STATUS REPORT
ON
LOCAL GOVERNMENT PENSION PLANS

A Summary and Analysis of

2001 Municipal Pension Plan Data
submitted pursuant to Act 205 of 1984
and
2000 County Pension Plan Data
submitted pursuant to Act 293 of 1972

Public Employee Retirement Commission
Commonwealth of Pennsylvania

April 2003

Report to the
General Assembly and Governor of the
Commonwealth of Pennsylvania

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COMMONWEALTH OF PENNSYLVANIA
PUBLIC EMPLOYEE RETIREMENT COMMISSION
HARRISBURG
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April 2003

To: Members of the Pennsylvania General Assembly
and Governor Rendell

Accompanying this letter is the Commission's ninth biennial report on the status of the Commonwealth's local government pension plans since the enactment of the Municipal Pension Plan Funding Standard and Recovery Act, Act 205 of 1984. Through this and subsequent reports, the Commission hopes both to accomplish its mandate to report to the Governor and the General Assembly on the status of local government pension plans and to facilitate the ongoing reform process by increasing the general awareness of local government retirement issues.

PROGRESS IN ACHIEVING ACT 205 OBJECTIVES

This report demonstrates that Act 205 has clearly addressed and continues to address:

– *The funded condition of municipal pension plans*. The actuarial funding requirement implemented for municipal pension plans has curtailed the growth of unfunded pension liabilities in the Commonwealth’s municipalities. The report calculates those liabilities at $2.0 billion, and it shows that the aggregate fund ratio of municipal pension plans has more than doubled (from 44% to 90%) since the passage of Act 205.

– *The maintenance of a municipal pension plan funding standard.* The status report identifies 75 instances where municipalities failed to comply with the actuarial funding standard mandated by Act 205. Through legislative improvements and continuing enforcement efforts, the funding deficiencies are becoming both less significant and less frequent.

– *Equitable distribution of state aid.* The Act 205 unit allocation formula provides aid in proportion to municipal pension costs, while the formula’s cost cap functions to ensure the efficient use of available state aid.

ADDITIONAL REFORM NEEDED

Problems inherent in the administrative and legislative structure of Pennsylvania local government pension systems are not being addressed by Act 205. Areas of local government that evidence the need for reform outside the parameters of Act 205 include:

- *Proliferation of small plans.* Sixty-seven percent of the Commonwealth's municipal pension plans have ten or fewer active members. Per member administrative expenses associated with small plans are disproportionately large and other administrative functions are absent or inadequate.

- *Lack of incentive to contain cost.* General Municipal Pension System State Aid in 2002 fully funded municipal pension costs in 64 percent of the recipient municipalities. Full funding of pension costs by state aid serves as an inducement in those municipalities to increase pension benefits as opposed to other forms of compensation.

- *Lack of fiduciary responsibility and liability standards.* The Commonwealth's 3,000 local government pension plans have over $16 billion in assets, yet these pensions have neither a comprehensive standard for administrative conduct, nor legislatively established responsibility for fiduciary breaches.

- *Deficient retirement codes.* The statutory framework is fragmented, portability is limited and there is substantial disparity in the provision of retirement benefits. One of the largest public employee retirement systems in the nation cannot function efficiently and effectively without adequate policy guidelines.

The administration of Act 205 has resulted in basic reform. Having implemented actuarial funding of local government retirement systems, it has averted the potential insolvency of multiple municipal retirement funds. Act 205 has been successful and continues to be successful, but it does not address the fundamental issue of structure. Administrative and structural reform of local government pension plans continues to be a priority for Commission activity, and this report addresses the need for the enactment of a fiduciary responsibility and liability law and the establishment of a statewide pension plan for municipal police employees.

CONCLUSION

On behalf of the Commission, I hope you find this report informative. It serves to provide basic information on Pennsylvania local government retirement systems and to convey the Commission's plan to systematically address the many local government retirement issues that require your attention. Through a series of special reports, the Commission is endeavoring to address individual issues by providing background information and suggested resolution. Through your attention and subsequent deliberations, the comprehensive policy guidelines needed for the Commonwealth's local government retirement systems can be established.

Sincerely,

Paul D. Halliwell
Chairman

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PREFACE

The following report contains data and discussion on the local government pension plans of the Commonwealth. For the purposes of this report, the local government pension plans established by municipalities now subject to the reporting requirements of Act 205 of 1984 are termed “municipal pension plans,” while the local government pension plans established by counties that continue to report under the provisions of Act 293 of 1972 are termed “county pension plans.” Where data is combined for municipal and county pension plans, the report uses the term “local government pension plans.”

The data presented in the report was extracted from the individual pension plan reports containing actuarial, financial and demographic information. The municipal pension plan reports submitted under Act 205 requirements covered the 2001 plan year, while the county pension plan reports submitted under Act 293 requirements covered the 2000 plan year. Throughout the filing periods, the Commission endeavored to ensure the reported data was complete and accurate. To the degree possible, the data provided in the individual reports was reviewed for completeness and internal consistency. In extracting the data from the database and in compiling this report, the Commission endeavored to minimize typographical errors and omissions.

When this report was prepared for publication, sixteen municipalities with one or more municipal pension plans remained delinquent in submitting the required Act 205 reports for the 2001 plan year. Consequently, data for at least eighteen municipal pension plans could not be included in this report. However, the omitted data is not statistically significant due to the small size of the pension plans involved.

PART I

EXECUTIVE SUMMARY

General Characteristics

Pennsylvania's local government pension plans comprise over 25 percent of the public employee pension plans in the United States. There are now more than 3,000 local government pension plans in Pennsylvania, and the number is continuing to grow. Seventy-one percent of the local government pension plans are self-insured, defined benefit plans, and 29 percent are money purchase or other type plans. The pension plans range in size from one to over 20,000 active members, but over 98 percent of the pension plans can be characterized as small. While 67 percent of the local government pension plans have ten or fewer members, 29 percent have three or fewer active members, the total active membership of local government pension plans exceeds the active membership of the Pennsylvania State Employees' Retirement System.

Funding Status

The rapid annual growth rate (10%) of unfunded actuarial accrued liabilities prior to the passage of Act 205 of 1984 has been curtailed. Between 1997 and 2001, the total unfunded actuarial accrued liabilities of local government pension plans decreased from $3.7 billion to $2.0 billion, primarily due to the issuance of bonded debt. Even without the effects of municipal debt issues, the unfunded liabilities would have decreased by about three percent during this period. The unfunded liabilities did increase slightly between 1999 and 2001, but the aggregate fund ratio did not change. Additionally, the report shows that the aggregate fund ratio of municipal pension plans has more than doubled (from 44% to 90%) since the passage of Act 205. Only five percent of municipal pension plans were considered to be poorly funded in 2001.

The report also shows that the approximate rate of return on investments declined from over 12 percent in 1998 to 1.8 percent in 2000, and that municipal contributions and total contributions to pension plans declined by 18 percent and 2 percent respectively between 1999 and 2000.

Compliance with Minimum Funding Standard

The mandated actuarial funding standard implemented by Act 205 has been in effect since 1986. The reported data shows that municipalities failed to comply with the actuarial funding standard in 75 instances in 2000. As a result of enforcement activities of the Commission, instances of noncompliance have become a less significant factor in the funded condition of municipal pension plans.

State Aid Allocation

Both under-funded and over-funded municipal pension plans continue to decrease in number since the enactment of Act 205. This reduction in numbers of plans outside a "normal range" is an indicator of an effective allocation formula. Between 1985 and 1989, the total state aid allocated under Act 205 increased dramatically, and the unit value increased from $1,146 to $3,269. The substantial increase in state aid during that period served as an inducement to municipalities to increase pension benefits as opposed to other forms of compensation. The unit value decreased substantially to $2,501 in 1990 and has since climbed to $2,763. In 2002, state aid was sufficient to fully fund pension costs in 64 percent of municipalities.

