An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund

PICA Issues Report

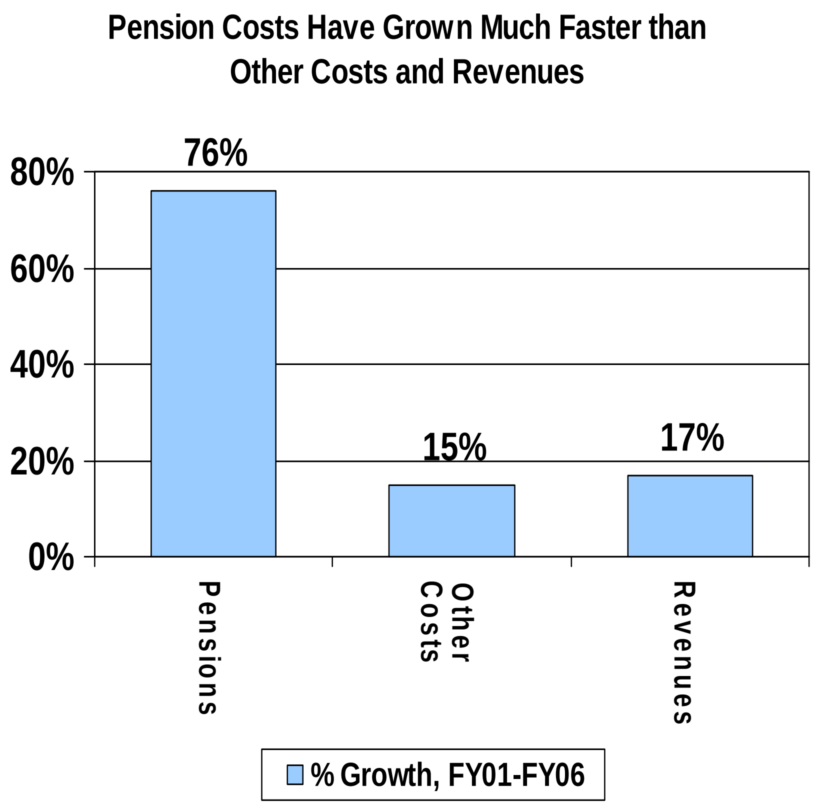
December 21, 2005

An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund

Extent of the Problem - History

- Pension costs have emerged as perhaps the most important financial issue facing the City.

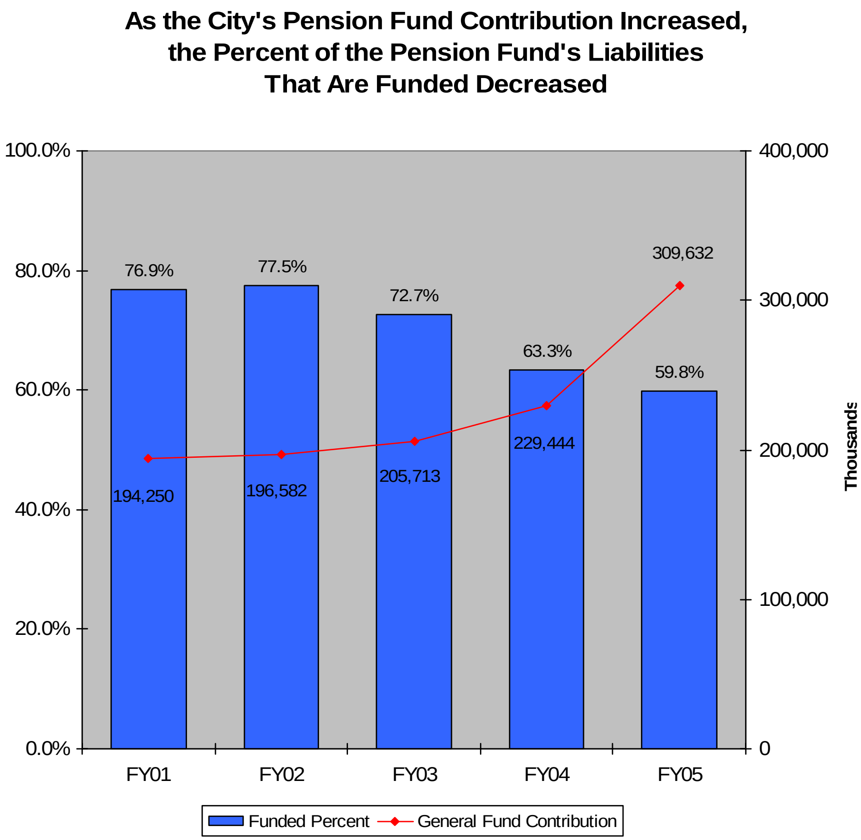
- From FY2001 to the City's current projection for FY2006, pension costs have grown five times faster than other costs and than revenues.



