

Pennsylvania Intergovernmental Cooperation Authority



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

PICA Issues Report

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**PENNSYLVANIA INTERGOVERNMENTAL
COOPERATION AUTHORITY**

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

There is no single policy choice on spending the City can make that will have a greater impact on the future of its finances than how to handle the skyrocketing costs and weakening financial position of its pension system. The latest actuarial report shows that as of July 1, 2004, the pension fund had a \$7.2 billion liability, but assets of only \$4.3 billion. The difference, 40.2 percent of the City's liability, is an unfunded liability of \$2.9 billion.

If no changes are made to the pension system, the City is likely to continue to have sharply increasing costs and a continued weakening of the pension fund's fiscal health. If, on the other hand, the City chooses to make changes, it can contain costs and improve the pension fund's health. The problem is so severe, however, that the changes necessary to bring about those improvements will require a reduction in the benefits that new employees receive.

Pension issues have plagued the City for decades and are increasingly challenging not only for other governments, but also for private corporations. Their impact on the City's fiscal health has become particularly clear over the last five years. In FY2006, the general fund is projected to spend almost \$150 million more on pensions than it spent in FY2001. Yet that increase in spending gets little attention, while other matters with much smaller costs have generated substantially more consideration. To illustrate, the \$150 million in increased pension fund spending is more than twice the \$70 million projected annual incremental cost of wage and business privilege tax cuts from FY2010 through FY2015. It is also more than three times larger than the amount the City will spend in FY2006 on debt service for NTI, the new Phillies stadium and the new Eagles stadium combined. Nevertheless, there were no long, intense debates about the pension fund spending like the ones about taxes, NTI and stadiums.

This paper analyzes the pension challenges facing the City, how the City's pension fund compares to those in other cities and what options the City has for managing those challenges. The analysis leads to the conclusion that the city must make a number of changes including:

1. modifying the benefits package that it offers new employees;
2. paying more than the minimum municipal obligation when possible;
3. not improving the benefits included in the pension package without doing a full analysis of the long-term financial impact of any proposed changes; and
4. reducing the pension fund's assumed earnings rate.

PICA believes that the City really has no choice when it comes to its pension fund: it must act and act quickly.

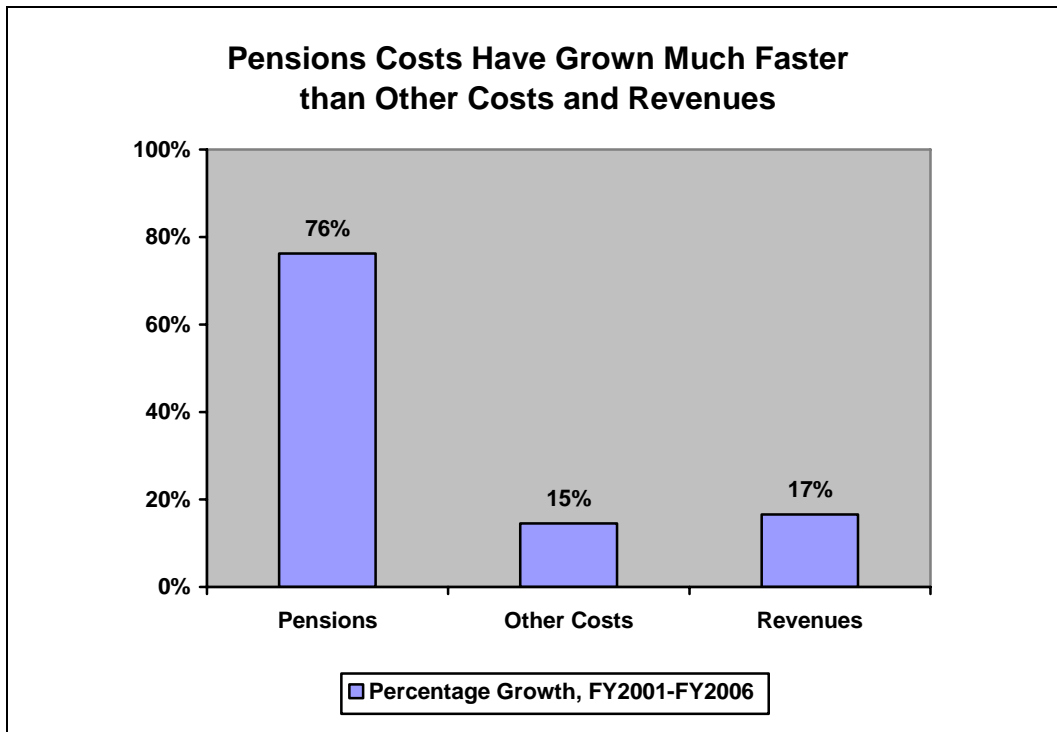
The Pension Problem Facing the City of Philadelphia