Additional Reform Needed

Fundamental problems inherent in the administrative and legislative structure of the Commonwealth's municipal pension systems are not being addressed by Act 205. The need for reform outside the parameters of Act 205 is evident.

1) Fiduciary Responsibility and Liability Law for Local Government Employee Pension Plans

   - The Commonwealth's 3,000 local government pension plans do not have a comprehensive standard for fiduciary responsibility or liability for fiduciary breach. In order to properly safeguard local government pension funds and investments, legislation establishing fiduciary standards must be enacted which sets clear performance standards and identifies whom to hold responsible in the event of breach. This report addresses the need for enactment of a fiduciary responsibility and liability law.

2) Statewide Pension Plan for Municipal Police Employees

   - With more than 900 police pension plans in Pennsylvania and at least a dozen laws governing their administrative and benefit structures, the disparity in benefits and the lack of portability of municipal police employees is cited as one of the most common deficiencies of the Commonwealth's municipal retirement system. A single statewide pension plan for municipal police employees would remedy the problems of ineffective administration, lack of portability and disparity in benefit structure, and it would provide better benefits at reduced costs. This report discusses the need and justification for the establishment of a statewide police employee pension plan.

PART II

GENERAL CHARACTERISTICS

NUMBER OF PLANS

Pennsylvania has a complex system of local government comprised of over 4,800 governing units. General purpose local governments — cities, boroughs, towns and townships — total approximately 2,600 governing units. Special purpose local governments — municipal authorities — total approximately 2,200 units, and counties total 67 units. General purpose local governments in Pennsylvania, in most instances, establish separate pension plans for their police, fire and nonuniformed employees, while counties and municipal authorities generally establish one pension plan for nonuniformed employees.

The local government pension plans in Pennsylvania are estimated to comprise more than 25 percent of the total number of public employee pension plans in the United States. With over 3,000 local government pension plans, the Commonwealth has over four times more public employee pension plans than any other state. Chart I shows the number of local government pension plans grouped by the type of employee and by the type of local government as of 2001.

CHART I

Number of Local Government Pension Plans

	Police	Fire	Nonuniformed	**Total**
County	0	0	72	**72**
City	58	46	64	**168**
Borough	504	19	551	**1,074**
Township (1st Class)	88	6	102	**196**
Township (2nd Class)	294	5	728	**1,027**
Authority	0	0	472	**472**
Council of Government	27	0	19	**46**
Total	**971**	**76**	**2,008**	**3,055**

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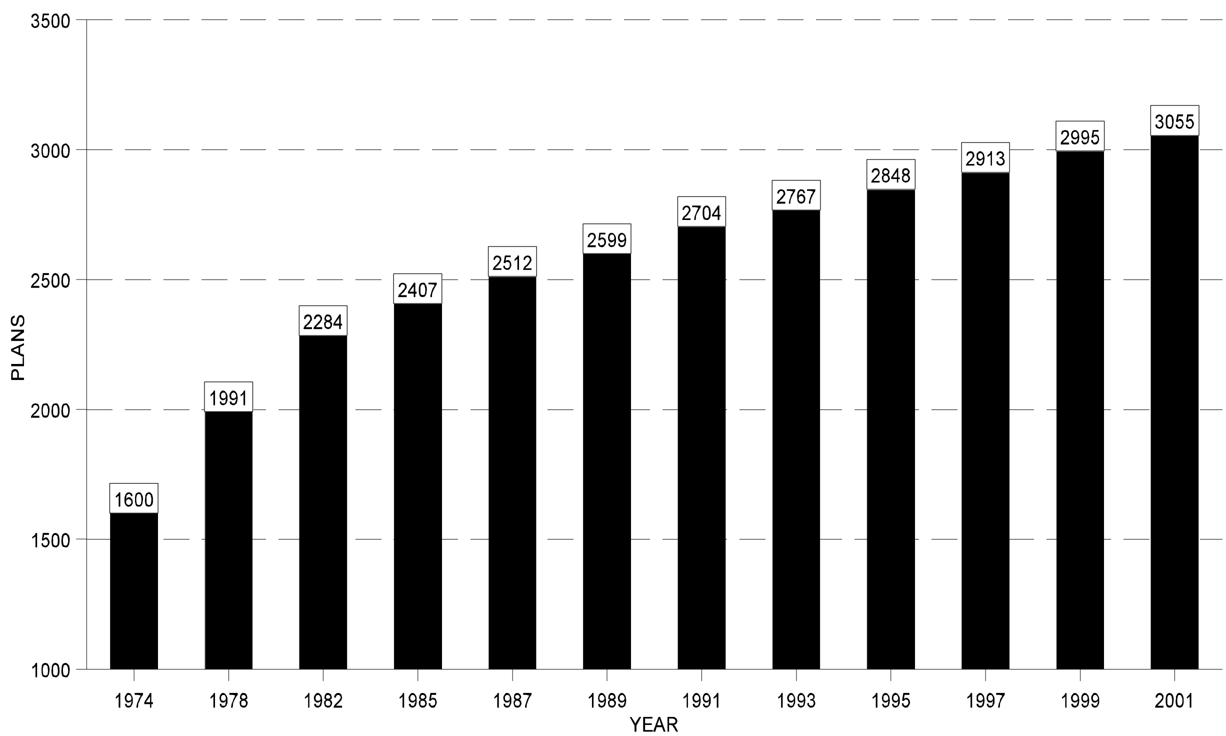
The over 4,800 local government units in Pennsylvania have the potential to establish more than 7,000 pension plans. Graph I shows the growth in the number of local government pension plans since state reporting requirements were initiated in 1974. Although reporting irregularities, varying reporting criteria, and a reporting frequency change have impacted on the data, the general trend is clear — the number of local government pension plans in the Commonwealth is continuing to increase. Since the 1999 reporting period, the number of pension plans reported has increased by sixty. Only three of these additional pension plans have 10 or more members.

GRAPH I

GROWTH IN NUMBER OF LOCAL GOVERNMENT PENSION PLANS



ADMINISTRATIVE COST

The small size of most municipal pension plans has a direct influence on the cost of administration. When stated on a per-member basis, reported administrative cost can be used as a measure of the relative efficiency of pension plan administration. The aggregate per-member administrative cost reported by municipal pension plans in 1997, 1999 and 2001 was $309.54, $353.29 and $413.78 respectively. Aggregate administrative costs have risen 34 percent since the 1997 reporting period. The escalation of expenses since the enactment of Act 205 may be attributable to the fact that, in many cases, most or all of the expense of pension administration is being covered by State aid, reducing the incentive to contain costs. When the reported per-member administrative cost is tabulated based on pension plan size, the administrative inefficiency associated with small size is evident.

Pension Plan Size	Per-Member Administrative Cost 2001	1999	1997
10 or less Active Members	$525.25	$497.56	$434.88
11 to 100 Active Members	$632.77	$545.32	$450.22
Greater than 100 Active Members	$276.18	$232.12	$217.50
Greater than 500 Active Members	$209.80	$170.02	$162.52
Average Cost Per-Member (All Plans)	$413.78	$353.29	$309.54

During the 2000 plan year, municipal governments reported administration expenses totaling $32.5 million. The reported administrative expenses are understated because they typically include only direct administrative expenses and because municipalities that utilize asset managers frequently pay administrative costs through a reduction of income distribution rather than a payment made from plan assets. Also, the reported administrative expenses in the "10 or less Active Members" category are understated because these very small plans are frequently money purchase plans that do not have a mechanism for reporting administrative expenses. As shown in the chart above, per-member administrative expenses are proportionately higher among smaller plans. If the 2001 per-member administrative costs associated with large plans ($209.80) were applied to all municipal pension plans instead of the administrative costs actually incurred, the annual savings to local governments would total over $16 million — showing a potential for a 50% reduction in administrative costs.

