MUNICIPAL ACTION GUIDE

Making Informed Changes to Public Sector Pension Plans

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About the National League of Cities

The National League of Cities (NLC) is the nation's leading advocacy organization devoted to strengthening and promoting cities as centers of opportunity, leadership and governance. Through its membership and partnerships with state municipal leagues, NLC serves as a resource and advocate for more than 19,000 cities and towns and more than 218 million Americans.

NLC's Center for City Solutions provides research and analysis on key topics and trends important to cities and creative solutions to improve the quality of life in communities.

About the Report

This report is a product of NLC's Public Sector Retirement Initiative, a resource for elected officials to help navigate the complexities of retirement and healthcare planning and funding for the municipal workforce. The Initiative is sponsored by ICMA-RC, an NLC Capstone Corporate Partner and non-profit independent financial services corporation focused on providing retirement plans and related services for over a million public sector participant accounts and approximately 9,000 retirement plans.

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Introduction

Pensions play a critical role in the ability of local governments to attract and retain the workforce needed to meet citizen demands. The costs associated with this employee benefit, however, can be substantial. A recent National League of Cities (NLC) survey revealed that over the past year the cost of pensions increased in more than 70 percent of cities.[1] One in three cities identified these expenses as the factor most negatively affecting their budgets.

Since the Great Recession, most cities have instituted some type of reform to their pension plans.[2] The purpose of this municipal action guide is to examine the types of reforms that cities have made between 2009 and 2016 and the impact of these reforms. This guide concludes with a city action worksheet and ways local leaders can become more active and informed decision makers, regardless of whether their city or state runs their employees' pension plan.

Pensions In Context

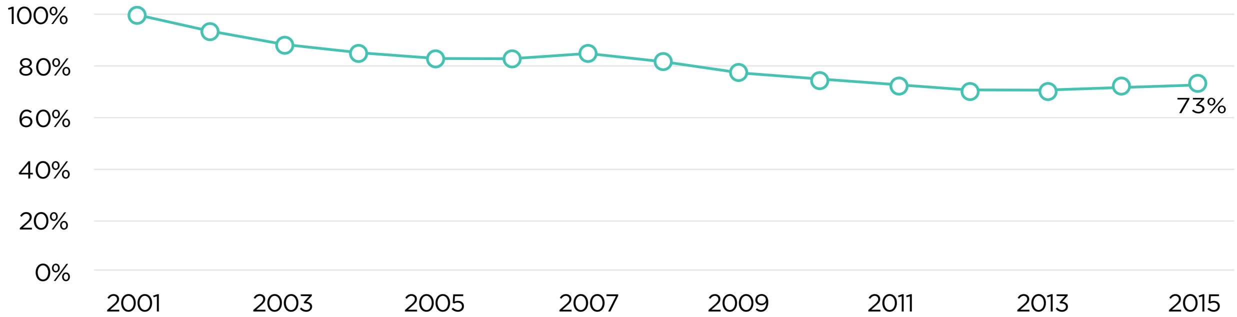
Initially, many public sector pensions were established on a "pay as you go" basis. The founding of the Government Accounting Standards Board (GASB) in 1984 led to the requirement that all cities review their liabilities from an "actuarial perspective" with the adoption of GASB 25 in the mid-1990s. An actuarial perspective assumes liabilities over the anticipated lifetime of members, given expected benefit payouts for the current workforce and retirees, including a wide range of factors, such as mortality, turnover, disability, salary increase assumptions, and Cost of Living Adjustments. This requirement helps leaders think about the future costs of the benefits as they make compensation decisions today.

In the 1990s, pension fund balances—assets set aside to meet future benefit expenses—soared as financial markets boomed. Coming out of this boom period in fiscal year 2001, public sector pensions were funded, on average, over 100 percent. As a result, many cities increased employee benefits and took contribution holidays.