The pension fund liability creates a two-pronged problem for the City. First, the amount the general fund pays annually for pensions (its contribution to the pension fund plus its debt service payments on pension obligation bonds) is skyrocketing. Second, the financial health of the pension fund is getting worse, not better. Each of these problems is discussed separately below.

Cost are Increasing Rapidly

Philadelphia's annual obligation to the pension fund is increasing exponentially. In FY2001, the City's general fund incurred \$194 million in pension costs. In FY2006, those costs are projected to increase to \$342 million, a 76 percent increase in five years. That rate of growth for pensions is almost five times faster than the roughly 16 percent rate of growth of costs across the rest of the general fund budget.

The staggering growth is projected to continue. The approved FY06-10 Five-Year Plan projects that pension costs will grow by another \$119 million to \$461 million by FY2010. From FY2001 to FY2010, pension costs will have grown by \$267 million. The rest of the budget, excluding health benefits,¹ and costs for the Department of Human Services, (which are largely reimbursed by the state and federal governments), is projected to decline by almost \$100 million over the same period. The expanding pension fund obligation is clearly cutting into the City's opportunity to grow its economy by reducing its tax burden while maintaining key city services.

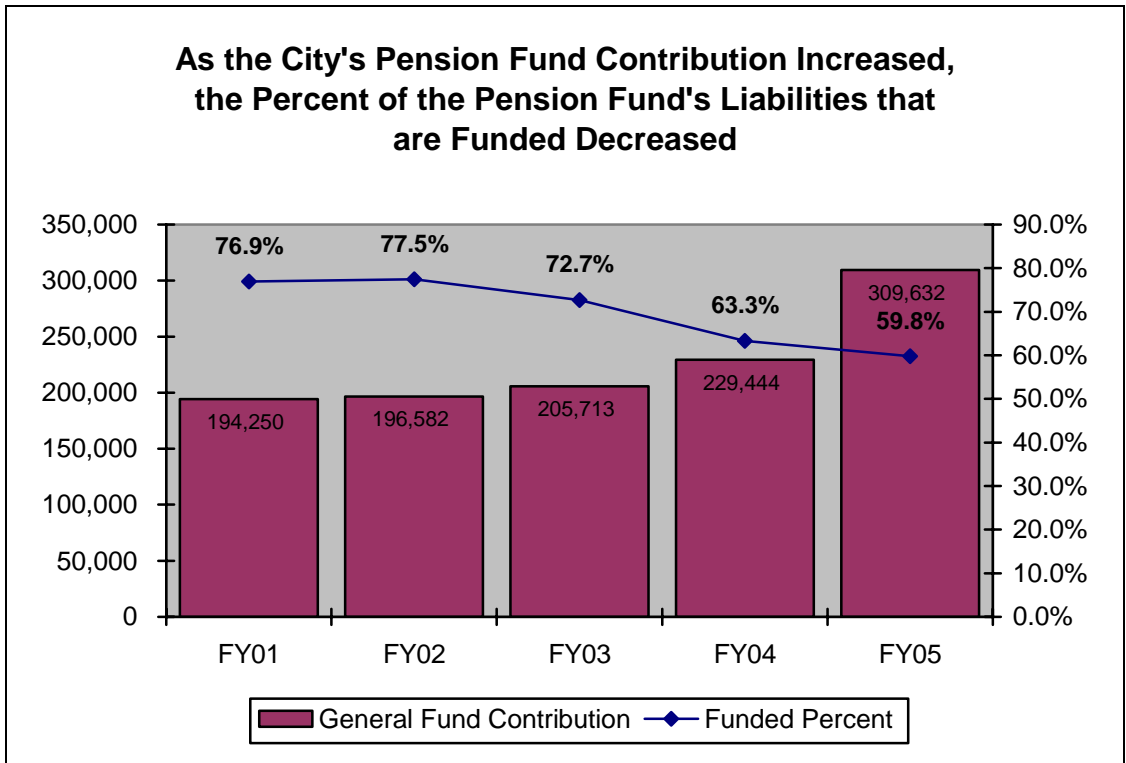


¹ PICA intends to release a separate issues paper addressing health/medical benefits in the summer of 2006.