NATURE OF PLANS

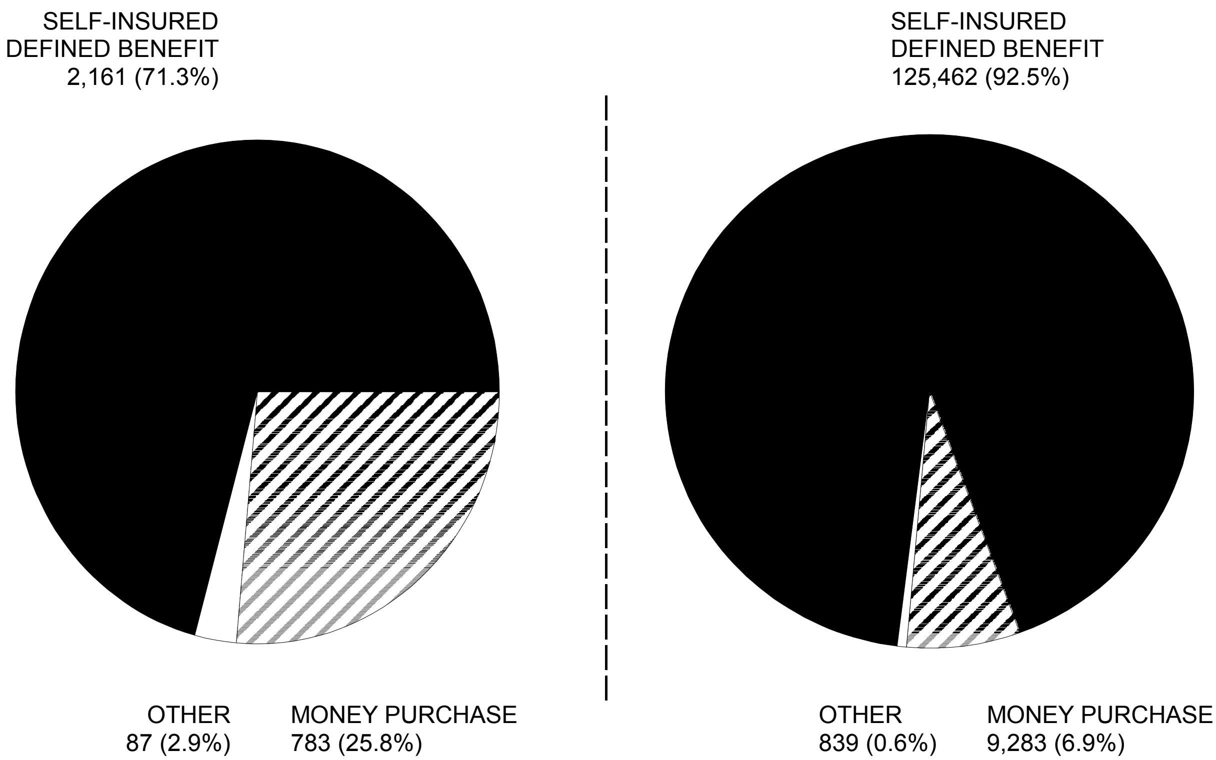
The municipal pension plans included in this report may be categorized as defined benefit or money purchase pension plans. In defined benefit pension plans, the pension benefit to be payable at retirement is fixed in some manner and a resultant actuarial liability is established and funded. Defined benefit pension plans may be characterized as "fully-insured" or "self-insured." In fully-insured pension plans, fund assets are allocated to individual members through insurance instruments prior to retirement and the insurance is sufficient to guarantee the pension benefits at retirement. Defined benefit pension plans characterized as self-insured are those plans where some or all of the risk of providing pension benefits remains with the municipality, even though the plan may have an insurance component. In some instances, defined benefit pension plans are provided by municipalities through participation in Taft-Hartley Act collectively bargained, jointly trusteed, multi-employer pension plans. In 2001, the defined benefit pension plans established by local governments included 2,161 self-insured pension plans and six fully-insured plans. Defined benefit pension plans were also provided by 77 local governments through jointly trusteed, multi-employer pension plans.

In money purchase pension plans, the pension benefit is determined by the monies accumulated in the retiring employee's account up to the time of retirement. Money purchase pension plans may be funded with defined contributions or less formal funding mechanisms, both of which allocate monies to the individual member accounts prior to retirement. In 2001, the 783 money purchase pension plans established by Pennsylvania's local governments were comprised of 739 defined contribution pension plans and 44 pension plans with no scheduled funding method. In addition to the defined benefit and defined contribution plans, pension plans were also maintained by ten local governments where no active, vested or retired employees exist at the present time. Graph II does not include 18 known local government pension plans that were delinquent in filing actuarial valuation reports at the time this report was prepared.

GRAPH II

LOCAL GOVERNMENT PENSION PLAN DISTRIBUTION

Pension Plan Distribution by Plan Type | **Employee Distribution by Plan Type**



Graph II shows that approximately 71 percent of the local government pension plans in Pennsylvania were self-insured, defined benefit pension plans, while almost 93 percent of the State's local government employees with pension benefit coverage were members of self-insured, defined benefit pension plans. The graphs also evidence that money purchase pension plans represented approximately 26 percent of the local government pension plans in the Commonwealth and that money purchase pension plans represented only about 7 percent of the local government employees for which pension coverage was provided.

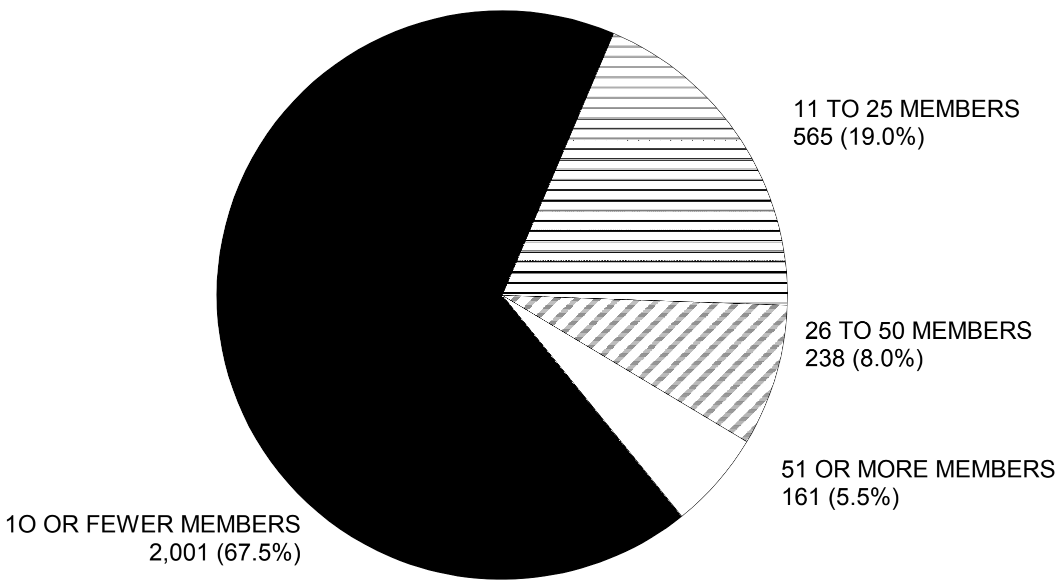
There were 82 new pension plans established since the 1999 reporting period. Sixty-one percent of the new pension plans are defined benefit plans. In the previous four years, about 45 percent of the new pension plans were defined benefit plans. This reversal of the defined benefit/defined contribution trend suggests that the decline in expected rates of return in recent periods has been a factor in the fundamental design of pension plans established by municipalities.

