

# Plan Design from a Local Perspective

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PAPERS

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# Agenda

- Basic Plan Designs
- Current Plan Designs
  - State Employees' Retirement System (SERS)
  - Public School Employees' Retirement System (PSERS)
  - 67 County Employee Retirement Systems
  - 3,228 Municipal Government Plans
    - 965 Police/82 Fire/2,181 Non-Uniformed
    - Defined Benefit: 70.3% of Plans/92.2% of Employees
  - What can be done?/What should be done?/Why can't we do anything?
  - §403(b) and §457 plans
  - Funding Facts

# Basic Plan Design

- Defined Benefit Plan
  - Benefit determined by formula (e.g., based on pay, service)
  - Can have multiple formulas for different tiers.
  - Ancillary benefits (death, disability)
  - Optional forms of payment at retirement
  - Risks and rewards accrue to employer (investment, longevity)
- Defined Contribution Plans
  - Contribution determined by formula (% of pay)
  - Benefit based on account earnings
  - Risks and rewards accrue to participant

# “Hybrid” Plans

- Cash Balance Plan
  - Account balance resembles defined contribution plan
  - Benefit funded like a defined benefit plan
    - Accounts credited with fixed rate or index
    - Employer contributions vary with actual investment return
- Pension Equity Plan
  - Benefit is lump sum based on formula (salary, service)
  - Account balance funded like defined benefit plan
- Floor/Offset Plan-Defined benefit plan provides minimum benefit in excess of benefit from defined contribution plan
- Target Benefit Plan-Defined contribution plan with contributions calculated to fund defined benefit

# Public Employees Pension Plans in PA

- State Employees' Retirement System (SERS)
- Public School Employees' Retirement System (PSERS)
- 67 County Employee Retirement Systems
- 3,228 Municipal Government Plans
  - 965 Police/82 Fire/2,181 Non-Uniformed
  - Defined Benefit: 70.3% of Plans/92.2% of Employees

# State Employees' Retirement System (SERS)

- Defined benefit plan
- Tiered System
- Required member contributions to fund pension; may be withdrawn at retirement (grandfathered employees) with reduced monthly pension
- Voluntary member contributions purchase additional pension
- Newer members may have to make additional “risk-based” contributions based upon fund earnings

# Public School Employees' Retirement System (PSERS)

- Covers employees of public school, community college, Penn State and State-owned Universities
- Defined benefit plan
- Required member contributions to fund pension
- Class Basis: Benefit formula and member contributions based on hire date and elections
- Funded by state and local school boards

# County Pension Plans (Act 96)

- Defined benefit pension based upon compensation (36 month average salary) and service
- Mandatory member (plus voluntary) contributions may be refunded or annuitized to purchase additional pension at retirement
- Member contributions credited with fixed rate of interest
  - Employer receives gain from any excess interest on member contributions
  - Acts like cash balance plan



# Local Municipal Plans

- Funding governed by Act 205 of 1984
- Third class city code (police, fire and non-uniformed)
  - Benefits generally 50% of final month's pay after 20 years of service (age 50 or no age requirement for uniformed, age 60 for non-uniformed)
- First and second class city benefits similar
- Boroughs and Townships
  - 3 or more police: Act 600
    - Retirement at 55/25 (or 50/25)
    - Pension of 50% of final 36 month average salary
  - Non-police: open benefit structure

# Features of Municipal Plans

- Vesting
- DROP Plans
- Disability and survivor pensions
- Service purchase (e.g., military, part-time, leave)
- General Municipal Pension System State Aid
- Collective bargaining
- Political decisions
- Pension spiking

# Impediments to Change

- State law (e.g., Act 600)
- Collective bargaining contracts
- State Constitution: Section 17, Ex Post Facto Laws; Impairment of Contracts
  - No ex post facto law, nor any law impairing the obligation of contracts, or making irrevocable any grant of special privileges or immunities, shall be passed.

# What Can Be Done

- Tiered Benefits
  - SERS
  - PSERS
  - County Plans
- Boroughs and Townships: Defined contribution or hybrid plans for new employees
- State Legislation
- Governor's Budget/challenge to prior court rulings

# Why Keep Defined Benefit Plans?

- Risk pooling
  - Investment gains and losses
  - Longevity
- Efficient delivery of benefits
  - Individual allocation and investment advice is expensive
  - Individuals tend to invest more conservatively than large funds
- Ancillary benefits-Defined contribution plan can only pay account balance
- Is the problem the size of the benefit, the lack of funding commitment, or the type of plan itself?

