A Missed Opportunity for Pension Reform - Continuing Generational Theft

Analysis of House Bill 1828 (PN 2609) by Rick Dreyfuss, Senior Fellow, Commonwealth Foundation

September 2, 2009

Summary Analysis of House Bill 1828 of 2009:

"Pension reform" should be guided by a responsible set of principles and standards which does not contribute to "generational theft" by passing today's unaffordable costs to future taxpayers.

1. HB 1828 is not well-understood and is being rushed to enactment. (NOTE: Please see *Philadelphia Daily News* and *Pittsburgh Tribune-Review* editorials on pages 2 and 3 and the related story on page 4.)

2. Permitting lower contribution levels to already poorly-funded plans and enabling more generational theft throughout the state is not pension reform.

3. The absence of a mandatory and uniform defined contribution plan for new hires together with establishing funding reforms to require 100% funding over a shorter duration is a missed opportunity to establish pension costs which are current, affordable, and predictable.

4. The state should adopt simplified and straightforward metrics and reporting standards. HB 1828 unnecessarily complicates and often provides the wrong solution to the problem of pension liability management.

5. Amortization periods should conform to the remaining working duration of active members of the plan. Asset values need to better conform to market-related values. HB 1828 backtracks on both these important funding goals. (As a benchmark, The Federal Pension Protection Act of 2006 applicable to private sector pension plans requires amortization periods of 7 years or less and assets to be valued at 100% of market value.)

6. Extending amortization periods and permitting asset losses to be further deferred creates short-term relief at an unaffordable long-term cost. "Fresh starting" to a new 30-year amortization period is generational theft.

7. Reforming both funding policies and benefit levels should come first. If relief is then deemed necessary then a transition schedule should be considered to achieve these reform standards.

8. The long-term financial implications in terms of projected funded ratios and required taxpayer contributions are not well-understood or well-defined. The separate and unfunded liabilities associated with post-employment retiree medical plans are also a significant burden.

9. Pension Obligation Bonds and Deferred Retirement Option Plans (DROPs) should be prohibited as they contribute to poor public policy.

10. The matrix beginning on page 3 is not intended to be a complete analysis and summary of the bill.

Philadelphia Daily News editorial**:** "Budget stakes get raised again in Harrisburg" (August 31, 2009)

Public pensions are long overdue for review and reform; underfunded pensions are at the heart of staggering budget problems not only around the state but in cities and states around the country.

But attaching such complicated reforms to what started out as a simple bill to help the city fill big holes in its five-year plan makes no sense - although stuffing bills with complicated amendments is a move familiar enough to those who regularly watch the legislative sausage being made. …

It's disturbing that something as overdue and complicated as pension reform has suddenly been thrown on the fast-track.

SOURCE: http://www.philly.com/dailynews/opinion/20090831_Budget_stakes_get_raised_again_in_Harrisburg.html

Pittsburgh Tribune-Review editorial**:** "Push comes to shove" (September 1, 2009)

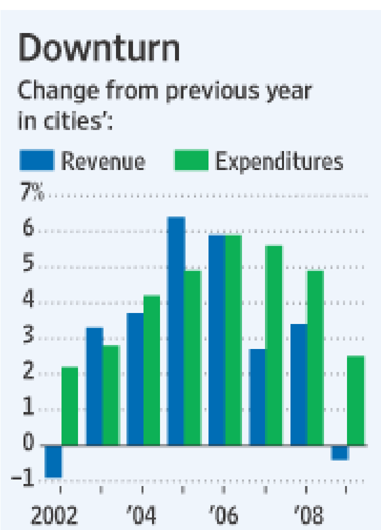
It's amazing what the threat of an imminent state takeover of Pittsburgh's troubled pension system does to those who have been tardy to address the problem. City officials are hoping to win a two-year reprieve by solving the problem locally. But this mess will repeat itself if city and state officials don't take steps now to radically alter how pensions are delivered. And that means breaking the stranglehold of defined-benefits pension plans that are not sustainable. Who will sound the certain trumpet of real reform?

SOURCE: http://www.pittsburghlive.com/x/pittsburghtrib/opinion/s_640895.html

THE WALL STREET JOURNAL.
WSJ.com

Cities Brace for a Prolonged Bout of Declining Tax Revenues (September 1, 2009)

SOURCE: http://online.wsj.com/article/SB125177344884874971.html



Notes: Data are inflation adjusted and are not seasonally adjusted. 2009 data are forecasts.
Source: National League of Cities

Objective #1 – Benefit Plan Design – Develop a standardized benefit plan design for new hires where employer costs are current (100% funded), predictable and affordable with an employer annual cost of 5% to 7% payroll.