SIZE OF PLANS

Not considering Philadelphia, which has 29,322 active members, including one plan in excess of 20,000 active members, the municipal pension plans in Pennsylvania range in size from one to over 2,000 active members. Surveys of public employee pension plans frequently use a threshold of 100 active members to categorize public employee pension plans as either small or large. Using a standard of 100 active members, 98 percent of Pennsylvania's pension plans (2,903) are small. Establishing the standard at 50 members, or one-half the usual standard, only decreases the percentage of Pennsylvania's municipal pension plans categorized as small to 95 percent. Graph III shows that pension plans with 10 or fewer active members comprise over 67 percent of Pennsylvania's municipal pension plans and that only about 13 percent of the municipal pension plans in the Commonwealth have more than 25 active members. While not disclosed by Graph III, 860 municipal pension plans (29%) have 3 or fewer active members.

GRAPH III

DISTRIBUTION OF MUNICIPAL PENSION PLANS BY NUMBER OF ACTIVE MEMBERS



The county pension plans in Pennsylvania range in size from plans with as few as 23 active members to one plan with over 7,000 active members. On average, the county pension plans have approximately 790 active members.

Distribution of County Pension Plans by the Number of Active Members

Number of Members	Number of Plans
100 or fewer	9
101 – 200	15
201 – 300	6
301 – 400	8
401 – 500	5
501 or more	29

When considered in the aggregate, the local government pension plans of the Commonwealth are the equivalent of a very large public employee pension system. When viewed in terms of the number of active members, the local government retirement systems are larger than the State Employees' Retirement System (SERS), which is one of the largest public employee pension plans in the United States. In 2001, the local government retirement systems had 135,584 active members with assets of $16,419,265,738, while as of December 31, 2000, SERS had 109,469 active members and assets of $26,094,306,293. Pennsylvania's local government retirement systems are 124 percent as large as SERS in terms of members, but are only 63 percent as large as SERS in terms of asset size.

CHART II

Local Government Retirement Systems
Compared with Pennsylvania State Employees' Retirement System

	Active Members	Actuarial Accrued Liability	Actuarial Assets	Unfunded Actuarial Accrued Liability
Local Government Retirement System	135,584	$16,905,007,990	$16,419,265,738 [2]	$2,052,956,197 [3]
State Employees' Retirement System [1]	109,469	$19,702,278,063	$26,094,306,293	($6,392,028,230)

[1] Data extracted from 12/31/2000 actuarial valuation.
[2] Includes $1,979,337 in assets of county pension plans that were omitted from actuarial valuations.
[3] Represents total of unfunded actuarial accrued liabilities reported for individual pension plans.

PART III

FUNDING STATUS AND PRACTICES

ACTUARIAL FUNDING METHODS AND POLICY

Most (97%) of the 2,161 self-insured, defined benefit local government pension plans in the Commonwealth are required to be funded in accordance with the actuarial funding standard established by Act 205 of 1984. The remaining self-insured, defined benefit local government pension plans — the county pension plans — are required to fund their employee pension plans on an actuarial basis, but there is no specific actuarial funding standard established for county pension plans. The Act 205 funding standard established for self-insured, defined benefit municipal pension plans is based on the entry age normal actuarial cost method. Since both the State Employees' Retirement System and the Public School Employees' Retirement System also use the entry age normal actuarial cost method, county pension plans are the only self-insured, defined benefit public employee pension plans in Pennsylvania not required by statute to use the entry age normal actuarial cost method for funding and reporting purposes.

Under Act 205 of 1984, the 870 local government pension plans that do not have self-insured, defined benefits are required to be funded at a level sufficient to satisfy the annual funding requirements specified in their plan documents. Seventy-three pension plans with defined contributions that may have experienced funding deficiencies in 2000, as indicated by their 2001 Act 205 reporting forms, were sent funding deficiency notices as part of a Commission effort to enforce compliance with the municipal funding standard among municipalities with money purchase plans. The Department of the Auditor General was notified of the reported deficiencies in an effort to aid in their audit planning and examination process for municipal defined contribution pension plan funding compliance.

ACTUARIAL FUNDING STATUS

The liabilities of money purchase pension plans equal the assets at retirement, and as a result, when contributions are made as specified in their plan documents, they are fully-funded by virtue of their design. For fully-insured defined benefit pension plans, the value of the pension plan's insurance policies equal the liabilities at retirement. And multi-employer, jointly trusteed, Taft-Hartley Act collectively bargained pension plans are treated like defined contribution pension plans with respect to funding requirements. Accordingly, analysis of the funding status of these fully funded municipal pension plans is not necessary.

The funding status of the 2,161 self-insured, defined benefit local government pension plans in the Commonwealth varies considerably. An easily understood and reliable method to gauge the funded status of municipal pension plans is available by virtue of the standard use of the entry age normal (EAN) actuarial cost method required by Act 205 of 1984. Because 64 of the 72 county pension plans did not use the entry age normal actuarial cost method, the following discussion of the funding status of local government pension plans only concerns the 2,089 self-insured, defined benefit municipal pension plans.

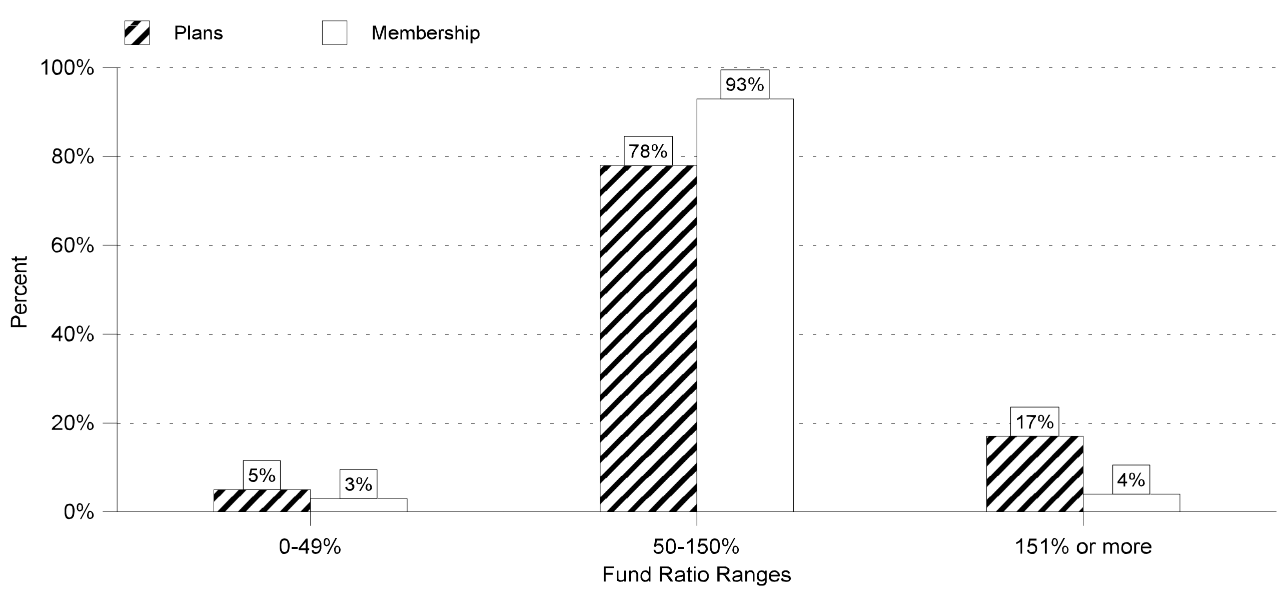
The EAN actuarial cost method provides for the even distribution of pension costs over the working career of individual employees. Accordingly, the assets of the pension plan may, at any time, be compared with the total value of the contributions that would have normally been made to the plan to date. The total value of the normal contributions to date is termed the actuarial accrued liability. By computing the fund ratio — the assets expressed as a percentage of the actuarial accrued liability — the pension plan's current funding status is made apparent. For example, when the fund ratio of a municipal pension plan is 100 percent, the assets are equal to the actuarial accrued liability and the pension plan is currently funded exactly on target with the actuarially estimated requirements.