As the 2001 recession began to take effect and yields on newly issued bonds declined, the assumed return on the bond component of plan portfolios began to decrease significantly[3] In order to address the large investment losses of the early 2000s in a declining interest rate environment, larger annual contributions were required to meet pension commitments. The actions taken in the 1990s, combined with general downward pressure on local budgets, exacerbated pension funding challenges and increased unfunded liabilities.

Pension funding took an even bigger hit as the Great Recession in 2008 materialized. The recession had an added component—beyond its depth and length—that previous recessions did not: a nearly decade-long period of exceptionally low interest rates. This feature of the recession resulted in lower expected returns and therefore higher pension funding requirements.[4] In response, many city officials instituted reforms, including lowering their investment-return assumptions and increasing contributions by governments and employees. Public pension funding ratios registered their first post-recession improvements in 2014.[5]

Aggregate public sector pension funding, FY 2001-2015[6]



Reforms

The long term sustainability of pension plans requires that plan sponsors actively adapt their plans to continue to provide adequate retirement benefits at manageable cost levels. As part of its annual *City Fiscal Conditions* survey, NLC surveyed city finance officers about the reforms made to their plans since the recession, regardless of whether their city or the state administers the plan. We present those findings here, along with an assessment of the broad fiscal and workforce implications. NLC partnered with GovInvest Inc., which designs and develops actuarial analysis software for the public sector, to model how changes to retirement benefits affect financial health and the municipal workforce.

The majority of respondents (65 percent) report that their plans are administered at the state level, while 32 percent of cities sponsor their own plan. It is no surprise that more cities in our sample (see page 15) have their plans run by the state given that smaller cities can utilize the expertise and cost savings by pooling their investments together. For comparison, the Center for Retirement Research examined larger municipalities and counties, finding 58 percent in state-run plans compared to 42 percent that are locally controlled.[7] In some states, local governments are mandated to participate in a state-run plan while other states make their plans available on a voluntary basis.

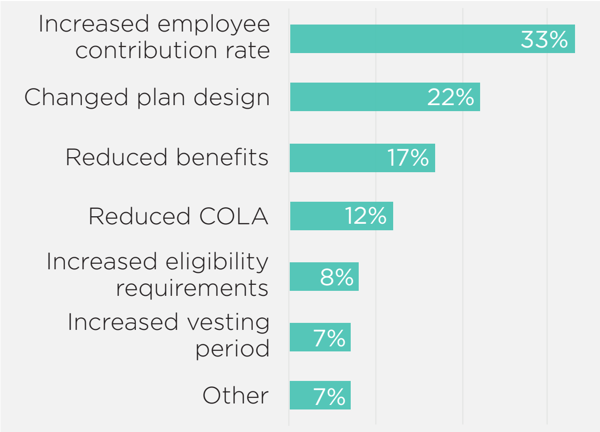
Considering Future Liabilities

In order to ensure these future liabilities are considered by current leaders, the Government Accounting Standards Board (GASB) issued Statement 68 which requires that city governments state their unfunded pension liabilities on their balance sheet (Statement of Net Position). GASB 68 requires all municipalities to show the net pension liability of defined benefit retirement plans in which they participate in their comprehensive annual financial reports, or CAFRs. GASB 68 extends to cities that have a state managing its defined benefit plan in a cost-sharing or agent relationship—the first time that a standard has been mandated for showing this liability when the pension is not run by the city itself.

