

**Testimony of Fran Burns, Executive Director,
Pennsylvania Intergovernmental Cooperation Authority,
before the Pennsylvania Public Employee Retirement Commission**

October 3, 2012

Good afternoon, Chairperson Salomone and members of the Public Employee Retirement Commission. My name is Fran Burns, and I am Executive Director of the Pennsylvania Intergovernmental Cooperation Authority (PICA). The funding of pension systems is a significant issue in Philadelphia, as in other local governments across the Commonwealth, and I appreciate the opportunity to testify today.

Background on PICA

PICA was created by the Commonwealth in 1991 as an independent authority to oversee the finances of the City of Philadelphia, create a long-term financial planning process and pull the city out of deficit through \$1 billion in bond issuance. While PICA issued bonds remain outstanding (\$494 million outstanding as of June 30, 2012), PICA exercises the power of review concerning the fiscal and budgetary affairs of the City.

PICA was created not only to ensure that the City maintain a balanced budget and a responsible financial planning process but also to foster sound financial planning and budgetary practices that address the underlying problems which result in deficits. In accordance with this mandate, PICA has issued reports examining major challenges to the City's long-term financial stability. In 2005, PICA issued a paper on the problems of the City's pension system and possible solutions, which I'll highlight later in this testimony.¹

Philadelphia's Pension System

The Philadelphia Public Employees Retirement System provides benefits to police, fire and civilian workers of the City of Philadelphia through the administration of 18 separate plans dating from origin in 1915. The Philadelphia pension system is one of the largest municipal pension systems in the country with 64,349 members in the system, of which 21,134 were retirees as of July 1, 2011.

Generally, benefit plans are distinguished by whether they apply to police, fire, non-uniformed, or elected employees. There are also three broad categories of plans. "Plan 87" which applies to employees hired after January 8, 1987, "Plan 67" which applies to employees hired prior to January 1987 and "Plan 10" a new category of pension plans that is a hybrid defined benefit/defined contribution plan. There are currently no city employees enrolled in Plan 10.

Philadelphia's system does not incorporate an automatic annual cost-of-living adjustment (COLA). Instead, a Pension Adjustment Fund (PAF) provides ad hoc benefit supplements that are dependent on investment earnings. When it was created, the PAF allowed for automatic

¹ *An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund*, PICA Issues Report, December 21, 2005.

contributions only if the fund was over 70 percent funded, to prevent taking resources from a seriously underfunded system. In 2007, Philadelphia City Council passed a bill (over the Mayor's veto) which allowed for automatic contributions to the PAF based solely on rates of return, regardless of the funding status of the Pension Fund.

Growing Unfunded Liability

The financial health of the City's pension fund has deteriorated significantly over the past decade. The funded ratio declined significantly from 72.7 percent in 2002 to 45.0 percent in 2008. Since 2008, the ratio has increased slightly, to 49.7 percent. The unfunded actuarial accrued liability (UAAL) of the pension system has increased in seven out of the past nine years, with the UAAL increasing from \$1.836 billion in 2002 to \$4.768 billion in 2011. The unfunded liability now represents 348 percent of covered salaries, compared to 152 percent in 2002. Research suggests that the funding level of Philadelphia's pension fund is particularly low compared to other major local pension systems. The Center for Retirement Research at Boston College found that Philadelphia's municipal pension system funding ratio of 47.0 percent in 2011 was the seventh lowest out of 97 major local pension systems in the United States.²

Philadelphia's Contribution Levels

Prior to FY04, the City would make annual payments of the actuarially determined normal cost, as well as an amortization payment based on a 30-year amortization of the unfunded liability. Beginning with FY04, the City reduced its contribution to the Act 205 mandated minimum municipal obligation (MMO), which resulted in short term reductions in annual contributions, but also contributed to the rapid growth in the unfunded liability from 2004 to 2008.