An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund

Extent of the Problem - History

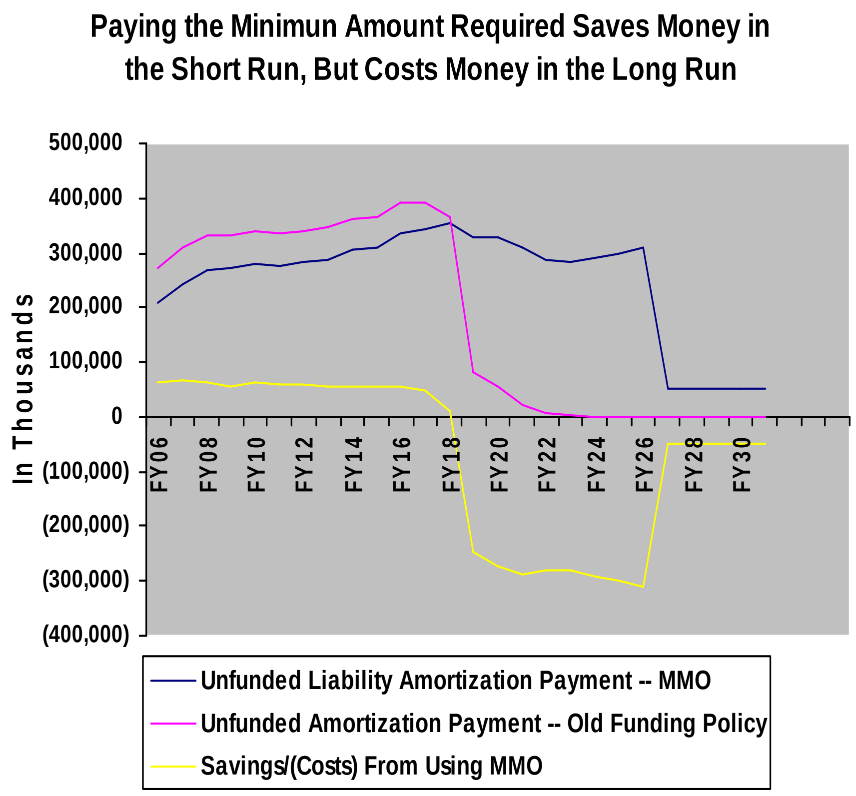
- Even while the City's pension costs have skyrocketed, its unfunded liability has been increasing.
- Pension costs were \$121 million higher in FY2005 than they were in FY2001, but the unfunded liability grew from about 23% to almost 40%.



An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund

Extent of the Problem - Future

- Payments are to projected to continue to grow over the next five years as the FY2006-FY2010 Plan includes $461 million for pensions -- $267 million more than was spent in FY01.
- The City's payments over the next five years would be projected to be even larger if it had not switched to paying the minimum amount required under state law.
- While pensions costs will be lower in the short term because the City pays the minimum legally required amount, the amounts the City pays in the long term will be $1.8 billion higher as the City pushes out payments to future years.

