

# FINANCIAL





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**Independent Auditor's Report**

The Board of Trustees  
Public School Employees' Retirement System  
Harrisburg, Pennsylvania

We have audited the accompanying financial statements of the Public School Employees' Retirement System (PSERS), a component unit of the Commonwealth of Pennsylvania, as of and for the years ended June 30, 2011 and 2010, as listed in the table of contents. These financial statements are the responsibility of PSERS' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, PSERS' plan net assets as of June 30, 2011 and 2010, and the changes in its plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis and Required Supplementary Schedules of Funding Progress and Employer Contributions (Schedules 1 and 2) are not a required part of the financial statements, but is supplemental information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplemental information. However, we did not audit the information and express no opinion on it.

Our audits were made for the purpose of forming an opinion on the financial statements taken as a whole. Supplementary Schedules 1 through 3 are presented for purposes of additional analysis and are not a required part of the basic financial statements. Supplementary Schedules 1 through 3 have been subjected to the auditing procedures applied in the audit of the basic financial statements, and, in our opinion, are presented fairly, in all material respects, in relation to the basic financial statements taken as a whole.

The Introductory Section, Investment Section, Actuarial Section and Statistical Section as listed in the table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The Introductory, Investment, Actuarial and Statistical Sections have not been subject to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

*Clifton Gunderson LLP*

Baltimore, Maryland  
September 21, 2011



## Management's Discussion and Analysis

Management's Discussion and Analysis (MD&A) of the Commonwealth of Pennsylvania Public School Employees' Retirement System (PSERS, System, Fund) for the fiscal year ended June 30, 2011 (FY 2011), provides a narrative summary of PSERS' financial position and performance, including highlights and comparative data. The MD&A is presented as required supplementary information to the financial statements and should be read in conjunction with the financial statements, the notes to financial statements, and the supplementary schedules.

### Overview of Financial Statements

PSERS is primarily responsible for administering a defined benefit pension plan for public school employees in the Commonwealth of Pennsylvania. PSERS also administers two postemployment healthcare programs, the Health Insurance Premium Assistance (PA) Program and the Health Options Program (HOP), for its annuitants. The financial statements present the financial position and activities for the pension plan and the two postemployment healthcare programs.

The *Statements of Plan Net Assets* provide a snapshot of the financial position of PSERS at June 30, 2011, including comparative amounts for the prior year.

The *Statements of Changes in Plan Net Assets* summarize PSERS' financial activities that occurred during the fiscal period from July 1, 2010 to June 30, 2011, including comparative amounts for the prior year.

The *Notes to Financial Statements* provide additional information that is essential to a full understanding of the financial statements. The notes are an integral part of the financial statements and include detailed information not readily evident in the basic financial statements such as accounting policies, plan membership and benefits, and summary disclosures of selected financial data.

The *Required Supplementary Schedules* immediately following the notes to financial statements provide two schedules showing historical information concerning the funded status of PSERS and the employer contributions. These schedules emphasize the long-term nature of the pension and premium assistance plans and show the progress of PSERS in accumulating assets sufficient to pay benefits when due.

The remaining supplementary schedules provide additional detailed information concerning the operating expenses, investment expenses and payments to non-investment consultants. All of this supplementary information is

considered useful in understanding and evaluating the financial activities of PSERS.

### Financial Highlights

- The rate of return on investments was 20.37% for fiscal year ended June 30, 2011, 14.59% for the fiscal year ended June 30, 2010 (FY 2010) and -26.54% for the fiscal year ended June 30, 2009 (FY 2009).
- PSERS' total plan net assets increased by \$5.6 billion from \$45.8 billion at June 30, 2010 to \$51.4 billion at June 30, 2011. This increase was due in large part to net investment income plus member and employer contributions exceeding the deductions for benefits and administrative expenses. The change in total plan net assets from June 30, 2009 to June 30, 2010 was an increase in the amount of \$2.6 billion from \$43.2 billion at June 30, 2009 to \$45.8 billion at June 30, 2010. This increase was due to net investment income plus member and employer contributions exceeding the deductions for benefits and administrative expenses.
- PSERS' funded ratio as of the latest actuarial valuation dated June 30, 2010 decreased from 79.2% at June 30, 2009 to 75.1% at June 30, 2010. This decrease is due to experience losses on investment assets, liability losses, assumption changes, and contributions that were less than the normal cost plus interest on the unfunded liability. The funded ratio at June 30, 2008 was 86.0%.
- Total member contributions increased from \$1.14 billion in FY 2010 to \$1.24 billion in FY 2011. The increase was due to a slight increase in the average member contribution rate and an increase in the active member payroll. The portion of member contributions for the HOP grew due to increased participation as well as ongoing health insurance rate increases.
- Total employer contributions increased from \$638.0 million during FY 2010 to \$747.8 million in FY 2011. This increase was primarily attributable to an increase in the total employer contribution rate from 4.78% in FY 2010 to 5.64% in FY 2011 and an increase in the active member payroll. Total employer contributions increased from FY 2009 to FY 2010 which was also attributable to a slight increase in the total employer contribution rate from 4.76% in FY 2009 to 4.78% in FY 2010.

## FINANCIAL SECTION

### Management's Discussion and Analysis (continued)

and an increase in the active member payroll in FY 2010.

- Total PSERS' benefit expense increased by \$300 million from \$5.3 billion in FY 2010 to \$5.6 billion in FY 2011. This increase is attributable to the number of new retirements for the year, higher lump sum payments as well as an ongoing increase to the average monthly benefit. New retirements during FY 2011 outpaced those of FY 2010 by approximately 25%. Total PSERS' benefit expense increased by \$400 million from \$4.9 billion in FY 2009 to \$5.3 billion in FY 2010. This increase is attributable to the number of new retirements for the year, higher lump sum payments as well as an ongoing increase to the average monthly benefit.
- Total PSERS' administrative expenses increased from \$30.5 million for FY 2010 to \$57.7 million in FY 2011. This overall increase is primarily due to the impact of the capitalization of intangible assets as a result of PSERS' implementation of Governmental Accounting Standards Board (GASB) Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, in FY 2010. This adjustment resulted in a \$23.8 million reduction in FY 2010. Total PSERS' administrative expenses in FY 2009 were \$51.3 million.

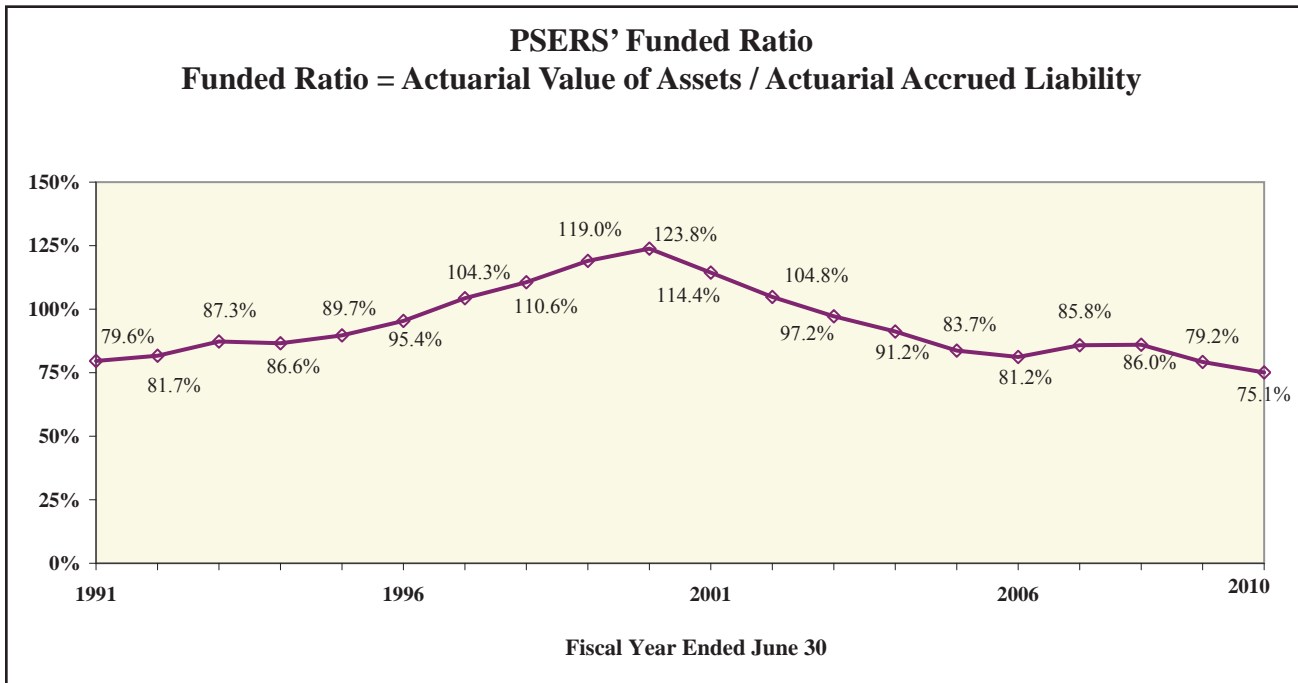
<b>Analysis of Plan Net Assets</b>					
<b>(Dollar Amounts in Thousands)</b>					
<b>Summary of Plan Net Assets</b>	<b>FY 2011</b>	<b>Increase (Decrease)</b>	<b>FY 2010</b>	<b>Increase (Decrease)</b>	<b>FY 2009</b>
<b>Assets:</b>					
Receivables	\$ 1,174,557	\$ 109,496	\$ 1,065,061	\$ (289,940)	\$ 1,355,001
Investments	51,829,164	5,324,896	46,504,268	3,160,333	43,343,935
Securities lending collateral pool	761,805	(762,429)	1,524,234	(67,486)	1,591,720
Capital assets	21,029	1,814	19,215	18,685	530
<b>Total Assets</b>	<b>53,786,555</b>	<b>4,673,777</b>	<b>49,112,778</b>	<b>2,821,592</b>	<b>46,291,186</b>
<b>Liabilities:</b>					
Payables and other liabilities	1,591,569	(159,448)	1,751,017	258,591	1,492,426
Obligations under securities lending	761,805	(762,429)	1,524,234	(67,486)	1,591,720
<b>Total Liabilities</b>	<b>2,353,374</b>	<b>(921,877)</b>	<b>3,275,251</b>	<b>191,105</b>	<b>3,084,146</b>
<b>Plan Net Assets</b>	<b>\$ 51,433,181</b>	<b>\$5,595,654</b>	<b>\$ 45,837,527</b>	<b>\$ 2,630,487</b>	<b>\$ 43,207,040</b>
<b>Summary of Changes in Plan Net Assets</b>					
<b>Additions:</b>					
Contributions	\$ 2,023,554	\$ 208,388	\$ 1,815,166	\$ 85,309	\$ 1,729,857
Net investment income (loss)	9,247,092	3,132,104	6,114,988	22,313,300	(16,198,312)
<b>Total Additions</b>	<b>11,270,646</b>	<b>3,340,492</b>	<b>7,930,154</b>	<b>22,398,609</b>	<b>(14,468,455)</b>
<b>Deductions:</b>					
Benefit expense	5,617,247	348,072	5,269,175	337,321	4,931,854
Administrative expenses	57,745	27,253	30,492	(20,783)	51,275
<b>Total Deductions</b>	<b>5,674,992</b>	<b>375,325</b>	<b>5,299,667</b>	<b>316,538</b>	<b>4,983,129</b>
<b>Changes in Plan Net Assets</b>	<b>\$ 5,595,654</b>	<b>\$2,965,167</b>	<b>\$ 2,630,487</b>	<b>\$22,082,071</b>	<b>\$ (19,451,584)</b>

**Management’s Discussion and Analysis (continued)**

**Funded Status**

PSERS uses an actuarial reserve type of funding that is financed by member contributions, employer contributions and earnings from invested assets. An independent actuarial valuation of PSERS’ actuarial assets and liabilities is performed annually. As part of this valuation, the progress toward funding pension obligations of PSERS is measured by comparing the actuarial value of assets to the actuarial accrued liability. This measurement is referred to as the funded ratio or funded status. The most recent actuarial valuation reports that PSERS is 75.1% funded as of June 30, 2010. The funded ratio decreased from 79.2% as of June 30, 2009 due to a decrease in the actuarial value of assets, which is based on a ten-year smoothing period, and an increase in the actuarial accrued liability.

The results of operations for FY 2011 will be reflected in the actuarial valuation for the year ended June 30, 2011. Due to the normal lag time for completion of the actuarial valuation, the resulting funded status will be available at the end of the 2011 calendar year and will be reported in the financial statements for the fiscal year ending June 30, 2012 (FY 2012). Based on the investment performance for the seven-year period ended June 30, 2011, which is below the investment rate of return assumption during that time period, the funded ratio at June 30, 2011 is expected to decrease. FY 2011 is the second year of a five year transition from five-year to ten-year smoothing of actuarial assets. PSERS’ State Accumulation Account had a negative balance at June 30, 2011 and 2010 (See Note 3). Employer contributions and investment earnings will be used to reduce the deficit in this Account in the future. A twenty year history of PSERS’ funded status is shown at the bottom of the page.



## Management's Discussion and Analysis (continued)

### Investments

PSERS is a long-term investor and manages the pension fund with long-term objectives in mind. A primary element of PSERS' investment philosophy is diversification among various asset classes which is the best way to achieve its goals. PSERS makes estimates of future long-term market returns and establishes an asset allocation plan taking into account the risk associated with each asset class as well as the financial objectives of the Fund.

Domestically, the first half of the fiscal year saw a continued pickup in the U.S. Gross Domestic Product (GDP). The growth quickly tapered off in the second half of the fiscal year as fiscal and monetary supports weakened. The unemployment rate fell modestly during FY 2011, while the U.S. Federal Reserve implemented another round of quantitative easing (a.k.a. QE2) in an effort to further stimulate the economy. Internationally, the news was driven by the geopolitical strife in the Middle East and Africa, a massive earthquake and resultant tsunami in Japan, and the European debt crisis which negatively impacted the economy. Despite the global hurdles, both domestic and international markets performed well, and as a result, PSERS' investment return for FY 2011 was one of the highest in its history.

For FY 2011, PSERS' rate of return on investments was 20.37% which exceeded PSERS' total fund Policy Index of 17.56%. The Policy Index is a custom benchmark, which is based on the Board-established asset allocation structure that seeks to generate a return that meets the actuarial rate of return assumption. Net investment income exceeded

\$9.2 billion in FY 2011 compared to a net investment income of \$6.1 billion in FY 2010.