# 403(b) and §457 Plans

Purpose: Help employees fund additional retirement income on a tax-preferred basis

Plan Sponsorship:

- §403(b) plans can be sponsored by state or local government entities
- §457 plans can be sponsored only public schools, universities or other “educational institutions”

May use tax-deferred or “Roth” accounts

# History of §403(b) and §457 Plans

§403(b) added to Internal Revenue Code in 1958  
(public educational institutions added in 1961)

Original products were annuities

- Life insurance product (endowment)
- High commission

Replaced by front-end loaded annuities

Today's fixed annuities are no-load, surrender charges  
first 8-11 years

Equity-linked and variable annuities

Custodial accounts

# 403(b) and §457 Deferral Limits

\$17,500 (2013) basic deferral limit

§403(b) combined with other §401(k), §403(b) plans

§457 combined with other §457 plans

“Catch-up” Contributions: greater of

- \$5,000 (2013) under §414(v)
- §457: Greater of:
  - Twice the dollar limitation, or
  - Unused maximum from prior years
- §403(b): Lesser of:
  - \$3,000
  - \$15,000 less prior years’ “catch-ups” (\$3,000)
  - \$5,000 for each year of service, less prior employer contributions



## §403(b) and §457 Employer Contributions, Discrimination Rules

### §403(b):

- Total contribution limited to \$51,000 (2013) plus “catch-up” contributions
- Universal availability

### §457:

- Limited to members deferrals (\$17,500 plus “catch-up”)
- Non-discrimination rules do not apply to state or local government entities; regulations pending for others

# Investment Arrangements

§403(b):

- Annuity contracts (tax-sheltered annuities)
- Custodial accounts

§457-Must be funded by assets insulated from claims of creditors

# Other Features

- Rollovers between these plans and §401(k) plans are allowed (except §457 plans for non-govt. employers)
- Rollovers to IRAs are allowed (except §457 plans for non-govt. employers)
- Loans allowed, subject to §72(p) restrictions (except §457 plans for non-govt. employers)
- Potential of ERISA Title I coverage (§403(b))

# Compliance/Enforcement

- History of tax-sheltered annuities
  - Multiple providers/access to employees
  - Marketing/incentives
- Full 5500 filing including plan audit for  $\geq 100$  members (§403(b))
- These plans are specific IRS audit targets

# Additional Resources

“The Source, 403(b) and 457 Plans,” published by  
National Tax Sheltered Accounts Association (2009)

<http://www.asppa.org/Document-Vault/PDFs/EE/The-Source-PDF.aspx>

# Funding Rules

- State –sponsored Plans
  - Budgeted Annually
  - “Phase-In” to Actuary’s Requirements
  - Past History of Underfunding and Risky Methods
- County Plans-No funding requirements, funding policies motivated by financial disclosures (GASB)
- Local Government Plans (Act 205)
  - Annual Pension Budget Requirement (MMO)
  - Enforcement Action
  - State Aid/Auditor General Audits