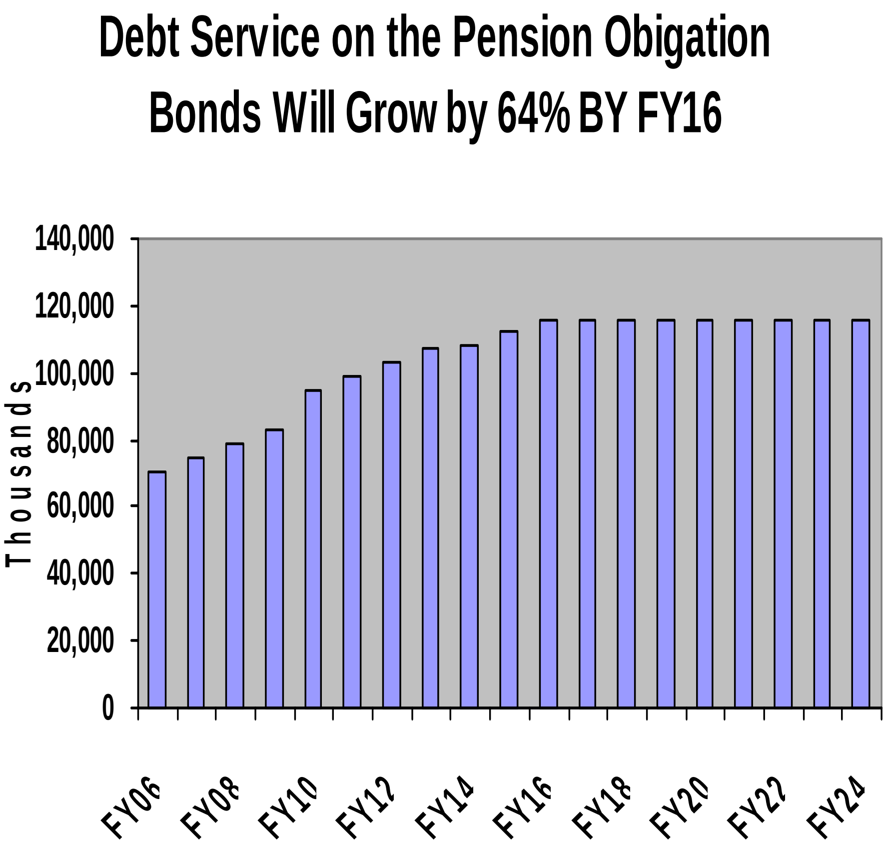


An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund

Extent of the Problem - Future

- In addition to paying its pension fund costs, the City must pay debt service on pension obligation bonds issued in an attempt to reduce the City's unfunded liability and its overall pension costs.

- Rather than helping to ameliorate the City's pension problems, the pension bonds are now exacerbating them. The debt service on the pension obligation bonds, like the City's pension payments, are scheduled to increase substantially over the next ten years.



Causes of the Pension Problems

- The City's pension costs have increased for a number of reasons including shortfalls in assumed earnings when the stock market dropped. The Pension Board assumes that the fund will earn 9% annually, but the fund actually lost money in each of FY01 (6%) and FY02 (5.2%).
- Other factors that contributed to the increase costs were:
  1. The possibility that employees are entering pension status earlier as a result of the Deferred Retirement Option Program
  2. Increases in the life expectancy of retirees.
  3. Increases in the number of retirees in the system
  4. Annual 4.5% increases built into the amortization schedule for paying off the unfunded liability.
- Those increases were partially offset by salary increases that were lower than the five percent rate the actuary assumed.

Pension Package Components

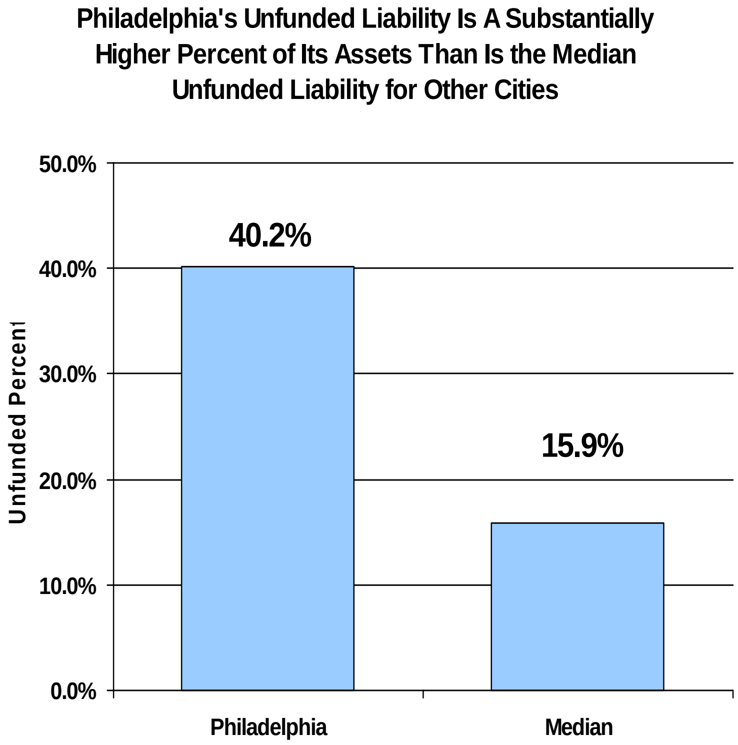
- The City could lower its costs by changing the components of its pension package for new employees through collective bargaining or arbitration. In order to see what options the City had for reducing its costs, the PICA Staff examined plans in nine other cities.