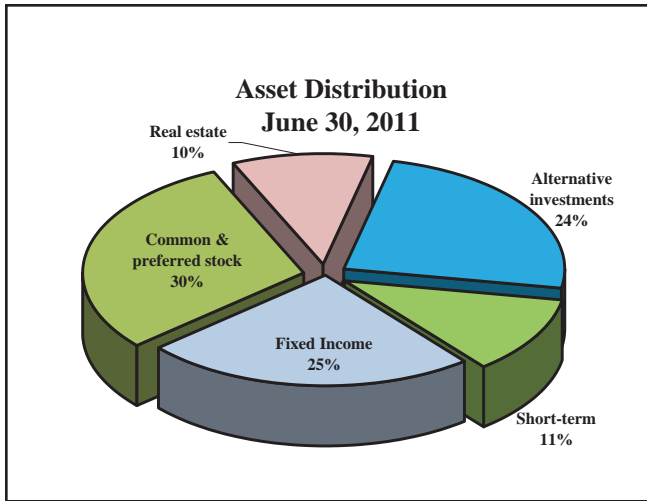
The annualized rate of return over the past three and five-year periods ended June 30, 2011 was .44% and 3.89%, respectively. The return for the three-year period trailed the total fund Policy Index return by 66 basis points while the return for the five-year period exceeded the total fund Policy Index return by 16 basis points. The annualized rate of return for the ten and twenty-five-year periods ended June 30, 2011 was 6.25% and 8.79%, respectively.

PSERS' long-term actuarial investment rate of return assumption was 7.5% at June 30, 2011. PSERS' Board of Trustees (Board) decreased the actuarial investment rate of return assumption from 8.25% to 8.0% effective for the June 30, 2009 actuarial valuation. The Board decreased the rate of return assumption further from 8.0% to 7.5% for the June 30, 2011 actuarial valuation. The changes made by the Board lowered PSERS' rate of return assumption to provide a more realistic outlook on the future earnings potential of the Fund as long-term capital market assumptions have declined. The .5% decrease in the rate of return assumption allowed PSERS to modify its asset allocation plan during FY 2011 to achieve its new return target with lower overall risk.

The asset distribution of PSERS' investment portfolio at June 30, 2011, 2010 and 2009, at fair value, and including postemployment healthcare assets, is presented in the table at the bottom of the page.

<u>Asset Class</u>	(Dollar Amounts in Thousands)					
	<u>2011</u>	<u>%</u>	<u>2010</u>	<u>%</u>	<u>2009</u>	<u>%</u>
Short-term	\$ 5,893,823	11.4	\$ 4,163,515	9.0	\$ 5,398,729	12.5
Fixed income	12,650,065	24.4	11,873,202	25.5	11,333,549	26.2
Common and preferred stock	15,436,643	29.8	15,316,957	32.9	13,883,372	32.0
Real estate	5,263,467	10.1	3,973,873	8.6	3,699,353	8.5
Alternative investments	12,585,166	24.3	11,176,721	24.0	9,028,932	20.8
<b>Total</b>	<b>\$ 51,829,164</b>	<b>100.0</b>	<b>\$ 46,504,268</b>	<b>100.0</b>	<b>\$ 43,343,935</b>	<b>100.0</b>

**Management’s Discussion and Analysis (continued)**



Short-term investments (cash and cash equivalents) increased by \$1.7 billion from \$4.2 billion at June 30, 2010 to \$5.9 billion at June 30, 2011 due to a reallocation of exposure from common and preferred stocks during FY 2011. Fixed income investments increased by \$800 million from \$11.9 billion at June 30, 2010 to \$12.7 billion at June 30, 2011 due to market value appreciation and allocation increases to the asset class. Common and preferred stock investments also increased by \$100 million from \$15.3 billion at June 30, 2010 to \$15.4 billion at June 30, 2011. The slight rise in this asset category was primarily the result of positive returns in the domestic and international equity markets which were almost entirely negated by allocation decreases to the asset class. Real estate investments rose by \$1.3 billion from \$4.0 billion at June 30, 2010 to \$5.3 billion at June 30, 2011 mostly as a result of contributions to new and existing partnerships combined with market recovery. Alternative investments increased by \$1.4 billion from \$11.2 billion at June 30, 2010 to \$12.6 billion at June 30, 2011 due to contributions to new and existing partnerships combined with strong appreciation in partnership portfolio investments which outweighed significant distributions.

Short-term investments decreased by \$1.2 billion from \$5.4 billion at June 30, 2009 to \$4.2 billion at June 30, 2010. Due to an improved liquidity situation in the financial markets, PSERS was able to substantially reduce its cash management level during FY 2010. Fixed income investments increased by \$600 million from \$11.3 billion at June 30 2009 to \$11.9 billion at June 30, 2010 mostly due to market value appreciation which was partially offset by allocation reductions. Common and preferred stock investments also increased by \$1.4 billion from \$13.9 billion at June 30, 2009 to \$15.3 billion at June 30, 2010. The upturn in this asset category was mainly the result of positive returns in the domestic and international equity markets which were counteracted to a certain extent

by allocation decreases to the asset class. Real estate investments rose by \$300 million from \$3.7 billion at June 30, 2009 to \$4.0 billion at June 30, 2010 as a result of contributions to new and existing partnerships offsetting continuing declines in value of partnership investments. Alternative investments increased by \$2.2 billion from \$9.0 billion at June 30, 2009 to \$11.2 billion at June 30, 2010 due to contributions to new and existing partnerships combined with a recovery of value in partnership portfolio holdings.

**Securities Lending**

Securities lending collateral pool and obligations under securities lending decreased from \$1.5 billion at June 30, 2010 to \$762 million at June 30, 2011. Due to a decrease in demand for securities lending activities, the market value of securities actually on loan declined from \$2.1 billion at June 30, 2010 to \$1.3 billion at June 30, 2011. The non-cash collateral decreased slightly from \$715 million at June 30, 2010 to \$651 million at June 30, 2011. Non-cash collateral is not reflected in the Statement of Plan Net Assets. The System experienced only a slight change in net gain from securities lending activities from \$8.5 million in FY 2010 to \$7.2 million in FY 2011 as spreads improved but volume declined.

**Contributions**

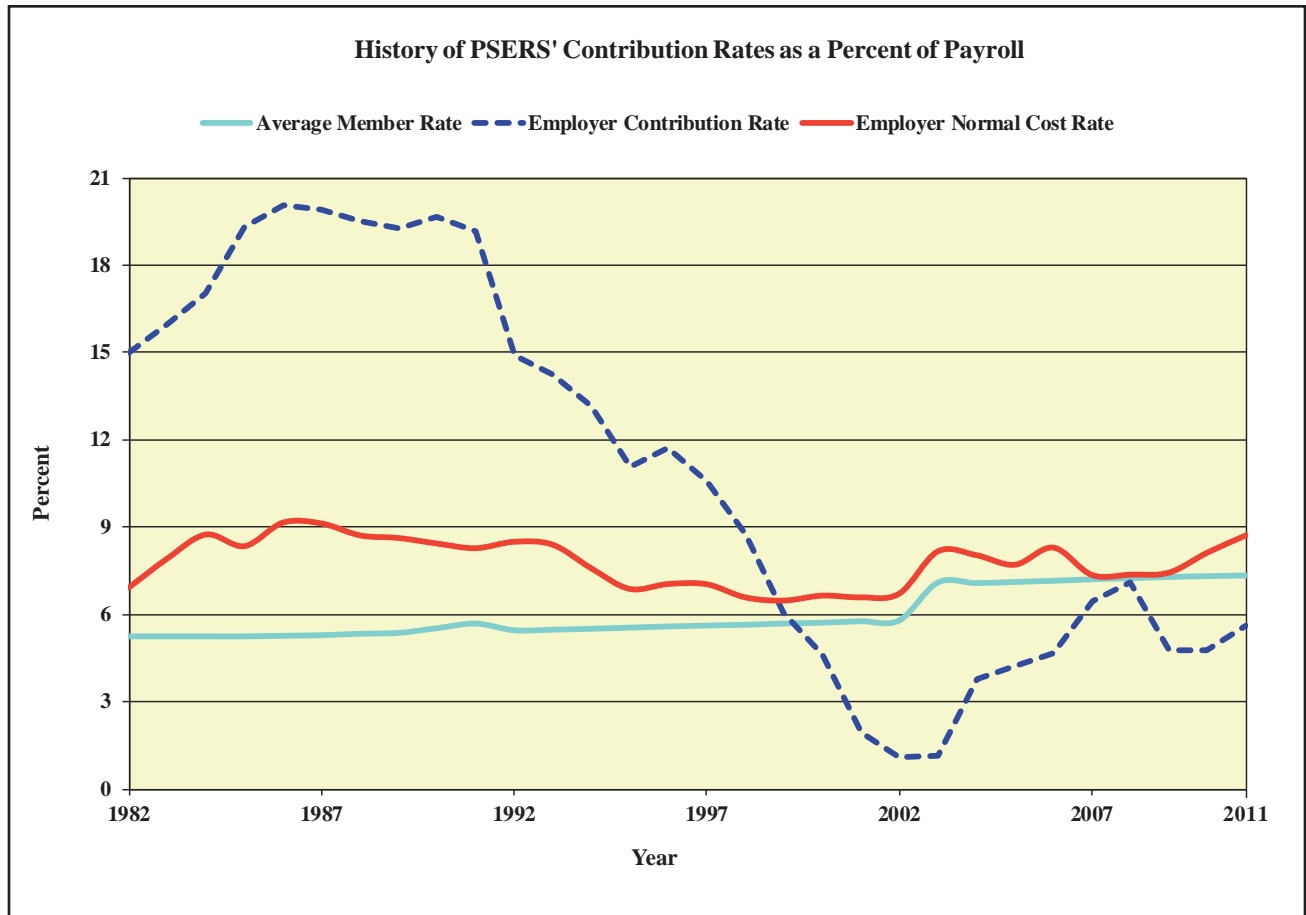
Employer contributions increased from \$638.0 million in FY 2010 to \$747.8 million in FY 2011 due to the increase in the total employer contribution rate from 4.78% in FY 2010 to 5.64% in FY 2011 and an increase in the active member payroll.

Total member contributions increased from \$1.14 billion in FY 2010 to \$1.24 billion in FY 2011 due to increases in both the average member contribution rate and active member payroll for pension and increased participation in the HOP. The average member contribution rate for pension increased from 7.32% in FY 2010 to 7.34% in FY 2011. Total member contributions increased from \$1.09 billion in FY 2009 to \$1.14 billion in FY 2010 as a result of the increase in the average member contribution rate and total active member payroll for pension and increased participation in the HOP. The average member contribution rate for pension increased from 7.29% in FY 2009 to 7.32% in FY 2010. A thirty-year history of PSERS’ contribution rates is presented on the next page.

As a result of an increase in member purchase of service credits and higher contribution rates, accounts receivable balances for member and employer contributions were



**Management’s Discussion and Analysis (continued)**



significantly higher at June 30, 2011 compared to June 30, 2010. Total member and employer accounts receivable at June 30, 2011 were \$531.0 million compared to \$450.6 million as of June 30, 2010.

employer cost structure for new members and shifted some of the investment risk to members. The employer normal cost for Act 120 members is 68% less than pre-Act 120 members as the benefit plan is primarily member funded.

**Pennsylvania Act 120 of 2010**

On November 23, 2010, the Governor signed HB 2497 into law. The legislation is now known as Act 120 of 2010.

Act 120 preserves the benefits of existing members and includes a series of actuarial and funding changes to PSERS and benefit reductions for individuals who become new members of PSERS on or after July 1, 2011. The Act created two new membership classes, T-E and T-F.

Act 120 has a projected net savings of \$1.38 billion through FY 2044 as the \$24.65 billion of projected savings from benefit reductions is offset by the \$23.27 billion cost of deferring contributions for budgetary purposes. Act 120 addressed the pending employer contribution rate spike projected for FY 2013 by smoothing the projected rate increases over a five to nine year time period. In addition, the benefit reductions and risk sharing provisions for new members on July 1, 2011 and thereafter have created a low



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## Management's Discussion and Analysis (continued)

### Benefit Changes

All new members will automatically become Class T-E members. New members however, will have a one-time opportunity to elect Class T-F within 45 days of receiving written notification from PSERS. Failure to elect Class T-F at time of original eligibility will make the member ineligible for Class T-F forever. In other words, once the election is made either by action or inaction, the election is permanent. Provisions affecting both new membership classes are as follows:

- The cost to purchase Non Qualifying Part Time (NQPT) service and most types of nonschool or nonstate service credit (other than military service) will be the full actuarial cost of the service.
- Ten year vesting period.
- For normal retirement, employees must work until age 65 with a minimum of 3 years of service, or attain a total combination of age and service that is equal to or greater than 92 with a minimum of 35 years of service.
- No projection of service for determining normal retirement.
- Cannot withdraw contributions and interest in a lump sum when retiring.
- Pension benefit cannot exceed the member's final average salary.
- New employees starting later than July 1, 2011 will contribute based on the "shared risk" rate in effect at date of hire.

Benefit and contribution rates for the new membership classes are as follows:

#### Class T-E

- Final average salary multiplier is 2% as opposed to 2.5% multiplier for most current members.
- Employee contribution base rate is 7.5% (base rate) with a "shared risk" provision that could cause the total contribution levels to fluctuate between 7.5% and 9.5%.

#### Class T-F

- Final average salary multiplier is 2.5%.
- Employee contribution base rate is 10.3% (base rate) with a "shared risk" provision that could cause the total contribution levels to fluctuate between 10.3% and 12.3%.

With a "shared risk" program, Class T-E and T-F members benefit when investments of the fund are doing well and share some of the risk when investments underperform. The member contribution rate will stay within the specified range allotted for Class T-E or T-F; but could increase or decrease by .5% every three

years starting July 1, 2015, dependent on investment performance of PSERS. The member contribution rate could never go below the base rate of 7.5% for T-E and 10.3% for T-F members, or above 9.5% for T-E and 12.3% for T-F members.

### Funding/Actuarial Changes

#### Funding Changes - Employer Contributions

The legislation also suppresses the employer contribution rate by using rate caps in future years to keep the rate from rising too high, too fast for budgetary purposes.

The rate caps limit the amount the pension component of the employer contribution rate can increase over the prior year's rate as follows:

- FY 2012 - not more than 3.0% plus the premium assistance contribution rate
- FY 2013 - not more than 3.5% plus the premium assistance contribution rate
- FY 2014 and thereafter - not more than 4.5% plus the premium assistance contribution rate

The rate cap remains at 4.5% until the rate cap no longer applies, i.e. the rise in the employer contribution rate is less than the rate cap in effect at that time. Once the rate caps no longer apply, the employer normal cost becomes the contribution rate floor.

