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Analyzing PA's Pension Reforms

Summary: Recent legislation changes the pension benefits for new hires of the two statewide pension systems beginning in 2019. The legislation will include three options for new employees: a defined contribution plan as well as two hybrid plans that combine features of defined contribution and defined benefit plans. However, the legislative reforms will not eliminate the fiscal and budgetary pressures caused by huge unfunded liabilities in the current pension plans.

Starting two years from now on July 1, 2019, individuals who are hired by one of Pennsylvania's school districts, intermediate units, area vocational-technical schools, state-owned universities, etc., will select from one of three pension plans. Two of those are hybrid plans, with a combination of elements of defined benefit and defined contribution aspects, and one is a pure defined contribution plan. They will be joining individuals taking employment with the state government (unless exempted by performing public safety related functions), who, roughly six months earlier, on January 1st, will choose from the same three plan menu.

These changes will come about due to Act 5, which reforms the benefits for new hires in the Public School Employee Retirement System (PSERS) and the State Employee Retirement System (SERS). At the end of 2016, the two systems combined had over 364,000 active employees throughout the Commonwealth in various tiers in the systems. These tiers have different contribution levels based on the date of hire. For PSERS, over three quarters of the current active members are in class T-D, which means they were hired sometime between July 1, 2001, and June 30, 2011. SERS has over 60 percent of its current active members in class AA, hired in the same time frame.

There are 4,480 SERS active employees work in Allegheny County according to officials with the system. Though PSERS could not break out a similar measurement for the County, the Department of Education's data on Professional and Support Personnel shows that for school districts, charters, intermediate units, and the like in Allegheny County there were 12,950 professional personnel, which includes close to 10,700 classroom teachers as well as administrators, service coordinators, and other professional personnel.

The Act 5 reforms will add three new classes to each system with the two hybrids and a pure defined contribution plan. A new hire that does not select a plan will be placed into hybrid option #1 which is designated to be the default plan.

As with most pension and post-employment benefit reform plans we have written about over the years (Allegheny County, City of Pittsburgh, and Port Authority for example) the reforms affect new hires on or after a certain date. In fact, for PSERS and SERS the reforms under Act 120 of 2010 applied to individuals hired on or after July 1, 2011, and those employees (as well as all other current employees in 2019) will stay under the terms of their current benefit structure unless they voluntarily opt in to one of the Act 5 plans. Since the Pennsylvania Constitution's language on the impairment of contracts has been interpreted to apply to pension benefits, most reforms are forward looking and thus take a long time to show improvement. In 2013 the previous Governor's pension reform proposal would have included a change in the multiplier of future (as yet not earned) benefits of current employees, a notion that was not well received.

Several aspects of pension plans available to new hires (employee contribution rate, employer contribution rate, vesting period, whether overtime is counted, normal retirement age and years of service, and nature of benefit) will be different from the current pension programs. For example, Act 5 alters the employee contribution rate (most PSERS members are contributing 7.5% of salary, SERS members 6.25%) for hybrid option #1 by requiring an 8.25 percent employee contribution rate (5.5% to defined benefit and 2.75% to defined contribution for PSERS and 5% to defined benefit and 3.25% to defined contribution for SERS). However, hybrid option #2's contribution is set at 7.5 percent (4.5% to defined benefit and 3% to defined contribution for PSERS and 4% to defined benefit and 3.5% to defined contribution for SERS). The pure defined contribution will also require a 7.5 percent employee contribution.

Employees choosing option #1 will get a 2.25 percent employer match for their defined contribution and option #2 will get a 2.0 percent defined contribution match. They will also get employer contributions for the defined benefit part of their plan that will be actuarially determined. Of course those choosing the pure defined contribution plan will receive no employer contribution for defined benefits but will receive a 2.0 percent employer contribution to defined contribution in PSERS and 3.5 percent in SERS.

Another important change from the existing pension plans are the payout rates for defined benefits under the hybrid plans for new hires. Those rates are set much lower than for rates current employees who get 2.0 to 2.5 percent of salary per year of service depending on plan type they are in. Option #1 participants will receive 1.25 percent of their highest five year average salary for each year of service while option #2 participants will get 1.0 percent per year of service. Defined contribution benefits will depend on how well invested funds perform.