Situations where the fund ratio is exactly 100 percent are rare. In most instances, the fund ratio is greater or less than 100 percent. When the fund ratio is less than 100 percent, the pension plan's assets are less than the currently estimated liabilities and an actuarial deficiency, termed an unfunded actuarial accrued liability, exists. When the fund ratio is greater than 100 percent, the pension plan's assets are greater than the currently estimated liabilities and an actuarial surplus exists. The fund ratio for each municipal pension plan in the Commonwealth is reported in Table I.

Fund ratios above and below 100 percent are not significant unless there is a substantial deviation. Due to normal fluctuations in actuarial cost estimates and other factors, there is an acceptable range in a pension plan's fund ratio. Although establishing a specific fund ratio range as acceptable is not appropriate, fund ratios under normal circumstances should reside in the range of 50 percent to 150 percent. The distribution of the 2,089 self-insured, defined benefit municipal pension plans in Pennsylvania among fund ratio ranges is examined in Graph IV. The graph indicates that 78 percent of the pension plans and 93 percent of the membership of defined benefit municipal pension plans reside in the 50 to 150 percent fund ratio range. In 1985, prior to the establishment and

GRAPH IV

DISTRIBUTION OF SELF-INSURED, DEFINED BENEFIT MUNICIPAL PENSION PLANS AND THEIR ACTIVE MEMBERSHIP AMONG FUND RATIO RANGES

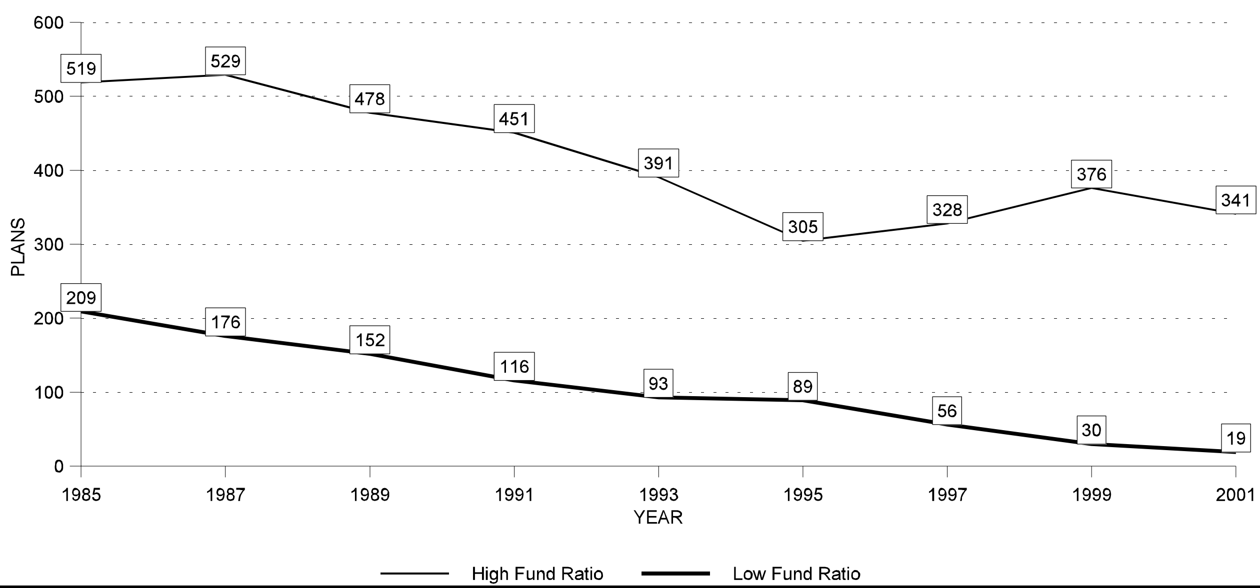


enforcement of actuarial funding under Act 205, only 58 percent of the pension plans and 30 percent of the membership of defined benefit municipal pension plans resided in the 50 to 150 percent fund ratio range. Graph IV also shows that while the 108 pension plans with low fund ratios (50% or below) represent 5 percent of the total pension plans, those same plans provide pension coverage for only 3 percent of the total active membership. The 359 pension plans with high fund ratios (151% or more) represent 17 percent of the total pension plans, but those same plans provide pension coverage for only about 4 percent of the total active membership.

There may be normal circumstances under which fund ratios may be less than 50 percent, such as the establishment of a new plan that recognizes prior service. However, historically, the primary reason for the low fund ratios in pension plans in the Commonwealth was the absence of actuarial funding. Prior to the enactment of Act 205 of 1984, the Municipal Pension Plan Funding Standard and Recovery Act, the municipal pension plans in Pennsylvania were not subject to mandated actuarial funding. Because Act 205 required actuarial funding commencing in 1986, the low fund ratios evident in 1985 and 1987 have become less frequent. The number of municipal pension plans in existence since 1985 with fund ratios below 50 percent has decreased from 209 in 1985 to 19 in 2001. Many of the 358 self-insured, defined benefit pension plans started after 1986 recognized prior service credit and thereby created unfunded actuarial accrued liabilities. These new self-insured, defined benefit plans increased the number of low fund ratio plans by 89. Most of these plans, however, are small and the unfunded actuarial accrued liabilities associated with the 358 new self-insured, defined benefit pension plans represent less than 1 percent ($8,884,091) of the statewide municipal total. The initiation of State aid in 1985 to municipalities to offset non-uniformed employee pension costs may have provided an incentive to create these plans. Graph V shows the decline in numbers of self-insured, defined benefit municipal pension plans with low fund ratios that were in existence on or before January 1, 1987.

GRAPH V

SELF-INSURED, DEFINED BENEFIT MUNICIPAL PENSION PLANS WITH HIGH AND LOW FUND RATIOS ESTABLISHED ON OR BEFORE 1/1/1987



Although other circumstances may result in fund ratios above 150 percent, the principal reason for the frequency of high fund ratios prior to the enactment of Act 205 was the allocation of the State's Foreign Casualty Insurance Premium Tax receipts to municipal police pension plans based largely on population. With the enactment of Act 205, the allocation of State aid to municipalities to offset employee pension costs was revised to provide General Municipal Pension System State Aid allocations based on employee units and, therefore, related to the pension costs. The Act 205 allocation formula also limits the State aid allocations to no more than 100 percent of the employer pension cost.