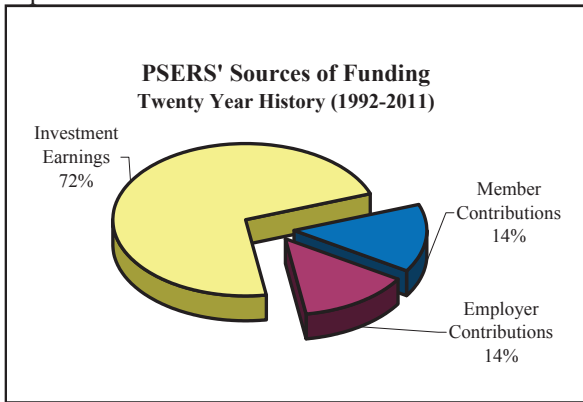
#### Actuarial Changes

- Currently liabilities are funded over various periods of time using level dollar amortization. Act 120 re-amortizes all unfunded liabilities over a 24 year period and uses level percentage of pay amortization.
- Level percentage of pay amortization is calculated using the same percentage of compensation each year during the amortization period. Under the level dollar amortization, the annual dollar amount of the payment remains the same each year.
- Act 120 changes the recognition of investment gains and losses from a five year smoothing period to a ten year smoothing period.
- Any future legislation enacted that adds liabilities to the system (i.e. cost-of-living adjustments, "30 and Out") will be amortized over 10 years, using a level percentage of pay method. The cost of any additional accrued liability must be reflected above the employer contribution rate caps.
- Establishes a prohibition on the use of Pension Obligation Bonds to fund the System.

**Management’s Discussion and Analysis (continued)**

**Investment Income**

Net investment income increased by \$3.1 billion from \$6.1 billion in FY 2010 to \$9.2 billion in FY 2011, which is consistent with the increase in the investment rate of return from 14.59% for FY 2010 to 20.37% for FY 2011. Net investment income (loss) changed by \$22.3 billion from -\$16.2 billion in FY 2009 to \$6.1 billion in FY 2010, which is consistent with the increase in the investment rate of return from -26.54% for FY 2009 to 14.59% for FY 2010. As depicted in the following chart, investment earnings provided 72% of PSERS’ funding over the past 20 years. Net investment income (loss) also includes investment expenses as a deduction. The “Total PSERS Benefits and Expenses” section that follows includes an analysis of investment expenses.



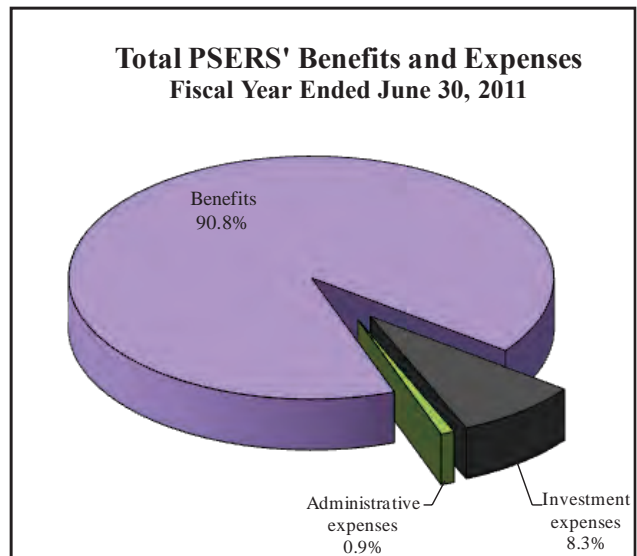
Investment expenses decreased by \$7.6 million from \$522.3 million in FY 2010 to \$514.7 million in FY 2011 mainly due to a decline in management fees in the alternative investment asset class. This reduction is widely attributable to changes in fee structure brought on by partnerships maturing. Investment expenses increased by \$44.7 million from \$477.6 million in FY 2009 to \$522.3 million in FY 2010 chiefly due to a rise in management fees in the public market asset classes. The growth in these fees was primarily a result of certain investment managers earning higher performance incentives in FY 2010 than in FY 2009.

Administrative expenses increased by \$27.2 million from \$30.5 million during FY 2010 compared to \$57.7 million during FY 2011. This increase was primarily caused by a \$23.8 million reduction in FY 2010 due to the capitalization of previously expensed GASB 51 qualifying costs for computer systems development. In addition the HOP administrative expenses increased by \$2.3 million due to an increase in member administrative fees and participation. Administrative expenses totaled \$51.3 million during FY 2009.

**Total PSERS’ Benefits and Expenses**

The primary source of expense during FY 2011 was for the payment of benefits approximating \$5.6 billion. The breakdown consisted of \$5.3 billion for Pension, \$94 million for the PA Program and \$215 million for HOP benefits. The chart at the end of this page illustrates the significant portion of expenses attributable to benefit payments.

Total PSERS’ benefit expense increased from \$5.3 billion in FY 2010 to \$5.6 billion in FY 2011. The slight increase is attributable to the number of new retirements for the year, higher lump sum payments, as well as an ongoing increase to the average monthly benefit. As a result of these factors pension benefits payable at June 30, 2011 increased to \$646.4 million compared to \$540.0 million at June 30, 2010. New retirements during FY 2011 outpaced the number from FY 2010 by approximately 25%. Benefit expense increased from \$4.9 billion in FY 2009 to \$5.3 billion in FY 2010. This increase is attributable to the number of new retirements for the year, higher lump sum payments, as well as an ongoing increase to the average monthly benefit.



**Management's Discussion and Analysis (continued)****Postemployment Healthcare**

PSERS administers two postemployment healthcare programs, the Health Insurance Premium Assistance (PA) Program and the Health Options Program (HOP) for its annuitants. The following paragraphs and summary data provide supplementary information to the financial statements which contain the financial position and activities for the two postemployment healthcare programs.

**Financial Highlights for Postemployment Healthcare****Health Insurance Premium Assistance (PA) Program**

- Total plan net assets decreased by \$5.6 million in FY 2011 due to benefit payments and the associated administrative expenses exceeding employer contributions. The change from June 30, 2009 to June 30, 2010 was an increase of \$11.7 million due to contributions exceeding expenses.
- Total receivables decreased slightly from \$37.5 million at June 30, 2010 to \$32.6 million at June 30, 2011 due to improved employer collections and a lower employer contribution rate factor.
- Investments remained fairly consistent from \$79.8 million at June 30, 2010 to \$80.6 million at June 30, 2011.

**Health Options Program (HOP)**

- Total plan net assets decreased by \$0.3 million in FY 2011 primarily due to the rise in claims expenditures outpacing the rise in contributions by a near 3 to 1 margin. The change from June 30, 2009 to June 30, 2010 is primarily due to the timing of vendor payments, which increased cash flows.
- Total receivables increased from \$13.4 million at June 30, 2010 to \$13.8 million at June 30, 2011. The increase is tied primarily to an increase in participation.
- Investments increased from \$142.4 million at June 30, 2010 to \$145.9 million at June 30, 2011 due to timing of vendor payments which increased cash flow.

- Total liabilities increased 12.2% from June 30, 2010 to June 30, 2011. The increase is due to increased participation in the program and due to payment timing for an invoice for prescription drug benefits.

**Contributions**

- Total employer contributions for the PA Program decreased from \$102.7 million in FY 2010 to \$89.2 million in FY 2011 due to the decrease in employer contribution rate from 0.78% in FY 2010 to 0.64% in FY 2011.
- Total member and CMS contributions for HOP increased from \$225.1 million in FY 2010 to \$233.1 million in FY 2011. This increase is representative of the 8.0% increase in plan participation.

**Investment Income**

- Total investment income for the PA Program decreased from \$0.9 million in FY 2010 to \$0.7 million in FY 2011. The decrease is due to declining short-term interest rates from FY 2010 to FY 2011.
- Investment income for HOP decreased from \$0.4 million in FY 2010 to \$0.3 million in FY 2011. This decrease is due to lower rates of return on short-term investments.

**Benefits and Expenses**

- Overall expenses for the PA Program increased from \$91.9 million in FY 2010 to \$95.5 million in FY 2011. This increase is primarily due to the increase in number of members receiving premium assistance benefits.
- Overall expenses for HOP increased from \$209.8 million in FY 2010 to \$233.7 million in FY 2011. The increase is due to increased claims experience of the program.

## FINANCIAL SECTION

### Management's Discussion and Analysis (continued)

#### Premium Assistance

##### Summary of Plan Net Assets

(Dollar Amounts in Thousands)

<b>Assets:</b>	<b>FY 2011</b>	Increase (Decrease)	FY 2010	Increase (Decrease)	FY 2009
Receivables	\$ 32,621	\$ (4,919)	\$ 37,540	\$ (787)	\$ 38,327
Investments	80,587	739	79,848	12,580	67,268
<b>Total Assets</b>	<b>113,208</b>	<b>(4,180)</b>	<b>117,388</b>	<b>11,793</b>	<b>105,595</b>
<b>Liabilities</b>					
Payables and other liabilities	1,950	1,393	557	76	481
<b>Total Liabilities</b>	<b>1,950</b>	<b>1,393</b>	<b>557</b>	<b>76</b>	<b>481</b>
<b>Plan Net Assets</b>	<b>\$ 111,258</b>	<b>\$ (5,573)</b>	<b>\$ 116,831</b>	<b>\$ 11,717</b>	<b>\$ 105,114</b>

##### Summary of Changes in Plan Net Assets

<b>Additions:</b>	<b>FY 2011</b>	Increase (Decrease)	FY 2010	Increase (Decrease)	FY 2009
Contributions	\$ 89,242	\$ (13,461)	\$ 102,703	\$ 10,210	\$ 92,493
Net Investment Income	691	(178)	869	(992)	1,861
<b>Total Additions</b>	<b>89,933</b>	<b>(13,639)</b>	<b>103,572</b>	<b>9,218</b>	<b>94,354</b>
<b>Deductions:</b>					
Benefit Expenses	93,518	3,607	89,911	6,705	83,206
Administrative Expenses	1,988	44	1,944	125	1,819
<b>Total Deductions</b>	<b>95,506</b>	<b>3,651</b>	<b>91,855</b>	<b>6,830</b>	<b>85,025</b>
<b>Changes in Plan Net Assets</b>	<b>\$ (5,573)</b>	<b>\$ (17,290)</b>	<b>\$ 11,717</b>	<b>\$ 2,388</b>	<b>\$ 9,329</b>

#### Health Options Program

##### Summary of Plan Net Assets

(Dollar Amounts in Thousands)

<b>Assets:</b>	<b>FY 2011</b>	Increase (Decrease)	FY 2010	Increase (Decrease)	FY 2009
Receivables	\$ 13,769	\$ 351	\$ 13,418	\$ 3,844	\$ 9,574
Investments	145,901	3,465	142,436	15,393	127,043
<b>Total Assets</b>	<b>159,670</b>	<b>3,816</b>	<b>155,854</b>	<b>19,237</b>	<b>136,617</b>
<b>Liabilities</b>					
Payables and other liabilities	37,741	4,108	33,633	3,462	30,171
<b>Total Liabilities</b>	<b>37,741</b>	<b>4,108</b>	<b>33,633</b>	<b>3,462</b>	<b>30,171</b>
<b>Plan Net Assets</b>	<b>\$ 121,929</b>	<b>\$ (292)</b>	<b>\$ 122,221</b>	<b>\$ 15,775</b>	<b>\$ 106,446</b>

##### Summary of Changes in Plan Net Assets

<b>Additions:</b>	<b>FY 2011</b>	Increase (Decrease)	FY 2010	Increase (Decrease)	FY 2009
Contributions	\$ 233,094	\$ 8,009	\$ 225,085	\$ 14,728	\$ 210,357
Net Investment Income	310	(130)	440	(1,088)	1,528
<b>Total Additions</b>	<b>233,404</b>	<b>7,879</b>	<b>225,525</b>	<b>13,640</b>	<b>211,885</b>
<b>Deductions:</b>					
Benefit Expenses	214,967	21,660	193,307	12,272	181,035
Administrative Expenses	18,729	2,286	16,443	2,626	13,817
<b>Total Deductions</b>	<b>233,696</b>	<b>23,946</b>	<b>209,750</b>	<b>14,898</b>	<b>194,852</b>
<b>Changes in Plan Net Assets</b>	<b>\$ (292)</b>	<b>\$ (16,067)</b>	<b>\$ 15,775</b>	<b>\$ (1,258)</b>	<b>\$ 17,033</b>

## FINANCIAL SECTION

### Statements of Plan Net Assets June 30, 2011 and 2010 (Dollar Amounts in Thousands)

	2011			
	Pension	Postemployment Healthcare		Totals
		Premium Assistance	Health Options Program	
<b>Assets:</b>				
Receivables:				
Members	\$ 300,448	\$ 5,893	\$ 38	\$ 306,379
Employers	198,739	25,899	-	224,638
Investment income	314,822	242	11	315,075
Investment proceeds	313,512	-	-	313,512
Centers for Medicare & Medicaid Services	-	-	6,639	6,639
Miscellaneous	646	587	7,081	8,314
<b>Total Receivables</b>	<b>1,128,167</b>	<b>32,621</b>	<b>13,769</b>	<b>1,174,557</b>
Investments, at fair value:				
Short-term	5,667,335	80,587	145,901	5,893,823
Fixed income	12,650,065	-	-	12,650,065
Common and preferred stock	15,436,643	-	-	15,436,643
Real estate	5,263,467	-	-	5,263,467
Alternative investments	12,585,166	-	-	12,585,166
<b>Total Investments</b>	<b>51,602,676</b>	<b>80,587</b>	<b>145,901</b>	<b>51,829,164</b>
Securities lending collateral pool	761,805	-	-	761,805
Capital assets (net of accumulated depreciation \$18,208)	21,029	-	-	21,029
<b>Total Assets</b>	<b>53,513,677</b>	<b>113,208</b>	<b>159,670</b>	<b>53,786,555</b>
<b>Liabilities:</b>				
Accounts payable and accrued expenses	118,980	340	1,230	120,550
Benefits payable	646,390	100	19,525	666,015
Participant premium advances	-	-	16,986	16,986
Investment purchases and other liabilities	786,508	1,510	-	788,018
Obligations under securities lending	761,805	-	-	761,805
<b>Total Liabilities</b>	<b>2,313,683</b>	<b>1,950</b>	<b>37,741</b>	<b>2,353,374</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits</b>				
(Schedules of funding progress are presented on Required Supplementary Schedule 1)				
	\$ 51,199,994	\$ 111,258	\$ 121,929	\$ 51,433,181

The accompanying notes are an integral part of the financial statements.

