Pennsylvania's Municipal Pension Challenges

Recommendations from Governor Tom Wolf's Task Force on Municipal Pensions

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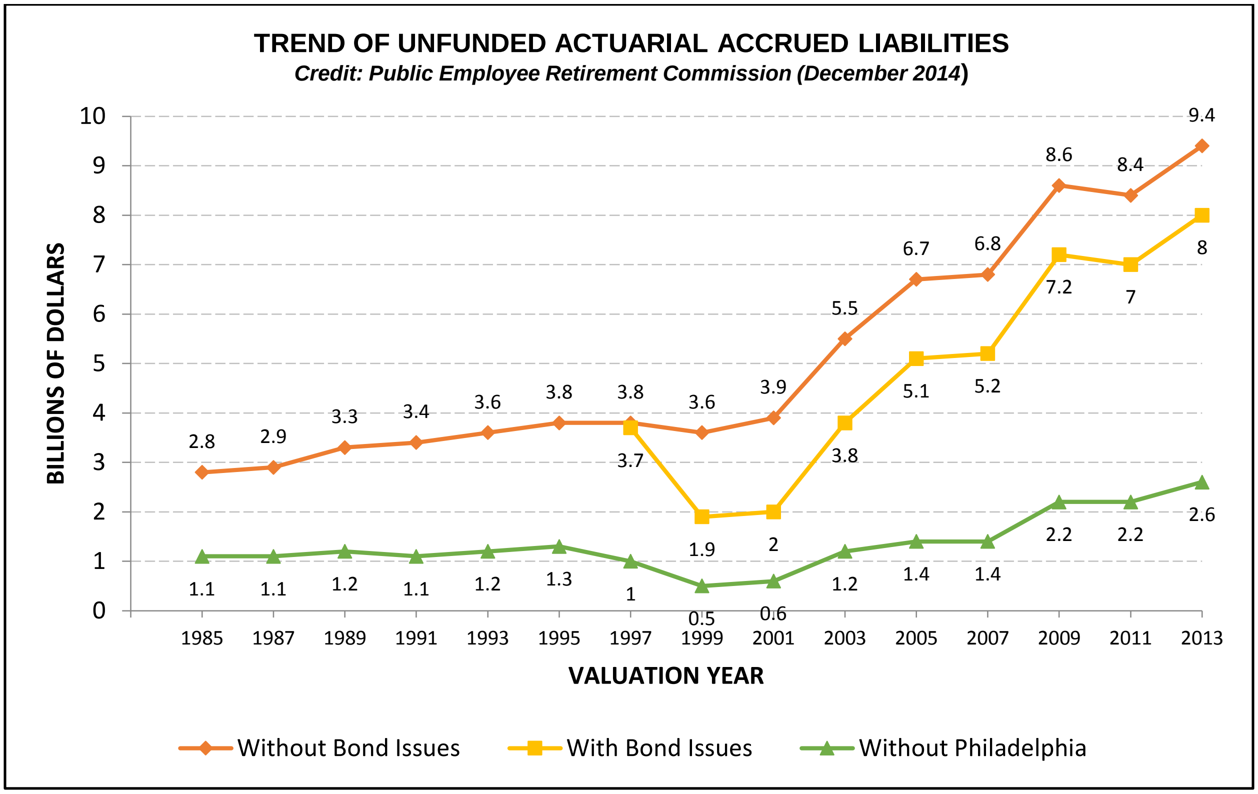
Introduction

According to the latest actuarial data from the Public Employee Retirement Commission (PERC), as of January 2013, the unfunded liability of Pennsylvania municipal pension plans has doubled in the last ten years. It is now $7.7 billion. Approximately 3,240 local government plans exist in the commonwealth; 2,600 of these are municipal plans. About one-third of Pennsylvania municipal pension plans are less than 80 percent funded. This report focuses on those underfunded plans.