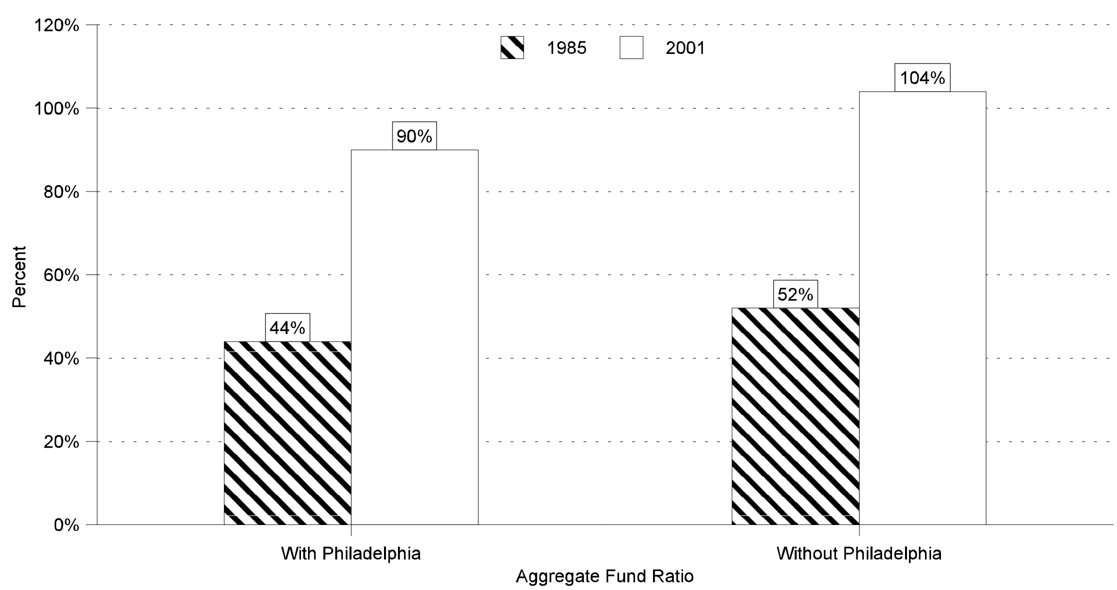
The recent increase in plans with high fund ratios and perhaps some of the decrease in plans with low fund ratios can be attributable to the high rate of return on investments between the 1995 and 1999 reporting periods. The overall decline in numbers of pension plans since 1985 with both high and low fund ratios can, however, be primarily attributed to the enactment and administration of Act 205 and the application of both the funding standard and the revised State aid allocation formula provided by the Act.

CHANGE IN AGGREGATE FUND RATIO SINCE THE ENACTMENT OF ACT 205

The change in aggregate fund ratio of defined benefit municipal pension plans is shown in Graph VI below. The aggregate fund ratio of all municipal pension plans is calculated without regard to individual plan funded condition, as if the plans were one single entity. Accordingly, individual pension plans with an over-funded condition offset individual plans with an under-funded condition. In other words, the statewide financial position is measured without regard to the specific position of individual pension plans. While aggregate fund ratio cannot be used to measure the impact of Act 205 upon individual pension plans, it is perhaps the single most important measurement when used as a factor in the assessment of changes in the overall financial condition of municipal pension plans on a statewide basis. Graph VI shows the fund ratio of municipal pension plans both with and without Philadelphia as of January 1, 1985, (the first Act 205 reporting period) and as of January 1, 2001. Philadelphia, which had a fund ratio of about 77 percent in the January 1, 2001, reporting period is shown separately because of its large size and its influence on statewide analysis.

GRAPH VI

CHANGES IN AGGREGATE FUND RATIO



When Philadelphia is included in the data, all municipal pension plans reported an aggregate fund ratio of 44 percent in 1985. While an aggregate fund ratio of 44 percent may or may not be a predictor of imminent default, it certainly is indicative of serious under funding. As of January 1, 2001, again including Philadelphia, the aggregate fund ratio of all municipal pension plans, more than doubled to 90 percent. When the City of Philadelphia is excluded, the aggregate fund ratio increased during this period from 52 percent to 104 percent.

Although economic conditions contributed to both the reduction in the annual growth rate of the unfunded actuarial accrued liabilities and the increase in the aggregate fund ratio, the passage of the Municipal Pension Plan Funding Standard and Recovery Act (Act 205 of 1984) is certainly the principal factor triggering the positive change in the funding pattern of municipal pension plans. This dramatic change in the funded condition of municipal pension plans since the inception of Act 205 is direct evidence of its effective provisions including the redirection of State aid and enforcement of the minimum municipal funding standard.

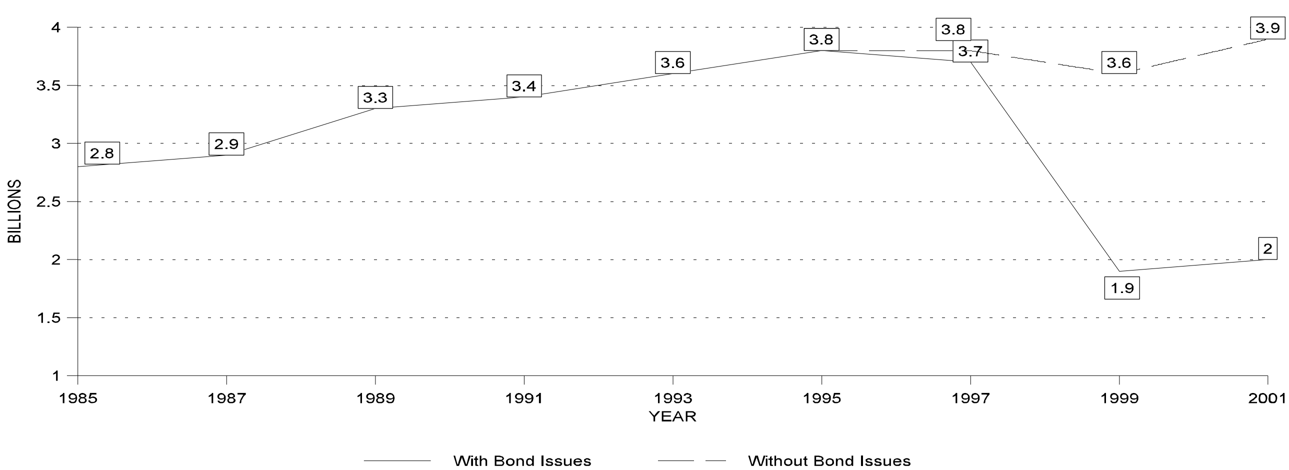
CHANGES IN UNFUNDED ACTUARIAL ACCRUED LIABILITIES

As the fund ratio of a pension plan decreases from 100 percent, the pension plan's assets represent an increasingly smaller percentage of the accrued liabilities. The funding shortfalls, termed unfunded actuarial accrued liabilities, may occur normally due to recognition of prior service credits, benefit liberalizations, or actuarial experience losses. However, the chief cause for the unfunded actuarial accrued liabilities accumulated by Pennsylvania's municipal pension plans was the inadequate funding in the past that occurred in the absence of actuarial funding requirements.

Between 1974 and 1985, prior to the Act 205 funding standard, the annual growth rate of the unfunded actuarial accrued liabilities of municipal pension plans was 10 percent. Between 1985 and 1997, due primarily to the Act 205 funding standard, the annual growth rate decreased to about two percent. Act 205 and the Local Government Unit Debt Act were amended in 1994 to provide authorization for municipalities to issue taxable