## FINANCIAL SECTION

### Statements of Plan Net Assets June 30, 2011 and 2010 (Dollar Amounts in Thousands)

	2010			
	Postemployment Healthcare			Totals
	Pension	Premium Assistance	Health Options Program	
<b>Assets:</b>				
Receivables:				
Members	\$ 240,569	\$ 6,597	\$ 40	\$ 247,206
Employers	173,258	30,184	-	203,442
Investment income	252,495	289	38	252,822
Investment proceeds	347,033	-	-	347,033
Centers for Medicare & Medicaid Services	-	-	6,231	6,231
Miscellaneous	748	470	7,109	8,327
<b>Total Receivables</b>	<b>1,014,103</b>	<b>37,540</b>	<b>13,418</b>	<b>1,065,061</b>
Investments, at fair value:				
Short-term	3,941,231	79,848	142,436	4,163,515
Fixed income	11,873,202	-	-	11,873,202
Common and preferred stock	15,316,957	-	-	15,316,957
Real estate	3,973,873	-	-	3,973,873
Alternative investments	11,176,721	-	-	11,176,721
<b>Total Investments</b>	<b>46,281,984</b>	<b>79,848</b>	<b>142,436</b>	<b>46,504,268</b>
Securities lending collateral pool	1,524,234	-	-	1,524,234
Capital assets (net of accumulated depreciation of \$16,641)	19,215	-	-	19,215
<b>Total Assets</b>	<b>48,839,536</b>	<b>117,388</b>	<b>155,854</b>	<b>49,112,778</b>
<b>Liabilities:</b>				
Accounts payable and accrued expenses	77,048	361	1,287	78,696
Benefits payable	540,011	196	16,047	556,254
Premium advances	-	-	16,299	16,299
Investment purchases and other liabilities	1,099,768	-	-	1,099,768
Obligations under securities lending	1,524,234	-	-	1,524,234
<b>Total Liabilities</b>	<b>3,241,061</b>	<b>557</b>	<b>33,633</b>	<b>3,275,251</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits</b>				
(Schedules of funding progress are presented on Required Supplementary Schedule 1)				
	\$ 45,598,475	\$ 116,831	\$ 122,221	\$ 45,837,527

The accompanying notes are an integral part of the financial statements.

## FINANCIAL SECTION

### Statements of Changes in Plan Net Assets Years Ended June 30, 2011 and 2010 (Dollar Amounts in Thousands)

	2011			Totals
	Postemployment Healthcare			
	Pension	Premium Assistance	Health Options Program	
<b>Additions:</b>				
Contributions:				
Members	\$ 1,042,707	\$ -	\$ 201,014	\$ 1,243,721
Employers	658,511	89,242	-	747,753
Centers for Medicare & Medicaid Services	-	-	32,080	32,080
<b>Total contributions</b>	<b>1,701,218</b>	<b>89,242</b>	<b>233,094</b>	<b>2,023,554</b>
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	8,494,530	(1,324)	-	8,493,206
Short-term	12,755	2,063	310	15,128
Fixed income	432,649	-	-	432,649
Common and preferred stock	368,901	-	-	368,901
Real estate	113,370	-	-	113,370
Alternative investments	331,286	-	-	331,286
<b>Total investment activity income</b>	<b>9,753,491</b>	<b>739</b>	<b>310</b>	<b>9,754,540</b>
Investment expenses	(514,647)	(48)	-	(514,695)
<b>Net income from investing activities</b>	<b>9,238,844</b>	<b>691</b>	<b>310</b>	<b>9,239,845</b>
From securities lending activities:				
Securities lending income	8,251	-	-	8,251
Securities lending expense	(1,004)	-	-	(1,004)
<b>Net income from securities lending activities</b>	<b>7,247</b>	<b>-</b>	<b>-</b>	<b>7,247</b>
<b>Total net investment income</b>	<b>9,246,091</b>	<b>691</b>	<b>310</b>	<b>9,247,092</b>
<b>Total Additions</b>	<b>10,947,309</b>	<b>89,933</b>	<b>233,404</b>	<b>11,270,646</b>
<b>Deductions:</b>				
Benefits	5,281,223	93,518	214,967	5,589,708
Refunds of contributions	17,695	-	-	17,695
Net transfer to State Employees' Retirement System	9,844	-	-	9,844
Administrative expenses	37,028	1,988	18,729	57,745
<b>Total Deductions</b>	<b>5,345,790</b>	<b>95,506</b>	<b>233,696</b>	<b>5,674,992</b>
<b>Net increase (decrease)</b>	<b>5,601,519</b>	<b>(5,573)</b>	<b>(292)</b>	<b>5,595,654</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits:</b>				
<b>Balance, beginning of year</b>	<b>45,598,475</b>	<b>116,831</b>	<b>122,221</b>	<b>45,837,527</b>
<b>Balance, end of year</b>	<b>\$ 51,199,994</b>	<b>\$ 111,258</b>	<b>\$ 121,929</b>	<b>\$ 51,433,181</b>

The accompanying notes are an integral part of the financial statements.



## FINANCIAL SECTION

### Statements of Changes in Plan Net Assets Years Ended June 30, 2011 and 2010 (Dollar Amounts in Thousands)

	2010			
	Pension	Postemployment Healthcare		Totals
		Premium Assistance	Health Options Program	
<b>Additions:</b>				
Contributions:				
Members	\$ 952,047	\$ -	\$ 191,184	\$ 1,143,231
Employers	535,331	102,703	-	638,034
Centers for Medicare & Medicaid Services	-	-	33,901	33,901
<b>Total contributions</b>	<b>1,487,378</b>	<b>102,703</b>	<b>225,085</b>	<b>1,815,166</b>
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	5,561,419	(1,039)	-	5,560,380
Short-term	19,015	1,955	440	21,410
Fixed income	440,358	-	-	440,358
Common and preferred stock	365,255	-	-	365,255
Real estate	62,273	-	-	62,273
Alternative investments	179,116	-	-	179,116
<b>Total investment activity income</b>	<b>6,627,436</b>	<b>916</b>	<b>440</b>	<b>6,628,792</b>
Investment expenses	(522,268)	(47)	-	(522,315)
<b>Net income from investing activities</b>	<b>6,105,168</b>	<b>869</b>	<b>440</b>	<b>6,106,477</b>
From securities lending activities:				
Securities lending income	9,574	-	-	9,574
Securities lending expense	(1,063)	-	-	(1,063)
<b>Net income from securities lending activities</b>	<b>8,511</b>	<b>-</b>	<b>-</b>	<b>8,511</b>
<b>Total net investment income</b>	<b>6,113,679</b>	<b>869</b>	<b>440</b>	<b>6,114,988</b>
<b>Total Additions</b>	<b>7,601,057</b>	<b>103,572</b>	<b>225,525</b>	<b>7,930,154</b>
<b>Deductions:</b>				
Benefits	4,962,222	89,911	193,307	5,245,440
Refunds of contributions	16,720	-	-	16,720
Net transfer to State Employees' Retirement System	7,015	-	-	7,015
Administrative expenses	12,105	1,944	16,443	30,492
<b>Total Deductions</b>	<b>4,998,062</b>	<b>91,855</b>	<b>209,750</b>	<b>5,299,667</b>
<b>Net increase</b>	<b>2,602,995</b>	<b>11,717</b>	<b>15,775</b>	<b>2,630,487</b>
<b>Net assets held in trust for pension and postemployment healthcare benefits:</b>				
<b>Balance, beginning of year</b>	<b>42,995,480</b>	<b>105,114</b>	<b>106,446</b>	<b>43,207,040</b>
<b>Balance, end of year</b>	<b>\$ 45,598,475</b>	<b>\$ 116,831</b>	<b>\$ 122,221</b>	<b>\$ 45,837,527</b>

The accompanying notes are an integral part of the financial statements.

**Notes to Financial Statements**  
**Years Ended June 30, 2011 and 2010**

**1. Organization and Description of the System**

**(A) Organization**

The System was established on July 18, 1917, under the provisions of Pamphlet Law 1043, No. 343 as a governmental cost-sharing multiple-employer plan that provides retirement allowances and other benefits to its members. Membership in the System is mandatory for nearly all qualifying public school employees in the Commonwealth of Pennsylvania (Commonwealth). At June 30, 2011, there were 756 participating employers, generally school districts. Membership as of June 30, 2010, the most recent year for which actual amounts are available, is presented in the table at the bottom of this page.

The Public School Employees' Retirement Board (Board) is established by state law as an independent administrative board of the Commonwealth. The Board exercises control and management of the System, including the investment of its assets. The Board has fifteen members including the Commonwealth's Secretary of Education, the State Treasurer, the Executive Director of the Pennsylvania School Boards Association, two members appointed by the Governor, six elected members (three from among the System's certified members, one from among the System's noncertified members, one from among the System's annuitants, and one from among school board members in Pennsylvania), two members from the Senate, and two members from the House of Representatives.

The State Treasurer is the custodian of the System's fund. The retirement plan of the System is a contributory defined benefit plan for which the benefit payments to members and contribution provisions by employers and employees are specified in the Pennsylvania Public School Employees' Retirement Code (Code). Changes in benefit

and contribution provisions for the retirement plan must be made by legislation. Pursuant to state law, all legislative bills and amendments proposing to change the System's retirement plan are to be accompanied with an actuarial note prepared by an enrolled pension actuary from the Public Employee Retirement Commission providing an estimate of the cost and actuarial effect of the proposed change.

Based upon criterion of financial accountability as defined by governmental accounting standards, the System is considered a component unit of the Commonwealth of Pennsylvania financial reporting entity and is included in the Comprehensive Annual Financial Report of the Commonwealth of Pennsylvania.

**(B) Pension Plan**

The following Footnote (B) subsections i., ii., iii., and iv. include benefit, contribution and actuarial provisions in effect at June 30, 2011. Act 120 of 2010 introduced major changes to these provisions for individuals who become new PSERS members on or after July 1, 2011 as discussed in the MD&A under the Pennsylvania Act 120 of 2010 section.

**i. Pension Benefits**

Under the provisions of the 1975 revision of the Code by the Pennsylvania General Assembly, members are eligible for monthly retirement benefits upon reaching (a) age 62 with at least 1 year of credited service; (b) age 60 with 30 or more years of credited service; or (c) 35 or more years of service regardless of age. The Internal Revenue Code (IRC) limitation on the annual benefits for a defined benefit plan was \$195,000 and age 62 for 2011 and 2010.

Benefits are generally equal to 2% or 2.5%, depending

Currently employed members:		
Vested	189,000	
Nonvested	93,000	
<b>Total currently employed members</b>		<b>282,000</b>
Retirees and beneficiaries currently receiving benefits	185,000	
Inactive members and vestees entitled to but not receiving benefits	112,000	
<b>Total retirees and other members</b>		<b>297,000</b>
<b>Total number of members</b>		<b>579,000</b>

**Notes to Financial Statements (continued)**

Membership Class T-C	Active members hired before July 22, 1983	5.25%
Membership Class T-C	Active members hired on or after July 22, 1983	6.25%
Membership Class T-D	Active members hired before July 22, 1983	6.50%
Membership Class T-D	Active members hired on or after July 22, 1983	7.50%

upon membership class, of the member’s final average salary (as defined in the Code) multiplied by the number of years of credited service. In most cases after completion of five years of service, a member’s right to the defined benefit is vested and early retirement benefits may be elected. Under certain features of the System, active members may purchase credit for various types of prior school and non-school service on a lump-sum, installment purchase basis, or through an actuarially calculated benefit reduction.

In addition to regular retirement benefits, the System also provides for disability retirement benefits and death benefits. Participants are eligible for disability retirement benefits after completion of five years of credited service. Such benefits are generally equal to 2% or 2.5%, depending upon membership class, of the member’s final average salary (as defined in the Code) multiplied by the number of years of credited service, but not less than one-third of such salary nor greater than the benefit the member would have had at normal retirement age. Members over normal retirement age may apply for disability benefits. Certain exceptions apply to normal disability retirements.

Death benefits are payable upon the death of an active member who has reached age 62 or who has at least five years of credited service. Such benefits are actuarially equivalent to the benefit that would have been effective if the member had retired on the day before death. Benefits may be distributed for a deceased member by a nonspouse beneficiary via a direct trustee-to-trustee transfer to an Individual Retirement Account (IRA), which is treated as an inherited account.

Members with credited service in the Commonwealth of Pennsylvania State Employees’ Retirement System (SERS) may elect to transfer service to the Public School Employees’ Retirement System upon commencement of employment in the public school system. Similarly, a member with credited service in the System may transfer such service to SERS upon becoming a member of that system.

All members are fully vested in their individual balance in the Members’ Savings Account which is described in Note 3. Upon termination of a member’s employment in the public school sector, the member’s accumulated contributions plus interest are refundable from the Members’ Savings Account.

**ii. Contributions**

The contribution policy is set by the Code and requires contributions by active members, employers, and the Commonwealth. The System’s funding policy provides for periodic employer and Commonwealth contributions at actuarially determined rates, expressed as a percentage of annual covered payroll, such that they, along with employee contributions and an actuarially determined rate of investment return, are adequate to accumulate assets to pay retirement benefits when due. Level percentage of payroll employer contribution rates is determined using the entry age normal actuarial funding method. This method determines the amount of contributions necessary to (1) fully fund all current costs, (also known as normal cost), which represents the estimated amount necessary to pay for the benefits earned by the employees during the current service year; and (2) liquidate the prior service cost for service earned prior to the current service year and subsequent benefit increases, which represents the amount necessary to fund accrued liabilities over the appropriate amortization periods.

Contribution rates for active members are set by law (redefined with the provisions of Act 9 of 2001) and are dependent upon members’ class. The contribution rates based on qualified member compensation for virtually all members are presented in the table at the top of this page. The IRC limitation on the annual compensation for a defined benefit plan was \$245,000 for 2011 and 2010.

Active members newly hired after July 1, 2001, the effective date of Act 9 of 2001, are automatically Class T-D. The contribution rates for all members in Membership Class T-D were effective January 1, 2002.

The total contribution rate for the employers and the Commonwealth was 5.64% and 4.78% of qualified compensation for the years ended June 30, 2011 and 2010, respectively. The total contribution rate for the year ended June 30, 2011 was recertified from an actuarially required rate of 8.22% to 5.64% based upon the statutory requirements of Act 46 of 2010.

Act 120 of 2010 suppresses the employer contribution rate by using rate caps in future years to keep the rate from rising too high, too fast for budgetary purposes.

**Notes to Financial Statements (continued)**

The rate caps limit the amount the pension component of the employer contribution rate can increase over the prior year's rate as follows:

- FY 2012 - not more than 3.0% plus the premium assistance contribution rate
- FY 2013 - not more than 3.5% plus the premium assistance contribution rate
- FY 2014 and thereafter - not more than 4.5% plus the premium assistance contribution rate

The rate cap remains at 4.5% until the rate cap no longer applies, i.e. the rise in the employer contribution rate is less than the rate cap in effect at that time. Once the rate caps no longer apply, the employer normal cost becomes the contribution rate floor.

According to requirements established in Act 29 of 1994, the Commonwealth reimburses school entity employers a portion of the employer contributions paid to the System. All school entity employers are reimbursed by the Commonwealth at least 50% of the total employer contributions based on the total contribution rate. The Commonwealth reimburses certain school entity employers at a rate greater than 50% based upon non-pension criteria which stipulate that the entity must have a Commonwealth Department of Education calculated Market Value / Personal Income Aid Ratio in excess of .5000. The Commonwealth remits employer contributions for employers other than school entities directly to the System. All contributions from employers and the Commonwealth are shown as employer contributions on the Statements of Changes in Plan Net Assets.

A portion of each employer and Commonwealth contribution to the System is set aside for the funding of the Health Insurance Premium Assistance (PA) Program. The PA Program contribution rate is set at a level necessary to establish reserves sufficient to provide PA Program payments for all participating eligible members for the subsequent fiscal year. The portion of the total contribution rate for employers and the Commonwealth used to fund the PA Program was 0.64% and 0.78% for the years ended June 30, 2011 and 2010, respectively.

