

PSERS Questions & Answers

Understanding the Impending Pension crisis

What is PSERS?

The Commonwealth Public School Employees Retirement System, better known as PSERS, was created by statute in 1917 and began operations on July 1, 1919 with the merger of 13 school district retirement systems into the new statewide system. It is one of the oldest public pension systems in the country.

Who are PSERS members?

Today, PSERS serves a membership that totals approximately 272,000 active qualified members and approximately 157,600 annuitants, 8,400 survivors and beneficiaries and 7,400 disabled annuitants. It is the 12th largest state-sponsored defined-benefit pension fund in the nation according to *Pensions & Investments* magazine. From 1999 to 2008, total active membership in PSERS increased by 22% and total annuitants, beneficiaries and survivor annuitants increased by 31%. Additionally, the average annual annuity of annuitants increased by 63% (from \$13,777 to \$21,963 as of the 2008 valuation). The system's total plan net assets total about \$43.2 billion. PSERS paid out over \$4.9 billion in benefits during FY 2008-09 and the amount is expected to rise to over \$5 billion in FY 2009-10.

Who governs PSERS?

PSERS is operated by an executive director and a 15-member board of directors, made up of representatives of certified and non-certified contributors, annuitants and school boards and includes representatives of the governor and the four legislative caucuses. PSBA's executive director is an *ex officio* member of the board and an active school board member is elected once every three years to serve on the PSERS board. PSERS employs approximately 300 individuals, including a full staff of investors, an internal auditor and eight field offices located around the state to serve members of the system and annuitants. The PSERS Code is the statute that governs the operations of the system.

PSERS membership

Membership in the system is mandatory for all school employees except for:

- Officers and employees of the PA Department of Education or state-owned educational institutions, community colleges, area vocational-technical schools, technical institutes or the Penn State University who are members of the State Employees Retirement System (SERS) or member of another retirement program approved by the employer

- School employees who are employed on a part-time per diem for less than 80 full-days of service in the school year or part-time hourly public school employees who render less than 500 hours in any school year
- An annuitant who returns to school service under the provisions of law
- Independent contractors and those who work on a fee basis are not included in the statute's definition of "school employee." PSBA employees, on the basis of a 1930s Attorney General Opinion, are members of PSERS.

What are PSERS benefits?

PSERS operates a defined-benefit pension plan funded by employer (school employers and the commonwealth) and employee contributions and investment earnings. A defined benefit system is one where a member's pension benefit is the result of a benefit calculation and the employer holds the risk of ensuring that benefits are paid out. The formula for benefits under PSERS is the employee's years of service times the employee's multiplier (2% or 2.5%) times the employee's average three highest years of salary (defined as the highest average compensation during any three non-overlapping periods of 12 consecutive months). The product equals the employee's maximum single life annuity.

There are five types of retirement benefits in PSERS: deferring, withdrawal, early, normal and disability retirement and a refund. A deferring retirement benefit allows an individual with five years of service to postpone retirement benefit until age 62. Under a normal retirement scenario, PSERS members are eligible to receive an annuity without any penalty when they reach superannuation (age 62 with one year of service, 35 years of service regardless of age or age 60 with at least 30 years of service). Members who seek early retirement, but who are below normal retirement age can receive an annuity reduced by a 3% penalty per year (15% maximum penalty) provided the member is both 55 years of age and has at least 25 years of service. In a disability retirement situation, a member must have five years of service and be medically eligible. Any person leaving the retirement system is entitled to a return of retirement contributions plus interest – any age and any years of service.

PSERS retirees have several retirement payment options available to them. With any of the options, a member may elect to receive all or part of contributions and interest at the time of retirement. This includes a single life annuity which is calculated by subtracting from the maximum single life annuity a single life annuity equal to the lump sum amount divided by the cost of a dollar annuity on the effective date of retirement.