PENSION REFORM IN BALTIMORE

Mayor Stephanie Rawlings-Blake of Baltimore knew that her city needed to put itself on a stronger fiscal path, and it was clear pension reform was a necessary component in achieving this goal. Mayor Rawlings-Blake made tough reforms, phasing in higher civilian employee contributions by 5 percent[8] and police and fire employee contributions by 4 percent[9] from 2013 to 2014. Mayor Rawlings-Blake also created a new retirement plan for newly hired civilian employees in which they could choose from either a hybrid or defined contribution plan. While these reforms clearly lower future liability increases, she also pushed through one reform with immediate impact: an end to the city's "variable benefit." Launched in the 1980s, the variable benefit program increased the COLA based on exceptional asset performance. However, there was not a corresponding reduction for years of poor performance. In the case of Baltimore police and fire pensions, performance exceeding 7.5 percent initiated this increase. What sort of savings did the removal of this provision generate? According to the *Baltimore Sun*, $97 million of the fund's FY 2014 return of $313 million (14.2 percent), would have been diverted to the COLA increase.[10]

City Pension Reforms 2009-2016



Percentages do not add to 100 as cities were able to select all applicable reform options.

Our survey asked cities what plan reforms were instituted between the fiscal years 2009 and 2016. Twenty-six percent noted no change while the remaining 74 percent made multiple changes to address their unfunded liabilities.

The most common change was to **increase the employee contribution rate** (33 percent), meaning that they increased the percentage of payroll that workers put into their own pension plan. It is commonplace for public sector employees to make contributions to their retirement benefits, typically at a fixed percentage. Employers will either contribute at the Actuarially Required Contribution (ARC) or at a rate restricted by statute or funding resources. In most instances, employer contributions increased well beyond those of employees.

Requiring employees to increase their contributions to the existing plan does not have a significant impact on existing liability or funding levels. It does, however, lower required employer contributions.

The second most common method was **changing plan design** (22 percent). Typical plan design changes include adoption of a hybrid plan, anti-"spiking" provisions, or placing a hard cap on maximum benefits. In the vast majority of instances, benefits were only changed for existing employees prospectively and/or new employees. As an example of a change that impacted current employees, Atlanta increased employee contributions by 5 percent for existing employees, while offering newly hired employees a reduced defined benefit plan along with mandatory defined contribution plan.

Implementing plan design changes that reduce retirement benefit levels may produces significant savings. There may also be ramifications on employee morale and possible personnel retention as a result of a "tiered" retirement plan structure where newly hired workers receive substantially smaller retirement benefits than their coworkers under an earlier, more generous retirement formula.

Preventing Pension Spiking

Pension spiking occurs when an employee receives a salary increase very close to retirement to inflate the average final compensation used to calculate benefits. A simple way to prevent spiking is to increase the number of years of used in the plan's definition of final compensation, lessening the impact of a single year's substantial raise in pay. Additionally, limits may be placed on the amount of overtime and/or unused vacation and sick pay that may be included in the average final compensation calculation. Spiking is frequently used by opponents of public sector pensions as an example of extraordinarily generous and costly benefits provided to few individuals. Thus, a number of pension plans have implemented anti-spiking reforms.

Types of Plan Designs

	Defined Benefit	Defined Contribution	Hybrid
General Description	Benefit is determined by a formula generally based on service and final average compensation. Cash balance plans are defined benefit plans where the benefit is expressed as an account balance.	Benefit is determined based on an account balance consisting of employer and/or employee contributions and investment earnings.	Generally, a combination of a defined benefit plan and a defined contribution plan with employer contributions.
Cost level	Unknown	Known by contribution formula	Combination
Benefit level	Predictable based on formula	Unknown. Benefit based on account balance.	Combination
Investment risk/reward	Generally, 100% employer	Generally, 100% employee	Shared
Balance sheet/credit rating impact	Underfunded liabilities reflected on employer balance sheet	None	Combination
Subsidies (e.g., early retirement, spouse, death and disability	Common based on plan provisions	None. The participant's account balance is the source of all benefits.	Combination
Vesting schedule	Based on plan provisions	Based on plan provisions	Combination

