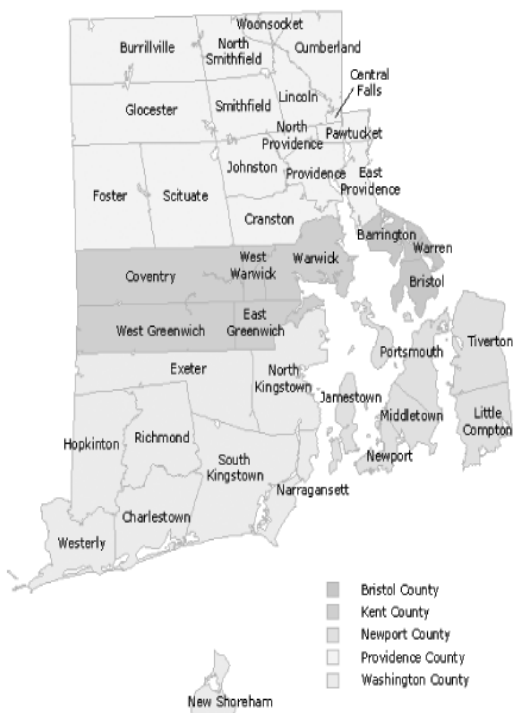
Status of Pension Plans

Administered by

Rhode Island Municipalities

July 2007



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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

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July 6, 2007

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SPEAKER William J. Murphy, Chairman

Senator Joseph A. Montalbano
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Representative Gordon D. Fox
Representative Robert A. Watson

We have completed a review of the status of defined benefit pension plans administered by Rhode Island municipalities. Our review is a natural extension of our oversight responsibilities with respect to Rhode Island municipalities.

Our report is included herein as outlined in the Table of Contents and includes recommendations to improve the funded status of pension plans administered by Rhode Island municipalities and also highlights matters which we believe warrant further legislative study and deliberation.

Sincerely,

Ernest A. Almonte, CPA, CFE
Auditor General

Status of Pension Plans

Administered by Rhode Island Municipalities

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Pension plans administered by Rhode Island municipalities are of concern because so many are considerably underfunded. The principal concern centers on ensuring that adequate funds will be available to meet benefit payments promised to retirees. A second and equally important concern is the negative impact these self-administered plans can have on the overall financial health of communities when not properly funded. The eventual costs to fund the plan become significantly larger and divert resources from other programs and initiatives when pension plans are chronically underfunded.

We identified 21 pension plans administered by 15 Rhode Island municipalities that we considered to be at risk. Of the 21 plans, seven were considered most at risk because the plans were significantly underfunded and annual contributions were significantly less than annual required amounts. For ten other plans, annual contributions were at or near 100% of annual required amounts; however, the plans were still significantly underfunded and therefore considered at risk. Four additional plans were considered at risk because contributions were significantly less than required amounts and generally declining over a multi-year period.

Twenty–five Rhode Island communities have created 37 pension plans, which they administer for their employees. Total assets collectively held by these plans were nearly $1.3 billion at June 30, 2006. The collective unfunded actuarial accrued liability for future benefits (for only locally administered plans) was nearly $1.6 billion (as of the actuarial valuation referenced in their June 30, 2006 financial statements).

Improving the funded status of these plans presents a significant hurdle to many communities that are already challenged to meet their obligations within state mandated property tax limits. The collective annual required contributions as a percentage of the municipality's property tax levy varies significantly by community. For five communities, the annual required contributions for pensions alone represents 20% or more of the community's fiscal 2006 property tax levy – a significant burden.

Underfunded pension plans are not unique to Rhode Island. The issues associated with defined benefit plans–both public and private–have received significant attention in light of increasing actuarial liabilities for future benefits driven in large part by employees retiring earlier and living longer.

Various structural issues contribute to or facilitate the poor funded status of many locally administered plans. Clearly, local administration of the plans allows flexibility in defining the benefit structure of the plan and also the timing and actual amounts contributed to the plan. In many instances that flexibility has resulted in generous benefits and failure to make annual required contributions. Additionally, local governments typically focus on the annual budget process and consequently have a short-term perspective. That short-term focus is often inconsistent with the long-term perspective required of pension plan stewards. These factors directly impact the poor funded status of the plans.

In contrast, all Rhode Island municipalities are making 100% of their annual required contribution for teachers to the state administered Employees' Retirement System. Similarly, all Rhode Island municipalities that participate in the Municipal Employees' Retirement System (MERS) are making 100% of their annual required contribution and are adhering to the established benefit structure outlined in the State's General Laws. In these instances, the municipality must fund required amounts – the General Laws allow for offset of state aid to local governments if the municipality is delinquent in making required pension contributions to the State administered pension plans. The same fiscal discipline is not forced upon a municipality with regard to its locally administered pension plan.

Failure to make annual required contributions can have a profound effect on pension costs for the municipality and ultimately the taxpayer. For example, the annual required contribution for the City of Cranston's Police and Fire Employees Retirement System was $21.7 million for fiscal 2006. This plan, which covers just 98 active members and 407 retirees for a total of 505 individuals, has been chronically underfunded. In contrast, the aggregate annual required contribution for all participating entities in the Municipal Employees Retirement System (MERS) was $20.1 million covering a total of 14,052 individuals (active and retirees). The wide disparity in relative annual contributions results from failure to contribute required amounts in the past and benefits that are more generous than those afforded retirees under the MERS. The liability for future benefits under the Cranston Police and Fire plan is estimated at $430,779 per member compared to $9,272 per member under the State administered MERS plan.

Locally administered plans also lack advantage in investing accumulated pension plan assets effectively with the aim of maximizing returns yet reducing risk exposure through diversification. The smaller size of the investment portfolios associated with the self-administered plans makes it more difficult to effectively diversify assets and fully participate in all types of investment options. With some exceptions, investment returns of the self-administered plans are less than the returns earned by the State retirement system. Further, the cost of investing and overall administrative costs of the self-administered pension plans are likely higher because of the lack of economies of scale.

All these considerations lead to the general conclusion that locally-administered pension plans can be problematic and their continued existence should be strongly reconsidered. Practically, locally administered pension plans are not likely to go away immediately. Therefore, several control measures and options should be considered and implemented to decrease the risk that these plans will be unable to meet their benefit obligations to retirees or negatively impact a community's overall fiscal health.

We recommended that municipalities take various measures to improve the funded status of their plans and also pursue merging their self-administered plans into the State administered Municipal Employees' Retirement System. Additionally, we recommend that municipalities consider establishing defined contribution plans for new hires. Municipalities also should ensure that required financial information regarding pensions is accurately and completely disclosed in their annual financial statements to allow taxpayers and others to assess pension costs and the progress made in accumulating assets to fund future benefits. Further, communities should prepare a "fiscal note" detailing the impact on contribution rates and the funded status of a locally administered pension plan when pension benefits are affected by new collective bargaining agreements.

We also identified a number of matters that we believe may warrant further legislative deliberation including the creation of a pooled investment trust for locally administered pension plans to improve investment performance. We also highlight that the enforcement provisions, contained within an existing statute, that are intended to ensure that municipalities make 100% of their annual required contribution could be enhanced. Other matters to be considered include implementing (1) incentives to encourage municipalities to merge locally administered pension plans into the State Municipal Employees' Retirement System, (2) criteria that would trigger increased State oversight of severely underfunded local pension plans, and (3) a two-tiered benefit structure within the Municipal Employees' Retirement System that is similar to statutory changes recently enacted for the Employees' Retirement System. Lastly, the State should contemplate what role it may assume in helping municipalities deal with the impact of new accounting guidelines for other post-employment benefits – typically health-care benefits for retirees.

OBJECTIVES

The objective of our review was to assess the fiscal health of the various locally-administered pension plans covering Rhode Island municipal employees. The fiscal health of these plans was measured by whether the municipality was consistently making 100% of annual required contributions to the plans, the overall funded status of the plan, and the investment performance of plan assets. We also assessed a community's capacity to meet its annual required contributions by measuring the total annual required contribution for all pension plans the municipality participates in as a percentage of the community's annual property tax levy.

In addition, we assessed the effectiveness of efforts outlined in the general laws to require local governments to make 100% of their annual required contributions. Further, we explored some of the factors that generally contribute to locally administered pension plans being at higher risk than plans administered by the State. Additionally, we outlined options that may be considered to enhance the funded status of locally administered pension plans thereby improving the overall fiscal health of the municipality. Finally, we discuss State initiatives that may be considered to limit locally administered pension plans or to prevent them from becoming problematic.

Our review was based on various data which is publicly available including the audited annual financial statements of each municipality in Rhode Island and periodic actuarial valuations performed for locally administered plans. It is intended to make an assessment at a common point in time using audited financial data included in the municipality's fiscal 2006 audited financial statements. When pension information was omitted or incomplete in the audit report, we requested information from the municipality. We did not consider fiscal 2007 budgeted contributions to locally administered pension plans or the results of more recent actuarial valuations (if available). Consequently, the current status of any locally administered pension plan may vary from the information presented herein.

We have not performed independent tests of the data included in these financial reports or actuarial valuations which were the bases for our analysis.

BACKGROUND

The fiscal health of pension plans, both public and private, has received significant attention recently as many entities struggle to contain escalating pension costs. This results largely from past underfunding of the plans and employees generally retiring earlier and living longer. Despite escalating pension costs, some entities have chosen to significantly reduce contributions thereby deferring their obligation to fund the liabilities into the future. Contributing less than actuarially required amounts provides a short-term solution to balance the annual operating budget but creates a much more serious and long-term financial problem. Many plans are severely underfunded which presents the risk that sufficient funds will not be available to meet promised benefits to retirees. It also undermines the overall fiscal health of the plan's sponsor.

This increased focus and attention has resulted in new federal requirements for private sector defined benefit pension plans. Although most of its provisions do not impact governmental pension plans, the federal Pension Protection Act of 2006 addresses key funding provisions for private-sector defined benefit pension plans. In general, it requires single-employer pension plans to be 100% funded over a 7-year period starting in 2008 and requires accelerated funding for plans defined as "at-risk" plans—those less than 80% funded. Pension benefits cannot be increased for plans that are less than 80% funded.

In the government environment, the annual cost of providing pension benefits can be a significant portion of the annual operating budget of a municipality. Failure to make annual required contributions to pension plans or invest pension assets prudently can have long-term effects on the community's overall fiscal health. Additionally, granting generous benefits without consideration of the long-term costs can have a far-reaching impact on the overall fiscal health of a community. Further, failure to fund annual required contributions to the plans ultimately increases the overall cost to the municipality.

Further focus and concern is likely as new governmental accounting pronouncements become effective requiring governments to also measure the future cost of other post-employment benefits (e.g., retiree health care) on an actuarial basis and disclose those costs in their annual financial reports.

OVERVIEW OF PENSION PLANS COVERING RHODE ISLAND MUNICIPAL EMPLOYEES

Rhode Island municipal employees are covered by a variety of pension plans, some administered by the State, others administered by the municipality, and a few administered by employee unions. While the focus of this report is primarily defined benefit pension plans administered directly by Rhode Island municipalities, it is useful to understand the types of pension plans (defined benefit vs. defined contribution) and the variety of plans covering local public employees.