Over the years there have been several statutes enacted to enhance member benefits. The so-called "thirty and out bills" essentially allowed members to retire once they had accumulated 30 years of service regardless of age without penalty. Several such statutes were implemented beginning in 1984. Also, Cost of Living adjustments for annuitants were also enacted during the 90s and in 2001. Act 9 of 2001 increased both employee benefits and employee contributions, both of which were effective on

members who elected to receive them. The so-called “Mellow Bill,” named after its sponsor Sen. Robert Mellow, was enacted in 1992 and gave members 55 years of age or older a 10% increase in service, allowing many experienced school employees to retire under superannuation.

What are Employer and employee contributions?

As previously mentioned, the system is funded by **employer** and **employee** contributions, as well as by investments made with those contributions. The **employer** rate, paid by both the commonwealth and school employers, is set each December by the PSERS Board of Directors. The employer contribution consists of two parts; a pension contribution, which is the rate recommended by the system’s actuaries as the rate needed to maintain annuity reserves on account of anticipated annuities and certified by the Board of Trustees in early December, and a premium assistance rate, which is the rate that is needed to continue to provide healthcare assistance premiums as provided by law. The rate is expressed as a percentage of compensation paid out by employers as defined by the PSERS Code and is split approximately 53%-47% between the commonwealth and school employers. Up until 1995, the employer rate was split 50-50 between the state and school employers. Act 29 of 1994 requires the commonwealth to contribute a share of the employer contribution to school districts based on the district’s market value/personal income aid ratio. Under the law, every district gets at least a 50% share of the employer contribution from the state and poorer districts get more. The current **employer rate is 4.78%**. The pension component of the employer contribution rate has been below the employer normal cost for 12 years.

The amount of employee contribution is spelled out in law and differs depending on when the member joined the system. The average **employee contribution for FY 2009-10 is 7.32%** and new members of the system contribute 7.5% of their annual compensation to the system. Employees contributed a total of \$1.09 billion to the system in FY 2008-09.

What happened to result in this crisis?

Over the next few years, the PSERS employer contribution rate is expected to increase by as much as 700% according to unofficial figures from the system. The seeds for such a large rate increase were sown in part by two events: first, the passage of Act 9 of 2001, which gave a substantial boost in retirement benefits for school and state employees; second, the downturn in the economy after the economic boom of the 1990s. Subsequent legislation exacerbated the problem as well. To understand the impact of these events on the system, a closer look at each is warranted.

On May 17, 2001, then Governor Tom Ridge signed Act 9 of 2001 into law. The law made several changes to the benefits paid under the system. It increased the employee multiplier used in the benefits calculation formula from 2% to 2.5%, a 25% increase. The new law also stipulated that new employees starting after July 1, 2001 would automatically receive the increased benefit rate and provided a window

by which current employees could elect the new benefit rate. Act 9 also provided that any person receiving the increased benefit either by election or due to their date of hire would pay an increased contribution rate. The majority of school employees at the time were paying 6.25% or 5.25% of salary in contributions. Act 9 changed those levels to 7.5% and 6.5% respectively, a 20% increase. Act 9 also decreased the vesting period from 10 years to 5 years, meaning that a person only had to work 5 years before he or she could receive state-funded benefits upon retirement.

At the time, the PSERS fund was the benefactor of several good years of investment experience. These good financial times were projected to last several more years. However, the events of 9/11/01 changed everything and the stock market began a two year stretch of underperformance.

In addition to Act 9, the legislature enacted Act 38 of 2002 and Act 40 of 2003, both of which changed the basic funding methodologies for PSERS and pushed back payments for additional benefits for an additional 10 years. The ten-year effect of those bills is now running out and is a contributing factor to the projected employer rate increase.