GRAPH VII

**TREND OF UNFUNDED ACTUARIAL ACCRUED LIABILITIES
IN BILLIONS OF DOLLARS**

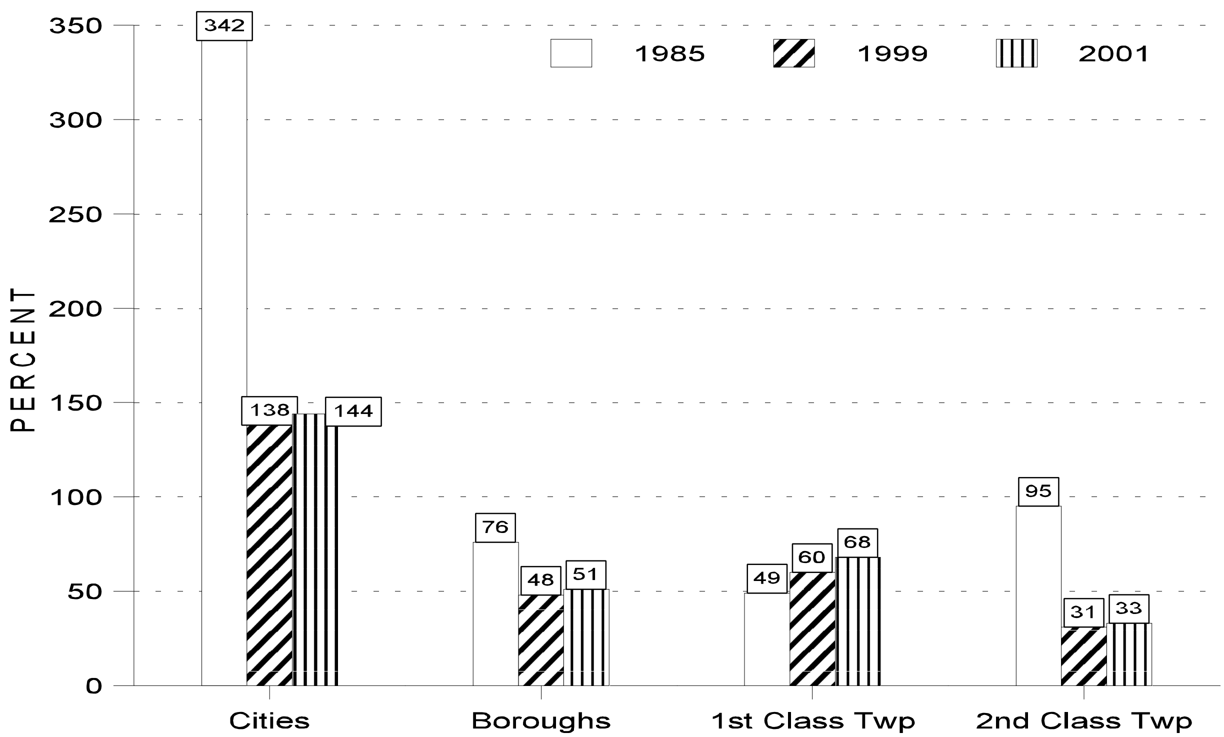


general obligation bonds to reduce unfunded actuarial accrued liabilities. Since then, fourteen municipalities (including Philadelphia, which issued bonds in the amount of $1.25 billion) have reduced their unfunded liabilities by $1.8 billion through bond issues, as indicated by Graph VII. There have been no bonded debt filings since January 1999. However, even without the effect of the bond issues, between 1995 and 1997, the unfunded liabilities of municipal pension plans would have remained level, and between 1997 and 1999 the unfunded actuarial accrued liabilities without the effect of bond issues would have declined by about three percent. Between the 1999 and 2001 filing periods, the dollar amount of unfunded liabilities of municipal pension plans, both with and without Philadelphia, increased slightly. Not disclosed by Graph VII, however, is the fact that the aggregate funded condition of these municipal pension plans remained stable during this period. The aggregate fund ratio of municipal pension plans that reported unfunded liabilities was 77 percent as of January 1, 1999, and was 77 percent as of January 1, 2001.

Another perspective may be obtained by examining unfunded actuarial accrued liabilities on a basis relative to the size of the municipality. Graph VIII shows the average amounts of unfunded actuarial accrued liabilities on a common basis (percentage of payroll) for 1985, 1999 and 2001, by municipal class, excluding Philadelphia. It is necessary to exclude Philadelphia from certain municipal comparisons in this report because their size (45% of the total municipal assets) impacts significantly upon data analysis. Stating unfunded actuarial accrued liabilities as a percentage of payroll tends to offset the effect of inflation during the period, and allows for a comparison of the average unfunded actuarial accrued liabilities among the classes of municipal government. Graph VIII shows that, except for townships of the first class, all classes of municipalities have had an overall decline in unfunded actuarial accrued liabilities, as a percentage of payroll between 1985 and 2001. Graph VIII shows that the

GRAPH VIII

AVERAGE UNFUNDED ACCRUED LIABILITIES AS A PERCENTAGE OF PAYROLL BY MUNICIPAL CLASS



unfunded actuarial accrued liabilities of cities declined from 342% of payroll in 1985 to 138% of payroll in 1999. The issuance of bonded debt accounted for about 85% of this reduction. Between 1999 and 2001, apparently due to decreased return on investments, unfunded actuarial accrued liabilities increased as a percentage of payroll in all classes of municipalities. It is important to note, however, that in the aggregate, the funded condition of municipal pension plans did not deteriorate during this period.

CONTRIBUTIONS TO MUNICIPAL PENSION PLANS

The Act 205 actuarial funding standard was implemented in 1986. Since that date, Act 205 reports have been submitted to the Commission biennially. The data contained in Act 205 reports shows the minimum municipal obligations and the actual contributions for the year prior to each valuation date and allows an analysis of the changes in funding practices and contribution components of individual pension plans.

Contributions to pension plans for all municipalities, excluding Philadelphia, for the years reflected by the 1995, 1997, 1999 and 2001 actuarial valuation reports are compared in Graph IX, while Chart III shows the total funding sources of municipal pension plans for the 1999 and 2001 filing periods and the changes in funding that occurred between those periods. As evidenced in Graph IX, both member and state contributions grew steadily since the 1995 filing period. Reported municipal contributions increased from $84 million in 1995 to $102 million in 1997. In both the 1999 and the 2001 filing periods, however, reported municipal contributions declined significantly. Member contributions to municipal pension plans typically remain stable as a percentage of payroll. State aid remains relatively level as a function of payroll-based costs and numbers of municipal employees. Municipal contributions, however, are the final factor in the determination of the Act 205 minimum municipal funding standard. Municipal contributions must make up the remainder of the required funding after consideration of State aid and member contributions. Accordingly, municipal contributions are more prone to fluctuation than the other funding sources. The unpredictability of municipal contributions (particularly in small plans) contributes to the difficultly in budgeting for pension costs. Municipal contributions reported during the 2001 filing period were only 52 percent as large as contributions made to pension plans by the state.

The issuance of bonded debt by municipalities prior to the 1999 valuation period to fund actuarial accrued liabilities was a factor in the reduced levels of municipal contributions. When a municipality funds all or part of its unfunded actuarial accrued liability through the issuance of bonded debt or other means, its amortization payments are reduced or eliminated. Amortization payments in some cases may be the largest component of the minimum municipal obligation. The issuance of bonded debt and very high investment returns from 1996 through 1998 were both a factor in the reduction of municipal contributions in the 1999 and the 2001 filing periods. Chart III shows that there was a decline in the contributions made to municipal pension plans from all sources of about $5 million, or 2.2%, between the 1999 and 2001 filing periods (even though these plans, on average, experienced an 11 percent increase in normal costs as a dollar amount).