> **Defined benefit pension plan** – A pension plan having terms that specify the amount of pension benefits to be provided at a future date or after a certain period of time; the amount specified is a function of one or more factors such as age, years of service, and compensation.
>
> **Defined contribution plan** – A pension plan having terms that specify how contributions to a plan member's account are to be determined, rather than the amount of retirement income the member is to receive. The amounts received by a member will depend only on the amount contributed to the member's account, earnings on investments of those contributions, and forfeitures of contributions made for other members that may be allocated to the member's account.
>
> Source: *Governmental Accounting and Financial Reporting Standards* published by the Governmental Accounting Standards Board

Employees' Retirement System of Rhode Island (ERS) - Teachers

- *Administered by State of Rhode Island*
- Covers local public school teachers
- Total plan assets - $3.8 billion (teachers share – fair value at June 30, 2006)
- Unfunded Actuarial Accrued Liability - $2.6 billion at June 30, 2005
- Funded ratio – 55.4% at June 30, 2005

All local school teachers are members of the Employees' Retirement System (ERS) of the State of Rhode Island (pursuant to General Law section 16-16-2). That plan also covers state employees and is administered by the State. The employer contribution to the plan for teachers is shared between the local school district and the State (currently 8.02% State and 11.62% local for a total employer contribution rate of 19.64% in fiscal 2007). Teachers contribute 9.5% of their salaries. The municipality has no responsibility for administering the plan and its primary obligation is to make annual required contributions. Separate actuarial valuations are not performed for each school district – all districts contribute at the same employer contribution rate which is shared with the State.

Municipal Employees' Retirement System of Rhode Island (MERS)

- *Administered by State of Rhode Island*
- Covers various categories of municipal employees - general, police and fire
- Total plan assets – $1 billion - fair value at June 30, 2006
- Unfunded Actuarial Accrued Liability - $130 million at June 30, 2005
- Funded ratio - 87.2% at June 30, 2005

Some municipal employees participate in the Municipal Employees' Retirement System (MERS) of the State of Rhode Island which is administered by the State. That system is a voluntary multiple-employer agent plan. The State acts as administrative agent but assumes no funding responsibility. A municipality may have multiple units covering specific groups of employees (e.g., police, fire, general employees) -- separate actuarial valuations are performed for each participating entity. The municipality has no responsibility for administering the plan but is required to make annual required contributions as determined by the actuary specifically for that unit.

Some municipal employees are covered by pension plans administered by their employee union. In these instances the municipality's obligation is solely to make annual required employer contributions.

Various Locally Administered Pension Plans

- *Administered by local governments*
- Covers various categories of municipal employees - general, police and fire
- Total plan assets – $1.3 billion (as of most recent data available in FY 2006 audit reports)
- Unfunded Actuarial Accrued Liability - $1.6 billion (as of most recent valuation dates)
- Collective funded ratio – 45% (as of the most recent information included in Fiscal 2006 audit reports)

Many municipalities have established pension plans for their employees where the city or town is solely responsible for all aspects of the administration and funding of plan benefits. In these instances the municipality is responsible for determining plan provisions, obtaining actuarial valuations, making required contributions, investing assets and paying benefits to retirees.

Twenty–five Rhode Island communities have created one or more pension plans, which they administer for their employees. The actuarial value of assets collectively held by these plans was nearly $1.3 billion at June 30, 2006. The collective unfunded actuarial accrued liability for future benefits (for only these locally administered pension plans) was in nearly $1.6 billion (as of the most recent actuarial valuation referenced in their June 30, 2006 financial statements).

A schedule on page 7 shows the various plans that each Rhode Island municipality administers or participates in.

Rhode Island Municipalities' Defined Benefit Pension Plans at June 30, 2006

	ERS	MERS			OTHER PLANS	LOCAL PLANS	
Municipality	Teachers	Municipal Employees	Police	Fire	Not Administered by Municipality	Administered by Municipality	Covered employees
Barrington	●	●	●	●			
Bristol	●	●	●	●		●	Police (prior to 3/22/98)
Burrillville	●	●	●				
Central Falls	●	●				●	Police & Fire (prior to 7/1/72) and Police & Fire (after 7/1/72)
Charlestown	●	●	●		●		
Coventry	●			●	●	●	Municipal Employees, Police, School Employees (other than teachers)
Cranston	●	●	●	●	●	●	Police & Fire EE's Pension Plan (prior to 7/1/95)
Cumberland	●	●		●		●	Police and other former employees
East Greenwich	●	●	●	●			
East Providence	●	●				●	Fire & Police
Exeter	●	●			●		
Foster	●	●	●				
Glocester	●	●	●	●			
Hopkington	●	●	●				
Jamestown	●	●	●			●	Police
Johnston	●	●		●		●	Police, Fire (prior to 7/1//99)
Lincoln	●	●			●	●	Police, Fire, Town and School ee's
Little Compton	●					●	Town employees other than certified teachers
Middletown	●	●	●	●		●	All Town ee's hired prior to 7/1/01
Narragansett	●					●	Police (prior to 7/1/78) and Town Plan
New Shoreham	●	●	●				
Newport	●	●				●	Fire and Police
North Kingstown	●	●	●	●		●	Police Pension Fund (retired as of 6/30/96)
North Providence	●	●		●		●	Police Pension Plan
North Smithfield	●	●	●	●			
Pawtucket	●	●	●	●		●	Pre 1974 Police & Fire (pay as you go) and Post 1974 Police and Fire
Portsmouth	●					●	Full-time Town employees except teachers
Providence	●					●	All city employees except teachers
Richmond	●	●	●	●			
Scituate	●	●	●			●	Police
Smithfield	●	●	●			●	Police (prior to 7/1/99), Fire
South Kingstown	●	●	●		●		
Tiverton	●	●		●		●	Police
Warren	●	●	●	●			
Warwick	●					●	City Employees, Police and Fire Pension I, Police and Fire Pension II, Public School Employees
West Greenwich	●	●	●				
West Warwick	●	●				●	Full time town ee's (except teachers), Police and Fire
Westerly	●	●			●	●	Police
Woonsocket	●	●	●	●		●	Police (hired prior to 7/1/80), Fire (hired prior to 7/1/85)

MEASURING THE FISCAL HEALTH OF PENSION PLANS ADMINISTERED BY RHODE ISLAND MUNICIPALITIES

The primary objective of a defined benefit pension plan is to pay current and future benefits to its members. These benefit obligations cannot be met without the appropriate level of available assets. Many factors such as market volatility, changes in benefits, and changes in membership can affect the assets and liabilities or funding status of a plan. Proper planning and management is required to ensure that plan assets will be sufficient to support liabilities. Periodic actuarial valuations are a tool used by management to assess the development of the liability components of the plan and how they relate to plan assets.

Various measures can be used in assessing the fiscal health of a pension plan. We have selected the following measures because they are both appropriate and generally readily available from either periodic actuarial valuations or the annual audited financial statements of a governmental entity.

Annual required contribution (ARC)	The amount required to be contributed to the plan as determined by an actuary in accordance with the plan's actuarial funding methodology and assumptions. Any contribution amount less than 100% of the ARC warrants attention.
Net pension obligation (NPO)	When a government contributes 100% of the ARC no liability is required to be presented on the face of the government's financial statements. When less than 100% of the ARC is contributed, the difference between the ARC and the actual contribution is reflected as a liability on the government's government-wide financial statements and is referred to as the net pension obligation. When an NPO exists on a government's financial statements, this amount represents the cumulative effect of contributions that should have been, but were not, made to a pension plan.
Unfunded actuarial accrued liability (UAAL)	The Actuarial Accrued Liability (AAL) is the present value of fully projected benefits attributable to service credit that has been earned. The Unfunded Actuarial Accrued Liability (UAAL) is the difference between the AAL and the actuarial value of assets available to pay benefits.
Funded ratio – overall funding status of the plan	The funded ratio of a pension plan is the relative value of the plan's assets and liabilities. The Plan's funded ratio is determined by dividing the actuarial value of assets by the actuarial value of liabilities.
Investment Performance	In addition to contributions, investment income is another source of funds to provide current and future pension benefits. Investment performance can be measured against the actuarial assumed rate of return and investment returns obtained by other similar investors.

Ultimately, the pertinent considerations regarding funding a public pension plan is the ability of the plan sponsor to continue to pay promised benefits and to make required contributions without causing fiscal stress; and whether the plan's unfunded liability is being amortized over an appropriate time period.

Locally Administered Plans Considered at Risk

We identified 21 plans administered by 15 municipalities that we considered to be at risk (based on information included in their fiscal 2006 audited financial statements). We arrived at this conclusion by identifying plans with a funded ratio of less than 50% and/or contributions of less than 80% of the ARC. The plans are listed in alphabetical order by municipality. Our assessment of plans includes only information available and included in the municipality's fiscal 2006 audited financial statements.

Locally Administered Pension Plans Considered at Risk

Pension Plan	Funded Ratio	Percentage of ARC made in Fiscal 2006	Unfunded Actuarial Accrued Liability	Risk Category	Comments
Bristol Police (prior to 3/22/98)	67.0%	53%	$ 5,608,883	3	Decline in funding the ARC
Central Falls Police and Fire (pre 7/1/72)	7.3%	127%	$ 14,591,702	2	62 members only
Central Falls Police and Fire (post 7/1/72)	34.6%	8%	$ 20,599,620	1	ARC as a % of tax levy is 32.9%
Coventry Police	8.0%	28%	$ 45,165,871	1	High risk – significantly underfunded – very slow progress in funding ARC
Coventry Municipal Employees	18.0%	13%	$ 11,343,042	1	
Coventry School Employees	46.6%	n/a	$ 9,368,668	1	
Cranston Police and Fire (pre 7/1/95)	15.5%	98%	$217,543,602	2	Significantly underfunded
East Providence Fire and Police	70.0%	24%	$ 31,720,000	3	Declining funded ratio
Johnston Fire (pre 7/1/99)	30.7%	93%	$ 30,529,696	2	Significantly underfunded
Johnston Police	30.8%	100%	$ 25,711,683	2	Significantly underfunded
Narragansett Police (pre 7/1/78)	5.1%	0%	$ 901,264	1	17 retired members only
Narragansett Town Plan	79.0%	47%	$ 10,957,669	3	Continual underfunding of ARC
Newport Firemen's Pension Plan	39.9%	100%	$ 41,257,640	2	Significantly underfunded
Pawtucket Police and Fire (post 1974)	42.5%	54%	$ 84,049,166	1	Significantly underfunded and slow progress in funding ARC
Providence	37.4%	96%	$659,036,000	2	Significantly underfunded
Scituate Police Pension Plan	37.0%	101%	$ 4,268,707	2	26 members only
Smithfield Police (prior to 7/1/99)	36.0%	153%	$ 12,529,685	2	64 members only
Smithfield Fire	86.0%	72%	$ 1,989,143	3	72 members only
Warwick Police Pension I and Fire	27.0%	100%	$194,841,382	2	Significantly underfunded
Westerly Police	43.4%	96%	$ 23,777,351	2	Significantly underfunded and declining funded ratio
West Warwick	48.0%	47%	$ 43,750,220	1	Significantly underfunded and declining funded ratio

Risk category :
1 – Plan is significantly underfunded and annual contributions are significantly less than annual required amounts.
2 – Plan is significantly underfunded but annual contributions are at or near 100% of annual required amounts.
3 – Annual contributions are significantly less than required amounts and generally declining over a multi-year period.