The Unfunded Liability is Also Increasing Rapidly

Philadelphia’s pension fund is growing weaker financially. In FY2001, when the City’s general fund incurred nearly \$200 million in pension costs, the pension fund’s assets equaled 77 percent of its liabilities. In FY2006, when the City’s general fund is budgeted to incur \$342 million in pension costs, its assets will equal less than 60 percent of its liabilities. This “unfunded liability” is increasing rapidly even as the City pours more and more money into the pension fund. Worse yet, since the City has adopted a policy of paying the legal minimum to the pension fund, it will be more difficult to reduce the unfunded liability than it would have been using the City’s old funding policy. The City is postponing the day when it will tackle its pension problem and ensuring that the problem will be bigger than it would have been if the City were paying more than its minimum legal requirement.

A large portion of the City’s pension payment goes towards eliminating its unfunded liability. The payments are scheduled to grow rapidly over the next several years, with the general fund portion increasing from \$208 million (out of a total general fund payment of \$342 million) in FY2006 to \$280 million (out of a total general fund payment of \$460 million) in FY2010. The annual payments for the unfunded liability are scheduled to continue to grow after the Five-Year Plan period is over, with the general fund portion reaching \$350 million in FY2018 before beginning to decline.



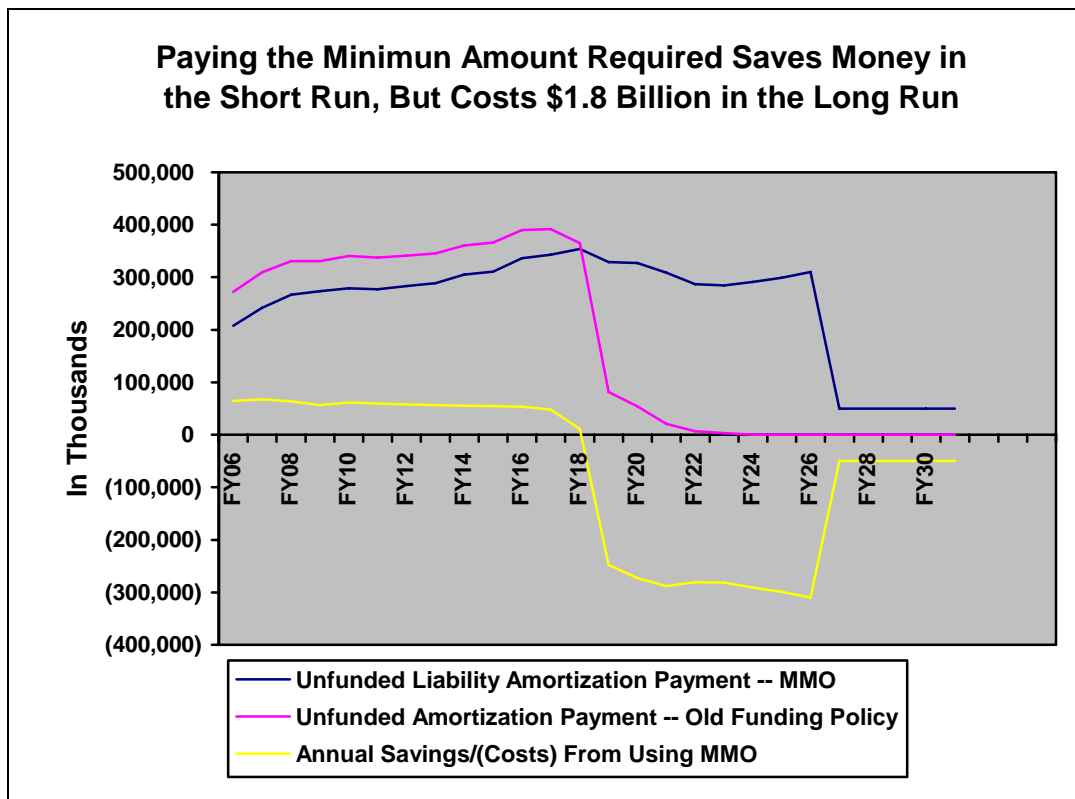
Payments Would Be Even Higher if the City Were Not Paying Only the Minimum Amount Required Under State Law

The payments for the unfunded liability would be even higher if the City paid more than the minimum allowed under state law. According to the latest actuarial report, the City’s minimum required pension payment for FY2006 is \$306.9 million. Of that amount, \$272 million is projected to be paid by the general fund, with the rest coming from other funds of the city.