As a result of the 2008-2009 financial crisis, the City received State authorization under Act 44 of 2009 to defer \$155 million of its FY10 MMO and \$80 million of the FY11 MMO. These deferred amounts must be repaid, along with 8.25 percent interest, by the end of FY14.³ Additionally, Act 44, allowed the City to base its MMO on a "fresh start" amortization of the July 1, 2009 UAAL, with the amortization based on level payments over a 30 year period altering the existing 40 year period. This change had the effect of stretching out the City's payments to amortize the unfunded liability, and substantially reduced the level of the MMO beginning in FY11. The City has always met its required MMO payments.

Investment Earnings Assumption

Some academic experts have argued that the appropriate discount rate for measuring pension liabilities is a risk-free rate, to reflect the relatively low uncertainty associated with required projected pension payments.⁴ Adoption of a risk free rate would result in dramatic increases in

² Alicia H. Munnell, Jean-Pierre Aubry, and Kelly Haverstick, "The Funding Status of Locally Administered Pension Plans," Boston College, Center for Retirement Research, December 2008; Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz, and Laura Quinby, "An Update on Locally-Administered Pension Plans," Boston College, Center for Retirement Research, July 2011.

³ At the time Act 44 was passed, 8.25 percent was the City pension fund's assumed rate of return on investments.

⁴ See, for example, Andrew G. Biggs, "The Market Value of Public-Sector Pension Deficits," Retirement Policy Outlook, No. 1 (Washington, DC: American Enterprise Institute for Public Policy Research, 2010); and Robert

estimates of the unfunded liability. It has been suggested that the use of the assumed rate of return of investments as the method of discounting pension liabilities masks the true dimensions of the pension underfunding problem. Higher than realistic earnings assumptions may also have the effect of increasing the incentive of investment managers to invest in more risky assets, which could result in less consistent returns, or lower returns over the long term. This is a national problem. Nonetheless, it is particularly a concern in Philadelphia due to the City's already relatively low funding ratio.

In recent years, the City has lowered its assumed investment rate of return, from 9 percent in 2004, to 8.75 percent in 2005, 8.25 percent in 2009, 8.15 percent in 2010, and 8.1 percent in 2011. Nonetheless, the City's current 8.1 percent rate remains high compared to some other municipal pension plans. Many plans are moving toward long-term investment return assumptions in the range of 7 percent, and some have questioned whether even 7 percent is realistic.⁵ The City's actual investment return in FY12 was 0.05 percent.

The risk of a relatively high assumed rate of return is that actual performance below the assumption will result in higher required contributions. The risk to Philadelphia is somewhat mitigated by the City's move in 2009 from a five-year to ten-year smoothing period. The increase in the asset smoothing period for deviations between actual and assumed investment gains should have the effect of diminishing year to year changes in the level of the City's pension costs due to changes in investment returns.

Impact on the Operating Budget

As the City's unfunded pension liability has increased over the past decade, so have its annual contributions to the pension fund. In FY01, the General Fund contribution to the fund was \$194.3 million, or 6.7 percent of General Fund obligations. By FY09, the contribution had increased to \$459.0 million, 11.7 percent of General Fund expenditures. In FY12, without deferrals, the City's contribution is estimated to have increased to \$554.3 million, 16.0 percent of General Fund obligations. Payments are projected to peak in FY14 at 18.1 percent and drop to 16.4 percent of General Fund obligations in FY17.⁶ This amount is larger than any direct agency appropriation projected for FY17, including the Philadelphia Police Department. Further, the actual amount could be increased depending on actual economic and demographic experience over the next five years, most notably if actual investment returns fall below the City's assumed 8.1 percent rate of return.

Pension Obligation Bonds

The City's pension costs include debt service on Pension Obligation Bonds (POB). Proceeds from these bonds in the amount of \$1.25 billion were deposited into the pension fund in February 1999. However, the impact of the POB proceeds on the long-term health of the pension fund

Novy-Marx and Joshua D. Rauh, 2009, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23 (4): 191-210.

⁵ Mary Williams Walsh and Danny Hakim, "Public Pensions Faulted for Bets on Rosy Returns," *New York Times*, May 27, 2012.