The 16 locally administered plans not considered at risk (those excluded from the preceding table) still require continual commitment to fund the plan responsibly by contributing 100% of annual required amounts and move toward fully funding the plan. Options to merge the plan into the Municipal Employees' Retirement System to reduce administrative costs and enhance investment performance and diversification should still be pursued.

Annual Required Contribution

> ***Annual Required Contribution***
>
> The amount required to be contributed to the plan as determined by an actuary in accordance with the plan's actuarial funding methodology and assumptions. Any contribution amount less than 100% of the ARC warrants attention.

Consistently funding 100% of the annual required contribution (ARC) to a pension plan is one of the best indicators of an entity's commitment to making incremental progress in meeting its obligation to employees and retirees for pension benefits. The table on page 12 demonstrates the actual percentage of the annual required contribution made by each locally administered pension plan over the five-year period 2002-2006.

The five-year ARC funding schedule indicates that eight plans substantially underfund their respective annual required contribution. Three communities, Coventry, Central Falls and Narragansett had plans for which they funded less than 15% of the ARC in fiscal 2006. Three additional plans are declining in the percentage of the annual contribution made in fiscal 2006 compared to prior years. For the remaining plans, the municipality either is nearing a 100% ARC contribution rate or has been consistently funding at least 100% of the ARC. Despite consistent funding of the ARC in the recent five-year period some of these plans are still significantly underfunded.

In fiscal 2006, The Town of Coventry reported funding 13% of the ARC for their self-administered Municipal Employee Retirement Plan. This plan reported a funded ratio of 18% as of June 30, 2006. The Town has consistently underfunded this plan for many years despite the reported shortfalls and efforts by the Office of the Auditor General to enforce compliance with requirement to move towards funding 100% of the ARC. The Town's Police Pension Plan reported an 8% funded ratio at June 30, 2006 yet the Town funded only 28% of the ARC that year.

To further underscore the serious condition of the Town of Coventry's self administered pension plans we cite the following statements from the actuarial valuation reports, for the plan year ended December 31, 2006, for both the Municipal Employees' and Police Officers' plans. According to the actuary, both plans have emerging retirement liability problems. For the Police Plan, the actuary warns that:

> "*Without a substantial increase in employer contributions, your plan is in danger of depleting assets. If this happens, benefits payments to current retirees will stop.*"

For the Municipal Plan, the actuary states that:

> "…we estimate there will be insufficient funds to pay all retirement charges by the year 2013."

The actuary in prior valuation reports made similar warnings yet contributions to these plans continue to be insufficient to address the funding recommendations.

In fiscal 2006, the City of Central Falls funded 8% of the ARC for their Police and Fire Pension Plan (for employees hired after July 1, 1972). This plan reported a funded ratio of 34.6% in 2006. In June 2007 the City adopted a five-year pension funding plan by ordinance in an effort to work towards funding 100% of the ARC. The Police and Fire Plan for pre July 1, 1972 employees reported a funded ratio of 7.3% in 2006 despite the City's funding 127% of the ARC for that year. The June 2007 ordinance also commits to funding 100% of the ARC for this plan.

Since property taxes are the primary revenue source for most Rhode Island municipalities, we prepared a schedule comparing each municipality's total actuarially determined annual required contribution, for all plans that it administers or participates in, to its total property tax levy for fiscal year 2006 (see page 13). For some communities, the percentage of their tax levy needed to fund their pension plans by contributing actuarially determined amounts is significant. Five communities have total annual required contributions that represent 20% or more of their tax levy. This means that $1 of every $5 raised through property taxes is needed to cover just pension costs each year. The wide disparity in the percentage of the annual property tax levy that would be required to fund 100% of the annual required contribution to all pension plans can be attributed to a variety of factors including differences in benefit provisions and the impact of continual underfunding in prior years. Generally, those communities that administer local plans have the higher percentage of total ARC to total property tax levy.

The schedule on page 13 was intended to highlight the potential capacity (or lack of capacity) a municipality may have in increasing its contributions to meet a 100% ARC funding level. This capacity factor may cause the consideration of other options including restructuring benefits and merging with the State MERS plan. For example, the Town of Coventry, based on current actual funding amounts, would have to increase property taxes by an additional 10% or approximately $5 million dollars to meet this funding level.

One of the key advantages of participating in the State administered MERS plan is that 100% of the annual required contribution must be made. The general laws provide for deducting required contribution amounts due the State Employees' Retirement System from state aid payments to the municipality. This seeming lack of flexibility and forced discipline is actually a benefit due to the dramatically increased costs associated with deferring contributions to a pension plan.

For those communities that may not be able to immediately fund 100% of the annual required contribution without having a severe increase in property tax rates in any one year, a plan (over no more than five years) should be established to fund 100% of the ARC. An existing law does not contain enforcement provisions to accomplish this and has resulted in poor compliance.

Rhode Island Municipal Pension Plans - Percentage of Annual Required Contributions Made - Fiscal Years 2002-2006

Municipality	Pension Plan	2002 ARC	2002 % of ARC	2003 ARC	2003 % of ARC	2004 ARC	2004 % of ARC	2005 ARC	2005 % of ARC	2006 ARC	2006 % of ARC	Comments
Bristol	Police Pension Plan (prior to 3/22/98)	$ 90,685	100%	$ 76,739	100%	$ 168,914	100%	$ 329,562	77%	$ 438,015	53%	declining funding of ARC
Central Falls	Police & Fire John Hancock (after 7/1/72)	1,265,606	17%	1,817,888	17%	1,817,888	17%	1,949,325	42%	1,949,325	8%	substantial underfunding of ARC
	Police & Fire 1% (prior to 7/1/72)	1,464,026	92%	846,798	143%	846,798	143%	974,873	126%	974,873	127%	funding on a pay as you go basis
Coventry	Town's Municipal EE Retirement Plan	1,014,424	14%	1,026,141	14%	1,143,540	8%	1,363,517	14%	1,443,927	13%	substantial underfunding of ARC
	Police Pension Plan	4,478,661	27%	4,487,552	28%	4,765,194	15%	4,870,087	28%	5,479,790	28%	substantial underfunding of ARC
	School EE's Pension Plan	-	n/a	-	n/a	-	n/a	-	n/a	-	n/a	not actuarially determined - 12.5% of payroll
Cranston	Police & Fire EE's Pension Plan (prior to 7/1/95)	18,996,537	50%	24,945,408	60%	21,877,449	109%	22,147,958	90%	21,723,021	98%	improving - nearing 100% of ARC
Cumberland	Town of Cumberland's Pension Plan	759,668	63%	565,208	100%	672,572	199%	763,015	100%	806,797	101%	consistently funding at least 100% of ARC
East Providence	Firemen's & Policemen's Pension Plan	2,209,148	14%	2,771,473	12%	3,225,223	23%	3,931,287	20%	4,192,401	24%	substantial underfunding of ARC
Jamestown	Police Pension Plan	141,332	100%	101,449	187%	101,449	195%	98,313	282%	98,313	222%	consistently funding at least 100% of ARC
Johnston	Police	1,711,000	30%	2,045,000	103%	2,137,000	100%	2,545,000	100%	2,659,000	100%	consistently funding at least 100% of ARC
	Fire (prior to 7/1/99)	2,153,000	44%	2,802,000	87%	2,928,000	90%	3,187,000	84%	3,330,000	93%	improving - nearing 100% of ARC
Lincoln	Town Retirement Plan	246,126	100%	264,016	274%	251,364	109%	136,746	158%	309,674	106%	consistently funding at least 100% of ARC
Little Compton	Town Employees Other than Certified Teachers	175,691	97%	193,240	104%	219,956	94%	181,676	176%	205,756	137%	consistently funding at least 100% of ARC
Middletown	Town Plan	1,598,047	102%	1,425,692	108%	2,038,820	101%	2,427,677	98%	2,693,913	95%	declining but near 100% of ARC
Narragansett	Police Plan (prior to 7/1/78)	86,712	115%	80,529	0%	80,529	168%	77,509	65%	71,561	0%	declining funding of ARC
	Town Plan	884,131	122%	1,986,691	46%	1,864,145	53%	2,258,060	43%	2,184,453	47%	substantial underfunding of ARC
Newport	Firemen's Pension Plan	3,106,881	129%	3,106,881	131%	3,317,767	100%	3,317,767	154%	3,543,234	100%	consistently funding at least 100% of ARC
	Policemen's Pension Plan	1,985,197	115%	1,985,197	136%	3,247,875	100%	3,247,875	120%	2,440,649	100%	consistently funding at least 100% of ARC
North Kingstown	Police Pension Fund (retired as of 6/30/96)	-	n/a	-	n/a	-	n/a	-	n/a	-	n/a	overfunded - no ARC
North Providence	Police Pension Plan	915,171	73%	1,109,061	66%	1,298,806	56%	1,140,847	95%	1,255,035	92%	improving - nearing 100% of ARC
Pawtucket	Pre 1974 Policemen & Firemen (pay as you go)	-	n/a	-	n/a	-	n/a	-	n/a	-	n/a	no ARC determined
	Post 1974 Policemen & Firemen	5,241,898	39%	5,933,743	41%	6,317,264	57%	7,052,881	56%	7,931,120	54%	substantial underfunding of ARC
Portsmouth	Employees of the Town of Portsmouth	1,088,547	100%	1,162,063	100%	1,292,432	100%	1,370,682	100%	1,552,169	100%	consistently funding at least 100% of ARC
Providence	ERS of the City of Providence	42,442,000	65%	42,008,000	80%	46,321,000	86%	49,329,000	92%	51,454,000	96%	improving - nearing 100% of ARC
Scituate	Police Pension Plan	334,856	66%	334,856	73%	414,630	98%	414,630	99%	410,834	101%	improving - now at 100% of ARC
Smithfield	Police (prior to 7/1/99)	1,179,112	32%	1,202,146	115%	1,200,397	115%	1,167,128	116%	1,032,192	153%	consistently funding at least 100% of ARC
	Fire Pension Plan	314,486	115%	556,855	68%	709,262	55%	596,055	64%	667,495	72%	substantial underfunding of ARC
Tiverton	Policemen's Pension Plan	362,472	100%	436,366	100%	526,242	100%	631,676	78%	631,676	100%	mostly consistent funding of ARC
Warwick	City Employees Pension Plan	1,246,068	103%	1,295,910	100%	2,308,830	100%	2,401,183	100%	3,043,476	100%	consistently funding at least 100% of ARC
	Police Pension II Plan	1,162,048	100%	1,146,891	100%	1,201,520	100%	1,729,765	100%	1,917,484	100%	consistently funding at least 100% of ARC
	Police Pension I & Fire Pension Plan	9,743,919	100%	9,059,151	100%	9,535,519	100%	10,112,932	100%	10,517,450	100%	consistently funding at least 100% of ARC
	Fire Pension Plan II	494,588	100%	588,974	100%	671,443	100%	866,234	100%	1,081,926	100%	consistently funding at least 100% of ARC
	Warwick Public Schools Employee Pension Plan	1,313,871	107%	1,408,793	110%	1,375,458	102%	1,557,272	96%	1,503,550	84%	declining funding of ARC
West Warwick	Town Plan	1,138,367	19%	1,552,933	32%	2,066,960	48%	2,617,422	0%	3,100,394	47%	substantial underfunding of ARC
Westerly	Police Pension Plan	1,134,700	88%	1,180,900	85%	1,214,900	93%	1,301,600	96%	1,355,800	96%	improving - nearing 100% of ARC
Woonsocket	Police (pre 7/1/80) & Firemen's (pre 7/1/85) Plan	-	n/a	-	n/a	-	n/a	-	n/a	-	n/a	note 1
	Totals:	$ 110,478,975	65%	$ 119,504,544	76%	$ 127,159,146	87%	$ 136,096,554	86%	$ 141,999,303	87%	

(shaded) plans where less than 90% of the annual required contribution was made during the fiscal year

n/a not applicable

Note 1 The City of Woonsocket issued $90 million of pension obligation bonds in fiscal 2003 to fund the actuarially determined pension obligation for these plans. As a result, the City's audit reports indicated that there is no unfunded actuarial liability or annual required contribution for these plans.