**iii. Funding Status and Annual Required Contributions (ARC)**

As of June 30, 2010, the most recent actuarial valuation, the plan was 75.1% funded. The actuarial accrued liability for pension benefits was \$79.0 billion, and the actuarial value of pension assets was \$59.3 billion, resulting in an unfunded accrued liability of \$19.7 billion. The covered

payroll of active members was \$12.8 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 154.0%.

For fiscal year ended June 30, 2011, the ARC was \$2.44 billion. The actual employer contributions, net of purchase of service contributions, for fiscal year ended June 30, 2011 was \$646.6 million resulting in a 27% contributed rate.

The Schedule of Funding Progress and Schedule of Employer Contributions included as Required Supplementary Information following the notes to the financial statements provide multiyear presentations of funding status and ARC to illustrate their trends over time.

**iv. Actuarial Assumptions and Methods****(a) Funding Method**

For purposes of determining pension contributions under the PSERS Code, the entry-age normal actuarial cost method is used in determining benefit liabilities and normal cost. Act 120 of 2010 modified the funding method. The outstanding balance of the unfunded accrued liability as of June 30, 2010 was re-amortized over a 24 year period with amortization payments based on level percentage of pay. Future valuation experience gains or losses, and changes in the unfunded accrued liability resulting from changes in actuarial assumptions and methods, are amortized over a 24-year period as a level percent of pay. Future increases in accrued liability enacted by legislation after June 30, 2010 will be funded over a 10-year period as a level percent of pay.

For purposes of determining the annual required contributions under GASB Statement No. 25, the same funding method is used as for pension funding, except that (i) the 4% pension floor is not taken into account and (ii) the amortization payment will be set equal to the level dollar amount that will amortize the unfunded accrued liability over a period of 30 years.

**(b) Asset Valuation Method**

For actuarial purposes, Act 120 of 2010 extended the asset smoothing from five years to ten years. Assets are valued using a ten-year moving market average value that will recognize the 8.00% actuarial expected investment return immediately and spread the difference between actual and expected investment return beginning with fiscal year ended June 30, 2010 over a period of ten years (the averaging period is being phased-in from fiscal year 2006).

**Notes to Financial Statements (continued)**

Previously, PSERS recognized the actuarial expected return immediately and spread the difference between actual and expected investment return over a period of five years.

**(c) Actuarial Assumptions**

Significant actuarial assumptions employed by the actuary for funding purposes as of June 30, 2010, the date of the most recent actuarial valuation include:

- Investment return - 8.00%, includes inflation at 3.25%
- Salary increases - 6.00%, which reflects an allowance for inflation of 3.25%, real wage growth of 1%, and merit or seniority increases of 1.75%
- Amortization method - level percent of pay
- Benefit payments - no postretirement benefit increases assumed in the future
- Multiple decrement tables - mortality, vesting, retirement age, and withdrawal estimates are based upon tables provided by the actuary

The System's actuarial liabilities are calculated separately for retirees and beneficiaries and for active and inactive members. The actuarial present value of benefits to be paid to retirees and beneficiaries currently receiving benefits and deferred survivor beneficiaries, whose benefits have been determined, is calculated using the assumptions noted above. The Annuity Reserve Account with interest credited thereon at an annual rate of 5.50% is compared to the actuarial accrued liability for the remaining lifetimes of the retirees and beneficiaries and any deficiency is then funded by a transfer from the State Accumulation Account. Consequently, all such determined benefits are fully funded.

The actuarial accrued liability for active and inactive members is calculated on the projected benefit basis using the entry-age normal actuarial cost method under which the present value of each member's expected benefit payable at retirement or death is determined. The assets of the Members' Savings Account, State Accumulation Account and the fair value adjustment are subtracted from this present value to arrive at the funded or unfunded actuarial accrued liability.

**(C) Postemployment Healthcare Plans****i. Health Insurance Premium Assistance Program****(a) Premium Assistance Benefits**

The System provides a Health Insurance Premium Assistance (PA) Program for all eligible annuitants who qualify or elect to participate. Under this program,

employer contribution rates for the PA Program are established to provide reserves in the Health Insurance Account that are sufficient for the payment of PA Program benefits for each succeeding year. Effective January 1, 2002, under the provisions of Act 9 of 2001, participating eligible annuitants are entitled to receive premium assistance payments equal to the lesser of \$100 per month or their out-of-pocket monthly health insurance premium. To receive premium assistance, eligible annuitants must obtain their health insurance through either their school employer or the PSERS' Health Options Program. As of June 30, 2011 there were no assumed future benefit increases to participating eligible annuitants in the PA Program.

**(b) Funding Status and Annual Required Contributions**

As of June 30, 2010, the most recent actuarial valuation, the plan was 10.1% funded. The actuarial accrued liability for benefits was \$1.162 billion, and the actuarial value of assets was \$116.8 million, resulting in an unfunded accrued liability of \$1.045 billion. The covered payroll of active members was \$12.8 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 8.2%.

For fiscal year ended June 30, 2011, the ARC was \$119.3 million. The actual employer contributions for fiscal year ended June 30, 2011 was \$88.8 million resulting in a 74.0% contributed rate.

The Schedule of Funding Progress and Schedule of Employer Contributions included as Required Supplementary Information following the notes to the financial statements provide multiyear presentations of funding status and ARC to illustrate their trends over time.

**(c) Actuarial Assumptions and Methods**

The health insurance liability and funding provisions of the PSERS Code differ from the GASB disclosure requirements. As a result, there are different determinations of actuarial liability and contribution requirements for GASB accounting purposes and for Commonwealth funding purposes. For purposes of funding, the actuarial liability equals the assets in the PA Program account, and the contribution required is the amount necessary to establish reserves sufficient to provide PA Program payments to all participating eligible annuitants during the fiscal year that immediately follows the year the employer contribution is made. For GASB accounting purposes, the actuarial liability has been determined under the entry age actuarial cost method, and the ARC is equal to the entry age normal cost for health insurance plus an amount that will amortize the entry age unfunded actuarial

**Notes to Financial Statements (continued)**

liability for health insurance over a period of 30 years using level dollar open amortization. The entry age actuarial cost method was selected for this calculation because it meets the GASB parameters for determining actuarial liability and normal cost, and is the cost method specified by the PSERS Code for the PSERS pension plan.

At the time of each actuarial valuation, actuarially determined amounts are subject to revision as results are compared to past expectations and long-term future estimates. Other significant actuarial assumptions employed by the actuary as of June 30, 2010, the date of the most recent actuarial valuation were:

- Investment return - 8.00%, includes inflation at 3.25%
- Salary increases - 6.00%, which reflects an allowance for inflation of 3.25%, real wage growth of 1%, and merit or seniority increases of 1.75%
- Multiple decrement tables - mortality, vesting, retirement age, and withdrawal estimates are based upon tables provided by the actuary

**ii. Health Options Program**

The Health Options Program (HOP) is a PSERS-sponsored voluntary health insurance program for the sole benefit of annuitants of PSERS, spouses of annuitants, survivor annuitants and their dependents who participate in HOP. The HOP is funded exclusively by the premiums paid by its participants for the benefit coverage they elect. HOP offers several health plans. Participants may select among a self-funded Medicare supplement plan, two Medicare Rx plans, and multiple Medicare Advantage plans for those eligible for Medicare. Participants not eligible for Medicare have a choice of a self-funded high deductible indemnity plan and multiple managed care plans. Medicare Advantage and managed care plans are available to retirees residing in the plan's service area. The Medicare Advantage and managed care plans are provided by private insurance companies or managed care organizations and benefits are fully insured. The Medicare supplement and high deductible plans are self-funded and claims are adjudicated by a third party administrator. The Medicare Rx Options and the prescription drug benefit of the high deductible plan for those not eligible for Medicare are also self-funded and HOP uses a pharmacy benefits manager to administer the benefits. Effective January 1, 2006, PSERS entered into an Employer/Union Entity contract with the Centers for Medicare and Medicaid Services (CMS) to operate a voluntary Medicare Prescription Drug Plan (PDP). Monthly contributions are received from CMS covering the 43,000 participants in the PDP. An independent actuarial consulting firm sets the rates for the self-funded benefits. The HOP maintains reserves for claims that are

incurred but not reported (IBNR) and for claim fluctuation for the self-funded benefit plans. At June 30, 2011 and 2010 PSERS recorded \$15,394,000 and \$10,107,000, respectively, in IBNR. The IBNR is included in benefits payable. The PSERS pension fund assets are not available to fund or satisfy obligations of the HOP.

**2. Summary of Significant Accounting Policies****(A) Basis of Accounting**

The financial statements of the System are prepared on the accrual basis of accounting under which expenses are recorded when the liability is incurred, revenues are recorded in the accounting period in which they are earned and become measurable, and investment purchases and sales are recorded as of their trade date. Member and employer contributions are recognized in the period for which employees' salaries are reported. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

The accounting and reporting policies of the System conform to accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of additions and deductions in plan net assets during the reporting period. Actual results could differ from those estimates.

**(B) Investments**

The System's investments are reported at fair value. Fair value is the amount that the System can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Short-term securities are carried at cost, which approximates fair value, unless they have published market prices or quotations from national securities exchanges or securities pricing services, in which case they are valued at the published market price. Fixed income securities and common and preferred stocks are generally valued based on published market prices and quotations from national securities exchanges or securities pricing services. Securities which are not traded on a national securities exchange are valued by the respective fund manager or other third parties based on similar sales.

Directly-owned real estate investments are primarily valued based on appraisals performed by independent appraisers and, for properties not appraised, the present

**Notes to Financial Statements (continued)**

value of the projected future net income stream is used. Real estate owned investments are reported net of related debt borrowed against the market value of the property. As of June 30, 2011 and 2010, \$132,000,000 in line of credit advances were netted against the related property valuation. The line of credit balance is due on March 9, 2012. The line is payable at an interest rate equivalent to the lender's commercial paper rate plus 100 basis points and is collateralized by certain fixed income investments of the System.

For alternative investments which include private equity, private debt, venture capital and equity real estate investments where no readily ascertainable market value exists, management, in consultation with the general partner and investment advisors, has determined the fair values for the individual investments based upon the partnership's most recent available financial information. Futures contracts, foreign exchange contracts, and options are marked-to-market daily based on published market prices and quotations from national securities exchanges or securities pricing services. The changes in market value are recognized as part of net appreciation/depreciation in the fair value of investments. Initial margin requirements for such financial instruments are provided by investment securities pledged as collateral or by cash.

Collective trust fund investments (CTF) consist primarily of domestic and international institutional funds. The funds generally do not pay interest or dividends to shareholders and reinvest all income earned on securities held by the fund. The fair value of CTF is based on the reported share value of the respective fund. CTF are managed by state chartered banks for which various state banking departments have regulatory oversight and investment advisors for which regulatory agencies such as the Securities and Exchange Commission have regulatory oversight. Investments that are not subject to this oversight are subject to annual independent audits.

In accordance with PSERS' investment guidelines, cash collateral from securities loaned is invested in one of two collateral investment pools, the first of which is denominated in U.S. dollars (USD) and the second in Euros. The USD pool is invested entirely in overnight repurchase agreements carried at amortized cost which approximates fair value. The Euro pool is invested in asset-backed floating rate notes which are marked-to-market daily based on published market prices and quotations from national securities exchanges or securities pricing services. In addition to the floating rate notes, the Euro pool is invested in repurchase agreements.

Investment expenses consist of investment manager fees and those administrative expenses directly related to the System's investment operations. Unsettled investment sales are reported as investment proceeds receivable and unsettled investment purchases are included in investment purchases and other liabilities.

**(C) Capital Assets**

Capital assets consist primarily of data processing equipment and software and internally developed computer software qualifying as intangible assets according to GASB 51. Capital assets other than intangible assets are depreciated using the straight-line method over an estimated useful life of five years. The System amortizes intangible assets using the straight-line method over an estimated useful life of twenty years.

**(D) Benefits Payable**

Benefits payable identifies the obligations of the System, on an accrual basis, at the end of the fiscal year. It includes the estimated retirement and death benefits payable, premium assistance benefits payable, and the HOP IBNR claims for its participants.

**(E) Compensated Absences**

The System uses the accrual basis of accounting for measuring vacation leave, sick leave, and other compensated absences liabilities. Employees of the System are paid for accumulated vacation leave upon termination or retirement. Retiring employees of the System that meet service, age, or disability requirements are paid between 30% and 100% of sick days available at retirement, up to 163 maximum days paid. As of June 30, 2011 and 2010, \$3,965,000 and \$3,324,000, respectively, was accrued for unused vacation and sick leave for the System's employees and included in "Accounts payable and accrued expenses" on the Statements of Plan Net Assets.

**(F) Participant Premium Advances**

Premium advances in the fiscal years ended June 30, 2011 and 2010 are for HOP premiums related to health care coverage to be provided in calendar year 2011 and 2010, respectively.

**(G) Federal Income Taxes**

The Internal Revenue Service (IRS) issued a determination letter dated March 3, 1978 which stated that the plan and its underlying trust qualify under the provisions of

**Notes to Financial Statements (continued)**

Section 501(a) of the Internal Revenue Code (IRC) and therefore are exempt from federal income taxes. The plan has been amended since receiving that determination letter. Additionally, the IRS issued a 1982 ruling which concluded that the fund and the board are integral parts of the Commonwealth, and are therefore not subject to federal income tax. In the opinion of management, the System has operated within the terms of the plan and remains qualified under the applicable provisions of the IRC.

**(H) Risk Management**

The System is exposed to various liabilities and risks of loss, including, without limitation, the ordinary risks of investment losses, risks related to theft or destruction of assets, liabilities resulting from injuries to employees, and liabilities resulting from court challenges to fiduciary decisions. As an administrative agency of the Commonwealth of Pennsylvania, the System is accorded sovereign immunity. For claims not shielded by sovereign immunity, the System participates in certain Commonwealth pooled insurance programs and requires asset managers to carry certain insurance coverage for the protection of the System. The System has implemented a self-insurance program for fiduciary and director and officer liability coverage. During the past three fiscal years, insurance settlements did not exceed insurance coverage.

**(I) Reclassifications**

Certain 2010 amounts have been reclassified in conformity with the 2011 presentation.

**(J) Members Receivables**

Members receivables include an amount for members' obligations to the System for the purchase of service credit. Members have a variety of options to remit purchase of service payments:

- Remit a lump sum payment.
- Request an installment plan from one to seven years where the member's employer establishes a payroll deduction process. The member's employer then forwards quarterly payments of the withheld amounts to PSERS.
- Accept an actuarial reduction debt through which the amount of the purchase plus accumulated interest will reduce the member's retirement or death benefit.
- Rollover funds from an eligible distribution.