⁶ These amounts include the City's required annual payments of debt service for pension obligation bonds.

was minimal because the issuance occurred before the stock market declines in 2001 and 2002. The overall rate of return on investments was negative in two of the three fiscal years after the POB issuance (a decline of 6.0 percent in FY01 and 5.2 percent in FY02). Accordingly, the UAAL declined following the POB issuance from \$2.7 billion in 1998 to \$1.4 billion in 1999, but increased significantly after 2001 as the investment losses were recognized in actuarial valuations. The funded ratio increased from 52.3 percent in 1998 to 76.7 percent in 1999, peaked at 77.5 percent in 2001, and then declined to 51.6 percent in 2006.

At the same time, the City has been required to meet increasing POB debt service costs.⁷ POB debt service began in FY99, with an initial cost of \$12.5 million, and has increased to \$124.7 million in FY13. Debt service will peak at \$134.7 million in FY16, and remain at that level through 2026. It will increase slightly to \$135.9 million in 2027 and 2029, before increasing to \$232.4 million in 2030, the final year of payments. The General Fund portion of the POB debt service is projected at \$107.1 million in FY13, which represents 17.0 percent of the overall General Fund pension contribution.

Pension Research

In December 2005, PICA issued a report that outlined the significant increases in pension costs from FY01 through FY06, as well as the decline in the funded ratio of the City's pension fund from 76.9 percent in FY01 to 59.8 percent in FY05. According to the report, the structure of Philadelphia's pension plan benefit is similar to that in nine other major cities, with respect to retirement age, minimum years of service, and the multiplier used to determine benefits. However, there were four areas in which Philadelphia's pension system diverged from the nine other cities, all relating to funding. First, the sum of employee contribution rates and the normal cost rate were relatively low in Philadelphia. Second, Philadelphia's assumed rate of return on investments of 9 percent was the highest among the comparison cities. Third, the funding ratio of the pension system was well below the median of other cities. Finally, the City's 40-year period for amortizing the unfunded liability was higher than the median 30-year amortization period in other cities.

The PICA report recommended increasing the retirement age; decreasing benefit multipliers; increasing the period used to calculate average final compensation; and increasing employee contribution rates. The report also recommended that that City offer a defined contribution plan, pay more than required MMO contributions and reduce the earnings assumption.

Special Pension Commission Study

State Act 44 of 2009 established a Special Pension Commission, chaired by PICA's chairperson, which is responsible for preparing benefit plan studies of each City of Philadelphia pension plan. Mr. Salomone and his designee are members of the committee. Consistent with its mandate, the Special Pension Commission's first benefit plan study was submitted to the General Assembly on August 5, 2011. One of the components of the study, prepared by Milliman, Inc., compared pension benefits provided by the City of Philadelphia with benefits provided by six other

⁷ The overall interest rate on these bonds was 6.61 percent.

jurisdictions - the Commonwealth of Pennsylvania, the State of New Jersey, Baltimore, Houston, Phoenix, and San Diego.

In general, Milliman found that for municipal workers hired under the more recent City Pension Plan 87, benefits in Philadelphia are generally higher than comparison jurisdictions but benefits are comparable for workers hired under the earlier City Plan 67. Philadelphia's pension benefit for police employees were found to be comparable to other jurisdictions. Benefits provided to fire employees in Plan 87 were found to be relatively low compared to other jurisdictions and those hired earlier in Plan 67 receive benefits comparable to the 6 jurisdictions studied.

The Milliman study also compared municipal employee contributions to support pension fund costs. For current hires, Philadelphia employees contribute an average of 1.94 percent of wages, compared to contributions that range from 5.0 percent (Phoenix) to 8.47 percent (San Diego). For earlier hires, Philadelphia employees contribute an average of 3.75 percent, compared contribution rates ranging from 5.0 percent (Phoenix) to 10.4 percent (San Diego). Notably, Baltimore and Houston do not require employee contributions for municipal employees.