Rhode Island Municipalities - Fiscal 2006
Total Annual Required Contribution as a Percentage of the Total Property Tax Levy

Municipality	2006 TAX LEVY(a)	State Administered Plans: Teachers ERS 2006 ARC	State Administered Plans: Other MERS 2006 ARC	Local Plans: 2006 ARC (b)	Total 2006 ARC All Plans (b)	(b) Total ARC as a % of Tax Levy
Barrington	$ 43,086,859	$ 1,782,692	$ 490,560	-	$ 2,273,252	5.3%
Bristol	29,350,483	1,373,943	547,144	$ 438,015	2,359,102	8.0%
Burrillville	19,162,222	1,289,164	258,130		1,547,294	8.1%
Central Falls	9,477,934		197,606	2,924,198	3,121,804	32.9%
Charlestown	16,823,683	624,582	463,969		1,088,551	6.5%
Coventry	50,446,107	3,219,156		7,600,883	10,820,039	21.4%
Cranston	145,337,455	6,163,913	1,784,980	22,087,431	30,036,324	20.7%
Cumberland	44,961,635	2,335,003	711,183	806,797	3,852,983	8.6%
East Greenwich	34,691,160	1,246,575	594,647		1,841,222	5.3%
East Providence	72,631,325	3,285,851	2,104,562	4,192,401	9,582,814	13.2%
Exeter	9,996,307	633,731	63,918		697,649	7.0%
Foster	7,843,650	428,082	137,748		565,830	7.2%
Glocester	15,647,919	920,748	422,261		1,343,009	8.6%
Hopkinton	14,019,545	795,853	213,697		1,009,550	7.2%
Jamestown	15,215,000	655,797	284,007	98,313	1,038,117	6.8%
Johnston	52,022,794	1,910,568	677,400	5,989,000	8,576,968	16.5%
Lincoln	42,923,047	2,288,729	150,709	519,850	2,959,288	6.9%
Little Compton	8,109,180	166,221		205,756	371,977	4.6%
Middletown	33,631,581	1,772,110	175,700	2,693,913	4,641,723	13.8%
Narragansett	36,186,903	1,091,348		2,256,014	3,347,362	9.3%
Newport	53,298,045	1,566,716	916,154	5,983,883	8,466,753	15.9%
New Shoreham	5,802,143	144,129	23,207		167,336	2.9%
North Kingstown	54,015,438	2,268,683	2,219,413	-	4,488,096	8.3%
North Providence	50,609,828	2,088,318		1,255,035	3,343,353	6.6%
North Smithfield	19,562,352	904,377	202,086		1,106,463	5.7%
Pawtucket	73,296,650	5,093,322	628,991	8,677,465	14,399,778	19.6%
Portsmouth	34,128,893	1,478,000		1,552,169	3,030,169	8.9%
Providence	259,991,095	12,800,000		52,654,000	65,454,000	25.2%
Richmond	11,112,169	755,810	163,341		919,151	8.3%
Scituate	20,086,630	950,942	173,581	410,834	1,535,357	7.6%
Smithfield	37,721,249	1,437,111	115,910	1,699,687	3,252,708	8.6%
South Kingstown	54,722,909	2,381,832	640,700		3,022,532	5.5%
Tiverton	23,623,340	973,814		631,676	1,605,490	6.8%
Warren	17,177,949	792,135	327,462		1,119,597	6.5%
Warwick	171,526,009	6,607,033		18,063,886	24,670,919	14.4%
Westerly	49,814,912	2,183,822	30,159	2,080,267	4,294,248	8.6%
West Greenwich	12,187,033	630,193	262,649		892,842	7.3%
West Warwick	42,061,061	2,220,531		3,100,394	5,320,925	12.7%
Woonsocket	36,794,838	3,376,291	1,673,657	-	5,049,948	13.7%
	$ 1,729,097,332	$ 80,637,125	$ 16,655,531	$ 145,921,867	$ 243,214,523	14.1%

(a) source - Office of Municipal Affairs
(b) includes contributions to all plans including pay-as-you-go plans and those where an annual required contribution is not actuarially determined (as is the case with plans administered by an employee union)

Net Pension Obligation

> ***Net Pension Obligation***
>
> When a government contributes 100% of the ARC, no liability is required to be presented on the face of the government's financial statements. When less than 100% of the ARC is contributed, the difference between the ARC and the actual contribution is reflected as a liability on the government's government-wide financial statements and is referred to as the net pension obligation. When an NPO exists on a government's financial statements, this amount represents the cumulative effect of contributions that should have been, but were not, made to a pension plan.

The net pension obligation is an amount defined by generally accepted accounting principles (GAAP) for governments. This liability is included in an entity's government-wide (accrual accounting basis) financial statements along with other long-term liabilities such as bonds payable. It represents the cumulative difference between amounts actually contributed to a pension plan and the annual required contribution as determined by an actuary in accordance with guidelines permitted by GAAP.

The NPO is a measure of the effect of not contributing the annual required contribution amount. The NPO amount, together with cumulative investment income, would have been available within the plan to fund future liabilities if the annual required contribution had been made.

The larger net pension obligations of municipalities with locally administered pension plans are summarized below.

Locally Administered Pension Plan	Net Pension Obligation
Providence	$ 120,526,000
Cranston Police and Fire (pre 7/1/95)	$ 88, 555,714
Pawtucket Police and Fire (post 1974)	$ 60,341,568
Coventry Police	$ 22,001,005
Coventry Municipal Employees	$ 7,200,074
Coventry School Employees	-
East Providence Fire and Police	$ 24,668,621
Central Falls Police and Fire (pre 7/1/72)	$ 320,242
Central Falls Police and Fire (post 7/1/72)	$ 18,719,865
West Warwick	$ 17,315,472
Narragansett Town Plan	$ 6,768,072
Newport Fire	$ 5,091,759
Johnston Fire (pre 7/1/99)	$ 3,018,000
Johnston Police	$ 1,079,000
North Providence Police	$ 2,767,818
Westerly Police	$ 2,112,378

Unfunded Actuarial Accrued Liability

> ***Unfunded Actuarial Accrued Liability***
>
> The Actuarial Accrued Liability (AAL) is the present value of fully projected benefits attributable to service credit that has been earned. The Unfunded Actuarial Accrued Liability (UAAL) is the difference between the AAL and the actuarial value of assets available to pay benefits.

The Unfunded Actuarial Accrued Liability (UAAL) is determined as a result of periodic actuarial valuations usually performed annually. The UAAL is the by-product of measuring both the assets and projected benefits (liabilities) of the plan using actuarial assumptions and methodologies. These measures become the basis for developing the annual required contribution amount and the funded ratio.

Basically, the UAAL demonstrates how well assets have been accumulated to meet future benefit obligations to retirees. The UAAL is expressed in dollars whereas the funded ratio uses the same data to express what percentage of the liability for future benefits (AAL) has been funded by the actuarial value of assets.

Some governments have issued pension obligation bonds to finance the unfunded actuarial accrued liability in their pension funds. In essence the pension obligation bonds provide a source of cash to pay off the unfunded pension liability. In selling these bonds, governments are counting on plan investment earnings being greater than the interest paid on the pension obligation bonds. Obviously, there is the risk that the market may not generate investment returns to exceed the rate paid on the bonds. Furthermore, once the bonds are issued, a government is committed to the debt service schedule whereas a government typically has more flexibility in deciding on the amount and the specific timing of future pension contributions. Through issuance of pension obligation bonds, a “soft” liability is exchanged for a “hard” liability.

Locally, the City of Woonsocket issued $90 million of pension obligation bonds in fiscal 2003. More recently, the City of Providence sought General Assembly approval to issue up to $700 million of pension obligation bonds to finance the unfunded liability in its pension plan. Providence’s proposal included closing the pension plan to new employees and providing new hires with a defined contribution plan.

The consideration of pension obligation bonds is often controversial since the amount of bonds contemplated is usually significant to the entity’s overall debt burden and the market returns required to ensure the viability of the proposal are anything but certain. The worst-case scenario is when investment returns fail to meet required amounts and further contributions are required to the pension plan in addition to the debt service on the bonds.

The State of New Jersey issued $2.8 billion in pension obligation bonds that initially met expectations in that investment returns exceeded the interest it was paying on the bonds. As investment returns later dipped due to market conditions, the situation reversed and New Jersey is now required to contribute to the pension plan in addition to meeting the debt service on the pension obligation bonds.

The table on the next page highlights the unfunded actuarial accrued liability and funded ratio (as of the most recent valuation included in the municipality’s fiscal 2006 financial statements) for each of the 37 pension plans administered by Rhode Island municipalities including the funded ratio trend for the period 2002-2006. When pension information was omitted or incomplete in the audit report we requested information from the municipality.