Pennsylvania's municipal pension challenges have resulted from a combination of many factors, including a lack of consistent and sound investment assumptions, a failure to fully fund obligations, increased life expectancies of retirees and current employees, cases where there are fewer active employees than retirees, and the stock market decline in 2008.

Regardless of the causes of the pension challenges, it is imperative that the Commonwealth's system of local government pension plans, as well as their administration, be reformed immediately. Given that the state courts have consistently and firmly decreed that pension obligations cannot be reduced or eliminated, a failure to address the funding gap will result in crippling cuts to critical municipal services that will dramatically impact the quality of life for residents, commuters, and anyone who does business with the municipality. In extreme cases, municipalities in other states have been forced into bankruptcy as a result of failing to address pension health appropriately.

Due to the need for swift action on municipal pension reform, Governor Tom Wolf assembled a Task Force on Municipal Pensions in May of this year to come up with workable, fair and responsible recommendations to address the pension challenges of municipalities. This report is the result of the work of that task force.

In developing this report, the task force received input from individuals representing government retirement entities, unions, elected officials, trade associations, research organizations with expertise in pension issues, and the financial industry (Appendix A). All who participated in these meetings provided helpful, real-life examples of the pension challenges and offered many carefully thought-out ideas.

The task force would like to thank all who offered their time and expertise to such an important endeavor.

Recommendations for Addressing Pennsylvania's Municipal Pension Challenge

The Municipal Pension Aid Fund receives about $267 million per year funded out of the Foreign Casualty Insurance Premium Tax and from a portion of the Foreign Fire Insurance Premium Tax. Currently, the formula for this state aid, as designed in Act 205 of 1984, covers 100 percent of the Minimum Municipal Obligation (MMO) for one-third of the municipalities. Other municipalities receive significantly less than 100 percent. There is little or no annual growth foreseen in the revenue stream that produces the Municipal Pension Aid Fund.

The task force recommends that any proposed revenue enhancements be considered only if structural changes are made to the plans. The recommendations from the task force focus on structural and operational changes that encourage, and in some cases require, responsible and prudent management of municipal pension plans.

Increasing transparency, accountability and fiscal responsibility to all plans

The following reforms should apply to **all** municipal pension plans. These standards provide a more transparent picture of a plan's fiscal health, control fees paid to external parties, and make a municipality's pension obligations more predictable. The purpose is to ensure that promises of retirement security that have been made to employees can be met without impairing the ability to maintain services and invest for the future.

- **Increase penalties for municipalities that do not pay their full minimum municipal obligation (MMO).** The MMO is the minimum amount municipalities are legally required to contribute annually to a pension fund to maintain long-term solvency. Currently, the penalty for failure to make the full MMO payment is an interest charge.

An additional penalty is recommended that would eliminate municipal pension state aid for each year the MMO is not fully paid. A state government entity should be authorized to enforce this provision.

- **End the current practice of allowing state aid to be spent on administrative expenses.** The annual distribution of state aid given to municipalities should assist with pension payments, not administrative fees. Given the number of employees and retirees counting on benefits, all state aid should be directed to the purpose of meeting the pension obligations. This change would also encourage control of administrative costs by requiring them to be part of the annual expenditures of the municipality and not paid for out of the pension trust assets.
- **Post actual pension liability.** Adopt Generally Accepted Accounting Principles standards (GAAP). Specifically, adopt and implement Governmental Accounting Standards Board (GASB) Statement 68, which requires state and local governments to include full disclosure of all pension obligations in their financial statements. This will increase transparency of the assumed rate of return versus the actual realized return.
- **Exclude municipal pensions from the collective bargaining process.** This considerably strengthens municipalities' ability to predict costs, a critical piece to reform.
- **Post municipal pension plan costs annually.** This includes fees paid to investment managers, the performance of the funds managed by those investment managers compared to an appropriate benchmark and administrative expenses of the plan.