Source: ICMA-RC

The third most prevalent change was to **reduce benefits** (17 percent). This approach is generally applied to newly hired employees, though there are limited instances of changes to current employees' future benefit accruals. Although unpopular with employees, a benefit reduction can significantly enhance a plan's funding level on a prospective basis. For example, Coral Gables, Florida, a city of about 60,000, changed the method by which benefits are calculated. Firefighters had received pension benefits based on a formula using 3 percent of average final compensation for all qualifying years of employment or creditable service. Effective October 2013, for newly hired firefighters, the 3 percent benefit calculation was only applied on the first ten years of creditable service, with the benefit on later service based on 2.5 percent of average final compensation.[11]

This type of change can have a large impact on defined benefit costs when the change impacts current employees. Extending or modifying the formula for the number of qualified years of salary from which benefits are calculated will also likely lower costs. In addition to potentially leading to a smaller benefit, extending the years of service used for the benefit calculation makes pension "spiking" less impactful. According to GovInvest, extending the final average compensation period from one to three years, or from three to five years, can lower the Normal Cost and Actuarial Liability for affected employees by 2 to 4 percent.

Reducing or eliminating cost-of-living adjustments, or COLAs, was utilized by 12 percent of respondents. Unlike many of the other changes mentioned in this paper, COLA reduction/suspensions generally apply to existing retirees as well as current workers. Although this change seems to be a simple and relatively easy cost saving measure to justify in the current low inflation environment, it generates substantial controversy with litigation a likely outcome.

PENSION REFORM IN PROVIDENCE

In 1989, the Providence Retirement Board granted 6 percent compounded raises (COLA increases) for retirees and reduced the years of service needed to receive a pension benefit. This act more than doubled Providence, Rhode Island's annual required contribution to its pension fund in two years. By 2012, Providence's pension fund was only 32 percent funded and had an unfunded liability of more than $900 million. Mayor Angel Taveras pushed through provisions to eliminate the COLA for ten years—and only allow this increase starting in FY 2023 in limited circumstances. Mayor Taveras also increased the number of years of service used to determine average final compensation as well as the period through which employees would need to make contributions towards their own benefits. These reforms reduced pension liabilities by $186 million.[12] While Mayor Taveras's reforms clearly had an impact, the city's funded status remains well below average at 28 percent as of FY 2015.[13]

In the past, many plans set a fixed cost of living adjustment not tied to an inflation metric like the consumer price index (CPI). For example, the Ohio Public Employees Retirement System provided a COLA of 3 percent but now keeps its COLA in line with inflation with a 3 percent annual cap on the adjustment.[14]

The savings from a COLA reduction may be significant. According to GovInvest, reducing the fixed percentage by 1 percent (e.g., from 3 percent to 2 percent) will generally reduce Normal Cost and Actuarial Liability by 13–15 percent for police officers or firefighters, and 10–12 percent for other employees. The costs for police officers or firefighters are affected more by COLAs because they tend to retire earlier and receive more COLAs during their retired lives.

Conclusion

This municipal action guide is a snapshot of city pension plan changes made since the Great Recession to help elected city leaders understand and weigh the choices they may be faced with in their own communities.

City leaders are the financial stewards of their governments, a role that demands that they focus on providing needed government services delivered by the right personnel in consideration of limited resources. While there may be the political will for reform, none of the options explored here will offer immediate, or complete remedy. Therefore it is better to think about this process as a path to fiscal health—and one that should not be ignored.

CITY ACTION WORKSHEET

Local elected officials are often in the position to make decisions regarding their city's pension plan. As noted, recent GASB changes mean that your city's liabilities in a state-run cost-sharing plan must appear on your own financial statements, and thus it is all the more important for city leaders to be aware of the management of such plans. Frequently state legislatures set funding policy, placing limits on city contributions rather than using actuarially determined payments, or capping revenue sources—even in instances where the city runs its own plan.

An important first step to making sound decisions—whether your plan is city or state run—is understanding the current benefits landscape. The questions below are intended for local elected official to use in conversations with their finance or budget director, accountant or pension plan administrator. A fresh set of questions should be posed for each plan (civil service, fire, police, etc.). If changes to any of the components below have been made in recent years, also inquire about the impact those changes have had both on city finances and the workforce.