The actuarial report also shows that if the City had not shifted to the minimum allowable payment in FY04, the funding requirement for FY2006 would have been \$381 million -- \$74 million more than the minimum required payment. The general fund would have been responsible for about \$330 million of that payment, which would have required that the City add \$60 million to the pension budget and remove \$60 million from other areas of the budget, assuming constant revenue.

Paying Only the Minimum Legally Required Amount to the Pension Fund Saves Money in the Short Run, But Increases the City’s Costs in the Future

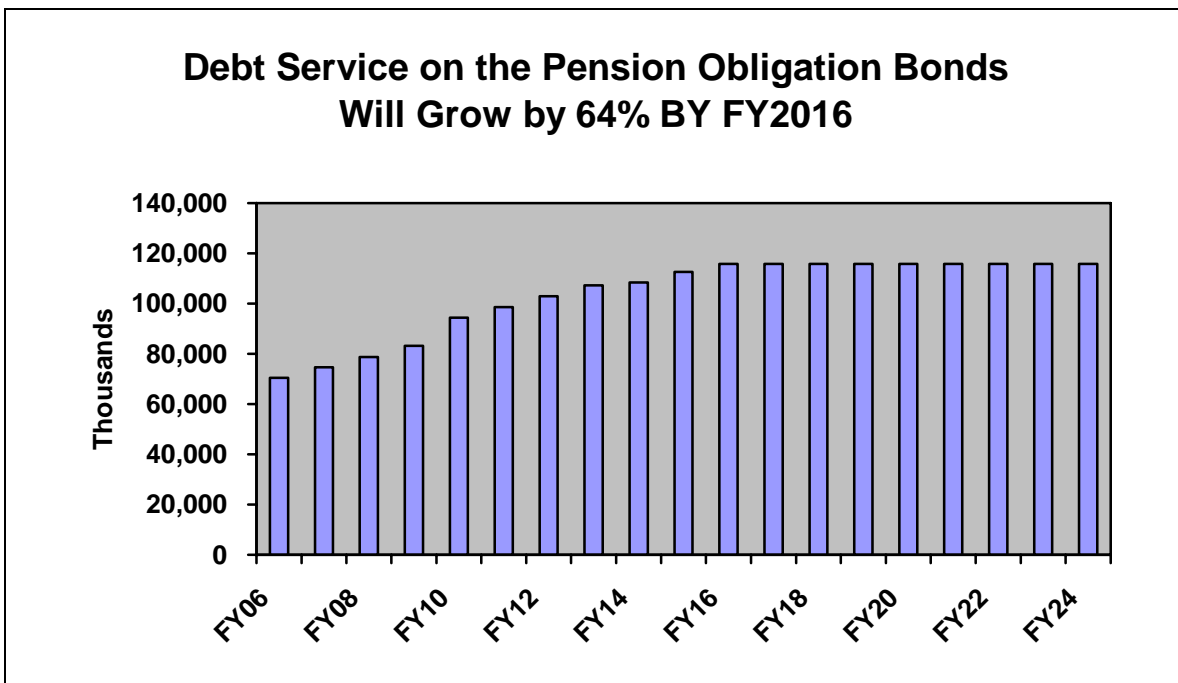
Before FY04, the City adhered to a funding policy under which it made payments to the pension fund designed to have it pay off its unfunded liability by FY2023 and to have its payments drop dramatically beginning in FY2019. The shift to the lower minimum legal requirement puts the City on a different amortization schedule, one that does not begin to show large reductions in payments until FY2027. By the time the unfunded pension liability is scheduled to be eliminated in FY2031, the City’s total cost will be \$1.8 billion higher than it would have been if the City had maintained its old funding policy.



The City Also Must Pay Debt Service on Pension Obligation Bonds

In addition to the actuarially determined pension fund payment, the City must pay principal and interest on pension obligation bonds. Paradoxically, these bonds were issued in an attempt to reduce the City’s accrued unfunded pension liability and its annual payments. While issuing the bonds did reduce the City’s unfunded liability, the bonds are now adding to the City’s rapidly increasing costs.

