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Late Summer 2002

Public Employee Benefit Review

Client Profile

Township of Upper St. Clair

Manager - Doug Watkins
Assistant Manager - Mark Mansfield
Finance Director - August Stache, Jr.

For over 25 years, the Township of Upper St. Clair has utilized the services of Mockenhaupt Benefits Group to assist it with pension matters, arbitration hearings and a variety of other financial-related reports/projects.

"Sometimes we put them under pressure," said Township Manager Doug Watkins. "But they always deliver."

"Sometimes we put them under pressure, but they always deliver."

– Doug Watkins, Township Manager

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(L-R) Manager Doug Watkins, Assistant Manager Mark Mansfield and Finance Director August Stache, Jr.

Two More Pension Bills Passed by the State

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Just as administrators of Act 600 plans began dealing with the impact of the sweeping pension mandates of Act 30 of 2002, two more pension bills, Act 64 and Act 65 *(House Bills 1360 and 1363 respectively)* were signed into law on June 19, 2002. Both bills, after Senate amendments to the original versions, were passed unanimously by the House and Senate.

Act 30 of 2002 (SB 16) - Amendment to Act 600

Act 30, which just passed in April 2002, amended Act 600 *(police pension law)* by adding new mandatory and floor benefits. Act 600 governs police plans sponsored by boroughs, towns, and townships with three or more full-time officers, municipalities that elected to be covered by Act 600, and regional police departments. The new benefits affect the surviving spouse, killed-in-service and disability benefits. The financial impact of these new benefits, which could be very costly, will not be realized until the 2003 actuarial valuations reports are completed. Plan sponsors will likely see the impact for the first time when preparing for the 2004 budget.

Act 64 of 2002 (HB 1360) - Ad hoc COLA increases to police and fire retirees

Act 64 of 2002, applicable to all local government pension plans statewide with retired police officers or firefighters, mandates cost of living increases to the monthly pension benefits of retired police officers and firefighters who were receiving benefits before Jan. 1, 1996. *(see "Summary of Act 64 of 2002" on page 6)* The increases are effective with the July 2002 payments; however, many municipalities may struggle to get increases made to retiree checks in August, or even September. Not only is the formula for calculating the increase somewhat complicated, but employers may also have to search for retirees' personnel records to find information needed to perform calculations, such as years of service with the municipality and the dates and amounts of any increases to their pensions since the last state-mandated increase, Act 147 of 1989, which became effective Jan. 1, 1989. While Act 64 applies to plans with retired police officers and firefighters, financially, it may affect any plan entitled to state funding.

Cost reimbursement?

Act 64 contains a reimbursement provision; however, it only covers a portion of the increased cost, and many municipalities will not be eligible for reimbursement at all. The reimbursement is a portion of the increase in a plan's amortization payment due to benefit increases. Reimbursements will be made in

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ACT 64 & ACT 65

the year after the municipality paid a Minimum Municipal Obligation *(MMO)* that included the higher amortization payment, which would be for 2005, at the earliest. Since amortization payments only apply to plans that have an unfunded liability, overfunded plans receive no reimbursement. And, only municipalities receiving the maximum allowable state aid allocation for their plans *(because their actual pension costs exceed the "unit value" calculation)* will receive a reimbursement. In most cases, if a municipality receives enough state aid in a given year to pay the budgeted MMOs for all of its plans, it will receive no reimbursement the following year for the Act 64 COLA. Act 64 also eliminates the annual reimbursement for Act 147 COLA for those municipalities. Unlike the new Act 64 reimbursement, Act 147 reimbursements were a dollar-for-dollar reimbursement of the actual COLA amounts paid in the previous year.

Who's paying for the COLAs?

At first glance, Act 64 would appear to be a generous appropriation to retired police officers and firefighters in our state with a provision to compensate some municipalities for part of the cost. However, that compensation isn't being paid directly from the state, but rather from the existing general municipal pension system state aid account. Reimbursements will be paid out of that fund before distributions of regular pension state aid are made.