- In general, the City's plan was not substantially different from plans in other cities. The City's 65,000 members have the following benefits:
  1. Retirement Age: 60 for nonuniformed employees and 50 for uniformed employees.
  2. Number of Years of Service Required to Vest: 10
  3. Nonuniformed employee Payment Calculation: 2.2% times the average of the three highest years salaries times years of service for the first 10 years and 2% times average of the three highest years salaries times years of service for each additional year of service.
  4. Uniformed employee Payment Calculation: 2.2% times the average of the three highest years salaries times years of service for the first 20 years and 2% times average of the three highest years salaries times years of service for each additional year of service.

Pension Program Components – A Comparative

The City's pension system was substantially different from those in other cities in three ways.

1. The combined employee and employer contribution of just over nine percent was substantially smaller than the 14 percent median for other cities.
2. The assumed investment earnings rate of nine percent was substantially higher than the eight percent median for other cities.
3. The unfunded pension liability of just over 40 percent was substantially higher than the median of just under 16 percent. The City may have to alter its benefits package to make the financial health of its system more consistent with those of other plans.



Plan Change Benefits – An Actuarial Review

In an attempt to determine whether there were ways that the City could reduce it pension costs without seriously compromising recipients' benefits, PICA asked Mercer, the City's actuary, to look at a number of scenarios for redesigning the City's pension benefit package for new employees. The changes included:

1. increasing the minimum retirement age by five years (from 60 to 65 for nonuniformed retirees and from 50 to 55 for uniformed retirees);
2. decreasing the current benefit multiplier from 2.2 percent to 2 percent for the first ten years of service for nonuniform employees or 20 years for uniform employees and from two percent to 1.75 percent for additional years of service;
3. increasing the period to determine average final compensation from three to five years (for nonuniform) and from two to three years (for uniform); and
4. increasing the employee contribution from 1.99 percent to 2.99 percent for nonuniformed employees and from five percent to six percent for uniformed employees.

Plan Change Benefits – An Actuarial Review (cont.)

Limiting the proposals to new employees reduces the amount of savings that the changes will generate in the short run, but it will still lead to long-term savings, which, in turn, will help the City bring down its unfunded liability. In particular, the changes would sharply reduce the City's pension costs for those new employees.

If the City implemented all of the proposals discussed above, it would save $9.7 million over five years. More importantly, however, it would reduce its pension costs for new employees by 38 percent. As employees in the pension system gradually change over from the old system to the new system, the benefits to the City will increase dramatically.

Recommendations

The City should modify the benefits package that it offers new employees.

The new package should include the changes discussed above – increasing the retirement age, decreasing the benefits multiplier, increasing the period used to determine final compensation and increasing the employee contribution percent. In addition, the City should offer a defined contribution plan as an option for all employees. While changing to a defined contribution plan will not necessarily produce savings, it will limit the City's investment risk.

When possible the City should pay more than the minimum municipal obligation.

If improvements in earnings or other underlying assumptions reduce the amount that the City is required to pay to meet its minimum municipal obligation, the City should not reduce its payments from the amounts included in the FY06-FY10 Five-Year Plan. Instead, the City should keep paying in accordance with the Plan as a way to bring down its unfunded pension liability.

Recommendations (cont.)

The City should never improve benefits included in a pension package without a full analysis of the long-term financial impact of the proposed changes.

Any such analysis should be made available for public discussion before any changes are implemented.

The City should reduce the pension fund's assumed earnings rate.

At nine percent, the City's earnings assumption is inconsistent with rates assumed in other cities. The higher rate heightens the likelihood that the City will miss its earnings assumption. While it would be preferable for the City to lower that assumption to the eight percent median of other cities, such a shift would likely cost over $80 million annually, which is far too expensive at this time. Instead the City should lower its assumed interest rate to 8.75% -- a change that the City said it is already considering. Following such a change, the City should continue to look for opportunities to further reduce the assumed interest rate without jeopardizing the City's fiscal stability.

.