Strategies for underfunded municipal pension plans other than Philadelphia and Pittsburgh

It is critical that significantly underfunded municipal pension plans be placed on a road to recovery. Specific actions include giving a realistic view of the status of each plan, changing how the plans are administered, prohibiting benefit enhancements, and creating a new statewide pension system for all new municipal employees. These significant reforms would put into place a structure that will prevent further deterioration and force municipalities to deal with a more realistic understanding of the problems. These steps are imperative if promises to plan beneficiaries are to be met.

The underfunded plans must adopt three major categories of change:

- Adherence to new investment and benefit standards
- Shifting of management responsibility away from the municipality
- Placement of new hires into a newly created statewide municipal pension system

"Underfunded" is defined as a funding ratio (percent of accrued pension liabilities that are covered by assets) below 80 percent. The funding ratio is calculated based on the required rate of return for the relevant year as described below. The task force presents two alternative options for the Governor to consider:

- **Alternative A.** Aggregate the funding ratio of all of a municipality's defined benefit plans; if the aggregate falls below 80 percent, all plans must adopt the changes described below. Currently, 363 municipalities' aggregate funding ratios fall below 80 percent.
  - **Pros:**
    - Mirrors Act 205 state aid distribution to each municipality, not to individual plans.
    - Requires more plans to adopt stronger and more responsible standards.
    - Prevents potentially damaging divisions between plans in the same municipality.
  - **Cons:**
    - Some municipalities may resist putting restrictions on an adequately funded plan simply because other plans in its purview are underfunded.
- **Alternative B.** Only individual plans that have a funding ratio below 80 percent must adopt the changes described below. Thus a municipality may have one plan that would have to adopt the required changes, and one that would not.
  - **Pros:**
    - Allows adequately funded plans to remain under the management of the municipality, with fewer restrictions on investments and benefit enhancements
  - **Cons:**
    - Increases divisiveness between plans within the same municipality
    - Might lead to tougher decisions for municipalities on how much to fund each plan
    - Fewer plans are required to adopt stronger standards

The following describe the strategies for the underfunded pension plans no matter which method above is selected. A variation on the strategies for Philadelphia and Pittsburgh appear in a subsequent section.

Require underfunded pension plans to adopt new investment and benefit standards. The following is meant to control costs and provide a more transparent picture of the actual funding status of the pension plan. All of these requirements on underfunded plans are permanent.

- **Cap the amount of overtime that may be included in the pension calculation at 10 percent of the final five years' average base salary.** This allows more predictability by the municipalities and the ability to project and manage their pension costs while still allowing some accumulated overtime to be reflected in pensioners' benefits.

- **Exclude accumulated leave from pension calculations.** As in Act 600 (Municipal Police Pension Law), any accumulated sick, vacation, or other unused leave may not be used in pension benefit calculations.
- **Adopt realistic rate of return assumptions.** Plans should adopt an assumed rate of return on investments that more accurately reflects long-term realized returns. The practice of using unrealistically high rates of return for investments must be eliminated. The practice allows local governments to pay lower MMOs and therefore underfund their pension obligations while simultaneously using the proceeds to help fund other budget holes. The result is a worsening funded status of plans.

  For municipalities currently using an excessively high rate of return, a reduction will be a material change, but the reduction is critical to reforming pension funding obligations and positioning funds to meet their obligations.