The following is a summary of the members receivables at June 30, 2011 and 2010:

	(Dollar Amounts in Thousands)	
	2011	2010
Pension:		
Member contributions	\$ 80,117	\$ 77,926
Purchase of service	212,431	157,714
Other	7,900	4,929
Total Members Receivable	<u>\$ 300,448</u>	<u>\$ 240,569</u>

**(K) Adoption of New Accounting Standards**

During the year ended June 30, 2011 the System adopted GASB Statement No. 59, *Financial Instruments Omnibus*, which was issued to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments.

In June 2007 the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*, which states that intangible assets are subject to all the accounting and financial reporting requirements applicable to other types of capital assets and offers specialized guidance on certain unique aspects of accounting and financial reporting for intangibles. The System adopted this Statement during the year ended June 30, 2010.

During the year ended June 30, 2010 the System adopted GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which was issued to address the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments.

**3. Description of Accounts**

The Code requires the System to maintain the following accounts which represent reserves held for future and current benefit payments as follows:



**Notes to Financial Statements (continued)**

	(Dollar Amounts in Thousands)	
	2011	2010
Pension:		
State Accumulation Account	\$ (5,704,296)	\$ (4,732,711)
Members' Savings Account	12,242,308	11,850,031
Annuity Reserve Account	44,661,982	38,481,155
	<u>\$ 51,199,994</u>	<u>\$ 45,598,475</u>
Postemployment healthcare:		
Health Insurance Account	\$ 111,258	\$ 116,831
Health Insurance Program Account	121,929	122,221
	<u>\$ 233,187</u>	<u>\$ 239,052</u>

**(A) State Accumulation Account**

The State Accumulation Account is credited with the contributions of the Commonwealth and the employers. Additionally, interest earnings of the System (after crediting the Members' Savings Account with 4% interest and the reserve for retirement with 5.50% statutory interest) are credited to this account. Each year, the necessary amounts, as determined by the actuary for the payment of retirement, disabilities, and death benefits, are transferred from the State Accumulation Account to the Annuity Reserve Account increasing the reserve credit to the 8.00% valuation assumption rate determined by the actuary. All administrative expenses necessary for the operation of the System, except for premium assistance and HOP expenses, are paid from the State Accumulation Account.

**(B) Members' Savings Account**

The Members' Savings Account is credited with all contributions made by active members of the System. Interest is added to the member's individual account at an annual rate of 4%.

Upon death or retirement of a member, the accumulated contributions plus interest are transferred to the Annuity Reserve Account for subsequent payment of benefits.

**(C) Annuity Reserve Account**

The Annuity Reserve Account represents the amounts transferred from the Members' Savings and State Accumulation Accounts, plus additional contributions made by the Commonwealth and employers for the payment of supplemental annuities and cost-of-living increases. All death, disability, and retirement benefits

are paid from this account. Annual interest of 5.50% is credited to the Annuity Reserve Account.

**(D) Health Insurance Account**

The Health Insurance Account is credited with contributions of the Commonwealth and the employers for the PA Program. Effective January 1, 2002, under the provisions of Act 9 of 2001, participating eligible annuitants are entitled to receive premium assistance payments equal to the lesser of \$100 per month or their out-of-pocket monthly health insurance premium. The Health Insurance Account pays all administrative expenses necessary to operate the health insurance premium assistance program.

**(E) Health Insurance Program Account**

The Health Insurance Program Account is credited with contributions from members of the HOP and from CMS. All benefits related to the HOP (premium payments to the insurance companies and self-funded benefits) are paid from this account. The Health Insurance Program Account pays all administrative expenses necessary to operate the HOP.

**4. Investments**

**(A) Summary of Investments**

The Board has the responsibility to invest and reinvest available funds of the System in accordance with the guidelines and limitations set forth in the Code and other applicable state law. The Board accomplishes the daily management of the System's investments through investment advisors who act as agents for the System and through internal investment managers.

The Board invests the funds of the System using the Prudent Investor Standard, as articulated in the Code, which means "the exercise of that degree of judgment, skill and care under the circumstances then prevailing which persons of prudence, discretion and intelligence who are familiar with such matters exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the fund, considering the probable income to be derived therefrom as well as the probable safety of their capital." The Board has adopted its investment policy to formally document investment objectives and responsibilities. This policy, as well as applicable state law, establishes guidelines for permissible investments of the System.

## FINANCIAL SECTION

### Notes to Financial Statements (continued)

A summary of the fair value of investments at June 30, 2011 and 2010 follows:

	(Dollar Amounts in Thousands)	
	2011	2010
<b>Pension investments:</b>		
<b>Short-term:</b>		
PSERS Short-Term Investment Fund	\$ 4,474,903	\$ 3,171,190
Other domestic short-term	758,775	544,374
Collective trust funds	80,402	-
International short-term	353,255	225,667
	5,667,335	3,941,231
<b>Fixed income:</b>		
Domestic asset-backed and mortgage-backed securities	3,418,696	3,774,747
U.S. government and agency obligations	1,773,700	1,619,970
Domestic corporate and taxable municipal bonds	1,724,004	2,074,746
Collective trust funds	4,122,432	3,227,846
International fixed income	1,611,233	1,175,893
	12,650,065	11,873,202
<b>Common and preferred stock:</b>		
Domestic common and preferred stock	5,280,081	5,052,127
Collective trust funds	4,403,692	4,681,792
International common and preferred stock	5,752,870	5,583,038
	15,436,643	15,316,957
<b>Real estate:</b>		
Equity real estate	5,036,219	3,780,406
Directly-owned real estate	227,248	193,467
	5,263,467	3,973,873
<b>Alternative investments:</b>		
Private equity	7,813,079	6,130,796
Private debt	3,922,952	4,277,438
Venture capital	849,135	768,487
	12,585,166	11,176,721
<b>Pension investments at fair value</b>	<b>\$ 51,602,676</b>	<b>\$ 46,281,984</b>
<b>Postemployment healthcare investments:</b>		
<b>Premium Assistance Program:</b>		
PSERS Short-Term Investment Fund	\$ 24,300	\$ 24,908
Other domestic short-term	56,287	54,940
	80,587	79,848
<b>Health Options Program:</b>		
PSERS Short-Term Investment Fund	87,977	85,141
Other domestic short-term	57,924	57,295
	145,901	142,436
<b>Postemployment healthcare investments at fair value</b>	<b>\$ 226,488</b>	<b>\$ 222,284</b>

**Notes to Financial Statements (continued)****(B) Deposit and Investment Risk Disclosures****i. Deposits**

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, the System would not be able to recover the value of the deposits. The Commonwealth's Treasury Department is the custodian of the System's funds. Commonwealth Treasury Department deposits must be held in insured depositories approved by the Commonwealth's Board of Finance and Revenue and must be fully collateralized.

The System, through its third party administrator, maintains certain bank deposits for the operation of its voluntary HOP. These deposits are not required to be collateralized by statute or policy. These deposits totaled \$57,924,000 and \$57,295,000 at June 30, 2011 and 2010, respectively, and are under the custody of M&T Bank which has an A-rating by Standard and Poor's (S&P) and an A3 rating by Moody's Investor Services (Moody's).

**ii. Investment Risks**

The System's investments, including derivatives and other similar investments, may be subject to various risks. Among these risks are concentration of credit risk, custodial credit risk, credit risk, interest rate risk, and foreign currency risk. The policies addressing each one of these risks, discussed in more detail below, are contained within the Investment Policy Statement, Objectives, and Guidelines reviewed and approved annually by the Board. Due to the level of risk associated with certain investments, it is possible that changes in the values of investments may occur in the near term and that such changes could materially affect the amounts reported in the Statements of Plan Net Assets.

**(a) Concentration of Credit Risk**

Concentration of credit risk is the risk of loss attributed to the magnitude of the System's investment in a single issuer. As of June 30, 2011 and 2010 the System had no single issuer that exceeded 5% of total investments. Investments issued or explicitly guaranteed by the U.S. government and investments in mutual funds, external investment pools, and other pooled investments were excluded.

**(b) Custodial Credit Risk**

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the

System would not be able to recover the value of investment or collateral securities that are in the possession of an outside party. In accordance with a contractual relationship between the Commonwealth's Treasury Department and its custodial agent, substantially all investments, where securities are used as evidence of the investment, are held by the custodian in book-entry form in the System's name. Those investments are defined as insured or registered investments for which the securities are held by the System or its agent and, therefore, have a very minimal level of custodial credit risk. The remaining investments, which do not have securities that are used as evidence of the investment, are primarily in collective trust funds and limited partnerships, which include real estate and alternative investments.

**(c) Credit Risk**

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is measured by nationally recognized statistical rating organizations (NRSRO) such as Fitch Investor Services (Fitch), Moody's, and S&P. Annually, the Board establishes an asset allocation plan. This plan manages the overall credit risk of the fixed income asset class through a clearly defined long-term asset allocation policy. This policy establishes a long-term target allocation of the fixed income asset class at 26.2% of the investment portfolio. The fixed income target allocation consists of:

- An allocation of 5.2% of the portfolio has been made to the domestic core plus segment of the fixed income asset class benchmarked to the Barclays Capital U.S. Universal Index. The domestic core plus allocation is composed of primarily investment grade, relatively liquid, public domestic bonds with an overall weighted-average NRSRO credit rating of A- or better.
- An allocation of 6.0% of the portfolio has been made to the high yield and opportunistic segment of the fixed income asset class benchmarked to the Barclays Capital U.S. High Yield Index. The high yield and opportunistic allocation is composed of less liquid public non-investment grade fixed income securities with an overall weighted-average NRSRO credit rating of B- or better.
- An allocation of 5.0% of the portfolio has been made to the Treasury Inflation-Protected Securities (TIPS) segment of the fixed income asset class benchmarked to the Barclays Capital U.S. TIPS Index and composed of primarily government issued TIPS with an overall weighted-average NRSRO credit rating of AA or better.

**Notes to Financial Statements (continued)**

The portfolio manager is permitted to leverage the portfolio using TIPS total return swaps up to 3:1.

- An allocation of 3.0% of the portfolio has been made to the global core plus fixed income asset class benchmarked to the Barclays Capital Multiverse Index composed of primarily investment grade, relatively liquid U.S. and non-U.S. public bonds with an overall weighted-average NRSRO credit rating of A- or better.
- An allocation of 2.0% of the portfolio has been made to the emerging markets fixed income asset class benchmarked to the JP Morgan GBI-EM Global Diversified (USD Unhedged) Index composed of primarily investment grade, relatively liquid non-U.S. public bonds with an overall weighted-average NRSRO credit rating of BB- or better.
- An allocation of 5.0% of the portfolio has been made to cash benchmarked to the Merrill Lynch U.S. Treasury Bill 0-3 Months Index composed of primarily investment grade, relatively liquid U.S. and non-U.S. public bonds with an overall weighted-average NRSRO credit rating of AA or better.

The following table discloses aggregate market value by credit quality rating category. Many securities have ratings from more than one NRSRO and sometimes those ratings differ from one NRSRO to another. The data listed below uses the rating (expressed as S&P equivalent) available from Fitch, Moody's and/or S&P that indicates the lowest credit quality at June 30, 2011 and 2010.

Quality Rating	(Dollar Amounts in Thousands)	
	2011 Fair Value	2010 Fair Value
AAA	\$ 2,749,362	\$ 3,347,321
AA	5,070,392	3,891,933
A	1,063,433	844,840
BBB	844,735	860,078
BB and Below	1,222,225	1,153,604
NR*	5,183,904	3,981,288
<b>Total Exposed to Credit Risk</b>	<b>16,134,051</b>	14,079,064
<b>US Government Guaranteed**</b>	<b>2,409,837</b>	1,957,653
<b>Total Fixed Income and Short-Term Investments</b>	<b>\$ 18,543,888</b>	<b>\$ 16,036,717</b>

\* Not Rated securities include \$4,202,834 and \$3,227,846 in collective trust funds at June 30, 2011 and 2010 respectively.

\*\* Comprised of U.S. government and agency obligations explicitly guaranteed by the U.S. government and not considered to have credit risk.

For derivatives exposed to credit risk, the table below presents aggregate market value by the least favorable credit rating provided by NRSROs at June 30, 2011 and 2010.

Quality Rating	(Dollar Amounts in Thousands)	
	2011 Fair Value	2010 Fair Value
AA	\$ 29,005	\$ 2,176
A	(211)	(197,715)
<b>Total Swaps - Total Return</b>	<b>\$ 28,794</b>	<b>\$ (195,539)</b>

**(d) Interest Rate Risk**

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of a fixed income investment. The System manages its interest rate risk by diversifying the fixed income portfolio and maintaining the fixed income portfolio at a Board-approved effective duration range of the benchmark index.

Duration is a measure of the approximate sensitivity of a bond's value to interest rate changes. The higher the duration, the greater the changes in fair value when interest rates change. For example, a duration of 4.0 would mean that, given a 100-basis point change up/down in rates, a bond's price would move down/up approximately 4.0 percent. PSERS measures interest rate risk using option-adjusted duration, which recognizes the fact that yield changes may change the expected cash flows due to embedded options.



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## FINANCIAL SECTION

### Notes to Financial Statements (continued)

At June 30, 2011 and 2010, the System's fixed income portfolio had the following option-adjusted durations by fixed income sector:

Investment Type	(Dollar Amounts in Thousands)			
	2011		2010	
	Option-Adjusted Duration	Fair Value	Option-Adjusted Duration	Fair Value
Domestic asset-backed and mortgage-backed securities	1.3	\$ 3,418,696	1.1	\$ 3,774,747
U.S. government and agency obligations	5.7	1,773,700	5.1	1,619,970
Domestic corporate and taxable municipal bonds	3.4	1,724,004	3.3	2,074,746
Collective trust funds	3.8	1,131,686	5.1	1,410,478
International fixed income	4.3	1,611,233	4.0	1,175,893
PSERS Short-Term Investment Fund	0.1	4,587,180	0.1	3,281,239
<b>Total</b>	2.4*	<b>\$ 14,246,499</b>	2.5*	<b>\$ 13,337,073</b>

\* Fixed income investment managers enter into futures contracts to adjust the durations of their portfolios as a whole rather than any particular investment type within the portfolio. In total, the futures contracts have adjusted PSERS' total portfolio duration upward by 0.1 at June 30, 2011 and 2010. The total portfolio option-adjusted duration is calculated by weighting each investment type by fair value.