State of Rhode Island Municipal Pension Plans
Unfunded Actuarial Accrued Liability (UAAL)

Municipality	Pension Plan	Date of Valuation	Actuarial Value of Assets	Actuarial Accrued Liability	Unfunded Actuarial Accrued Liablity	Funded Ratio	Funded Ratio Trend 2002-2006
Bristol	Police Pension Plan (prior to 3/22/98)	6/30/2006	$ 11,575,785	$ 17,184,668	$ 5,608,883	67.0%	decreasing
Central Falls	Police & Fire (after 7/1/72) John Hancock	7/1/2006	10,909,756	31,509,376	20,599,620	34.6%	consistent
	Police & Fire (prior to 7/1/72) 1%	7/1/2006	1,146,741	15,738,443	14,591,702	7.3%	consistent
Coventry	Town's Municipal EE Retirement Plan	1/1/2006	2,491,657	13,834,699	11,343,042	18.0%	decreasing
	Police Pension Plan	1/1/2006	3,875,285	49,041,156	45,165,871	8.0%	consistent
	School EE's Pension Plan	9/1/2004	8,176,178	17,544,846	9,368,668	46.6%	unavailable
Cranston	Police & Fire EE's Pension Plan (prior to 7/1/95)	7/1/2006	39,931,111	257,474,713	217,543,602	15.5%	increasing
Cumberland	Town of Cumberland's Pension Plan	7/1/2005	9,288,610	15,617,633	6,329,023	59.5%	inconsistent
East Providence	Firemen's & Policemen's Pension Plan	10/31/2006	73,760,000	105,480,000	31,720,000	70.0%	decreasing
Jamestown	Police Pension Plan	3/1/2004	6,745,427	5,442,622	(1,302,805)	123.9%	increasing
Johnston	Police	6/30/2005	11,455,511	37,167,194	25,711,683	30.8%	increasing
	Fire (prior to 7/1/99)	6/30/2005	13,549,265	44,078,961	30,529,696	30.7%	increasing
Lincoln	Town Retirement Plan	1/1/2006	15,730,030	17,296,311	1,566,281	90.9%	decreasing
Little Compton	Town Employees Other than Certified Teachers	7/1/2005	4,732,930	5,883,241	1,150,311	80.5%	consistent
Middletown	Town Plan	6/30/2005	7,926,793	10,974,290	3,047,497	72.2%	decreasing
Narragansett	Police Plan (prior to 7/1/78)	7/1/2005	48,555	949,819	901,264	5.1%	decreasing
	Town Plan	7/1/2005	41,278,370	52,236,039	10,957,669	79.0%	consistent
Newport	Firemen's Pension Plan	7/1/2006	27,413,402	68,671,042	41,257,640	39.9%	increasing
	Policemen's Pension Plan	7/1/2006	39,118,117	62,635,048	23,516,931	62.5%	increasing
North Kingstown	Police Pension Fund (retired as of 6/30/96)	7/1/2006	3,508,888	2,374,917	1,133,971	147.8%	decreasing
North Providence	Police Pension Plan	7/1/2006	18,763,757	27,794,462	9,030,705	67.5%	decreasing
Pawtucket	Pre 1974 Policemen & Firemen (pay as you go)	N/A					
	Post 1974 Policemen & Firemen	7/1/2005	62,097,816	146,146,982	84,049,166	42.5%	consistent
Portsmouth	Employees of the Town of Portsmouth	7/1/2006	25,129,703	38,459,122	13,329,419	65.3%	consistent
Providence	ERS of the City of Providence	6/30/2006	393,768,000	1,052,805,000	659,036,000	37.4%	consistent
Scituate	Police Pension Plan	4/1/2005	2,510,044	6,778,751	4,268,707	37.0%	increasing
Smithfield	Police (prior to 7/1/99)	7/1/2005	7,161,996	19,691,681	12,529,685	36.0%	increasing
	Fire Pension Plan	7/1/2006	12,402,997	14,392,140	1,989,143	86.0%	consistent
Tiverton	Policemen's Pension Plan	7/1/2005	5,490,958	11,006,944	5,515,986	49.9%	decreasing
Warwick	City Employees Pension Plan	7/1/2004	64,006,602	81,587,332	17,580,730	78.5%	consistent
	Police Pension II Plan	7/1/2005	106,857,258	104,458,087	(2,399,171)	102.3%	decreasing
	Police Pension I & Fire Pension Plan	7/1/2005	71,984,600	266,825,982	194,841,382	27.0%	consistent
	Fire Pension Plan II	7/1/2005	7,571,670	8,774,481	1,202,811	86.3%	decreasing
	Warwick Public Schools Employee Pension Plan	7/1/2006	30,185,621	37,280,441	7,094,820	81.0%	consistent
West Warwick	Town Plan	7/1/2005	40,301,196	84,051,416	43,750,220	48.0%	decreasing
Westerly	Police Pension Plan	6/30/2005	18,221,293	41,998,644	23,777,351	43.4%	decreasing
Woonsocket	Police (pre 7/1/80) and Fire (pre 7/1/85) Pension Plan	6/30/2006	87,976,576	87,180,329	(796,247)	100.9%	decreasing
		Totals	$ 1,287,092,498	$ 2,860,366,812	$ 1,575,541,256	45.0%	

The cost of providing pension payments to plan members can vary widely amongst plans and is affected by numerous factors. Calculating the UAAL per plan member allows comparison of plans of different sizes as illustrated in the table below.

Pension Plan	UAAL	Plan members (a)	UAAL per plan member
Locally administered pension plans (aggregate) (b)	$ 1,575,541,256	13,995	$ 112,579
MERS (state administered - aggregate) (b)	$ 130,289,578	14,052	$ 9,272
Providence – ERS of the City of Providence	$ 659,036,000	5,934	$ 111,061
Cranston – Police and Fire (pre 7/1/95)	$ 217,543,602	505	$ 430,779
Warwick – aggregate of 5 locally administered plans	$ 218,320,572	2,238	$ 97,552
Employees' Retirement System of RI – State employees	$ 1,680,127,552	25,025	$ 67,138
Employees' Retirement System of RI – Teachers (state administered)	$ 2,638,178,890	25,049	$ 105,321

General – plan benefits and member characteristics (e.g., average salary) can vary significantly between plans which affects the comparability of the UAAL per plan member. UAAL is as of the most recent valuation included in the entity's fiscal 2006 audited financial statements.

(a) plan members includes active employees, terminated employees not collecting benefits, and retirees

(b) separate actuarial valuations are performed for each unit; the UAAL presented is the aggregate UAAL for all units -- no adjustment has been made for the inclusion of individual plans which are overfunded in the aggregate UAAL for all plans – inclusion of overfunded plans in the aggregate UAAL understates the UAAL per member.

Since plan benefits and plan member characteristics can vary significantly among plans, one must exercise caution in drawing specific conclusions from the UAAL per plan member. It is clear, however, that the UAAL is significantly impacted by failure to contribute required amounts, investment performance and specific benefit provisions. It is noteworthy that MERS has the highest funded ratio (87%) of the plans used in the foregoing comparison and it also has the smallest UAAL per plan member. For four of the last six years for which funding progress data is presented (see Appendix A) the MERS funded ratio was 100% or more. This demonstrates that timely and consistent funding of annual required amounts will generally result in significantly reduced pension costs.

Funded Ratio

The funded ratio quantifies the overall funding status of the plan and is a key measure of the fiscal health of a pension plan. It represents the relative value of the plan's assets compared to plan liabilities. The Plan's funded ratio is determined by dividing the actuarial value of assets by the actuarial value of liabilities.

Funded Ratio

The funded ratio of a pension plan is the relative value of the plan's assets and liabilities. The Plan's funded ratio is determined by dividing the actuarial value of assets by the actuarial value of liabilities.

Conceptually, a pension fund should be at or near 100% funded meaning that sufficient assets have been accumulated to meet estimated future pension liabilities. The further a plan is from 100% funded, the greater the risk that, without increased contributions and investment income or gains, assets will be insufficient to meet expected pension benefits. Larger contributions are required to make-up for the funding deficiency when plans are significantly less than the 100% funded ratio.

At the other end of the spectrum from plans that are 100% funded, plans that are pay-as-you-go use current receipts to pay current benefits with no assets set aside for future costs. In most cases, pay as you go pension plans eventually become too expensive to support with only tax receipts and contributions. This typically occurs in an established plan where the number of retirees continually increases yet the number of active employees decreases or remains relatively constant. Investment earnings count for most of the revenue generated by a prefunded plan, lessening the impact on employer contributions.

Wilshire Consulting published a report on funding levels of 125 state retirement systems in March 2006. Wilshire estimated the funded ratio for all 125 systems surveyed was 87% in 2005. Generally, nationwide funded ratios of public pension plans have declined largely due to investment losses that occurred during 2001 and 2002. As shown in Appendix A, the funded status of the Employees Retirement System of Rhode Island covering state employees and teachers and the Municipal Employees Retirement System has declined based on actuarial valuations performed through June 30, 2005.

Recent initiatives in other states to identify pension plans at risk have generally targeted any plan with a funded ratio less than 80%. Using this parameter, there are a number of municipalities in Rhode Island with self-administered pension plans that are at risk (based on the most recent funded ratio reported in the municipality's Fiscal 2006 audited financial statements).

- Twenty-seven self-administered pension plans have funded ratios of less than 80%.
- Eighteen self-administered pension plans have funded ratios of less than 50%.
  - Six of these plans have funded ratios less than 30%.
    - Five of the six are less than 20% funded.
    - Three of the six are less than 10% funded.

As stated earlier, some of these municipalities continue to underfund their plans as evidenced by the amount of the ARC actually contributed each year.

The tables on the next page list the 27 self-administered pension plans with a funded ratio of less than 80% as reported in the fiscal 2006 audit reports of the respective municipality. The actual percentage of their annual required contribution made in fiscal 2006 is also included in the table. The same statistics are also presented for the state administered pension plans for comparison purposes.

Locally Administered Pension Plan	Funded Ratio	% of ARC Contributed in Fiscal 2006
Narragansett Police (prior to 7/1/78)	5.1%	0%
Central Falls Police and Fire (prior to 7/1/72)	7.3%	127%
Coventry Police	8.0%	28%
Cranston Police And Fire (pre 7/1/95)	15.5%	98%
Coventry Municipal Employees	18.0%	13%
Warwick Police Pension I and Fire	27.0%	100%
Johnston Fire (prior to 7/1/99)	30.7%	93%
Johnston Police	30.8%	100%
Central Falls Police & Fire (after 7/1/72)	34.6%	8%
Smithfield Police (prior to 7/1/99)	36.0%	153%
Scituate Police	37.0%	101%
Providence	37.4%	96%
Newport Firemen's	40.0%	100%
Pawtucket Post 1974 Police and Fire	42.5%	54%
Westerly Police	43.4%	96%
Coventry School Employees	46.6%	n/a
West Warwick Town Plan	48.0%	47%
Tiverton Police	49.9%	100%
Cumberland	59.5%	101%
Newport Policemen's	62.5%	100%
Portsmouth	65.3%	100%
Bristol Police (prior to 3/22/98)	67.0%	53%
North Providence Police	67.5%	92%
East Providence Firemen's and Policemen's	70.0%	24%
Middletown Town	72.3%	95%
Warwick City Employee's	78.5%	100%
Narragansett Town Plan	79.0%	47%

State Administered Pension Plans	Funded Ratio *	% of ARC Contributed in Fiscal 2006
Employees' Retirement System - State Employees	56.3%	100%
Employees' Retirement System - Teachers	55.4%	100%
Municipal Employees' Retirement System	87.2%	100%

* funded ratio is as of valuation performed at June 30, 2005

Investment Performance

Investment Performance

In addition to contributions, investment income is another source of funds to provide current and future pension benefits. Investment performance can be measured against the actuarial assumed rate of return and investment returns obtained by other similar investors.

After making annual required contributions, the next most important factor impacting the financial health of a pension plan is overall investment performance. Achieving average investment returns equal to the assumed rate of return used in periodic actuarial valuations is necessary to meet planned funding targets. Failure to meet the assumed rate of return adds to the growth in plan liabilities.

According to *Public Fund Survey Summary of Findings for FY 05* issued by the National Association of State Retirement Administrators in September 2006, one of two important actuarial assumptions incorporated into calculating a plan's long-term liabilities is investment return.

Since a majority of revenue for most public pension funds comes from investment earnings, the nominal and real rate of return assumptions can have a dramatic effect on a plan's funding level and required contributions.

The assumed rates of return for pension plans administered by Rhode Island municipalities ranged from 6.5% to 9.0% with an average of 7.85%. The assumed rate of return used by the State of Rhode Island Employees Retirement System is 8.25%.