The debt service payments on the pension obligation bonds, like the City’s pension payments, are scheduled to increase substantially. The general fund’s portion of the bond payments is budgeted at \$70.5 million in FY2006 and will increase to \$94.3 million by FY2010. Those costs are scheduled to continue to increase until they reach \$115.9 million in FY2016.



The Causes of the Pension Fund Problems Facing Philadelphia

Earnings on the Pension Fund Dropped

One of the key determinants of the size of the City’s contribution is the amount that the pension fund earns on its assets. The City assumes that the fund will earn nine percent annually. If the fund earns less than nine percent in a year, the City’s general fund must increase its contribution to compensate for the shortfall in assumed earnings. Stock market drops in 2000, 2001 and 2002 made it impossible for the City to achieve its assumed nine percent earnings. In fact, the fund lost money in FY2001 (six percent) and FY2002 (5.2 percent) and made only 2.9 percent in FY2003, before bouncing back to 16.6 percent in FY2004. Lower than anticipated earnings led to an increase in the City’s unfunded liability and, as a result, to an increase in the City’s funding obligation. Even though the increase in the City’s payment is amortized over a number of years, it can be

significant when the gap between assumed investment earnings and actual earnings are as large as they were when the market declined.

While the Change in Earnings Had the Biggest Impact on the City's Required Payments, Other Factors Also Contributed

In projecting the pension fund's liabilities, actuaries make a number of assumptions, such as how salaries will change, the number of employees, retirement ages, life expectancy, etc. Liability assumptions are only as good as the assumptions on which they are based. Changes in any of the factors driving costs will change the pension fund's liabilities.

One possible reason the City's required contribution has increased is that the Deferred Retirement Option Program (DROP) may have meant that more people enter into retired status for pensions purposes earlier. Under DROP, employees who have reached the age at which they are eligible to begin receiving a pension can enter retired status for pension purposes, but remain on the City's payroll for up to four years. During those four years, employees receive both a salary and a pension. The pension payment is put into a separate account that employees can roll over into an IRA or receive as a lump sum payment when they leave the City's payroll. If the DROP has meant that more employees have entered retirement status earlier, it would also mean that they will receive a pension for a longer period of time, thereby increasing the fund's liability.

Other reasons for the increased contribution are that people are living longer and, as a result, receiving pensions for longer periods; that the number of retirees increased more quickly than projected, from 17,989 in FY02 to 19,243 in FY04; and, that the amortization schedule for eliminating the unfunded liability includes 4.5 percent annual increases. The factors pushing the contribution up have been partially offset by salary increases that were lower than the actuarially assumed five percent rate.

Solving the Problem: Adjusting the Pension Package

The City could change its pension costs by changing any of the components of its benefits for employees through collective bargaining or arbitration. It is unclear whether the City can reduce benefits for existing employees, but it is clearly legal to change the benefits package for new employees. For example, if the City increased the age at which new employees can begin receiving a pension, the City's liabilities would begin to decrease. A comparison with other cities shows that there are many different ways to structure pension plans and that the City has options available to reduce costs and still offer a benefits package similar to what other cities offer.

Comparing Philadelphia to Other Large Cities
The Philadelphia Pension Plan

With just under 65,000 members, the Philadelphia pension system is one of the largest municipal plans in the country. Employees are eligible to retire at age 60 (50 for uniformed employees) with 10 years of service, at which point they can begin to collect 2.2 percent of the average of their three highest years' earnings times the number of years

they work for the first ten years employed (20 years for uniformed employees) and 2 percent of the average of their three highest years' earnings for each additional year worked.