# Comparison of Public Pension Plans

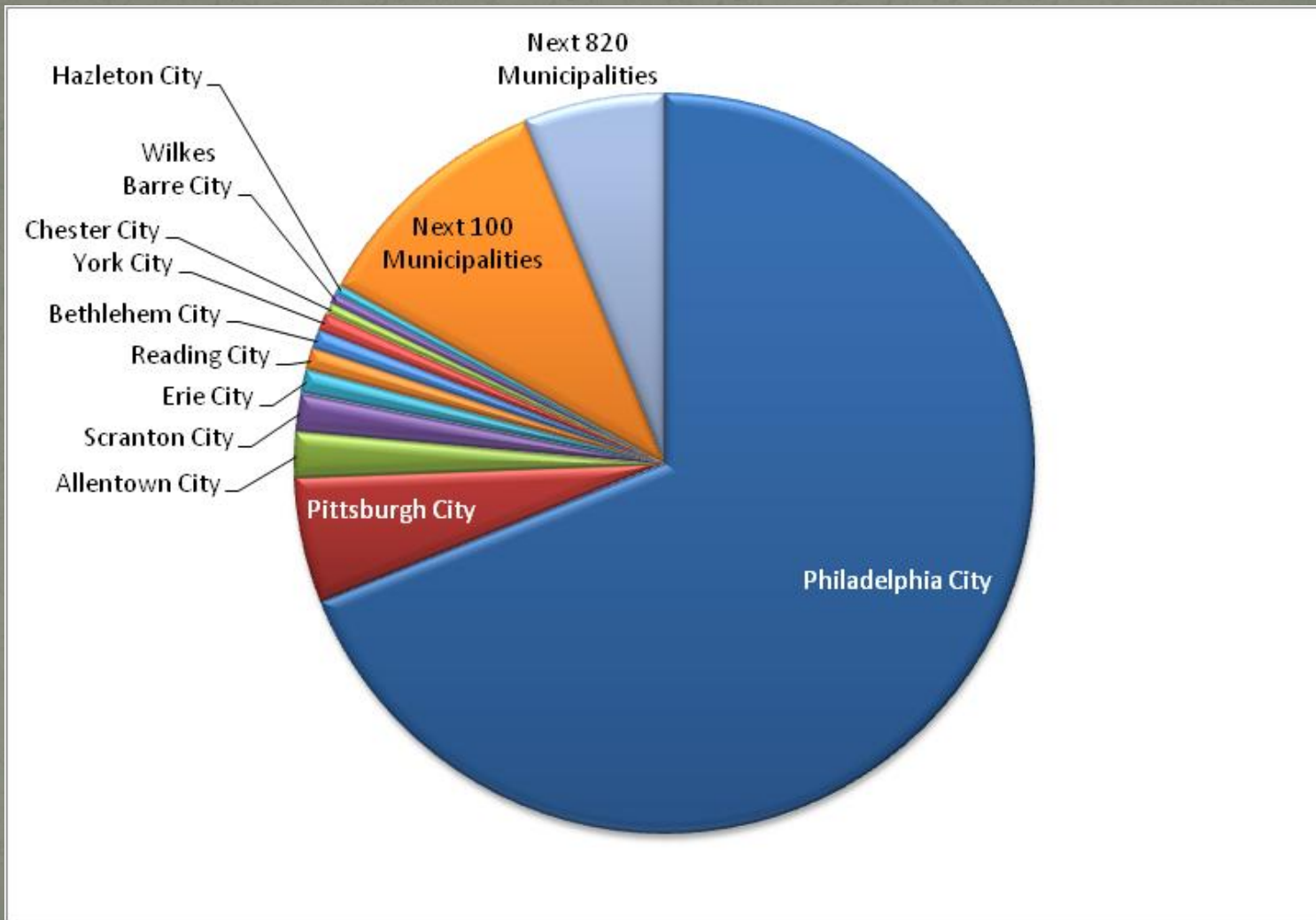
	SERS	PSERS	County Government Plans	Municipal Government Plans
Valuation Date	12/31/2011	6/30/2012	1/1/2010	1/1/2011
Investment Return Assumption	7.50%	7.50%	7.0%-7.5%	6.63%
Market Value of Assets	\$24,371,432,161	\$48,627,549,000		
Actuarial Value of Assets	\$27,618,460,988	\$58,321,400,000	\$6,497,751,796	\$13,080,476,002
Actuarial Accrued Liability	\$42,282,862,034	\$87,854,400,000	\$8,001,846,378	\$19,825,835,352
Shortfall	\$14,664,401,046	\$29,533,000,000	\$1,504,094,582	\$6,745,359,350
Funding Percentage (Market)	57.6%	55.4%		
Funding Percentage (Actuarial)	65.3%	66.4%	81.2%	66.0%

# Municipal Pension Funding Progress

- Of 1444 municipalities at 1/1/2011, 513 have surpluses totaling \$173,908,320.
- The other 931 municipalities have shortfalls totaling \$6,919,267,670.
  - Of this, \$4,768,359,000 (68.9%) is from the City of Philadelphia alone
  - The shortfall for Philadelphia and the next 10 cities is \$5,743,250,406 ( 83.0% of the total)