Nationally, many plans have adjusted downward their assumed non-inflation-adjusted investment return assumption. Although 8% is the most popular assumption, the number of plans using an assumption lower than 8% has increased.

Smaller plans typically have difficulty achieving the overall investment performance of larger plans because they have fewer opportunities to spread risk, cannot invest as efficiently (higher costs), may not have access to all types of potentially higher yielding investments and may not have developed appropriate asset allocation strategies to diversify risk.

The average five-year investment performance of the locally-administered pension plans in Rhode Island varied widely from a high of 9.4% to a low of -0.9%. The five-year average investment return of the locally-administered plans was, with one exception, consistently less than returns earned by the State administered Employee's Retirement System of RI. The five-year average rate of return and comparison to the assumed rate of return for the Employees' Retirement System is highlighted below. The same comparison for each of the locally administered pension plans is included in the table on the next page.

		Actual Rate of Return *						
Pension Plan	Assumed Rate of Return	2002	2003	2004	2005	2006	Average rate of return	Average return compared to assumed return
Employees Retirement System- State of Rhode Island	8.25%	-8.3%	3.9%	19.5%	12.2%	12.6%	8.0%	-0.25%

* Actual annual rates of return as reported by the Employees' Retirement System on a time-weighted average return basis.

Municipal Pension Plans - comparison of assumed rate of return to actual rate of return

Municipality	Pension Plan	Assumed Rate of Return	Actual Rate of Return					Average rate of return	Average return compared to assumed return
			2002	2003	2004	2005	2006		
Bristol	Police Pension Plan (prior to 3/22/98)	8.00%	-6.5%	2.4%	11.7%	5.3%	2.5%	3.1%	-4.9%
Central Falls	Police & FireJohn Hancock (after 7/1/72)	7.75%	4.1%	3.7%	6.9%	10.7%	8.5%	6.8%	-1.0%
	Police & Fire 1% (prior to 7/1/72)	7.50%	2.5%	1.7%	1.3%	1.4%	2.1%	1.8%	-5.7%
Coventry	Town's Municipal EE Retirement Plan	7.25%	8.1%	7.0%	9.0%	5.9%	6.3%	7.3%	0.0%
	Police Pension Plan	6.50%	8.9%	6.3%	8.5%	6.7%	7.2%	7.5%	1.0%
	School EE's Pension Plan	7.00%	-3.7%	8.2%	9.6%	8.7%	n/a	4.5%	-2.5%
Cranston	Police & Fire EE's Pension Plan (prior to 7/1/95)	8.00%	-5.3%	1.7%	0.8%	2.9%	8.3%	1.7%	-6.3%
Cumberland	Town of Cumberland's Pension Plan	8.25%	-4.9%	0.6%	5.6%	-10.7%	4.8%	-0.9%	-9.2%
East Providence	Firemen's & Policemen's Pension Plan	8.50%	-5.3%	14.3%	9.1%	9.9%	15.6%	8.7%	0.2%
Jamestown	Police Pension Plan	7.00%	-2.3%	-2.7%	12.7%	0.6%	3.3%	2.3%	-4.7%
Johnston	Police	7.75%	-3.7%	1.9%	8.0%	4.4%	8.1%	3.8%	-4.0%
	Fire (prior to 7/1/99)	7.75%	-12.2%	5.2%	15.7%	7.5%	8.2%	4.9%	-2.9%
Lincoln	Town Retirement Plan	8.00%	13.4%	7.9%	9.0%	7.9%	8.7%	9.4%	1.4%
Little Compton	Town Employees Other than Certified Teachers	7.50%	-12.1%	3.2%	8.5%	7.5%	8.4%	3.1%	-4.4%
Middletown	Town Plan	7.50%	-0.7%	3.8%	12.5%	6.9%	9.1%	6.3%	-1.2%
Narragansett	Police Plan (prior to 7/1/78)	7.50%	-3.7%	3.0%	11.8%	6.3%	0.0%	3.5%	-4.0%
	Town Plan	7.50%	-3.7%	3.0%	11.8%	6.3%	8.4%	5.1%	-2.4%
Newport	Firemen's Pension Plan	8.25%	-9.1%	21.7%	10.8%	1.9%	8.4%	6.7%	-1.5%
	Policemen's Pension Plan	8.25%	-9.1%	21.7%	10.8%	1.9%	8.3%	6.7%	-1.5%
North Kingstown	Police Pension Fund (retired as of 6/30/96)	7.50%	5.7%	4.3%	3.6%	3.7%	-1.8%	3.1%	-4.4%
North Providence	Police Pension Plan	8.00%	0.9%	4.6%	13.7%	8.2%	10.2%	7.5%	-0.5%
Pawtucket	Pre 1974 Policemen & Firemen (pay as you go)								
	Post 1974 Policemen & Firemen	8.00%	-2.5%	5.4%	11.6%	10.0%	7.4%	6.4%	-1.6%
Portsmouth	Employees of the Town of Portsmouth	8.00%	-0.4%	-7.1%	14.7%	8.7%	4.6%	4.1%	-3.9%
Providence	ERS of the City of Providence	8.50%	-3.5%	1.2%	22.7%	8.3%	12.2%	8.2%	-0.3%
Scituate	Police Pension Plan	9.00%	5.4%	-12.3%	26.6%	6.9%	n/a	5.3%	-3.7%
Smithfield	Police (prior to 7/1/99)	8.50%	-21.4%	-7.7%	15.2%	4.3%	7.3%	-0.5%	-9.0%
	Fire Pension Plan	8.50%	-17.4%	-3.1%	17.4%	7.7%	8.2%	2.6%	-5.9%
Tiverton	Policemen's Pension Plan	7.00%	-9.9%	10.6%	6.4%	5.2%	5.9%	3.6%	-3.4%
Warwick	City Employees Pension Plan	8.00%	-3.1%	5.2%	14.3%	n/a	n/a	3.3%	-4.7%
	Police Pension II Plan	8.00%	-3.5%	4.9%	15.0%	9.5%	n/a	5.2%	-2.8%
	Police Pension I & Fire Pension Plan	8.00%	-6.3%	2.5%	16.6%	9.2%	n/a	4.4%	-3.6%
	Fire Pension Plan II	8.00%		1.3%	13.7%	8.2%	n/a	4.6%	-3.4%
	Warwick Public Schools Employee Pension Plan	7.00%	5.6%	7.7%	10.4%	6.7%	8.2%	7.7%	0.7%
West Warwick	Town Plan	8.50%	-11.3%	3.4%	11.7%	4.5%	8.6%	3.4%	-5.1%
Westerly	Police Pension Plan	8.00%	1.0%	10.6%	6.4%	4.8%	4.3%	5.4%	-2.6%
Woonsocket	Police (pre 7/1/80) and Fire (pre 7/1/85) Plan	8.25%	-12.7%	7.9%	7.9%	8.5%	6.6%	3.6%	-4.6%
	Average	7.85%	-3.4%	4.3%	11.2%	5.9%	6.9%	4.7%	-3.1%

Of the 37 pension plans that are locally administered (as reported in the table on the preceding page) all but 5 experienced average five-year investment returns which were less than the assumed rate of return used in performing the annual actuarial valuation of the plan. In many instances the difference between actual investment performance and the assumed rate of return was significant. In the case of Cumberland and Cranston, average five-year investment returns were 9.2% and 6.3% less, respectively, than the assumed rate of return. The State Employees' Retirement System's actual five-year investment performance also trailed its assumed rate of return (8.25%) by approximately 25 basis points.

It is important to note that the average investment performance for a specific five-year period can vary widely depending upon overall market performance in those years. For example, the averages above are for the five-year period 2002-2006. Results for the five-year period 2001-2005 would have been less because market conditions were poor in 2001.

We did not assess the investments held by each of the locally administered pension plans but did obtain investment performance data from the municipality and, for fiscal 2006, made our own approximation of investment returns based on financial data included in the municipality's fiscal 2006 audited financial statements. Our fiscal 2006 investment return calculations do not consider the timing of inflows and outflows within the pension fund. Investment return data reported to us by a municipality was not independently verified. Additionally, the annual investment return may not be computed on a consistent basis among plans. The average rate of return is an approximation only intended to demonstrate investment performance relative to a plan's rate of return assumption and between plans.

The actual rates of return for Rhode Island's locally administered pension plans supports the conclusion that smaller plans struggle to achieve the same rates of return earned by larger, well diversified and professionally managed plans. Considering that investment performance can have a significant impact on the plan's funded status and contribution rates, efforts to improve investment performance by (1) merging the locally administered plans into the State administered Municipal Employees' Retirement System or (2) creating a state administered pooled investment trust for locally administered pension plans deserve serious consideration.

To demonstrate the impact of actual investment performance on a plan's funding status, we estimated investment income for the Cranston and West Warwick locally administered plans if the plans had achieved their assumed rate of return. Over the last five fiscal years (2002-2006) we estimated Cranston and West Warwick would have realized an additional $8 million and $11.9 million, respectively, had the actual investment return matched the investment return assumption for that plan. We also estimated investment income over the same five-year period if the plans had the earned the same rate of return as the Employees' Retirement System of Rhode Island. Under this scenario, the Cranston and West Warwick plans would have realized an additional $9 million and $7.4 million, respectively.

OVERSIGHT OF LOCALLY ADMINISTERED PENSION PLANS

State of Rhode Island General Laws

Rhode Island General Laws Section 45-10-15 requires the following:

- For any audit year in which a municipality contributes materially less than 100% of the annual required contribution to its pension plan(s) as reported in accordance with GASB Statement Number 27 "Accounting for Pensions by State and Local Governmental Employers" or any successor statement, the municipality shall submit to the Auditor General and the state Director of Administration:
  - the municipality's most recent actuarial study of the plan(s), and
  - management's recommendations for assuring future payments equal to the annual pension cost (APC).
- This information must be submitted within three (3) months of completion of the audited financial statement.

The General Laws of the State of Rhode Island contain few provisions regarding locally administered pension plans since the plans are established and governed by local ordinance or municipal charter provisions. Section 45-10-15 of the Rhode Island General Laws, however, requires a municipality to submit certain information when they have not contributed 100% of the annual required contribution.

The Office of the Auditor General notifies all municipalities contributing materially less than 100% of their ARC of their responsibility to develop a plan to assure future payments equal to the ARC. Although these municipalities generally develop corrective action plans, some are inadequate and problems often exist with plan implementation. Some municipalities have repeatedly failed to comply with their corrective action plans by either not appropriating the contribution stipulated or not contributing the amount appropriated if budgetary shortfalls occur elsewhere. The current law lacks enforcement provisions. Because of the flexibility locally administered plans can exercise, pension contributions (to locally administered plans) are often the first item to be cut when budgetary shortfalls arise.

Many municipalities have expressed difficulty in meeting the ARC due to constraints on their ability to raise property taxes, the primary source of revenue for most municipalities. A schedule on page 13 compares the annual required contributions for all of the pension plans a municipality participates in to its property tax levy and reports the percent of the levy that the ARC represents.

ACCOUNTING PRINCIPLES APPLICABLE TO GOVERNMENTAL PENSION PLANS

The Governmental Accounting Standards Board (GASB) issues accounting principles for governmental entities. In general, these accounting principles (1) require that periodic actuarial valuations be performed of governmental pension plans, (2) define the acceptable actuarial methods that can be used in valuing pension benefit liabilities, and also (3) specify the pension related disclosures that must be included in the annual financial reports of a governmental entity.