Philadelphia's Plan Compares to Those in Other Cities

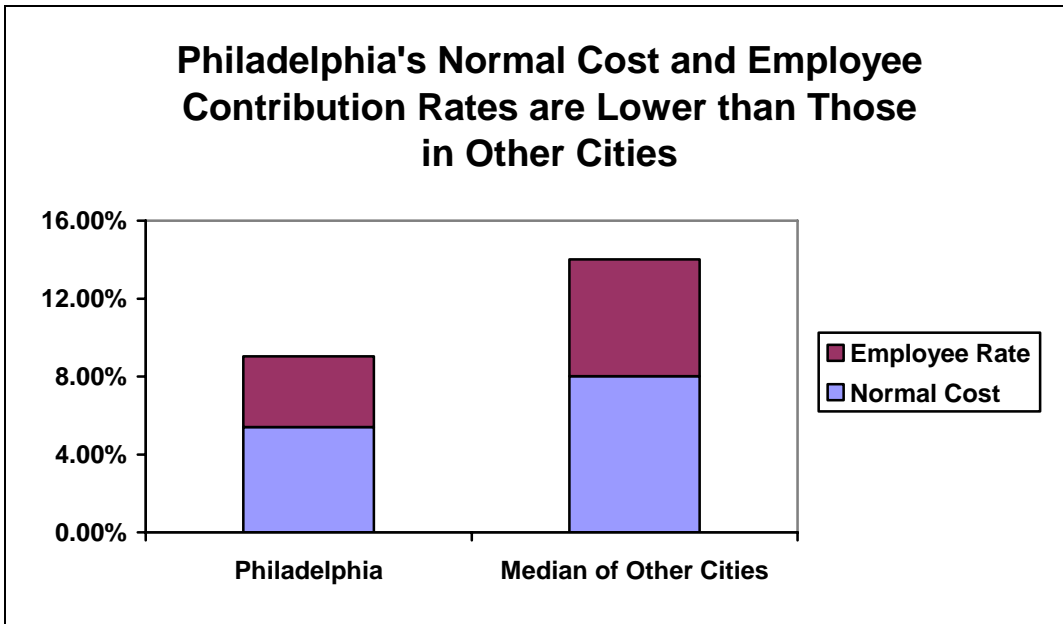
In many areas, Philadelphia's pension plan is very similar to plans in other cities.² There are, however, some areas in which Philadelphia's plan is very different including:

- combined contributions of the city and employees;
- assumed rate of investment return; and
- unfunded liability.

Combined Contributions of Cities and Employees. Almost all major municipal pension systems have set percentage contributions from the employer (also called the normal cost) and the employee. In Philadelphia, employee and employer contributions vary by plan, but the average expected employee contribution was 3.63 percent in FY04 and the City's normal cost was 5.41 percent of payroll for a combined contribution of 9.04 percent. These rates are far below the median for the cities PICA surveyed. The median contribution across the selected cities was 6.00 percent for members and 8.02 percent for the cities. This puts the combined contribution for Philadelphia's system at nearly 5 percent below the median. Other cities are already recognizing the combined contribution as a potential area for change. Denver's city government, for example, recently passed a regulation, effective 2005, increasing the combined contribution from 10 percent to 11 percent by adding an additional percent to the member contribution requirement.

² PICA obtained information on the pension systems of nine large cities, focusing on the following features of each plan: retirement age, years of service required for retirement, basic service benefit multiplier, basic service benefit by years of service, total members, member contribution, city contribution, assumed investment rate of return, actual investment rate of return and unfunded liability.

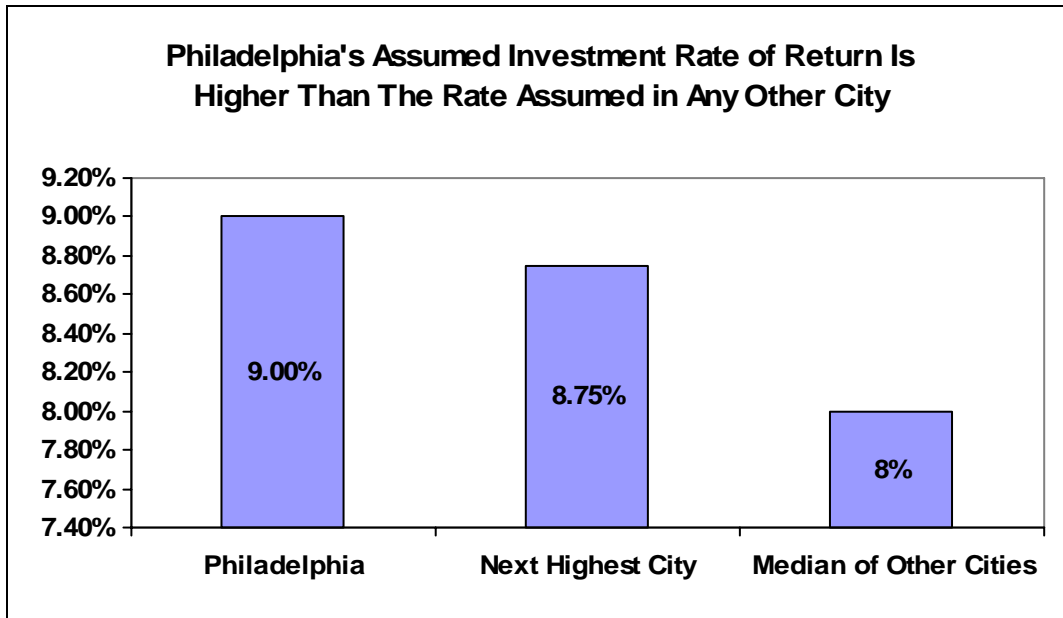
The data used for the comparison was taken from the most recent published report for each city. All of the cities have reports from either 2003 or 2004, except for Baltimore, for which the most recent report is from 2002 and covered the period ending June 30, 2001.