  To soften the impact of the adjustment, plans may transition to a lower rate of return gradually, by reducing their current rate by one percentage point per year.
- **Control investment management fees.** Require that investment management fees not exceed 50 basis points per annum. For reference, plans should use fees charged by passively managed funds as a benchmark. While active investment managers have a role in investment management, and a very few managers have consistently demonstrated an ability to earn returns in excess of the market, such relationships need to be carefully monitored. Employing active managers must not come at the expense of putting someone's retirement income at risk.
- **Disallow any benefit enhancement that would cause the funding ratio to fall below 90 percent.** Quite simply, you should not enhance benefits if you cannot honestly afford to do so. Enhancements may be considered only if, after making them, the pension plan remains at least 90 percent funded.
- **Specifically require that any gains above the projected rate of return be retained by the fund until the plan is 130 percent funded.** Given the volatility of the market, firm restrictions should be put in place as to how higher-than-expected returns may be used. This is the key to preventing actions such as what happened in the City of Philadelphia earlier this year, where the city – despite having its pensions funded at less than 48 percent of its obligation – mailed $31 million in bonus checks to retirees, when the actual rate of return exceeded the assumed rate.
- **Prohibit Deferred Retirement Option Plans (DROP).** Lump-sum payments resulting from DROP programs should be eliminated for all plans. DROPs represent a financial

burden on the city or municipality obligated for the payment, and take monies away from the pension plan of retirees

***Shift management responsibility for underfunded plans to a single shared investment manager and plan administrator*.** While the investments would be managed by an independent statewide organization, the current benefit levels – as determined by the contract between the municipality and the employee – will remain the same, at least for current employees. The plans also will remain the financial responsibility of the municipality. Municipalities will be charged for the administrative costs in this statewide management plan based upon the number of plan members. Once a plan shifts to this manager, it may not shift back out.

The shared investment manager and plan administrator must adhere to all of the standards above, including utilizing a realistic assumed rate of return and maintaining controls on investment management fees.

Moving these underfunded plans to a new shared manager would begin one year from the date of the authorizing legislation being signed into law, with staggered entry dates based on level of underfunding. This approach to implementation provides time for the shared manager to adequately handle the influx of new plans. The specifics of this phase-in should be determined in collaboration with the shared manager.

Underfunded plans may opt not to enter the shared management if they demonstrate that their pension plan funding level has risen above 80 percent since publication of the most recent data from PERC and before the required entrance date.

The shared investment manager and plan administrator must meet the following qualifications:

- Possesses an existing cost effective structure to centralize management of assets
- Has expenses that do not exceed existing cost levels of the Pennsylvania Municipal Retirement System (PMRS).
- Requires the use of a realistic rate of return when municipalities are estimating their pension liability.
- Demonstrates a minimum of 10 years' experience in managing multiple public pension funds in Pennsylvania.

***Consider the creation of new statewide benefit structures for all new hires in the underfunded plans*.** Two benefit structures are included; one for public safety employees and one for non-uniformed employees. If this avenue is pursued, the task force recommends immediately consulting with a public employee pension design expert who can recommend a fair and predictable benefit plan design based on nationally accepted best practices and tailored to our specific circumstances. This plan should include a provision for portability of pension benefits accrued between municipalities.

Review the viability of the sale/lease/securitization of assets to help address significant unfunded liabilities. Municipalities with underfunded pension plans should assess potential benefits of selling, leasing, or otherwise securitizing assets, such as water and sewer systems, that would provide a fiscal net gain and would not lead to higher costs for the municipality in the future. This is a viable option for only a very small number of municipalities with underfunded pensions.

Strategies for Philadelphia and Pittsburgh

Because Philadelphia and Pittsburgh together represent over $6 billion of the state's total municipal pension plan unfunded liability, the task force recommends that each of the two cities have the option of either joining the other underfunded municipalities in the statewide management system outlined above, or that each maintain its own investment manager/plan administrator that adopts the recommended standards above.

If opting to adhere to the standards under their own management, Philadelphia and Pittsburgh must develop, within six months of enactment, a five-year plan to meet the standards and create a new plan for new hires. Both cities must submit an annual report detailing the implementations and achievements to date, with copies to the Governor, General Assembly, Auditor General, and PERC. Failure to submit a five year plan or annual report or to comply with the five-year plan will result in the loss of all Act 205 state aid.