Cost of Living Adjustment (COLA)

What is the current COLA structure?

Has the COLA been modified since the Great Recession?

What potential effect would a reduction or elimination of the COLA have on long-term pension funding levels like the rate of inflation? Is it sustainable?

What are the state court's views on COLA reduction/suspensions? Have there been relevant court decisions in the past ten years?

Calculation of benefits

How many years of compensation history are used to determine benefits?

What components of compensation are included (e.g., is overtime pay included)?

Does the plan structure allow pension spiking, or the opportunity to vastly increase benefits based on the final year or so of salary?

Does the actuary employ explicit assumptions to reflect the current incidence of pension spiking?

Investment return

What rate of return is the plan actuary using in making assumptions?

What factors are used for determining the investment rate?

Has the assumed rate changed since the Great Recession?

Is the current rate reasonable given long-term estimates of the economy and equity/bond markets?

What are the financial consequences of a 1% reduction in the rate of return?

Employee contribution

What % of payroll do employees contribute to their own benefits?

Has the % contributed changed since the Great Recession?

Is the current % comparable to other cities?

Do employees participate in Social Security?

Plan design or benefit reduction

Has the plan be modified since the Great Recession?

If changes were made, how were they applied to existing and/or new employees?

What effect have these changes created?

Vesting

How many years of service are needed for one to qualify for a pension?

How many years of service are needed to qualify for the maximum available benefit?

Have any changes to the vesting schedule been made since the Great Recession?

Endnotes

1 McFarland, C. & Pagano, M. A. (2016, Oct. 13). *City Fiscal Conditions 2016.* Retrieved from http://www.nlc.org/resource/city-fiscal-conditions-2016.

2 Aubry, J. P. & Crawford, C. V. (2016, Dec.). *State and Local Pension Reforms since the Financial Crisis.* Retrieved from http://slge.org/publications/state-and-local-pension-reforms-since-the-financial-crisis.

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4 Average actuarial funding level as reported in the survey was in line with the aggregate level found in the benchmark Public Plans Database. Respondents noted an average of 71.5% funding level compared to the 73% found in larger plans for FY 2015.

5 Munnell, A. H. & Aubry, J. P. (2015, June). *The Funding of State and Local Pensions: 2014-2018.* Retrieved from http://slge.org/publications/the-funding-of-state-and-local-pensions-2014-2018.

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11 Gabriel Roeder Smith & Company. (2016, April 27). *City of Coral Gables Retirement System: Actuarial Valuation Report as of October 1, 2015.* Retrieved from http://www.coralgables.com/modules/showdocument.aspx?documentid=17625.

12 Taveras, A. (2016, Nov. 18). *Politics of public sector pensions* [PDF document]. Retrieved from http://citysummit.nlc.org/files/2016/08/Politics-of-Public-Sector-Pensions-Taveras.pdf.

13 City of Providence, R.I. (2016, Jan. 6). *Comprehensive Annual Financial Report: Fiscal Year Ended June 30, 2015.* Retrieved from https://www.providenceri.com/efile/6430.

14 Brainard, K. & Brown, A. (2016, June). *Significant Reforms to State Retirement Systems.* Retrieved from http://www.nasra.org/files/Spotlight/Significant%20Reforms.pdf.

About the Survey

The City Fiscal Conditions Survey is a national email survey of finance officers in U.S. cities conducted annually from May to July. The survey was emailed to city finance officers from 1,046 cities with populations greater than 10,000, asking for their assessments of fiscal status, actions taken and factors affecting their fiscal conditions. In total, the 2016 data are drawn from 277 cities, for a response rate of 27 percent. The data allow for generalizations about the fiscal condition of cities.

Categories	Survey Responses	%
TOTAL	277	100
Population		
>300,000	55	20
100,000-299,999	86	31
50,000-99,999	80	29
10,000-49,999	56	20

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