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## FINANCIAL SECTION

### Notes to Financial Statements (continued)

#### (e) Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. As part of the System's program to manage risk and enhance returns, the System invests in non-U.S. markets. Investment managers in non-U.S. equity and global fixed income may hedge their non-U.S. foreign currency exposure back to U.S. dollars. At June 30, 2011 and 2010 PSERS had the following non-U.S. currency exposures:

2011					
(Dollar Amounts in Thousands)					
Currency	Equity	Fixed Income	Alternative Investments & Real Estate	Short-Term*	Total Fair Value
Euro	\$ 869,631	\$ 283,457	\$ 2,700,941	\$ (42,624)	\$ 3,811,405
British pound sterling	1,037,285	28,124	7,905	(83,210)	990,104
Japanese yen	888,939	59,028	-	19,296	967,263
Canadian dollar	570,515	17,855	2,163	(32,757)	557,776
Australian dollar	387,318	6,982	-	130,042	524,342
Brazil real	103,195	57,054	-	145,027	305,276
Hong Kong dollar	254,608	-	-	176	254,784
Swiss franc	334,961	-	-	(96,720)	238,241
South African rand	65,946	49,997	-	116,948	232,891
Indian rupee	67,743	-	-	138,855	206,598
Indonesian rupiah	39,246	47,443	-	80,196	166,885
Norwegian krone	30,641	3,808	-	131,625	166,074
South Korean won	102,798	7,550	-	53,188	163,536
Other Non-US currencies	558,614	331,305	-	14,558	904,477
<b>Total</b>	<b>\$ 5,311,440</b>	<b>\$ 892,603</b>	<b>\$ 2,711,009</b>	<b>\$ 574,600</b>	<b>\$ 9,489,652</b>

2010					
(Dollar Amounts in Thousands)					
Currency	Equity	Fixed Income	Alternative Investments & Real Estate	Short-Term*	Total Fair Value
Euro	\$ 718,560	\$ 225,174	\$ 1,569,466	\$ (1,062,424)	\$ 1,450,776
Japanese yen	1,002,241	44,154	-	265,647	1,312,042
British pound sterling	925,069	27,859	6,361	(255,052)	704,237
Canadian dollar	449,599	28,858	1,635	(15,744)	464,348
Brazil real	106,741	48,410	-	203,926	359,077
Hong Kong dollar	331,705	-	-	2,235	333,940
Australian dollar	319,224	3,230	-	(28,455)	293,999
South African rand	124,363	20,119	-	143,848	288,330
Indonesian rupiah	51,497	26,481	-	171,451	249,429
Turkish lira	40,351	21,626	-	143,646	205,623
Indian rupee	113,637	-	-	76,055	189,692
Mexican new peso	34,856	45,167	-	79,731	159,754
Other Non-US currencies	964,616	121,486	-	(649,128)	436,974
<b>Total</b>	<b>\$ 5,182,459</b>	<b>\$ 612,564</b>	<b>\$ 1,577,462</b>	<b>\$ (924,264)</b>	<b>\$ 6,448,221</b>

\* Includes investment receivables and payables

**Notes to Financial Statements (continued)**

<u>Currency</u>	(Dollar Amounts in Thousands)	
	2011	2010
	Notional Value	Notional Value
British pound sterling	\$ 122,723	\$ 72,823
Japanese yen	102,741	107,111
Euro	30,072	23,146
Canadian dollar	36,761	27,023
Australian dollar	9,161	17,839
Malaysian ringgit	-	1,099
<b>Total Futures Contracts and Total Return Swaps</b>	<b>\$ 301,458</b>	<b>\$ 249,041</b>

At June 30, 2011 and 2010, the System had foreign currency exposures for its derivatives (except for foreign exchange contracts which are included in Note 5) as presented in the table at the top of the page.

**(C) Securities Lending**

In accordance with a contract between the Commonwealth and its custodial agent, the System participates in a securities lending program. Under this program, the custodian, acting as the lending agent, loans securities (equities, fixed income and money market instruments) to independent brokers and dealers in exchange for collateral in an amount not less than 102% of the fair value of any securities loaned except for non-U.S. corporations for which 105% of the fair value is required. For Euro fixed income debt issues, for which the Commonwealth receives Euros as collateral and international fixed income debt issues denominated in U.S. dollars, the collateral required to be exchanged is in an amount not less than 102% of the fair value of any securities loaned. Collateral is marked-to-market daily. If the fair value of the collateral held falls below the minimum guidelines for securities loaned, additional collateral is obtained. In lieu of certain approved securities or cash, the borrower may deliver to the lending agent irrevocable bank letters of credit as collateral. If the collateral obtained consists in whole or in part of cash, the lending agent may use or invest the cash in accordance with reinvestment guidelines approved by the System.

As of June 30, 2011 and 2010, the System had no credit risk exposure to borrowers because the amounts the System owed the borrowers exceeded the amounts the borrowers owed the System. Under the securities lending program, the lending agent provides indemnification to the Commonwealth if the same borrowers fail to return the underlying securities (and the collateral is inadequate to replace the loaned securities) or fail to pay income distributions on them. There were no losses during the fiscal years ended June 30, 2011 and 2010, resulting from a default of the borrowers or the lending agent.

All securities loans can be terminated on demand by either the System or the borrower, although the average term of the loan is one day. There were no term loans as of June 30, 2011 and 2010.

Cash collateral is invested in one of two short-term collateral investment pools, the first of which is denominated in U.S. dollars and the second in Euros. Each collateral investment pool is managed by the lending agent, is segregated from all other clients of the lending agent, and is not subject to custodial credit risk. The System's income from securities lending represents its pro-rata share from participating in the program. The weighted-average maturity of the investments in the pool was 2 days at June 30, 2011 and 2010. During the fiscal years ended June 30, 2011 and 2010, the mismatch between the maturities of the investments made with cash collateral and the maturities of the securities loans may have posed some interest rate risk to the System. The System cannot pledge or sell collateral securities received unless the borrower defaults. In the event of a default, the lending agent may use the collateral to replace the loaned securities.

As of June 30, 2011, the fair value of loaned securities was \$1,338,387,000, which includes \$600,228,000 of loaned securities which are collateralized by securities and irrevocable letters of credit that are not included in the Statements of Plan Net Assets. The fair value of the associated collateral was \$1,412,915,000 of which \$761,805,000 was cash. As of June 30, 2010, the fair value of loaned securities was \$2,102,223,000, which includes \$636,236,000 of loaned securities which are collateralized by securities and irrevocable letters of credit that are not included in the Statements of Plan Net Assets. The fair value of the associated collateral was \$2,239,674,000 of which \$1,524,234,000 was cash.

**Notes to Financial Statements (continued)****5. Derivative and Other Similar Investments**

The System enters into a variety of financial contracts, which include options and futures. The System also enters into foreign exchange positions, such as forward and spot contracts to obtain or hedge foreign currency exposure; swap agreements to gain exposure to certain sectors of the equity and fixed income markets; collateralized mortgage obligations (CMOs); other forward contracts, and U.S. Treasury strips. The System is not a dealer, but an end-user of these instruments. The contracts are used primarily to enhance performance and reduce the volatility of the portfolio. The System is exposed to credit risk in the event of non-performance by counterparties to financial instruments. The System generally enters into transactions only with high quality institutions. Legal risk is mitigated through selection of executing brokers and review of all documentation. The System is exposed to market risk, the risk that future changes in market conditions may make an instrument less valuable. Exposure to market risk is managed in accordance with risk limits set by senior management, through buying or selling instruments or entering into offsetting positions.

The notional or contractual amounts of derivatives indicate the extent of the System's involvement in the various types and uses of derivative financial instruments and do not measure the System's exposure to credit or market risks and do not necessarily represent amounts exchanged by the parties. The amounts exchanged are determined by reference to the notional amounts and the other terms of the derivatives.

Futures contracts are contracts in which the buyer agrees to purchase and the seller agrees to make delivery of a specific financial instrument at a predetermined date and price. Gains and losses on futures contracts are settled daily based on a notional (underlying) principal value and do not involve an actual transfer of the specific instrument. Futures contracts are standardized and are traded on exchanges. The exchange assumes the risk that a counterparty will not pay and generally requires margin payments to minimize such risk. In addition, the System enters into short sales, sales of securities it does not presently own, to neutralize the market risk of certain equity positions. Initial margin requirements on futures contracts and collateral for short

sales are provided by investment securities pledged as collateral and by cash held by various brokers. Although the System has the right to access individual pledged securities, it must maintain the amount pledged by substituting other securities for those accessed. The value of securities pledged and the amount of cash held at June 30, 2011 and 2010 represent a restriction on the amount of assets available as of year-end for other purposes.

Option contracts provide the option purchaser with the right, but not the obligation, to buy or sell the underlying security at a set price during a period or at a specified date. The option writer is obligated to buy or sell the underlying security if the option purchaser chooses to exercise the option. The System generally uses exchange listed currency, index, stock, and futures options. The System authorized an investment manager to write covered call stock index option spreads up to a notional amount of \$1,500,000,000 for FY 2010. The program was terminated in FY 2011. The fair value of option contracts of \$7,289,000 and \$2,093,000 at June 30, 2011 and 2010, respectively, is included in the Statements of Plan Net Assets.

Foreign exchange contracts involve an agreement to exchange the currency of one country for the currency of another country at an agreed-upon price and settlement date. To reduce the risk of counterparty non-performance, the investment managers generally enter into these contracts with institutions regarded as meeting high standards of credit worthiness. The contracts reported below on the following page primarily include forwards. The \$9,941,182,000 of foreign currency contracts outstanding at June 30, 2011 consist of "buy" contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign currencies of \$5,342,849,000 and "sell" contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of \$4,598,333,000. The \$11,147,219,000 of foreign currency contracts outstanding at June 30, 2010 consist of "buy" contracts of \$5,219,411,000 and "sell" contracts of \$5,927,808,000. The unrealized gain (loss) on contracts of \$3,896,000 and \$(4,414,000) at June 30, 2011 and 2010, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts.



## FINANCIAL SECTION

### Notes to Financial Statements (continued)

The table presented below summarizes the aggregate notional or contractual amounts for the System's derivative financial instruments at June 30, 2011 and 2010.

	(Dollar Amounts in Thousands)	
	2011	2010
Futures contracts - long:		
Treasury futures	\$ 295,044	\$ 400,302
Eurodollar futures	551,678	83,922
U.S. equity futures	613,483	424,961
Non-U.S. equity futures	175,136	154,454
Commodity futures	1,526,770	1,015,632
Non-U.S. bond futures	77,793	69,060
Futures contracts - short:		
Treasury futures	187,080	294,089
Eurodollar futures	275,905	263,378
U.S. equity futures	99,626	-
Commodity futures	-	21,659
Non-U.S. bond futures	56,045	40,038
Foreign exchange forward and spot contracts, gross	9,941,182	11,147,219
Options - calls purchased	4,336,538	2,555,244
Options - puts purchased	4,708,379	2,241,375
Options - calls sold	4,673,491	2,784,401
Options - puts sold	5,024,008	2,376,839
Swaps - total return type	2,931,449	3,950,185

The fair values of derivative instruments outstanding at June 30, 2011 and 2010 are classified by type and by the changes in fair value of the derivative instrument in the table below.

Investment Derivative Type	(Dollar Amounts in Thousands)			
	Change in Fair Value Gain/(Loss) FY 2011		Fair Value at June 30, 2011	
	Classification	Amount	Classification	Amount
Futures	Investment income	\$ (26,858)	Receivable/(Payable)	\$ (26,858)
Total return type swaps	Investment income	28,794	Receivable/(Payable)	28,794
Options	Investment income	7,289	Investment	7,289
Foreign exchange contracts	Investment income	3,896	Receivable/(Payable)	3,896
<b>Total</b>		<b>\$ 13,121</b>		<b>\$ 13,121</b>
Investment Derivative Type	(Dollar Amounts in Thousands)			
	Change in Fair Value Gain/(Loss) FY 2010		Fair Value at June 30, 2010	
	Classification	Amount	Classification	Amount
Futures	Investment income	\$ (16,146)	Receivable/(Payable)	\$ (16,146)
Total return type swaps	Investment income	(195,539)	Receivable/(Payable)	(195,539)
Options	Investment income	2,093	Investment	2,093
Foreign exchange contracts	Investment income	(4,414)	Receivable/(Payable)	(4,414)
<b>Total</b>		<b>\$ (214,006)</b>		<b>\$ (214,006)</b>

## FINANCIAL SECTION

### Notes to Financial Statements (continued)

The following table summarizes the System's foreign exchange contracts by currency at June 30, 2011 and 2010:

2011				
(Dollar Amounts in Thousands)				
Currency	Buys	Unrealized Gain/(Loss)	Sells	Unrealized Gain/(Loss)
Euro	\$ 811,997	\$ 6,664	\$ 805,874	\$ (6,999)
Brazil real	405,682	11,530	264,077	(5,937)
Swiss franc	373,760	884	390,096	(160)
Australian dollar	345,768	2,981	197,644	(2,932)
British pound sterling	336,006	(4,028)	417,026	4,981
Canadian dollar	309,000	2,677	353,205	(4,410)
Norwegian krone	262,880	2,685	102,507	(1,673)
Japanese yen	255,697	1,879	256,718	(721)
South African rand	247,660	1,378	133,093	(2,618)
Turkish lira	212,215	(4,230)	110,831	1,497
New Zealand dollar	210,700	2,388	201,563	(2,362)
Swedish krona	210,291	559	221,263	(2,402)
Indonesian rupiah	208,656	2,296	54,681	(101)
Hungarian forint	151,655	2,109	92,520	(2,200)
Indian rupee	134,337	1,762	73,340	(583)
Taiwan dollar	98,614	(43)	196,674	(1,463)
Russian ruble	91,420	888	40,380	(205)
Mexican new peso	87,501	710	60,635	(659)
Other non-US currencies	589,010	4,167	626,206	(4,413)
<b>Total</b>	<b>\$ 5,342,849</b>	<b>\$ 37,256</b>	<b>\$ 4,598,333</b>	<b>\$ (33,360)</b>

2010				
(Dollar Amounts in Thousands)				
Currency	Buys	Unrealized Gain/(Loss)	Sells	Unrealized Gain/(Loss)
British pound sterling	\$ 586,528	\$ (2,641)	\$ 851,017	\$ (5,525)
Euro	539,486	(2,917)	1,527,863	13,594
Swiss franc	511,100	13,794	678,377	(26,277)
Japanese yen	466,086	12,782	204,617	(5,852)
Brazil real	412,989	194	210,547	666
Australian dollar	405,024	(5,533)	368,986	3,188
Canadian dollar	233,343	(6,153)	234,936	4,381
Turkish lira	212,278	(2,691)	68,574	88
South African rand	200,943	(271)	58,571	(42)
Mexican new peso	199,108	(3,426)	120,167	56
Indian rupee	175,622	2,612	4,563	5
Norwegian krone	171,567	2	146,774	328
Swedish krona	157,145	1,490	171,665	(2,202)
New Zealand dollar	113,680	(419)	92,993	(154)
Philippines peso	92,357	(614)	26,114	(24)
South Korean won	91,801	(1,986)	162,813	5,823
Indonesian rupiah	89,833	(162)	16,661	(51)
Malayssian ringgit	86,622	537	34,484	(609)
Other non-US currencies	473,899	(2,675)	948,086	6,270
<b>Total</b>	<b>\$ 5,219,411</b>	<b>\$ 1,923</b>	<b>\$ 5,927,808</b>	<b>\$ (6,337)</b>

**Notes to Financial Statements (continued)**

Swap agreements provide for periodic payments at predetermined future dates between parties based on the change in value of underlying securities, indexes or interest rates. During the year ended June 30, 2011 and 2010, the System entered into total return type swaps. Under the total return type swap arrangements, the System receives the net return of certain equity securities or indexes in exchange for a short-term rate minus a spread or a predetermined fixed charge. The receivable (payable) on the total return type swap contracts of \$28,794,000 and \$(195,539,000) at June 30, 2011 and 2010, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts. The contracts have varying maturity dates ranging from August 9, 2011 to May 17, 2012.