Ending Salary Multiplier. Denver’s approach to the ending salary multiplier is also instructive. It recently lowered the percent of ending salary that it pays its retirees from 2 percent to 1.5 percent. Philadelphia’s salary multiplier payment of 2.2 percent for the first 10 years (20 for uniformed employees) and 2 percent for each year thereafter is slightly below the median payment of 2.4 percent, but still substantially higher than the lowest multipliers used.

Assumed Investment Rate of Return. The area in which Philadelphia is most different from other cities is its assumed investment rate of return. Philadelphia’s assumed 9 percent is higher than any other city PICA examined. The median assumed rate of return for cities surveyed is 8 percent. The risk in assuming an aggressive rate of return is that it makes it more likely that the City will miss its target and have to pay more in the future to compensate for the lower than anticipated earnings.

There is, of course, a cost to reducing the assumed rate of return. If the City assumes an investment return of lower than nine percent, it would have to increase its annual payment to compensate for the lowered projected earnings. For example, if the City dropped its assumption to 8.75 percent – the assumed investment rate of the City with the next highest assumption -- the City’s contribution would increase by \$21 million annually.



Defined Contribution Plan. The City has a defined benefit plan, which means that the City guarantees a set annual payment to each of its eligible retirees. In its FY2006-FY2010 Five-Year Financial Plan, the City discusses changing from that defined benefit plan to a defined contribution plan, which would look similar to a private sector 401(K). By moving to a plan in which it guarantees only how much it will put into the pension system, but not how much will go out of the pension system to retirees, the City would essentially be shifting earnings risk to employees.

One of the reasons that the City's pension fund payments have gone up so dramatically over the last several years is that the City had to compensate for shortfalls in pension fund earnings. When those earnings dropped as the stock market sagged, the pension fund's investments were not producing enough income for the fund to be able to ensure the benefits defined in its plan. The only way to ensure those benefits was for the City to increase its payment.

Under a defined contribution plan, the City would no longer bear that market risk. Eligible retirees would be responsible for investing so that they would get the benefit of strong earnings, but also shoulder the risk of weak earnings. In order to help employees minimize their investment risk, the City should offer the best available investment counseling if it moves to a defined contribution plan.

In its Five-Year Plan, the City correctly says that moving to a defined contribution plan will not create savings in FY06, but will help address the City's unfunded pension liability. For employees in a defined contribution plan, the City will have no unfunded liability for that plan because it will not have guaranteed any benefit.

If the City begins to offer a defined contribution plan, it will have to reach agreement with union employees on the amount the City would provide for each retiree. The City would only generate current savings from a defined contribution plan if it set its

