



Audit Summary

Dennis E. Hoyle, CPA

Acting Auditor General
dennis.hoyle@oag.ri.gov

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Status of Pension and OPEB Plans

Administered by Rhode Island Municipalities

Many of the pension plans administered by Rhode Island municipalities have deteriorated further since our last report in July 2007. In several cases, municipalities have continued to contribute less than 100% of the annual required contributions and funded ratios have continued to decline; thereby, leaving some of these plans in perilous condition. At \$2.4 billion, the newly disclosed unfunded liability for other post-employment benefits provided by municipalities ("OPEB" – generally retiree healthcare) overshadows the collective unfunded liability for all locally administered pension plans which now totals \$1.9 billion.

We performed a review to assess the fiscal health of the various locally-administered pension and OPEB plans covering Rhode Island municipal employees. The fiscal health of these plans was measured by whether the municipality was consistently making 100% of required contributions to the plans, the overall funded status of the plans and the investment performance of plan assets. Information was accumulated from the audited financial statements of each municipality and periodic actuarial valuations of the plans.

The number of pension plans considered to be at risk has grown from 21 to 23 and their collective funded ratio decreased from 45%, as reported in July 2007, to 43% currently. Of the 23 (out of 36) locally administered pension plans considered to be at risk, seven were considered most at risk because the plans were significantly underfunded and annual contributions were significantly less than actuarially determined amounts. For twelve other plans, annual contributions were more than 80% of annual required amounts; however, the plans were still significantly underfunded. Four additional plans were considered at risk; despite a funded ratio greater than 60%, annual contributions were generally declining over a multi-year period. The collective unfunded liability for locally administered pension plans has increased \$300 million from \$1.6 billion in July 2007.

Many municipalities are challenged to contribute at required levels, a necessary component to eventually reduce unfunded liabilities. 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 and reductions in state aid to municipalities. Recent investment losses have further eroded the funded ratios of the plans although the full impact of those market conditions has yet to be recognized in actuarial valuations of the plans.

Governmental employers must now recognize OPEB costs on an actuarial basis. These costs are almost totally unfunded - the collective unfunded liability for OPEB benefits is \$2.4 billion and assets to cover less than 1% of the actuarial accrued liability have been set aside.

The collective annual required contributions (for pensions) for all municipalities was approximately \$295 million for fiscal 2009 of which \$161 million related to locally-administered plans. The annual required contribution for OPEB plans was \$190 million. The total annual cost to municipalities (if 100% of the required contributions were made) was \$485 million. The amount actually funded was approximately \$367 million.

For nine communities, the annual required contribution for pensions and OPEB (if 100% were made) represents 25% or more of the community's fiscal 2009 property tax levy – a significant and likely unsustainable burden. In Central Falls, Pawtucket, and Johnston the annual required contributions (for pensions and OPEB) were 57%, 59%, and 47%, respectively, of their annual property tax levy.

Report Highlights

- 23 out of 36 locally administered pension plans are considered at risk due to poorly funded status, failure to contribute annual required amounts or declining contributions.
- The collective unfunded liability of the locally administered pension plans is \$1.9 billion. The funded ratio of these plans decreased from 45% in 2007 to 43% currently.
- The collective unfunded liability for municipal OPEB (primarily retiree healthcare) plans is \$2.4 billion. These plans are less than 1% funded.

All municipal OPEB plans are locally administered. Consistent with the conclusions outlined herein that locally administered pension plans are at risk, locally administered OPEB plans should likely be viewed in the same light. An opportunity exists to restructure plan design and benefit delivery before each community creates a trust and begins to accumulate assets to fund future benefits.

Underfunded pension and OPEB 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

March 2010

actuarial liabilities for future benefits. This is driven in large part by employees retiring earlier and living longer as well as recent investment losses.

Various structural issues contribute to or facilitate the poorly 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 have a short-term annual budget process perspective which is often inconsistent with the long-term perspective required of pension plan stewards. These factors directly impact the poorly 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. The MERS plan has a funded ratio of 93%. 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 \$20.1 million for fiscal 2009. This plan, which covers just 70 active members and 426 retirees for a total of 496 individuals, has been chronically underfunded (funded ratio of 15.1%). In contrast, the aggregate annual required contribution for all participating entities in the Municipal Employees' Retirement System (MERS) was \$33.5 million covering a total of 14,667 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 unfunded liability under the Cranston Police and Fire plan is estimated at an average \$492,413 per member compared to \$6,253 per member under the State-administered MERS plan.

Similarly, the fiscal 2009 annual required contribution to the City of Providence's pension plan for its employees (excluding teachers) was \$48.5 million of which the City made 100% of the required contribution. The composite employer contribution rate (different rates are actually applied to different groups of employees - e.g., police, fire, general) was 41.95% of payroll. Within the rate, only 5.81% related to normal or current service costs and 36.14% related to amortization of the unfunded liability and interest thereon.

Due to their size, locally administered plans are at a disadvantage in investing plan assets 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 fully participate in all types of investment options. With some exceptions, investment returns of the self-administered plans are generally less than the returns earned by the State retirement system.

Since fully funding these plans in the near term is unlikely given the current fiscal stress on all municipalities, several control measures and options should be considered and implemented to decrease the risk that these plans (1) will be unable to meet their benefit obligations to retirees, or (2) continue to negatively impact a community's overall fiscal health.

We recommended previously, and continue to recommend, 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, municipalities should consider alternatives to defined benefit plans (e.g., defined contribution, and "hybrid" plans) for new hires. We also recommend that municipalities adopt a plan to begin funding OPEB liabilities and revise benefits as needed to ensure that OPEB plans are sustainable.

In addition, we identified a number of matters that 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 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 administering either a pooled investment trust for assets accumulated by municipalities to fund their OPEB liabilities or offering a multiple-employer agent OPEB plan to achieve economies of scale and cost savings in providing post-retirement healthcare benefits to municipal employees. This later option would be consistent with (1) the goal of merging locally administered pension plans into the state-administered MERS plan and (2) various initiatives to foster a statewide healthcare contract for teachers and municipal employees with a common health insurer/administrative agent.

Copies of this report can be obtained by calling 222-2435 or by visiting our website at www.oag.ri.gov.