The System also invests in mortgage-backed securities (MBS) such as CMOs and MBS forwards to maximize yields. These securities are sensitive to prepayments of mortgages, which may result from a drop in interest rates. The MBS forwards are subject to credit risk in the event of nonperformance by counterparties. The fair value of CMOs at June 30, 2011 and 2010 is \$1,735,359,000 and \$2,089,780,000, respectively.

The System invests in U.S. Treasury strips which essentially act as zero coupon bonds and are subject to market volatility from a rise or drop in interest rates.

Through certain collective trust funds, the System also indirectly holds various derivative financial instruments. The collective trust funds invest in futures and options thereon; forward foreign currency contracts; options; interest rate, currency, equity, index, and total return swaps; interest-only strips; and CMOs, to enhance the performance and reduce the volatility of their portfolios.

**6. Pension Plan for Employees of the System**

The System contributes to the Commonwealth's State Employees' Retirement System (SERS), a cost-sharing multiple-employer defined benefit pension plan. SERS provides retirement, death, and disability benefits to plan members and beneficiaries according to Commonwealth statute. SERS issues a publicly available financial report that can be obtained by writing to SERS, 30 N. Third Street, P. O. Box 1147, Harrisburg, Pennsylvania 17108-1147.

The contribution requirements of plan members and the System are mandated by Commonwealth statute. Most SERS plan members are required to contribute 5% or 6.25% of their annual covered payroll depending upon service class. The System is required to contribute at an actuarially determined rate.

The rates applied to annual covered payroll were 4.11% at June 30, 2011, 3.15% at June 30, 2010, 3.29% at June 30, 2009. The System's contributions to SERS for the years ended June 30, 2011, 2010 and 2009 were \$790,000, \$601,000 and \$625,000, respectively, which were equal to the required contributions each year.

**7. Postemployment Healthcare Plan for Employees of the System**

The System participates in the Commonwealth's Retired Employees Health Program (REHP). The REHP is a single-employer plan and provides certain healthcare benefits to qualifying individuals meeting specified age and/or service requirements. The Commonwealth's Office of Administration (OA), in its sole discretion, determines available REHP benefits on an ongoing basis. The Pennsylvania Employees Benefit Trust Fund (PEBTF) is a third-party administrator for the REHP under the provisions of an Administrative Agreement between OA and PEBTF.

Employer costs for retiree healthcare benefits are charged as a component of payroll expenditures on a 'pay-as-you-go' basis. REHP funding is arranged between OA and the Governor's Budget Office. FY 2011 employer costs were charged at the rate of \$200/employee/bi-weekly pay period. Plan members who retired after June 30, 2005 contribute to the plan based on a percentage of their final annual gross base salary at the time of retirement. Plan member contribution rates vary based on the member REHP enrollment date.

In October 2009, the Commonwealth released an Actuarial Valuation of its Post-Retirement Medical Plan with calculations made as of July 1, 2008 using census data collected as of December 2008 and health care claims costs for calendar 2008. This valuation provided Other Postemployment Benefits (OPEB) reporting that was used for both FY 2009 and FY 2010. The Commonwealth engaged an Actuary again in early 2011; providing the valuation for OPEB reporting for FY 2011. The valuation for FY 2009 reported overall ARC of \$818,510,000 with the System's allocated ARC of \$3,566,000. Based on the aggregate REHP qualifying contributions for FY 2009, the net OPEB liability for the System was \$1,363,000. For FY 2010, the valuation indicated overall Annual OPEB Cost (AOC) of \$850,440,000 with the System's allocated AOC of \$3,705,000. Based on the aggregate REHP qualifying contributions for FY 2010, the net OPEB liability for the System was \$1,460,000 for that fiscal year; the cumulative net OPEB liability as of June 30, 2010 was \$2,823,000. For FY 2011, the valuation indicated overall AOC of \$883,160,000 with the System's allocated AOC of \$3,319,000. Based on the aggregate REHP qualifying

**Notes to Financial Statements (continued)**

contributions for FY 2011, the net OPEB liability for the Systems was \$1,070,000 for that fiscal year; therefore, the cumulative 3 year total net OPEB liability as of June 30, 2011 is \$3,893,000.

<b>Fiscal Year</b>	<b>Commonwealth ARC/AOC</b>	<b>PSERS' ARC/AOC</b>	<b>PSERS' Net OPEB</b>
2011	\$ 883,160,000	\$ 3,319,000	\$ 1,070,000
2010	850,440,000	3,705,000	1,460,000
2009	818,510,000	3,566,000	1,363,000
<b>3 year Cumulative OPEB</b>			<b>\$ 3,893,000</b>

**8. Litigation and Contingencies**

The System is subject to various threatened and pending lawsuits. These lawsuits include issues related to benefit calculations and eligibility. It is the opinion of management that the ultimate liability arising from such threatened and pending litigation will not have a material effect on the financial position of the System. The System is exposed to various other liabilities and risks related to fiduciary responsibilities of directors and officers.

**9. Intangible Assets**

In compliance with the requirements of GASB 51, the System examined its administrative expense records to determine if any expenditure qualified for intangible asset recognition. It was found that the multi-year initiative to redesign the System's member and pension administration systems qualified for recognition as internally developed computer software under GASB 51 and Commonwealth of Pennsylvania Management Directives.

**(A) Assumptions**

In FY 2003, the System began contracting with third parties on a multi-year project to develop a new pension administration system (NPAS) using customized off-the-shelf computer software (V3). The System will continue to contractually rely on third parties to reengineer and upgrade V3 to meet PSERS business requirements. V3 software will have major upgrades over time and will have a finite expected useful life estimated at 20 years. The first release of NPAS was implemented during July 2004, which is the start of the useful life of V3 for amortization purposes.

**(B) Recognition**

From FY 2003 through FY 2010, it was determined that \$23.8 million qualified for recognition under GASB 51 as intangible assets. Amortization for fiscal years prior to FY 2010 was calculated starting in fiscal year ended June 30, 2005 (FY 2005) assuming an estimated useful life period of 20 years. Cumulative amortization through the end of FY 2010 totaled \$5.7 million. Recognition of intangible assets and amortization was made during FY 2010 by offset to administrative expenses.

During FY 2011 expenditures of \$3.1 million for internally developed computer software qualified for recognition as intangible assets. Cumulative amortization of intangible assets was \$7.0 million through the end of FY 2011.

**10. Subsequent Events**

The System has performed an evaluation of subsequent events through October 7, 2011, the date the basic financial statements were available to be issued. No material events were identified by the System.



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## FINANCIAL SECTION

### Required Supplementary Schedule 1 Schedules of Funding Progress\* (Unaudited – See Accompanying Auditor’s Report) (Dollar Amounts in Millions)

Pension							
Valuation as of June 30	(1)	(2)	(3)	(4)	(5)	(6)	
	Actuarial accrued liabilities (AAL)	Actuarial value of assets	Unfunded actuarial accrued liabilities UAAL (1) - (2)	Ratio of assets to AAL (2) / (1)	Covered payroll	UAAL as a percentage of covered payroll (3) / (5)	
2010	\$ 79,005.4	\$ 59,306.8	\$ 19,698.6	75.1%	\$ 12,788.8	154.0%	
2009	75,520.7	59,781.6	15,739.1	79.2%	12,524.6	125.7%	
2008	70,845.6	60,922.1	9,923.5	86.0%	11,921.5	83.2%	
2007	66,495.8	57,057.8	9,438.0	85.8%	11,410.3	82.7%	
2006	64,627.3	52,464.7	12,162.6	81.2%	11,419.0	106.5%	
2005	61,129.4	51,122.1	10,007.3	83.6%	10,527.7	95.1%	

Premium Assistance							
Valuation as of June 30	(1)	(2)	(3)	(4)	(5)	(6)	
	Actuarial accrued liabilities (AAL)	Actuarial value of assets	Unfunded actuarial accrued liabilities UAAL (1) - (2)	Ratio of assets to AAL (2) / (1)	Covered payroll	UAAL as a percentage of covered payroll (3) / (5)	
2010	\$ 1,162.2	\$ 116.8	\$ 1,045.4	10.1%	\$ 12,788.8	8.2%	
2009	1,159.0	105.1	1,053.9	9.1%	12,524.6	8.4%	
2008	1,133.0	95.8	1,037.2	8.5%	11,921.5	8.7%	
2007	1,058.1	97.3	960.8	9.2%	11,410.3	8.4%	
2006	1,056.2	92.8	963.4	8.8%	11,419.0	8.4%	

\* The amounts reported in the Schedule of Funding Progress do not include assets or liabilities for the HOP.

Each time a new benefit is added which applies to service already rendered, an “unfunded accrued liability” is created. The laws governing PSERS require that these additional liabilities be financed systematically over a period of future years. Also, if actual financial experiences are less favorable than assumed financial experiences, the difference is added to unfunded accrued liabilities.

In an inflationary economy, the value of the dollar is decreasing. In this environment, employees pay in greater dollar amounts, resulting in a dollar increase in unfunded accrued liabilities.

This occurs at a time when the actual substance of these items may be decreasing. Looking at just the dollar amounts of unfunded accrued liabilities can be misleading. Unfunded accrued liabilities divided by active employee payroll provides an index which clarifies understanding. The smaller the ratio of unfunded liabilities to covered payroll, the stronger the system. Observation of this relative index over a period of years will give an indication of whether the system is becoming financially stronger or weaker.

## FINANCIAL SECTION

### Required Supplementary Schedule 2 Schedules of Employer Contributions (Unaudited – See Accompanying Auditor’s Report) (Dollar Amounts in Thousands)

<b>Pension</b>				
<b>Year ended June 30</b>		<b>Annual Required Contributions</b>	<b>Actual Employer Contributions*</b>	<b>Percentage Contributed</b>
2011	\$	2,436,602	\$ 646,560	27%
2010		1,928,278	527,212	27%
2009		1,761,295	503,227	29%
2008		1,852,238	753,532	41%
2007		1,708,821	659,545	39%
2006		1,328,373	456,878	34%

<b>Premium Assistance</b>				
<b>Year ended June 30</b>		<b>Annual Required Contributions</b>	<b>Actual Employer Contributions</b>	<b>Percentage Contributed</b>
2011	\$	119,320	\$ 88,796	74%
2010		117,187	102,703	88%
2009		109,531	92,493	84%
2008		101,352	81,317	80%
2007		94,970	86,763	91%

The Board adopted all contribution rates as recommended by the Board’s actuary pursuant to the prevailing provisions of the Retirement Code for each year, with the exception of the year ended June 30, 2011. Act 46 required the Board to recertify the employer contribution rate from 8.22% to 5.64%, allocating 5% to the pension component and .64% to the premium assistance component.

\* Includes purchase of service contributions in FY 2006 to FY 2008.

## FINANCIAL SECTION

### Supplementary Schedule 1 Schedule of Operating Expenses Year Ended June 30, 2011 (Dollar Amounts in Thousands)

	Administrative Expenses (1)	Investment Expenses (2)	Total
<b>Personnel costs:</b>			
Salaries and wages	\$ 14,910	\$ 3,482	\$ 18,392
Social security contributions	1,120	205	1,325
Retirement contributions	643	147	790
Employees' insurance contributions	4,361	521	4,882
Other employee benefits	5	135	140
<b>Total personnel costs</b>	<b>21,039</b>	<b>4,490</b>	<b>25,529</b>
<b>Operating costs:</b>			
Investment managers' fees	-	500,186	500,186
Custodian fees	-	600	600
Specialized services	22,431	2,968	25,399
Rental of real estate, electricity	2,101	166	2,267
Consultant and legal fees	1,420	4,119	5,539
Treasury and other commonwealth services	168	181	349
Postage	1,332	-	1,332
Contracted maintenance and repair services	248	18	266
Office supplies	378	9	387
Rental of equipment and software	1,079	299	1,378
Printing	411	-	411
Travel and training	422	8	430
Telecommunications	691	-	691
Equipment (non-capital assets)	823	-	823
Miscellaneous expenses	3,635	1,651	5,286
<b>Total operating costs</b>	<b>35,139</b>	<b>510,205</b>	<b>545,344</b>
<b>Other charges:</b>			
Depreciation	1,567	-	1,567
<b>Total other charges</b>	<b>1,567</b>	<b>-</b>	<b>1,567</b>
<b>Total operating expenses</b>	<b>\$ 57,745</b>	<b>\$ 514,695</b>	<b>\$ 572,440</b>

(1) Includes administrative expenses of \$1,988 related to Postemployment Healthcare Premium Assistance and \$18,729 related to Postemployment Healthcare Health Options Program for the fiscal year ended June 30, 2011.

(2) Includes investment expenses of \$48 related to Postemployment Healthcare Premium Assistance for fiscal year ended June 30, 2011 and does not include \$11,752 in capitalized broker commissions for the fiscal year ended June 30, 2011.

**FINANCIAL SECTION**

**Supplementary Schedule 2**  
**Summary of Investment Expenses**  
**Year Ended June 30, 2011**  
(Dollar Amounts in Thousands)

	<u>Fees</u>
<b>External management:</b>	
Domestic equity	\$ 4,926
International equity	30,002
Fixed income	65,444
Real estate	87,293
Alternative investments	156,980
Absolute return	138,931
Commodities	16,610
<b>Total external management</b>	<b>500,186</b>
<b>Total internal management</b>	<b>9,790</b>
<b>Total investment management</b>	<b>509,976</b>
Custodian fees	600
Consultant and legal fees	4,119
<b>Total investment expenses</b>	<b>\$ 514,695</b>



**FINANCIAL SECTION**

**Supplementary Schedule 3**  
**Schedule of Payments to Non-Investment Consultants**  
**Year Ended June 30, 2011**  
(Dollar Amounts Greater than \$50,000)

<b>Consultant</b>	<b>Fees</b>	<b>Services Provided</b>
CoreSource, Inc.	\$ 12,168,669	Postemployment healthcare benefits administration and claims adjudication
Rx Solutions, Inc.	4,538,549	Administration of postemployment healthcare benefits and prescription drug plan
ViTech Systems Group, Inc.	4,452,065	Pension administration system services
The Segal Company	3,116,391	Actuarial services and consulting for HOP and prescription drug plan
Buck Consultants LLC	624,333	Pension benefit actuarial services
Independent Pharmaceutical Consultants, Inc.	612,332	Pharmacy benefit consulting services
Clifton Gunderson LLP	110,000	Financial audit of pension system and postemployment healthcare programs



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