Not surprisingly, the potential increase in employer contributions was first noted in PSERS' June 30, 2003 actuarial valuation. Despite the anticipated increases, PSERS' investment returns for the years 2004 through 2007 were such that the increased projected to occur after 2010 were reduced by more than 50%. Unfortunately, the sharp decrease in the economy over the last 18 months obliterated the gains made previously. PSERS' rate of return on investments was -26.54% for the fiscal year ended June 30, 2009 (FY 2009) and -2.82% for the fiscal year ended June 30, 2008 (FY 2008) as compared with a 22.93% rate of return for the fiscal year ended June 30, 2007 (FY 2007). Not only do the losses over the last two years erase the progress that was made during 2004-07, but the initial estimate of the increase in employer contributions will likely be higher by the end of this year than when the original increase was first noted in 2003.

The new employer contribution rate for 2010-11 is 8.22% Official projections on the employer contribution have it increasing to 10.59% in 2011-12, 29.22% in 2012-13, 32.09% in 2013-14 and 33.60% in 2014-15, Official employer contribution projections will not be available until after the PSERS board meeting .

Is the only reason for the coming rate spike the lack of employer contributions at the normal cost level for a number of years?

While that is one factor, it is most definitely not the only factor. Other reasons for the spike are investment losses, particularly in the two recessions the country's experienced since 9/11/2001; the increase in the multiplier that was lobbied for; the change in the vesting rules are some of the other components of this equation.

Is it true that school employees contributed more to PSERS in the past decade than have school employers (school boards and the Commonwealth)?

Again, that is true, however, employer contributions for the four decades prior to 2002 exceeded both the normal cost and the employee contribution.

Does PSERS cover all school employees?

PSERS covers full-time employees that work five hours or more per day or five days a week or its equivalent (25 or more hours per week) and who are required by law to become members of PSERS. Part-time salaried, part-time hourly and part-time per diem employees are also eligible for membership in PSERS, depending on how many hours or days they work. Independent contractors, persons compensated on a fee basis and school crossing guards are not eligible for membership in PSERS.

How is PSERS funded?

PSERS is funded with employer (school employer and state) contributions, employee contributions and investment earnings.

How are the employer and employee contribution rates set?

The employer contribution rate is set each December by the PSERS Board of Directors and is calculated by the system's actuaries to be the contribution needed to pay for its unfunded liability when combined with the employee contributions. The employee contribution is set by law.

What are the current rates?

The 2009-10 employer contribution rate is 4.78%. The employer rate is split approximately 53%-48% between the commonwealth and school employers. That means that school employers must contribute an amount to the system that is equal to about 2.25% of the payroll for member school employees. The employee rate is 7.5% for most school employees. For some who have been in the system longer, the rate is 6.5%. The employee rate is a percentage of their wages earned as a school employee.

Why is the employer contribution rate scheduled to increase by so much?

There are several factors that have contributed to the projected increase in employer contribution rate. First, the stock market, from which PSERS receives the bulk of its investment revenue, has performed very poorly over the last two years. The rate of return on PSERS investments was -26.54% for the fiscal year ended June 30, 2009 (FY 2009) and -2.82% for the fiscal year ended June 30, 2008 (FY 2008) resulting in a devaluation of PSERS assets. Second, legislation approved during the previous decade that increased employee benefits and subsequent legislation, which re-amortized the system's liabilities, had the effect of pushing off liability to the future in exchange for providing fiscal relief to school employers and the commonwealth during recessions at the time. These liabilities are now becoming due.

What are the projected employer contribution rates for the next several years?

The latest unofficial projections are 8.40% for 2010-11; 10.70% for 2011-12; 29.55% for 2012-13; 32.45% for 2013-14 and 33.95% for 2014-15.

How can PSERS mitigate these rate increases?

Fundamentally, there are only three things that can be done: 1) increase the funding for the system, 2) decrease or cut the costs of the liabilities of the system or 3) defer the liabilities of the system.

What is likely to happen?

Because the projected increases in employer contribution are so steep, it is likely that all three tools will be used to some extent. The extent to which they are used will depend on legislative action and the performance of the stock market.

Information for this document has been gathered from many resources including the Pennsylvania School Board Association, PSBA (www.PSBA.org) and Pennsylvania Association of School Business Officials, PASBO (www.pasbo.org).