Modernize data collection, reporting requirements, and state aid system

Currently, municipalities must submit their pension information via hard copy to PERC and the Department of the Auditor General. In addition to being a cumbersome, labor-intensive, and outdated process, it creates a frustrating lag in the reporting of data. PERC must manually enter all information for thousands of plans. As a result, PERC is only able to publish their report every two years, which prevents a timely assessment of the status of Pennsylvania's municipal pension funds.

The Department of the Auditor General, PERC, and the appropriate commonwealth agencies should work together to develop a cost-effective plan to modernize state aid distribution and reporting systems to create greater efficiencies and enable annual reporting in line with common industry practice. If moved to an electronic reporting system, PERC should be required to report annual figures, creating a more up-to-date understanding of a plan's relative health, including any progress or decline in unfunded liability. In addition, the MMO calculation should be made annually.

The goal for implementation for electronic filing should be 2017. The Department of the Auditor General will continue previous discussions with the Governor's Center for Local Government Services to utilize their new e-filing system to obtain necessary data. PERC will establish its plan for e-filing as well.

Summary

A consensus of stakeholders – on all sides of the pension issue – believe that it is imperative that we immediately address problems with the commonwealth's system of local government pension plans. The recommendations presented in this report of Governor Tom Wolf's Municipal Pension Task Force are realistic and responsible reforms to Pennsylvania's municipal pension challenges.

We recommend increasing transparency and accountability for all municipal pension plans by:

- Increasing penalties for municipalities that do not pay their full minimal municipal obligation (MMO).
- Ending the current practice of allowing state municipal pension aid to be used for administrative expenditures.
- Adopting standards to require municipalities to disclose pension liability and requiring the public posting of municipal pension costs.
- Excluding municipal pensions from collective bargaining.

We recommend helping with the recovery of underfunded pension plans by:

- Requiring underfunded pension plans to adopt new investment and benefit standards including controlling management fees, capping overtime and excluding accumulated leave from pension calculations, eliminating lump-sum DROP payments, adopting realistic rates of return on investments and limiting benefit enhancement.
- Shifting management responsibility for underfunded plans to a shared investment manager.
- Possibly creating a new statewide defined benefit structure for all new hires in underfunded plans.

We recommend that the Pittsburgh and Philadelphia pension plans be given the option of joining the other underfunded municipalities in the plan outlined above, or maintaining their own investment managers/plan administrators, with specific requirements and consequences for achieving those reforms.

Lastly, we recommend that the Department of the Auditor General and the Public Employee Retirement System work together to modernize state aid distribution and reporting systems to enable annual reporting.

These recommendations will require discipline at both state and local levels. This discipline is important for the viability of Pennsylvania's communities. If we are able to adequately address the municipal pension issue, a significant stressor for local government, we will be able to put all communities on stronger ground which, in turn, will help Pennsylvania as a whole.

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Appendix A: Organizations Who Participated in Discussions

Allegheny Conference on Community Development

City of Lancaster

City of Philadelphia

City of Pittsburgh

City of York

Commonwealth Foundation

Council 13 AFSCME

Greater Reading Area Chamber of Commerce

International Association of Fire Fighters

Keystone Research Center

K&L Gates LLP

Lancaster County Chamber of Commerce

McNees Wallace & Nurick LLC

Pennsylvania Professional Firefighters Association

Pennsylvania State Association of Township Commissioners

Pennsylvania State Association of Township Supervisors

Pennsylvania Fraternal Order of Police

Pennsylvania Municipal Retirement System

Pennsylvania Municipal League

Pennsylvania State Association of Boroughs

Pennsylvania Infrastructure Investment Authority (PENNVEST)

Philadelphia Fire Fighters' & Paramedics' Union I.A.F.F. Local #22

Philadelphia Fraternal Order of Police Lodge #5

Pittsburgh Firefighters I.A.F.F. Local #1

Pittsburgh Fraternal Order of Police Lodge #1

Public Employees Retirement Commission

SEIU Local 668

York County Controller