Other Research on Philadelphia's Pension System

One of the most comprehensive studies of Philadelphia's pension system was a 2008 report commissioned by the Pew Charitable Trusts and the Economy League of Greater Philadelphia.⁸ Written by Katherine Barrett and Richard Greene, the report found that the average city pension benefit in Philadelphia is comparable to other cities, but that the amount paid into the system by City employees is generally below other major cities. It also found that the current unfunded liability is largely the result of periods in the 1970s and 1980s when the City made minimal contributions to the pension fund. Barrett and Greene made many recommendations to address Philadelphia's pension problem, including: increasing current employee contribution; a careful analysis of the level of pension benefits in Philadelphia compared to other cities; review of investment practices; evaluation of benefit levels in relation to an appropriate standard of income replacement, taking into account Social Security; public reporting of investment performance; a change to the City Charter to increase the number of pension board members who have no personal interest in the system; and institution of a new pension plan for new hires that would increase the retirement age, change vesting requirements, reduce the multiplier, and include a hybrid defined benefit-defined contribution plan. The report also recommended consideration of paying off the unfunded liability over a thirty year period, consistent with GASB recommendations.

Policy Options to Consider

Policy reforms need to be considered in terms of the fundamental purpose of a pension system to provide replacement income adequate to ensure maintenance of living standards after retirement. Some experts believe that a replacement ratio – post-retirement income from all sources expressed as a percentage of pre-retirement income from all sources – ranging from 77 to 90

⁸ Katherine Barrett and Richard Greene, *Philadelphia's Quiet Crisis: The Rising Cost of Employee Benefits* (Philadelphia: Pew Charitable Trusts and Economy League of Greater Philadelphia, 2008).

percent is an appropriate goal.⁹ Philadelphia's pension system clearly meets this goal for those workers who spend a substantial portion of their careers as City employees.

Aside from the question of whether Philadelphia's pension benefits are appropriate in relation to basic standards of income replacement, there is the question of whether they are competitive with other jurisdictions and whether they are financially sustainable over the long term. On this question, the research tends to conclude that the City's current benefits are generally more than competitive and they are not financially sustainable.

States and localities around the country have been taking various steps to reduce the costs of pensions so that they are financially viable. Common steps include those mentioned already in this testimony: increased employee contribution rates, reduced multipliers, reductions in cost of living adjustments, stricter requirements for vesting, changes to the calculation of final average compensation, higher retirement ages, movement to hybrid defined contribution/defined benefit plans. The City of Philadelphia has made some progress, with contracts with the police and fire employees now requiring higher contributions or participation in a hybrid defined contribution benefit plan for new hires. Under new contracts for correctional officers, Deputy Sheriffs, and court and Register of Wills, newly-hired employees are required to participate in the city's hybrid pension plan, Plan 10. City Council has also taken steps to reduce the cost of the Deferred Retirement Option Plan (DROP).

Funding into the pension system will come from either employees, government or return on investment. The government options to put more money into the system fall into categories of efficiency savings, cost reductions, service reductions, tax increases and identifying new revenue streams. The City of Philadelphia is currently considering privatization of the Philadelphia Gas Works (PGW). Net proceeds from a privatization transaction such as the sale of PGW could be deposited into the pension fund resulting in a significant reduction in the unfunded liability, relief to the general fund and a reduction in amortization payments going forward. Monetizing large assets to invest in pension funds or reduce long term debt is an area that some municipalities have successfully executed but remains a complex option and few and far between.

The pension liability presents the greatest risk to the City's fiscal health. From 2001 to 2011, the City's general fund contribution to the pension system grew by 185% and controls 16% annual expenditures, larger than Police department expenses. With only 49.7 percent of the funded the unfunded accrued liability in 2011 is \$4.78 billion. The time to act with significant purpose is now. PICA will continue to raise the issue to the forefront and be a helpful partner.

I hope this testimony has been useful. Please reach out to me if we can be of assistance as you continue your work. I welcome any questions at this time and thank you for again for the opportunity to testify.

⁹ Jun Peng and Ilana Boivie, "Sensible Solutions: Lessons from Well-Funded Public Pensions: An Analysis of Six Plans that Weathered the Financial Storm" (Washington, DC: National Institute of Retirement Security, June 2011).