Less money will be available to pay municipalities for regular pension costs, which means the unit value will go down. Reduced unit values could affect any municipal plan that depends on state aid, even if it isn't affected by the cost of living increase mandate - like non-uniformed plans or plans that have no eligible retirees. There is no new revenue source at the state level for these benefit increases. Unfortunately, it will be the communities already dipping into local coffers to cover pension obligations that will be paying for the increases to retirees statewide because they are at the maximum level of state aid. For those communities, not only are they likely to see a decrease in their regular state aid, but they may also have to pay part of the cost of the Act 64 COLA benefits and all of the cost of the mandatory benefits under Act 30.

Act 65 of 2002 - Amendment to Third Class City Code

The primary change enacted by Act 65 was to increase the dollar limit in monthly service increment benefits for retiring police officers and firefighters of Third Class Cities. The Third Class City Code provides a service increment benefit for police officers and firefighters who serve more than the minimum required years of service for retirement. The extra benefit, which is added to their regular pension of 50 percent of their monthly pay at retirement, is equal to one-fortieth *(or 2.5 percent)* of their base pension for each year over the minimum up to a maximum of $100 per month. Depending on an employee's pay at retirement, he/she will typically earn the full $100 increment by working 1 1/2 to 3 years over the minimum *(which is usually 20 years)*.

Increase Not Mandatory

Act 65 permits a city to increase the $100 limit to $500. This benefit increase is not mandatory. However, given that the $100 cap has not changed in many decades, the increase is likely to be the subject of upcoming negotiations in many third class cities.

Excess Benefits "Grandfathered"

In a last minute amendment to House Bill 1363, now Act 65 of 2002, language was added to grandfather excess benefits for certain plans of home rule municipalities and cities operating under an optional charter. The Third Class City Code provides normal retirement benefits for police and fire pension plans of 50 percent of pay. Prior to the *Monroeville* decision being handed down in 2001, which effectively limited the authority of Home Rule communities to provide excess benefits, many third class cities operating under Home Rule Charters were of the understanding that they could exceed the pension limitations of the Code. Therefore, in some cases, benefits were granted to police officers or firefighters in excess of 50 percent. Act 65 appears to have made those benefits legal if they existed prior to June 19, 2002.

It has been the opinion of the Department of the Auditor General, both before and after the *Monroeville* decision, that plans of third class cities operating under the Optional Third Class City Charter Law already possessed the authority to exceed third class city code limits. So it is unclear why the legislature included those municipalities in the "grandfathering" clause.

A previous version of the bill would have lifted the 50 percent cap for police and fire plans of all Third Class Cities, subject to actuarial soundness and other subjective measures.

Timing is Everything

With huge pension surpluses in hand, many local government officials and bargaining representatives walked confidently into contract negotiations on the heels of unprecedented stock market gains through 1998. Pension improvements were negotiated, the costs of which appeared to be easily covered by the surpluses accumulated. In many cases, the investment gains recognized by pension plans during that period paid off all future actuarial costs, thus eliminating the need for any contributions to the plan. But as we all know by now, what the stock market giveth, the stock market taketh away. And, "actuarial costs" and "overfunded" are relative terms depending, to a great extent, on many predictions coming true in the future. A plan that was vastly overfunded two years ago, may be underfunded now.

Place state-mandated pension increases on top of investment losses, negotiated benefit improvements, payroll increases and potentially lower state aid allocations, and you can expect to start seeing increasingly tight budgets, pension improvements removed from bargaining tables, applications for bonds to pay off unfunded liabilities, and possibly increased taxes. So far, 2002 doesn't appear to be the year Pennsylvania local government pension plans will turn the corner.

So what's the good news? Hmmm, let me think about it and get back to you next quarter.

Pension Bonds for Pennsylvania Municipalities - The Risk Factor

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In Pennsylvania, pension bonds have become a popular means of improving the funded status of previously underfunded municipal pension plans. If the expected rates of return on pension plan assets are greater than the rates of interest paid to the lenders on the pension bonds, a municipality will appear to gain from the transaction by a reduction in contribution requirements. Initially, the municipality will pay less in combined contributions to the pension plan and interest and principal payments on the bond than they would have if the bonds were not issued.

