fiscally responsible and actuarially sound manner?

Before turning to the second issue, it is important to understand the causes of the funding issue as they are often misunderstood. It is also important to understand what caused the issue as they impact the proposed solutions that are being discussed. For example, I have heard that some place the entire blame of the funding issue on Act 2001-9, while others blame the System's under performance of its assumed investment rate of return at certain times. In fact, the causes of the unfunded liability debt are multiple and vary when examined from both a short-term and long-term perspective.

Over the short-term (10+ years) the causes include:

- The actuarial and funding methodology changes made by Acts 2002-38, 2003-40, and 2010-120, which intentionally underfunded PSERS by suppressing the employer contributions (school employer and Commonwealth) for the last 10+ years below the employer normal cost[1]
- The negative arbitrage caused by intentionally paying below the employer's normal cost for 10+ years when there has been an unfunded accrued liability, which means the Commonwealth and school employers did not pay for the annual benefits earned by members, much less the principal and interest needed to amortize the accrued unfunded liability debt that existed during this period
- Two historic downturns in the investment markets within a very short 10 year timeframe
- Acts 9 and 38 benefit enhancements (increased multiplier and Cost-of-Living Adjustment)

Over the long-term (30+ years) the causes include:

- Failure to properly fund with "new money" post-funded benefit increases (ad hoc COLAS, early retirement incentives, Act 9 enhancements, etc.) over an extended period of time, which effectively siphoned away any "surplus" produced by above actuarial assumption performance by

[1] The employer normal cost is the annual cost that the employer incurs for the benefits that the active members earned in that year, presuming all Plan assumptions are met. The employer normal cost could be compared to an employer match in 401(k) plan.

PSERS, thus eliminating its ability to mitigate the impact of under actuarial assumption performance by the System
- Failure to pay off, in a timely fashion, the unfunded liability created by post-funded benefit enhancements, thereby adding additional liability
- The cumulative impact of the above on PSERS' investment performance—less assets to invest, reduced employer contributions, greater benefits payments, creation of negative cash flow and thus greater need to maintain liquidity, etc.

With that background, the second issue is the perceived need for additional pension reform over and beyond that already accomplished by Act 2010-120, which in the case of PSERS, resulted in $24.65 billion in savings by reducing future benefits for new school employees. The Act 120 benefit reductions also will lower over time PSERS' 8%+ employer normal cost of the pre-Act 120 plan to approximately 3%. As a result the benefits for new employees under Act 120 are now primarily funded by the members themselves. Moreover, Act 120 members, who contribute either 7.5% or 10.3% of their pay, are subject to a risk share provision that permits their contribution rate to be adjusted up or down depending on the investment performance of the Fund, thus introducing a defined contribution component to the new tier of benefits. These benefits reductions and savings tend to be overlooked because Act 120 also deferred employer contributions payments, at a cost of $23.27 billion, to provide a more reasonable payment schedule to both the Commonwealth and school employers, i.e. continued the underfunding.

In light of this, why is additional pension design/reform being discussed? Some view it as the way to completely resolve the pension funding issue. As noted above, however, PSERS' unfunded liability is made up of many components of which underfunded benefit enhancements is only one. Thus additional pension reform in the form of further reductions in PSERS' benefits, by itself, will not solve its funding issue. At best any additional pension reform will only marginally produce future savings that can be used to partially help offset/pay the accrued unfunded debt of PSERS. As such it is only one of a series of smaller solutions that are needed to help mitigate the funding issue including:

- One time cash infusions/prepayments of the debt, e.g., through sale of assets or the use of pension obligation bonds (POB's)[2]
- Providing a dedicated source of funding
- Continued performance of PSERS' assets, which provide 70% of the of funding for the Plan
- Continued significant increases in employer contributions

In short, there is no simple, easy solution or "silver bullet" to resolve PSERS' funding issue. The systemic and intentional underfunding of the System has simply gone on too long.

Before closing, I would like to echo a comment made by Jim Allen in his testimony about the absence of and need to develop a long-term pension policy that would then drive the resolution of the issues noted here and especially the nature of additional pension reform. One of the critical components of that hoped for policy is the need to address the adequacy of retirement benefits in both the public and private sector, for the real story is that Americans, in general, are unprepared for retirement. Indeed, they typically have no resources to support them if they should become unable to work, let alone sustain them in retirement. The social service cost implication of this situation is not being acknowledged and will become a huge burden in the future if not dealt with in a thoughtful, deliberate manner. The prudent resolution of PSERS' funding challenges is an opportunity to take one small step in addressing this larger issue.

Again, I thank you for the opportunity to appear today and I look forward to your questions.

[2] The use of POB's are currently prohibited under Act 120.