

Managing Pennsylvania's Municipal Pension and Other Long-Term Benefit Liabilities Analysis and Recommendations

*Senate Finance Committee
August 12, 2009*

Rick Dreyfuss
*The Commonwealth Foundation
Senior Fellow*



Scope of Testimony

- Share my research and build upon my experience as an HR executive and actuary
- Provide background comments together with analysis on PA municipal pension legislation:
 - Specific comments on HB 1828 (SB 1058) – relating to Philadelphia
 - General comments addressing PA municipal pension reform



The Basics of Pension Funding

- Actuarial funding methods are established to have obligations funded as benefits are earned. This means, in the aggregate, retiree obligations should be “paid up” when members retire.
- Two portions of employer pension contributions (net of employee contributions)
 1. Recurring annual premiums referred to as the “normal cost”
 2. Annual amortization payments
- The periodic measurement of “assets” versus accrued liabilities defines the unfunded liabilities. These liabilities/surpluses are spread or “amortized” like a mortgage. Amortization payments result from:
 - Experience (gains and losses)
 - Benefit changes
 - Changes in assumption and funding methods.
- If the average age is 45 and retirements are assumed to occur at 60 – then the amortization periods should be limited to 15 years.

Managing Pension Liabilities

The Wall Street Journal

The Public Pension Crisis

August 18, 2006; Page A14

- “.... the fundamental problem is that public pensions are inherently political institutions.”
- “... the current public pension system simply isn't sustainable in the long run.”



Three Sources Enable the Institution of Public Pensions

Source #1: Poor Benchmarking

- The PA public pay and benefit programs are typically benchmarked only against other public plans rather than the entire marketplace.
 - This fosters “financial relativity”
 - Affordability and market trends in the private sector are directly relevant to the public sector.
- My review of market trends suggests an annual net employer cost of 5% to 7% of payroll should be achieved to sustain long-term pension affordability.



31 Pennsylvania Companies

Participating in the 2009 Hewitt Annual Salaried Benefit Survey

<ul style="list-style-type: none">■ Air Products■ Allegheny Energy■ Armstrong Wood Products■ Armstrong World■ Black Box Network Services■ Carpenter Technology■ CertainTeed■ CIGNA■ Comcast■ Delaware Investments	<ul style="list-style-type: none">■ Duquesne Light■ Federated Investors■ Giant Eagle■ GlaxoSmithKline■ Heinz■ Hershey Company■ IKON Office Solutions■ IMS Health■ Knoll■ Lincoln Financial Group■ NOVA Chemicals	<ul style="list-style-type: none">■ Penn National■ PNC Financial Services■ Rohm and Haas■ Toll Brothers■ Unisys■ United States Steel■ UPMC■ US Filter■ Voith Siemens Hydro Power■ Westinghouse Electric
--	--	--



Survey Results

- Only 11 of 31 companies (35%) sponsor DB plans for new hires. Among the 765 companies nationally, the result is 37%.
- All 31 companies had DC plans with an average employer match of \$.70 on 6.1% of payroll. Nationally, the results \$.79 and 5.6%.
- Why the transition?
 - The inability of companies to achieve pension costs that are current, predictable and affordable.
 - Unaffordable retiree medical liabilities.