Further, state aid will not be lost to the extent that the deposit of bond proceeds has reduced plan contribution requirements. The reason for this is that Act 205 of 1984, as amended to allow for pension bonds, provides that the maximum "need" of a plan for state aid purposes is determined based upon the hypothetical actuarial requirements of the plan if pension bonds had not been issued. The resulting state aid may be deposited either in the plan or for repayments of principal and interest on the debt.

A municipality would appear to automatically gain an advantage by issuing pension bonds as long as the valuation interest rate for the pension plan is greater than the bond interest rate. The degree of advantage would depend on the difference between the two rates.

But is this all there is to it? If it were, it would seem that any municipality sponsoring a pension plan with a large unfunded actuarial accrued liability should automatically consider issuing pension bonds. When fixed interest rates are relatively low, it would seem that the sooner action was taken, the greater would be the advantage to the municipality.

The main missing ingredient in the discussion thus far is risk. Quite simply, the expected contribution savings are not guaranteed. The municipality's obligation regarding the pension bonds is fixed - to pay off the principal borrowed at a fixed interest rate or rates. However, if the pension plan assets are invested to achieve a higher return, at least a good portion of those assets is likely to be invested in equities.

An actuarial valuation used to determine contribution requirements for a Pennsylvania municipal pension plan is required to use a valuation interest rate that is, in the opinion of the actuary and the governing body of the municipality, the best estimate of future experience. Since pension plan liabilities extend out over a long period into the future, this estimate would therefore incorporate long-term expectations of return. Studies have consistently shown that equities outperform fixed income investments over the long haul. If this were not so, there would be no "reasonable" motivation to invest in equities since they are much riskier. The investor takes on higher risk in the hopes of achieving higher returns. While it is not considered prudent to invest a pension plan trust fund totally in equities, investment policies for such funds commonly target 40 to 60 percent of funds to be invested in a diverse portfolio of equities, either a group of individual stocks, appropriate mutual funds, or both. Typically, such plans will be valued using an interest rate of at least 7.5 percent.

A municipality issuing pension bonds hoping to thereby realize a net reduction in local contributions is in some respects like an individual investor buying equities on margin. In both cases, the borrower hopes to profit by assuming an equity risk on borrowed money. The investor does not lose as long as the investment returns are at least equal to the borrowing rate. Based upon averages, there is a good chance of winning. But the investor is exposed to the possibility of loss on every dollar borrowed. Losses could lose big-time. Even with a diversified portfolio such as you would see in a pension plan, returns from year to year vary significantly, increasing the possibility of loss.

Consider the past few years for example. Most pension plans with diversified portfolios achieved returns during the late nineties that were considerably higher than the assumed valuation interest rate, generating actuarial gains. While funds are earning higher returns than assumed, a municipality that has issued pension bonds is coming out ahead, at least in the short term. On the other hand, beginning in 2000, and continuing to date, returns have typically been less than valuation interest rates, generating actuarial losses. If bonds are issued and returns for several years are below the expected rate, then annual costs can become substantially higher than if bonds had not been issued.

Consider the following example. Municipality Y sponsors one pension plan, Plan X. As of Jan. 1, 2000, Plan X has an actuarial accrued liability of $15,000,000 and only $5,000,000 in assets, leaving an unfunded actuarial accrued liability of $10,000,000. Assets for Plan X are invested in a balanced portfolio, and the assumed valuation interest rate is eight percent per year. Plan X is required to fund the unfunded actuarial accrued liability over 20 years. To simplify the illustration, assume that in all years the sum of maximum state aid and employee contributions is equal to the sum of normal cost and

PENSION BONDS

expenses. The required amount from local revenues will then be the amortization payment.