Governmental accounting principles relating to pensions specify how pension costs are measured, reported, and disclosed, however, they do not mandate actual funding requirements. For instance, a municipality that fails to contribute 100% of the annual required contribution to its pension plan (determined in accordance with acceptable GASB guidelines) must disclose the actual amount contributed and report the full annual required contribution amount (funded and unfunded portion) as an expense in its government-wide financial statements. The amount reported in the fund level financial statements is only the actual amount funded.

A municipality's government-wide financial statements should reflect, as a long-term liability, the cumulative difference between the annual required contribution amount and the amount actually contributed to the pension plan.

Since implementation of GASB pronouncements relating to pensions, governments are required to include basic information about their pension plans that allows a reader of the financial statements to determine whether actual contributions are equal to 100% of annual required amounts, the unfunded actuarial accrued liability and the overall funded status of the plan.

SUMMARY AND CONCLUSIONS

Pension plans administered by Rhode Island municipalities are of concern because so many are considerably underfunded. The principal concern is ensuring that adequate funds will be available to meet benefit payments promised to retirees. A second and equally important concern is the negative impact these self-administered plans can have on the overall financial health of a community when not properly funded. When pension plans are chronically underfunded, the eventual costs to fund the plan become significantly larger and tend to divert resources from other programs and initiatives.

Bond rating agencies do focus on how well a community is managing its pension obligations. The rating agencies view failure to adequately manage a locally administered pension plan and overall pension obligations negatively. Consequently, this can affect the ratings assigned to debt of the municipality which directly impacts the community's borrowing costs.

Nearly one-half of the City of Cranston's general long-term debt stems from the chronic failure to contribute actuarially determined amounts to fund the City's Police and Fire Employees Retirement System. If no further contributions were made to the plan, assets available within the plan would only be sufficient to make pension benefit payments to retirees for approximately two years. Even when rating agencies upgraded the City's bond rating in 2006, they continued to cite the unfunded pension liability as an important factor.

> *"Moody's believes that the retirement system is a key component of the city's overall credit quality and continued reduction of the unfunded pension liability will be an integral part of any future rating analysis." – Moody's Investors Service*

> *"Although Cranston has made significant strides in restoring fiscal balance, its very large $220 million unfunded police and fire pension plan liability remains a credit weakness … this significant liability will continue to be a burden for years to come." – Standard & Poors Ratings Service*

It is also noteworthy that the annual required contribution for the City of Cranston's Police and Fire Employees Retirement System was $21.7 million for fiscal 2006. This plan covers 98 active members and 407 retirees for a total of 505 individuals. In contrast, the aggregate annual required contribution for all participating entities in the Municipal Employees Retirement System (MERS) was $20.1 million covering a total of 14,052 individuals (active and retirees). This significant disparity in the relative annual required contribution between the plans results from the impact of Cranston not contributing required amounts each year and the benefits afforded retirees under the Cranston plan relative to those in MERS.

Improving the funded status of these plans presents a significant hurdle to many communities that are already challenged to meet their obligations within state mandated property tax limits. As demonstrated in the table on page 13, the collective annual required contributions as a percentage of the municipality's property tax levy varies significantly by community. For five communities, the annual required contributions for pensions alone represents 20% or more the community's fiscal 2006 property tax levy – a significant burden.

Underfunded pension plans are not unique to Rhode Island. The issues associated with defined benefit plans–both public and private—have received significant attention in light of increasing actuarial liabilities for future benefits driven in large part by employees retiring earlier and living longer.

Various structural issues contribute to or facilitate the poor funded status of many locally administered plans. Clearly, local administration of the plans allows flexibility in defining the benefit structure of the plan and also the timing and actual amounts contributed to the plan. In many instances that flexibility has resulted in generous benefits and failure to make annual required contributions. Additionally, local governments typically focus on the annual budget process and consequently have a short-term perspective. That short-term focus is often inconsistent with the long-term perspective required of stewards of a pension plan. These factors directly impact the poor funded status of the plans.

In contrast, all Rhode Island municipalities are making 100% of their annual required contribution for teachers to the state administered Employees Retirement System. Similarly, all Rhode Island municipalities that participate in the Municipal Employees' Retirement System are making 100% of their annual required contribution and are adhering to the established benefit structure outlined in the State's General Laws. In these instances, the municipality must fund required amounts – the General Laws allow for offset of state aid to local governments if the municipality is delinquent in making required pension contributions to the State administered pension plans. The same fiscal discipline is not forced upon a municipality with regard to its locally administered pension plan.

When a municipality also administers a pension plan for certain of its employees, retiree benefits are often renegotiated through the collective bargaining process. Oftentimes, the "cost" of the contract focuses on the near term cash outflows for salary increases and health care but ignores the long-term and perhaps more substantial costs related to enhanced pension benefits. Consequently, the total cost of the labor contract–both short and long term—should be disclosed to those with responsibility for approving the contract terms. This may require engaging the municipality's actuary to calculate the future costs associated with the enhanced pension benefits and the impact on employer annual contributions to the plan.

Locally administered plans also lack advantage in investing accumulated pension plan assets effectively with the aim of maximizing returns yet reducing risk exposure through diversification. The smaller size of the investment portfolios associated with the self-administered plans makes it more difficult to effectively diversify assets and fully participate in all types of investment options. With some exceptions, investment returns of the self-administered plans are less than the returns earned by the State retirement system. Further, the cost of investing and the overall administrative costs of the self-administered pension plan are likely higher because of the lack of economies of scale.

We observed that information and disclosures regarding pension plans and related costs as included in a municipality's financial statements were at times incomplete or inaccurate. Accurate and timely pension information allows those vested with oversight responsibility to assess the financial health of the pension plans, and the progress made in accumulating assets to meet future benefits.

All these considerations lead to the general conclusion that self-administered pension plans can be problematic and their continued existence should be strongly reconsidered. Practically, locally administered pension plans are not likely to cease to exist immediately or in the near term. Several control measures and options should be considered or implemented to decrease the risk that these plans will be unable to meet their benefit obligations to retirees or negatively impact a community's overall fiscal health.

One option that has been widely adopted by the private sector is establishing defined contribution plans rather than defined benefit plans. These are attractive since once the required employer contribution is made to the defined contribution plan, the employer has no further liability. One of the primary benefits of a defined-contribution plan, from a government employer's perspective, is that it provides a great deal of stability since contribution levels are known in advance and do not change much from year to year. This is in sharp contrast to the volatility in contribution levels experienced under defined-benefit plans. Additionally, since defined contribution plans are more portable to the employee, some believe that defined contribution plans are beneficial in recruiting workers since the typical long vesting provisions of governmental defined benefit plans can be a disincentive in today's increasing mobile workforce.

Recommendations for Municipalities

1. Contribute no less than 100% of the annual required contribution (ARC) to locally administered pension plans. When current contribution levels are less than 100% of the ARC, comply with General Law section 45-10-15, and submit a plan to the Auditor General to reach a funding level that is equal to 100% of the annual required contribution. Once a plan has been developed and approved by the Auditor General, adhere to the funding plan provisions.

2. Earmark any unexpected revenues and/or budget surpluses for making supplemental contributions to any underfunded locally administered pension plan.

3. Pursue moving active members now covered by locally administered pension plans to the State administered Municipal Employees' Retirement System.

4. Consider increasing employee contributions to the locally administered pension plans to lessen the impact of increased contribution rates to employers.

5. Consider defined contribution plans for new hires rather than defined benefit plans to control municipal retirement plan costs.

6. Ensure that local government financial statements include all required financial information and related disclosures regarding pension plans covering the municipality's employees. This would provide readers with adequate information about pension costs, the funded status of the plans and progress made in accumulating assets to fund future pension benefits.

7. Prepare a fiscal note detailing the impact on contribution rates and funded status of a locally administered pension plan when pension benefits are affected by new collective bargaining agreements. The fiscal note should provide the governing body approving the contract with sufficient information to ascertain the full cost of the proposed collective bargaining agreement.

Matters Warranting Further Legislative Deliberation

The issues impacting the fiscal health of locally administered pension plans are multi-faceted and long-term in nature. It is likely that actions to address the issues will also involve various options and occur over a period of time rather than immediately. Based on our review, we have outlined various matters that we believe warrant consideration as options to ensure that promised pension benefits can be provided to employees/retirees without undermining the fiscal health of the sponsoring municipality.

1. *Create a pooled investment trust for locally administered pension plans to improve investment performance*

Self-administered plans lack advantage in investing accumulated pension plan assets effectively with the aim of maximizing returns yet reducing risk exposure through diversification. The smaller size of the investment portfolios associated with the self-administered plans makes it more difficult to effectively diversify assets and fully participate in all types of investment options. With some exceptions, investment returns of the self-administered plans are less than the returns earned by the State retirement system. Further, the cost of investing and the overall administrative costs of the self-administered pension plan are higher because of the lack of economies of scale.

Optimally, locally administered plans should be merged into the State administered MERS plan – this option best addresses all the concerns associated with the locally administered plans. If these efforts are unsuccessful, a pooled investment trust, administered by the State should be explored to optimize the advantages of a professionally managed, well-diversified investment option. With a pooled investment trust, the assets of locally administered pension plans are commingled for investment purposes. Investment gains and losses are distributed pro-rata to each participating entity. This would allow for broader diversification of assets thereby mitigating risk, enhancing investment returns through exposure to a wider variety of investment vehicles and reducing costs by spreading asset management expenses over a larger base. The State could utilize the existing structure in place to invest assets of the Employees' Retirement System. Since the investment objectives of the local pooled investment trust would be similar if not the same as the ERS, the same asset allocation model and investment objectives could be followed.

2. *Amend the general laws to enhance the enforcement provisions relating to communities that are not funding 100% of the annual required contribution to their locally administered pension plan*

Due to the significant negative impact that underfunding pension plans can have on a municipality's long-term fiscal health, a bill was introduced in both the 2005 and 2006 sessions of the Rhode Island General Assembly in an effort to increase compliance with funding the ARC.

The bill addressed contributions by municipalities to self-administered municipal pension funds as follows:

- For any pension plan(s) administered directly by a municipality or at the direction of the municipality, the municipality shall budget and contribute the full actuarially computed annual required contribution as set forth in the most recent actuarial study of the plan(s), in accordance with GASB Statement 27 or any other successor statement, unless it receives the approval of the state auditor general to make a contribution which is less than said annual required contribution.

- In the event the municipality seeks to contribute less than one-hundred percent (100%) of the annual required contribution, it shall request approval for the lesser contribution from the state auditor general no less than sixty (60) days prior to the date it submits the municipal budget to the local government body responsible for the approval of said budget. In support of its request to the auditor general, the municipality shall submit all financial information which the auditor general requires to render a decision, including the most recent actuarial study of the plan(s). The failure to cooperate in providing the information to the auditor general shall result in the denial of the request.

- All municipalities shall be required to have an actuarial study of all its pension plans performed at least every two (2) years. The state auditor general may require said actuarial study on a more frequent basis if he or she determines a more frequent study is warranted by the fiscal status of the municipality. The actuarial study shall be deemed a public record, and the actuary is hereby authorized to provide the study as well as all supporting data used in said study to the state auditor general without the approval of the municipality to release said study and data.