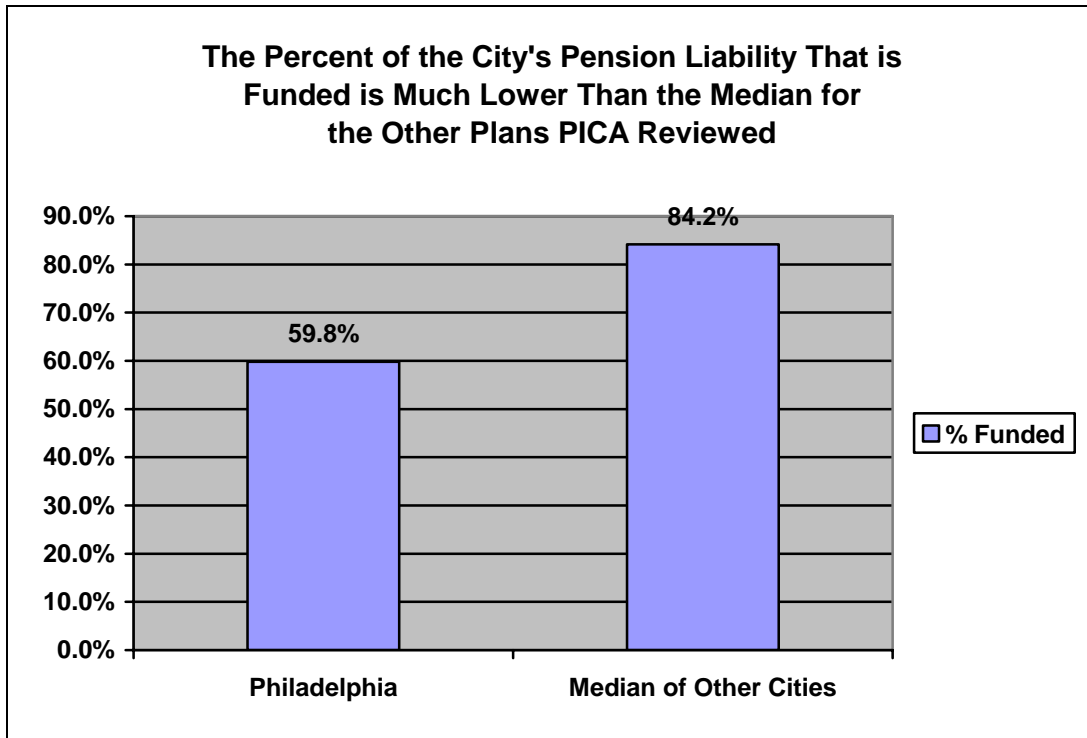
contribution rate at a level below its current normal cost. Since the City's normal cost is now 5.4 percent, a defined contribution plan that included a City payment that equaled less than 5.4 percent would save the City money.

PICA believes a shift toward a defined contribution plan is necessary and appropriate and is consistent with trends in other cities. Detroit, Chicago, Seattle, Denver and the District of Columbia have already added an option for a supplemental defined contribution plan in addition to the current defined benefit plans they provide.

Retirement Dates & Final Salary Computations: Three of the key determinants of the annual pension payment retirees receive are retirement age, years of service required to be eligible for a pension payment and final salary calculations. For cities surveyed, the median retirement age was 55; the median years of service required to retire was 10 and the median multiplier to calculate pension benefits was 2.4 percent. For retirees who had worked ten years that would mean that their annual pension payment would equal 24 percent (2.4 pension multiplier times ten years) of their final salary and they could begin receiving that payment at age 55.

Philadelphia's non-uniform and uniform systems are relatively consistent with the systems in other cities. Non-uniform workers who began working for the City after 1986 are eligible to begin receiving pension payments at age 60 if they have worked 10 years and their payments equal 2.2 percent of their highest average 3 years' earnings times the number of years they worked. For each year after the first 10, the multiplier is two percent. Uniformed employees who began working for the City after 1986 are eligible to begin receiving payments at age 50 with 10 years of service with a multiplier of 2.2 percent for the first 20 years of a service and a multiplier of two percent for each additional year.

Unfunded Pension Liability: While the City's benefit plan is not substantially different from plans offered in other cities, the financial health of its system does appear to be different. At just under 60 percent, the percent of the City's liability that is funded, is well below the 84 percent median for other funds PICA studied. In order to improve the percent of the City's liability that is funded, the City should change its benefit package.



Amortization Period. In addition to having a larger unfunded liability than other cities, the City uses the longest amortization period allowed by law, 40 years, to calculate the pay off schedule. By using a longer amortization period and funding a smaller portion of its liability, the City is shifting a heavier burden to future taxpayers. The median amortization period for the other cities is 30 years.

Costs and Benefits Associated with Pension Package Adjustments

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:

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

Limiting the proposals to new employees reduces the amount of savings that the changes will generate, but it will still lead to long-term savings, which, in turn, will help the City reduce its unfunded liability. In particular, the changes would sharply reduce the City's pension costs for 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 those in the old system to those in 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 make 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 continue paying in accordance with those Plan amounts as a way to bring down its unfunded pension liability.

The City should never improve the 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 for the City at this time. Instead the City should lower its assumed interest rate to 8.75 percent. The Administration has indicated that it is considering making such a change. 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.