On Jan. 1, 2000, a decision is made to fund the entire actuarial accrued liability by issuing pension bonds netting $10,000,000 which is deposited in the plan. The unfunded actuarial accrued liability is thereby eliminated. Assume that the bonds are to be repaid over a 20 year schedule with even payments (principal repayment and interest combined) with the interest rate being seven percent per year. Initially, the required contribution from local sources will be the amount of the principal and interest payments due on the bonds. This will replace the amortization payment to the plan. Since the bond interest rate is seven percent and the valuation rate (the rate for determining amortization payments) is eight percent, the payment will drop and a savings will occur as indicated below for the year 2000. But suppose returns for a few years are unfavorable. The chart below illustrates what would happen to the required contributions from local sources:

Year	Interest Rate	Contribution from Local Sources		
		If Bonds are Issued	*If No Bonds are Issued*	*Increase or Reduction*
2000	-1%	$ 882,000	$ 943,000	$ (61,000)
2001	-5%	$ 1,014,000	$ 998,000	$ 16,000
2002	0%	$ 1,210,000	$1,095,000	$ 115,000
2003	8%	$ 1,331,000	$1,163,000	$ 168,000
2004		$ 1,331,000	$1,163,000	$ 168,000

What was a saving of $61,000 in 2000 will become an additional obligation of $168,000 by 2003. Of course, if initial returns are more favorable than the assumed rate, the reverse will occur and the apparent advantage of having issued the bonds would increase. This would help cushion the blow if a few less favorable years follow. But there is a danger that the appearance of more favorable results than expected can lead to pressure for benefit improvements, increasing the cost of the Plan. This would decrease or eliminate the cushion against future losses.

Remember the pension plans involved are "Defined Benefit" plans. The plan provisions state how to calculate a benefit. The benefit does not depend on investment earnings or the level of advance funding. The obligation of the municipality is to provide the benefit, no matter how or when the benefit is funded. If a municipality has no offsetting liabilities outside of the pension plan that are directly attributable to the plan, then the municipality with a well-funded plan is unquestionably better off than a municipality with a poorly funded plan. Future contribution requirements will be lower than a poorly funded plan with the same obligations. However, if the well-funded position of the pension plan is due to pension bond deposits, the immediate advantage is more apparent than real. The plan assets are offset by the pension bond obligation, which is directly due to the plan. The municipality with the bonds must make not only pension contributions but contributions to retire the debt. The real advantage only comes if the municipality and its taxpayers "win" in the long run on the additional risk they have taken in investing a portion of the pension bond deposits in equities. Even if they do, the fluctuations in equity returns can make the road very bumpy along the way.

The choice of whether or not to issue pension bonds is ultimately up to the municipality and its taxpayers. The purpose of this article is to increase awareness of the possible pitfalls, the biggest being the risk involved. If valuation interest rates are higher than the bond interest rates, initial required contributions from local revenues will be lower. But even with the most accurate choice of an interest rate assumption for the long run, investments will never perform at exactly the assumed level year after year. Yes, the "average" plan at the "average" time should come out financially ahead. But there is a large risk involved as outcomes will not exactly equal the "averages" and in many cases will be very different. The municipality and the plan may end up reaping a windfall with better than expected performance. But if performance turns out poorer than expected, the municipality will bear fully the results of this risk through higher required contributions. The municipality should decide if it is willing and able to absorb these adverse results if they occur.

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Specializing in Municipal Benefit Consulting and Actuarial Services

PROFILE

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"They've provided us with an excellent level of satisfaction meeting both our expectations and timetables."

– Doug Watkins, Manager
Township of Upper St. Clair

According to Township Finance Director August Stache, Jr., Mockenhaupt assists him on a quarterly basis providing an actuarial study for the police department and teamster's union.

"I do the information gathering and my representative, Colleen Deer, does the study," said Stache.

Stache said that Mockenhaupt Benefits Group also assists him by providing the MMO *(Minimum Municipal Obligation)* enabling him to finalize the amount of money the Township has to pay into the plan.

"The process for calculation of the MMO is an annual project," said Stache. "It usually starts in August and we prepare a worksheet for participants with their estimated salary....we then calculate in all new demographic information."

Once complete, Stache forwards the information to Mockenhaupt Benefits Group for their assistance in calculating the MMO.

"When we start a new year, we prepare documents that we send to Mockenhaupt Benefits Group with any changes in plan participant demographics; they take this information and calculate a new study supplying us with data that we include in our comprehensive annual report," said Stache.

Mockenhaupt also assists the Township with its calculations to present to retirees or those considering retirement.

"Mockenhaupt has also done a cost study analysis on the post retirement healthcare benefits for the police," said Stache.