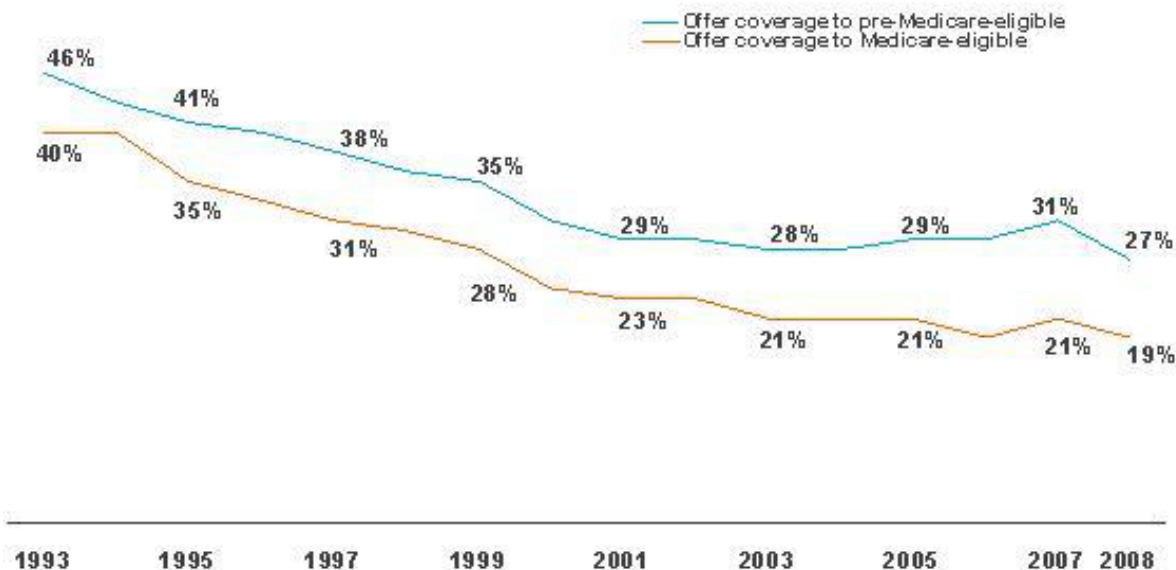
Trends in the Marketplace

Mercer 2008 - *National Survey of Employer-Sponsored Health Plans*
Approximately 3000 employers

FIGURE 7

Offerings of retiree medical plans* have fallen sharply over the past decade

Percentage of large employers



*Plan must be offered on an ongoing basis (i.e., new hires are eligible).

Source: Mercer's National Survey of Employer-Sponsored Health Plans



Source #2: Non-existent Metrics and the Unmanaged Risk to Taxpayers

- No absolute metrics defining the affordability or reasonableness of costs given the “perpetual life of the government entity.”
- Creates unreasonable risks to taxpayers.
- Actuarial assumptions do not create certainty.
- Little consistency in funding assumptions and funding methods making comparisons most difficult.

July 24, 2009

California Pension Fund Hopes Riskier Bets Will Restore Its Health

- Calpers intends to return to its goal of 7.75% annual returns.
- Gov. Arnold Schwarzenegger, who is on the Calpers board, has called the fund “unsustainable.”
- He has specifically criticized a decision by Calpers last month to give California municipalities a break on their required contributions.
- Mr. Schwarzenegger called it a “pass the buck to our kids idea.”

JULY 6, 2009

Public Pensions Cook the Books

Some plans want to hide the truth from taxpayers.

- While corporate pension funds are required by law to use low, risk-adjusted discount rates to calculate the market value of their liabilities, public employee pensions are not. However, financial economists are united in believing that market-based techniques for valuing private sector investments should also be applied to public pensions.
- But as the Congressional Budget Office has pointed out in 2004, "The government does not have a capacity to bear risk on its own" -- rather, government merely redistributes risk between taxpayers and beneficiaries, present and future.
- Market valuation makes the costs of these potential tax increases explicit, while the public pension administrators' approach, which obscures the possibility that the investment returns won't achieve their goals, leaves taxpayers in the dark.
- But the association's objections seem less against market valuation itself than against the fact that higher reported underfunding "could encourage public sector plan sponsors to abandon their traditional pension plans in lieu of defined contribution plans."



Source #3: The Politics of Public Pensions



Public Pensions are a major source of significant political capital

- Pension surplus is considered the source of benefit improvements and deficits represent under-funding by taxpayers. This paradigm will not change.
- Maintaining or improving pension benefits carries a high political rate of return – however, properly funding these plans carries a low political rate of return.
- Public Pension Plans are also an esoteric afterthought
 - Not well understood – an over-abundance of half-truths
 - Benefit commitments can be over 50 years
 - Funding is most easily manipulated – proper funding should occur as benefits are earned over the “working career of the employee.” Easy to (re)defer costs to the next generation.
 - Local and city pension shortfalls are becoming political problems for the state – consider Philadelphia, Pittsburgh and Allentown.



Specific Comments on HB 1828

- This is “Generational Theft.” My op-ed appeared in The Philadelphia Inquirer on March 25 and in The Philadelphia Bulletin on April 1.
- The policy of shifting these unaffordable liabilities to future generations is immoral.
- The bill legalizes greater financial manipulation.
- The expedited consideration in the House is significant. Few understand the long-term implications of this bill.
- HB 1828 creates more problems than it purports to solve. Why does contributing less to an already poorly funded plan get marketed as sound public policy?



Specific Comments on HB 1828

- Why not fix the liability problem rather than just deferring it? What generation will deal with this reality?
- Clarification is needed in defining the asset value used in determining the unfunded liability to be amortized over the new 30 year period. Earlier reports indicated a move to 10 year averaging which is a common practice in manipulating pension costs.
- If 20 year amortization already defers significant costs to the next generation, why would you consider permitting 30 years?
- The significant part of the legislation is the establishment of a new 30 year period payment period but emphasis is placed on the interest only arrangement over the next 5 years.