Benefit Plan Design	Current Status	HB 1828 Changes	CF Recommendations	CF Rationale
Defined benefit pension plans are prevalent retirement payment vehicle	The current system is unsustainable and funded status is often underreported against market-related criteria. Significant cost transfer to next generation.	Creates a new set of rich DB plans for municipalities and separate DB criteria for Philadelphia. DC plan provisions are a non-competitive option against these proposed DB plans. DC plan with an employer cost of 6% for municipalities and limited to 4% for Philadelphia. Balances converted into an annuity (risk assumed by taxpayers).	Require a new DC plan where costs are current, predictable and current. DC plan with an employer match of up to 6% leaving the annuity to the member as an investment option. Any new DB plan will not reform the system since contributions are only estimates. Benefits can be retroactively modified with funding deferred to next generation.	The current system is unsustainable and unaffordable. A new set of DB plans throughout the various municipalities will not satisfy long-term cost criteria. Philadelphia's new DB criteria of having 80% of the value of the prior plan represent unsustainable costs.
Current DB design features	Over promised, undervalued. and underfunded benefits	Freeze of accrued benefits for Philadelphia	Freeze of accrued benefits wherever plans are significantly underfunded	The current system is unsustainable and unaffordable
Deferred Retirement Option Plan (DROP)	Exists in many plans	Eliminated for future elected officials	Should be uniformly prohibited	Poorly-designed and costly plan feature

Objective # 2 – Reforming Existing DB Plans – Recognize that the problems are institutional and political in nature. We must implement state-wide pension funding reforms that make benefit plans current, predictable, and affordable in order to preclude the generational transfer of costs.

Amortization Period	Current Status Maximum Duration	HB 1828 Changes Maximum Duration	CF Recommendations	CF Rationale
Plan Experience – Principally Investment Gain and Loss	15 years	20 years	Average Remaining Duration (ARD) of active workforce. Federal reform of private sector DB plans in Pension Protection Act of 2006 (PPA) permits up to 7 year maximum.	HB1828 further extends the generational transfer of costs with the over-promising of unaffordable benefits.
Actuarial Assumption Changes	20 years	15 years	Limited to ARD	
Active Member Benefit Changes	20 years	10 years	Limited to ARD	
Retired Member Benefit Changes	10 years	20 years – mandatory benefits 1 year – other benefits	Immediate - 1 year as there is no remaining ARD	
Fresh start (reset) of existing unfunded liabilities	Subject to limits above	A new 30 years permitted for most underfunded plans	Limited to ARD	Poorly funded plans should be contributing more money, not less

Asset Valuation Methods used for Funding and Funded Ratios	Current Status	HB 1828 Changes	CF Recommendations	CF Rationale
Rolling average period for computing asset values	5 years	5 years	3 years	Strikes an appropriate balance between market realities and the desire to reduce volatility in costs
Corridors test against market value of assets	80% to 120%	80% to 120% with at least two years 70% to 130% temporary provision	90% to 110%	As a benchmark, The Federal Pension Protection Act of 2006 mandates 100% of market value for private sector DB plans.

Standardize Reporting Metrics – Inconsistent measuring of defining a distressed pension plan.

Reporting Metrics	Current Status	HB 1828 Provision	CF Recommendation	CF Rationale
Standardize the measurement of assets and liabilities to promote a uniform standard and a comparison among and between plans.	Most plans use asset and liability metrics unique to their plans making comparability of diminished value.	A complex and over-engineered methodology.	Adopt a simplified and standardized set actuarial assumptions for reporting and possibly funding purposes based upon an approach such as the 6% employed by PMRS. Adopt an asset valuation approach based upon a three year rolling average and with a corridor of 90% to 110% of fair market value. A ratio of 50% or worse defines a severely distressed plan.	Simplifies and creates a uniform standard thereby facilitating comparison among plans. Promotes comparison and more conservative and responsible funding policies.
Pension valuation completed	Bi-annual process	Unchanged	Require annual valuation for plans with over 250 lives	Ensures better tracking and current metrics of assets and liabilities