In addition, Stache said that he can rely on Mockenhaupt Benefits Group for assistance with pension plan amendments and plan documents along with expert testimony during arbitration hearings.

According to Mark Mansfield, assistant manager, "We've contacted Mockenhaupt Benefits Group representatives to present expert testimony in such areas as Act 111 arbitration dealing with our police department."

"This testimony is vital since there are different issues with each plan for our various employee groups," said Watkins. "The police are structured within the confines of the law while the teamsters are not clearly defined by law."

Recently, Upper St. Clair Township made a switch from a defined benefit program to a defined contribution benefit program for many employees.

"Mockenhaupt Benefits Group has been excellent in assisting us through this process," said Watkins.

Watkins, Mansfield and Stache also credited Mockenhaupt Benefits Group with offering analysis on the financial impact of benefit increases, for keeping clients "plugged in" to various changes in statutes, and for providing expert testimony to the state legislature on behalf of the Pennsylvania League of Cities and Municipalities *(PLCM)*.

USC

About the Township of Upper St. Clair

The Township of Upper St. Clair is a 10.5 square mile, primarily residential community 10 miles southwest of Pittsburgh in Allegheny County with over 20,000 residents.

The Township recently won its 18th Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association. This marked the 14th consecutive year and the 18th time that the Township received the honor since 1980.

The award, based on the Township's comprehensive annual financial report *(CAFR),* is the highest form of recognition in the area of governmental accounting and financial reporting.

Along with its financial excellence, the Township is increasingly utilizing advanced computer technology to assist its residents.

"We're trying to provide 'e-government' to our citizens," said Watkins. "We'll do anything we can to provide better service to our citizens...and we realize everyone isn't connected to the Internet yet, so we still utilize traditional communication methods *(cable, written literature)* along with the Internet."

Stache agreed. "We are moving increasingly towards electronics...much of our banking is done via direct deposit or through ACH *(automatic clearinghouse)* transfer," said Stache. "And, we now make our pension payments electronically to the provider...this is about 4-5 days ahead of schedule from what used to happen."

"We're trying to be a more cost efficient operation and maximize benefits to everyone," added Stache.

Other recent innovations have included the Township moving to "e-procurement" and soon to be including GIS data on the Township's comprehensive website.

Visit the Township of Upper St. Clair on the web at www.twpusc.org.

IN BRIEF

Summary of Act 64 of 2002

1. Mandates increases to the monthly pension benefits of all police officers and firefighters, whether for age, service or disability, who retired before Jan. 1, 1996.
2. Formula for calculating increases is: *(15¢ x years of service x years retired)* multiplied by [1 + *(2.5 percent x years retired up to 25)* + *(7.5 percent x years retired over 25)*].
3. Effective July 2002
4. Increase is offset by 65 percent of increases granted by municipality between 1/1/1989 and 1/1/2001.
5. Increase in unfunded liability due to the cost of the COLA is amortized over 10 years.
6. Provides for reimbursement of a portion of cost increase to municipality in the year following the year in which the cost of the COLA is recognized and paid.
7. Reimbursement only applies to municipalities that do not receive a sufficient state aid allocation to fund the pension costs, and whose police and/or firefighter plans have an unfunded liability.
8. Reimbursements are paid from the general municipal pension system state aid pool prior to allocation of regular pension aid distributions.
9. Reimbursement is equal to the amortization payment attributable to the ad hoc COLA multiplied by a percentage representing the municipality's portion of the overall pension costs *(ex. if a city pays 60 percent of the aggregate pension obligation and the state pays 40 percent, the city will receive 60 percent of the amortization payment attributable to the COLA as a reimbursement)*.
10. Reimbursements currently being paid under 1989 ad hoc mandate *(Act 147)* will cease to any municipality that receives sufficient state aid to fund pension costs.

Reminders/Deadlines for Remainder of 2002

September 1 (approx.)
Act 147 (ad hoc COLA) reimbursement checks mailed

September 30
2003 MMOs must be submitted to the governing body

October 1 (approx.)
State aid checks for 2002 will be mailed

October 31 (approx.)
State aid must be deposited to pension funds (30 days after receipt)

December 31
2002 MMO deposit due

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