# Distribution of Shortfall

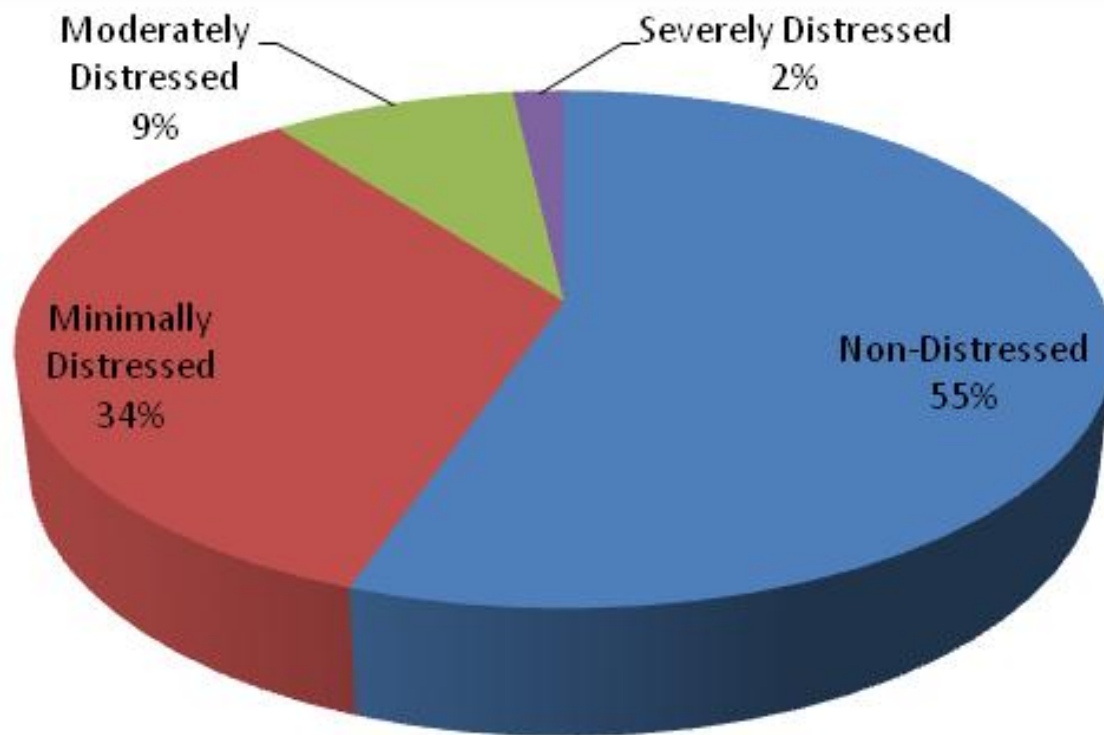


# Underfunding Problems Localized

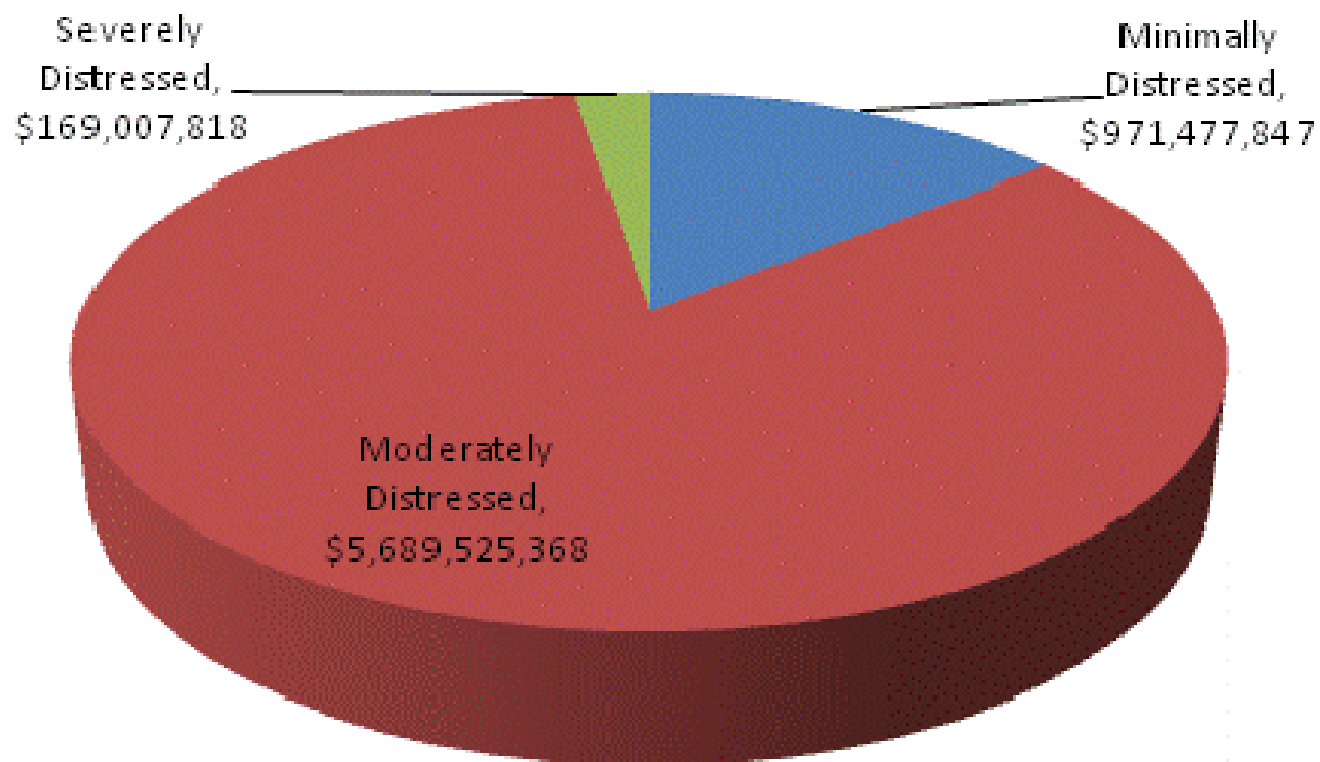
Underfunded Plans Generally the Result of:

- Unfunded Benefit Increases (DROPS)
- Unrealistic Actuarial Assumptions
- Pension Spiking

# Distribution of Distressed Municipalities



# Distribution of Shortfall by Distress Category



## The Big Question

How does one solve the problem of underfunded municipal plans without the result being the big cities being bailed out by the small municipalities that followed the rules?