A principal change brought about by Act 5 is that some of the risks associated with investments, longevity changes and inflation are shifted to employees in their defined contribution component. And longer term, the plan becomes more fiscally stable—absent legislative tinkering that reverses the advantages offered the government by the defined contribution component.

The difference between the default hybrid plan (option #1) retirement benefits and the current plan for PSERS employees can be shown by an example provided in the actuarial notes. A retiree age 65 with 30 years of service and a qualifying final salary average of $90,000 would receive $61,038 per year under the current system. In the default hybrid (expected to be chosen by 65 percent of new hires) a retiree of the same age, years of service and qualifying salary of $90,000 would receive $36,973 in defined benefits and an estimated $13,971 in defined contribution payments for a total of $50,944 or 83 percent of the current plan payout. Option #2 choosers in the same scenario will receive $25,548 in annual defined benefits and $13,972 in define contribution payouts for a total of $39,519. Those choosing the pure defined contribution plan would get projected payments of $26,545. Little wonder the forecasts assume most employees will chose option #1. The employer contribution will be higher for that option.

One other significant change from the current plans that will be in effect for new hires should be noted. Currently SERS and PSERS members can achieve normal retirement at age 65 with three years of service or an age and years of service combination of 92. The hybrid options will require age 67 and three years of service or a combination that equals 97. The final average salary will be the highest five years, rather than the current highest three years. The pure defined contribution plan has a three year vesting period but no age or years of service requirement beyond the three years to get benefits.

PSERS and SERS, Projected Schedule of Funding Progress ($, billions)

	PSERS				SERS			
FY Ending	AA	AAL	AA-AAL	AA/AAL	AA	AAL	AA-AAL	AA/AAL
2015	$ 57.2	$ 94.5	$ (37.3)	60.5	$ 26.5	$ 44.7	$ (18.1)	59.4
2030	$ 97.6	$ 135.2	$ (37.6)	72.2	$ 40.5	$ 51.9	$ (11.4)	78.0
2040	$ 145.6	$ 152.1	$ (6.5)	95.7	$ 50.3	$ 50.4	$ (0.1)	99.8
2050	$ 160.4	$ 161.0	$ (0.6)	99.6	$ 45.9	$ 43.8	$ 2.1	104.8

So how long will it take to see fiscal results? Unfortunately, the Act 5 plan will have little impact on how much the employers have to pay into the systems for a long time because of the requirement to reduce the unfunded liabilities through very large annual employer contributions and the removal of the "collar" which had lowered the annual employer payments. Indeed, employer contributions are projected to rise for another fifteen years after the new program goes into effect. For example, PSERS employer contributions are projected to climb from 30 percent of PSERS payroll in 2017 to 44 percent in 2035. In dollars, that means a jump from $4 billion to $7.9 million per year. Interestingly these projections are virtually identical to those for the current pensions program because of the length of time it takes new hires to replace a substantial share of the payrolls and the fact that defined benefit plans will remain a very large part of the pension program in the future.

In short, over the next decade or more, the Commonwealth and school districts will face a continuation of budget problems as they deal with the massive unfunded liability issue.

Currently (2015 latest actual available), the funded ratio (assets [AA] divided by liabilities [AAL], noted in the table above) put PSERS at 60.5 percent and SERS at 59.4 percent. By 2030, the actuarial tables that accompany the legislation forecast the funded ratios will rise fifteen to twenty points to place them at 72.2 percent and 78.1 percent, respectively. By the end point of the projection period, 2050, the ratios would be close to or over 100 percent funded ***if the projections hold and that depends on how close to reality the assumptions turn out to be.*** The projections are based on the actuarial assumptions related to the hybrid plans, both of which will have an actuarially determined contribution to the plan as opposed to a specified percentage to the defined contribution portion. On a cash flow basis, the reduction in employer contributions for the combined systems through 2050 is projected to be close to $1.4 billion; $217 million for PSERS and $1.18 billion for SERS according to the Senate fiscal note on the legislation. In present value terms, at 3.6 percent, the savings would be $319 million—not very much.

That's the plan going forward for PSERS and SERS, which will have another year or so of employees joining the workforce and becoming enrolled in pension systems before the changes take effect in 2019.

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