Comments on HB 1828

- The crisis is presented as a “financial timing” issue whereas the problem is institutional and political in nature. What is to prevent future benefit improvements?
- What set of dynamics will allow Philadelphia to have these unaffordable deferred costs become “affordable” in 2014? The parallels to Act 40 of 2003, which is contributing to the PSERS and SERS sustained increases in FY 2012 (and beyond) increases, are most noteworthy.
- The financial actuarial note of July 29, 2009 is superficial, misleading, incomplete and should be redone. In what year will this plan be 100% funded? What are the projected deficits? What are the risks to the taxpayer?



HB 1828 Actuarial Impact

The PERC consulting actuary indicated that enactment of the bill would not result in any actuarial cost, since it pertains only to the funding of the retirement systems and does not result in any additional benefits provided to the members of the retirement systems.

Actual pension reform strategies versus just deferring the problem

The Prerequisites to HB 1828

Recommended Actions: A five step approach

1. Establish a unified DC plan to curtail open-ended liabilities and long-term commitments from being created for new members
 - SB 566 (2009)
2. Prohibit Pension Obligation or other post-employment benefits (OPEB) bonds on a statewide basis – (borrowing one's way to prosperity).
3. Mandate minimum funding reforms for any newly created liabilities resulting in both pension and OPEB plans
 - For actives – maximum funding period is the average remaining working career of recipients.
 - For retirees – 1 year funding period (no remaining working career).
 - Permit asset averaging of up to 3 years subject to a 90% to 110% corridor test against the market value of assets.
 - No benefit improvements permitted if the result of such improvements causes the funded ratio to fall below 90%.



Actual pension reform strategies versus just deferring the problem

The Prerequisites to HB 1828

Recommended Actions: A five step approach

4. Consider modifications to current member's unearned pension benefits including a reduced formula, redefinition of eligible earnings, increasing the normal retirement age, curtailing early retirement subsidies, eliminating pension COLAs and deferred retirement option programs (DROPs).
5. Consider funding reforms in HB 1828 only after prior steps are achieved.
6. To omit steps 1,2,3,4 ≠ pension reform.



PA Municipal Pension Reform (Highlight of Recommendations)

- Enroll new employees in a unified defined contribution plan – SB 566
- Standardized reporting requirements
 - Annual valuation required for plans with over 250 lives.
 - Establish a common plan year of July 1.
 - For state reporting proposes – establish a uniform set of actuarial assumptions and methods.
- Implement amortization periods which may not exceed the average expected remaining careers of the active workforce.
- Amortization payments based upon level payment only.
- Implement asset values limited to a three-year averaging period and subject to a 90% to 110% corridor of the market value.



PA Municipal Pension Reform (Highlight of Recommendations)

- Any existing state subsidies will be granted upon successful compliance with these funding reforms.
- No state subsidies to employees entering new DC plan.
- Pension obligation bonds or any other form of third-party debt are not permitted.
- No benefit improvements permitted if the result of such improvements causes the funded ratio to fall below 90%.
- Effective career management strategies needed for uniformed employees in latter part of careers - prior to age 62.



Severely Underfunded Plans

If funded ratio falls below 50%

- If the plan has over 250 lives, then the local pension board will be replaced with certain conditions:
 - No elected public officials
 - No current or former plan members
 - No one who is a potential supplier to the plan
 - Term limits will apply
- If under 250 lives, the entire plan administration will be assumed by PMRS

Wall Street Journal

ABREAST OF THE MARKET - AUGUST 10, 2009

“Debt Burden to Weigh on Stocks”

“Consumers' Inability to Drive Economic Growth Likely to End Big Gains”

- Consider the convergence of federal, state and municipal pension and retiree medical deficits.
 - Will these funds achieve asset returns of 8% or better?
 - Who will be taxed to pay for these costs?



For pension plans to be viable they must achieve three criteria

- Fund balances must be current – 100% funded ratio. Significant private sector pension reforms occurred in 2006.
- Costs must be predictable.
- Costs must be affordable (5% to 7%) of payroll.

Managing Pension Liabilities

The Wall Street Journal

The Public Pension Crisis

August 18, 2006; Page A14

- "... the fundamental problem is that public pensions are inherently political institutions."
- "... the current public pension system simply isn't sustainable in the long run."