



AUDIT SUMMARY

ERNEST A. ALMONTE, CPA, CFE
AUDITOR GENERAL
ernest.almonte@oag.ri.gov

INTEGRITY ♦ RELIABILITY ♦ INDEPENDENCE ♦ ACCOUNTABILITY

Status of Pension Plans Administered by Rhode Island Municipalities JULY 2007

We performed a review 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. Our review was based primarily on data which is publicly available in the audited annual financial statements of each municipality and periodic actuarial valuations of the plans.

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

REPORT HIGHLIGHTS

- 21 of the locally administered plans were considered to be at risk due to the poor funded status of the plan, failure to contribute annual required amounts or declining contributions.
- Total assets collectively held by the 37 locally-administered pension plans were \$1.3 billion at June 30, 2006. The collective unfunded actuarial accrued liability for future benefits was nearly \$1.6 billion for the locally-administered plans.
- Employer contributions for pensions can represent a significant financial burden – for five communities the annual required contributions represents 20% or more of their 2006 tax levy.
- Investment performance of the locally-administered pension plans generally lagged that of the state administered Employees' Retirement System of Rhode Island.

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 (in aggregate).

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. However, 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.

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