- In the event that a municipality does not comply with the requirements of this law, the state auditor general may elect any or all of the following remedies:

    - Petition the superior court for mandatory injunctive relief seeking compliance with the provisions of this section. The superior court shall make a finding of fact as to whether there has been compliance with the provisions of this section. In the event the court finds that the municipality has failed to make the annual required contribution to the pension plan(s) as indicated in the actuarial study, or lesser amount set by the auditor general, the court shall order the municipality to make said contribution(s). The approval or disapproval of a request by the state auditor general under this section shall be conclusive upon the court.

    - Re-direct state aid to the pension plan(s). The state general treasurer, upon the request of the auditor general shall adjust state aid by making direct payment of state aid monies originally designated for purposes other than for education into the pension plan(s) in an amount necessary to make the full annual required contribution. The redirecting of this state aid shall reduce the overall state aid originally budgeted to the municipality, other than state aid to the municipality for education. (The state municipal employees retirement system presently has the ability to do this for municipalities that participate in their state administered plans.) The finance director of the municipality shall be required to insure that state aid redirected under this section is deposited into the pension plan(s) and not allocated or used for any other purpose. The superior court shall have jurisdiction to enforce this section upon petition of either the state auditor general or any member of the pension plan(s).

This bill did not pass but serves as an outline for enhanced State oversight of the locally administered pension plans.

If a municipality determines that it is unable to comply with the requirement to fully fund its ARC by developing a plan which increases the ARC to 100% over a reasonable period of time (e.g. a five-year period); other measures (such as those described herein) need to be explored in an effort to remedy the financial burden these pensions place on the municipality.

3. <u>Prevent municipalities from establishing new pension plans (other than through the Municipal Employees' Retirement System) or expanding benefits provided under existing locally administered plans</u>

Due to the overwhelming evidence that locally administered plans can easily become problematic due to failure to make annual required contributions and poor investment performance, creation of new locally administered pension plans should be prohibited by the General Laws. Additionally, the following measures should also be considered:

- Prohibit benefit enhancements unless a pension plan is at least 90 percent funded.
- Prohibit new employees from entering an underfunded plan — prompting employers to establish new plans with proper funding or lower benefits, or alternatively, to establish defined-contribution plans.

4. <u>Consider creating incentives to encourage municipalities to merge locally administered plans into the State Municipal Employees' Retirement System</u>

Some locally administered plans have merged with the state administered Municipal Employees Retirement System, typically by having new hires join the MERS and the prior employees remaining within the locally administered plan. The usual impediment to merging a local plan into the MERS is conforming the benefit structure of the local plan to the statutory provisions of the MERS.

Although administering the MERS with widely divergent benefit provisions for the various participating entities could be cumbersome, significant benefits such as imposing the discipline to make 100% of annual required contributions, improving investment performance, and reducing administrative costs more than outweigh any administrative disadvantages.

One incentive that could be considered would allow a local plan to merge with the MERS despite a nonconforming benefit structure. Since separate actuarial valuations are performed for each participating entity and separate contribution rates are established for each unit within MERS, a nonconforming benefit structure would not impact other participating entities.

Financial incentives are unlikely, in the near term, due to budgetary constraints and the State's own challenges in funding its pension costs for local teachers and state employees as well as post-employment health care costs for state employees.

5. ***Consider a minimum funded ratio (or other indicators), which if not achieved, would trigger enhanced State oversight and commencement of discussions to merge the plan into the State Municipal Employees' Retirement System***

A state pension oversight body could have responsibility for periodically assessing the status of locally administered pension plans and ensuring that appropriate corrective actions are taken including requiring merger of the locally administered plan into the State Municipal Employees' Retirement System. Indicators such as a funded ratio below a target (e.g., less than 80% funded) or continued failure to make 100% of annual required contributions, could trigger enhanced State oversight and prompt negotiations to merge the locally administered pension plan into the state administered MERS plan. The pension oversight body could also require increased employer, and possibly employee, contributions to a pension fund if its funded ratio is below 90 percent.

Massachusetts recently proposed an initiative whereby locally administered plans with a funded ratio of less that 80% would be required to be merged into the State retirement system.

6. ***Consider implementing a two-tiered benefit structure within MERS that is similar to the two-tiered benefit structure recently enacted for the Employees' Retirement System***

Members of the State administered Employees' Retirement System, which covers state employees and teachers are subject to a two-tiered benefit structure based on whether the member had achieved 10 years of service by July 1, 2005 (Schedule A benefits). Schedule B benefits are reduced and affect members with less than 10 years of service by July 1, 2005.

A similar two-tiered benefit structure could be implemented for members of the Municipal Employees' Retirement System (MERS). Over time this would serve to reduce the annual required contribution to the plans as more members are covered by the reduced benefit provisions.

There have been various legislative efforts made to help reduce the burdensome cost of pension plans on local governments in view of increasing budgetary constraints. For example, in Rhode Island, a bill was introduced during the 2007 session of the General Assembly to create a two-tiered benefit structure for members of MERS as to the age at which they would be eligible to retire. The legislation proposed that the retirement age requirements for employees with 10 or more years of service as of July 1, 2007 would remain unchanged. However, for non-vested or new employees the minimum retirement age, as it relates to years of service, would increase.

The law was not enacted; however, an actuarial study commissioned to determine the potential cost savings from the proposed changes estimated that Rhode Island municipalities could collectively realize annual savings of approximately $4.5 million.

7. ***<u>Contemplate what role the State may assume in helping municipalities deal with the impact of new accounting guidelines for other post-employment benefits (OPEB)</u>***

New accounting guidelines (issued by the Governmental Accounting Standards Board) relating to other post-employment benefits such as retiree healthcare will soon be effective for governmental entities. These guidelines will require governmental employers to measure the cost of the post-employment benefits provided to retirees on an actuarial basis and recognize these costs (i.e., annual required contribution) in the entity's government-wide financial statements.

The costs associated with these other post-employment benefits, specifically healthcare benefits, are significant. In most cases, governmental employers have recognized these costs on a pay-as-you-go basis and there has been no accumulation of assets to pre-fund these costs. Further, health care costs continue to increase at a dramatic pace; therefore any projection of the future cost of benefits to retirees must reflect an aggressive cost escalation trend rate.

These costs will further challenge Rhode Island municipalities as many are already struggling to properly fund their obligation for pension benefits. There may be opportunities for the State to assist the municipalities in better managing and reducing the costs of providing other post-employment benefits.

One option would be for the State to create a pooled investment trust for other post-employment benefits. This would serve as a common investment vehicle for municipalities that are accumulating assets to meet the future cost of OPEB. Similar to the benefits highlighted in number 1 above entitled "*Create a pooled investment trust for locally administered pension plans to improve investment performance*", a pooled investment trust administered by the State could provide a well diversified, professionally managed investment option for Rhode Island municipalities. It is likely that the investment return of the pooled trust could exceed the return obtained by a municipality acting individually particularly for smaller communities that are just beginning to accumulate assets for OPEB.

Another option is to administer a statewide OPEB health care plan that could decrease overall costs through economies of scale, reduce administrative costs and enhance bargaining position with health insurers. A statewide OPEB plan would also be consistent with the goal of merging locally administered pension plans into the state administered MERS plan.

Appendix A

EMPLOYEES' RETIREMENT SYSTEM OF THE STATE OF RHODE ISLAND

REQUIRED SUPPLEMENTARY INFORMATION

Schedules Of Funding Progress

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) - Entry Age - (b)	Unfunded AAL (UAAL) (b - a)	Funded Ratio (a / b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b - a) / c)
ERS (*State Employees*)						
6/30/2005	$ 2,163,391,323	$ 3,843,518,875	$ 1,680,127,552	56.3%	$ 606,474,789	277.0%
6/30/2004	2,202,900,345	3,694,787,818	1,491,887,473	59.6%	606,087,585	246.2%
6/30/2003 ±	2,267,673,016	3,517,352,031	1,249,679,015	64.5%	606,102,182	206.2%
6/30/2002	2,353,855,871	3,284,126,961	930,271,090	71.7%	586,888,754	158.5%
6/30/2001	2,406,278,029	3,089,247,738	682,969,709	77.9%	539,015,218	126.7%
6/30/2000	2,345,319,663	2,874,905,547	529,585,884	81.6%	517,632,152	102.3%
ERS (*Teachers*)						
6/30/2005	$ 3,280,977,321	$ 5,919,156,211	$ 2,638,178,890	55.4%	$ 898,051,154	293.8%
6/30/2004	3,340,527,073	5,634,195,435	2,293,668,362	59.3%	866,532,598	264.7%
6/30/2003 ±	3,427,685,554	5,341,627,416	1,913,941,862	64.2%	834,642,391	229.3%
6/30/2002	3,553,823,995	4,857,003,061	1,303,179,066	73.2%	792,015,577	164.5%
6/30/2001	3,619,863,426	4,679,288,010	1,059,424,584	77.4%	748,460,527	141.5%
6/30/2000	3,514,399,312	4,359,881,262	845,481,950	80.6%	703,201,056	120.2%
State Police Retirement Benefit Trust						
6/30/2005	$ 29,616,896	$ 37,510,992	$ 7,894,096	79.0%	$ 13,225,400	59.7%
6/30/2004	24,767,014	32,689,173	7,922,160	75.8%	11,421,880	69.4%
6/30/2003	20,966,294	28,443,717	7,477,423	73.7%	11,286,365	66.3%
6/30/2002	17,770,149	23,527,125	5,756,976	75.5%	10,933,360	52.7%
6/30/2001	14,386,064	16,649,820	2,263,756	86.4%	9,139,418	24.8%
6/30/2000	11,336,596	13,917,343	2,580,747	81.5%	8,916,914	28.9%
Judicial Retirement Benefit Trust						
6/30/2005	$ 19,347,372	$ 22,250,728	$ 2,903,356	87.0%	$ 5,684,585	51.1%
6/30/2004	16,019,053	21,845,744	5,826,691	73.3%	5,637,865	103.3%
6/30/2003	13,270,977	18,435,395	5,164,418	72.0%	5,303,153	97.4%
6/30/2002	11,129,208	16,243,709	5,114,501	68.5%	4,738,059	107.9%
6/30/2001	9,190,325	12,026,257	2,835,932	76.4%	4,092,423	69.3%
6/30/2000	7,374,851	9,719,608	2,344,757	75.9%	3,533,354	66.4%
MERS						
6/30/2005	$ 886,964,787	$ 1,017,254,365	$ 130,289,578	87.2%	$ 265,123,725	49.1%
6/30/2004	879,449,653	943,536,048	64,086,395	93.2%	258,985,220	24.7%
6/30/2003	885,842,533	879,589,065	(6,253,468)	100.7%	241,201,031	(2.6)%
6/30/2002	907,193,399	814,857,497	(92,335,902)	111.3%	247,613,063	(37.3)%
6/30/2001	895,475,425	758,089,758	(137,385,667)	118.1%	225,827,136	(60.8)%
6/30/2000	885,392,216	710,616,311	(174,775,905)	124.6%	207,834,738	(84.1)%

± Restated June 30, 2003 actuarial value after adopting Article 7, Substitute A as Amended

Source – Fiscal 2006 audited financial statements of the Employees Retirement System of Rhode Island