GRAPH IX

CONTRIBUTIONS TO MUNICIPAL PENSION PLANS

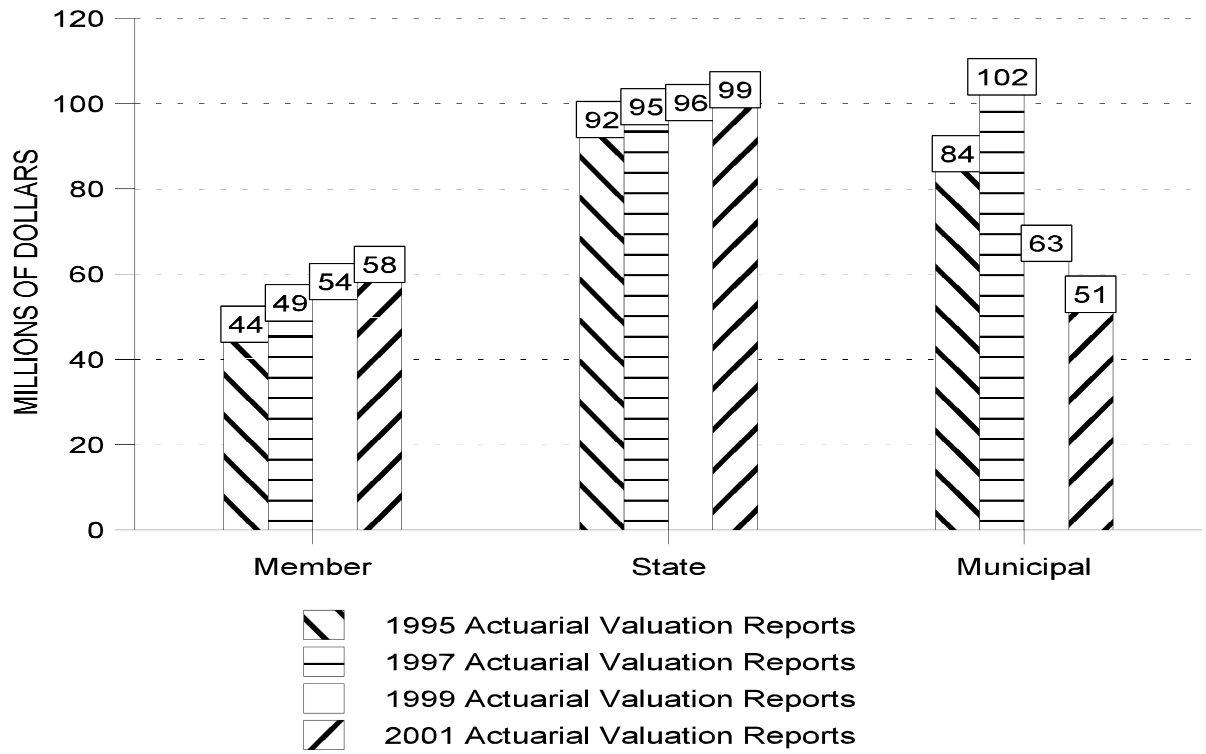


CHART III

Contributions To Municipal Pension Plans

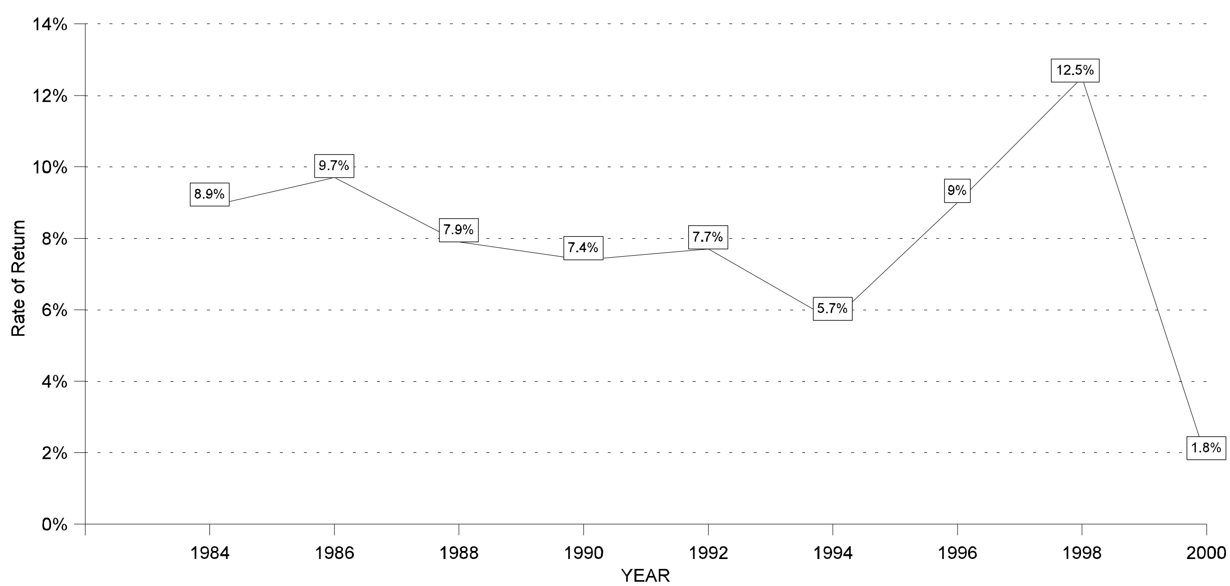
	2001 FILING PERIOD	1999 FILING PERIOD	PERCENT CHANGE
Member Contributions			
As Dollar Amount	57,873,447	54,298,871	6.6
As % of Contributions	27.6	25.3	2.3
State Contributions			
As Dollar Amount	99,938,162	96,898,845	3.1
As % of Contributions	47.7	45.2	2.5
Municipal Contributions			
As Dollar Amount	51,642,270	63,033,233	-18.0
As % of Contributions	24.7	29.4	-4.7
Total Contributions			
As Dollar Amount	209,453,879	214,230,939	-2.2
As % of Contributions	100.0	100.0	

RATE OF RETURN ON INVESTMENTS

The aggregate rate of return on investments for Pennsylvania's over 2,900 municipal pension plans, other than Philadelphia, was at 12.5 percent during the year 1998, as reported in the 1999 filing period. During the 2001 filing period, the aggregate rate of return fell to 1.8 percent, the lowest rate reported since Act 205 filing began. During the year 2000, the individual rates of return were relatively level across classes of municipalities. The rates of return for each class of municipal government were: cities – 1.1 percent, boroughs – 3 percent, first class townships – 2.2 percent and second class townships – 2.9 percent. During the seventeen year period ending with the year 2000, the rate of return for all municipal pension plans, excluding Philadelphia was approximately 7.8 percent. The rates of return experienced by municipal pension funds in recent years reflect entry into the equity market by many municipalities that had not invested in equities in the past. With continuing exposure to the more volatile returns typically experienced by equity investments, the average rate of return on municipal pension funds may be less stable in the future than the rates experienced between 1984 and 1994. By way of comparison, the rate of return on investments of the State Employees' Retirement System (SERS) for the seventeen year period ending with the year 2000 was 13.1 percent, and the SERS' rate of return for the year 2000 was approximately 2.2 percent.

GRAPH X

APPROXIMATE RATES OF RETURN ON INVESTMENTS OF MUNICIPAL PENSION PLANS



COMPLIANCE WITH ACTUARIAL FUNDING STANDARD

The uniform actuarial funding standard implemented under Act 205 of 1984 was first effective for municipal pension plans in 1986. The 2001 Act 205 reports solicited documentation of both the 2000 minimum municipal obligation (MMO) calculated for the pension plans and the actual municipal contributions to the pension plans in 2000. When a municipality contributes less than the Act 205 minimum municipal obligation to a pension plan, a funding deficiency is created. The Commission monitors compliance with the actuarial funding standard through the Act 205 reporting process and compiles compliance data in the biennial status reports, which enables the Commission to meet its statutory responsibility to disclose instances of noncompliance in a public report to the Governor and the General Assembly.

The January 1, 2001, actuarial valuation reports submitted for self-insured, defined benefit pension plans disclosed 75 instances of noncompliance with the Act 205 funding standard. Orders to comply with the Act 205 mandated funding standard were issued by the Commission to all municipalities which reported a funding deficiency in a self-insured, defined benefit pension plan.

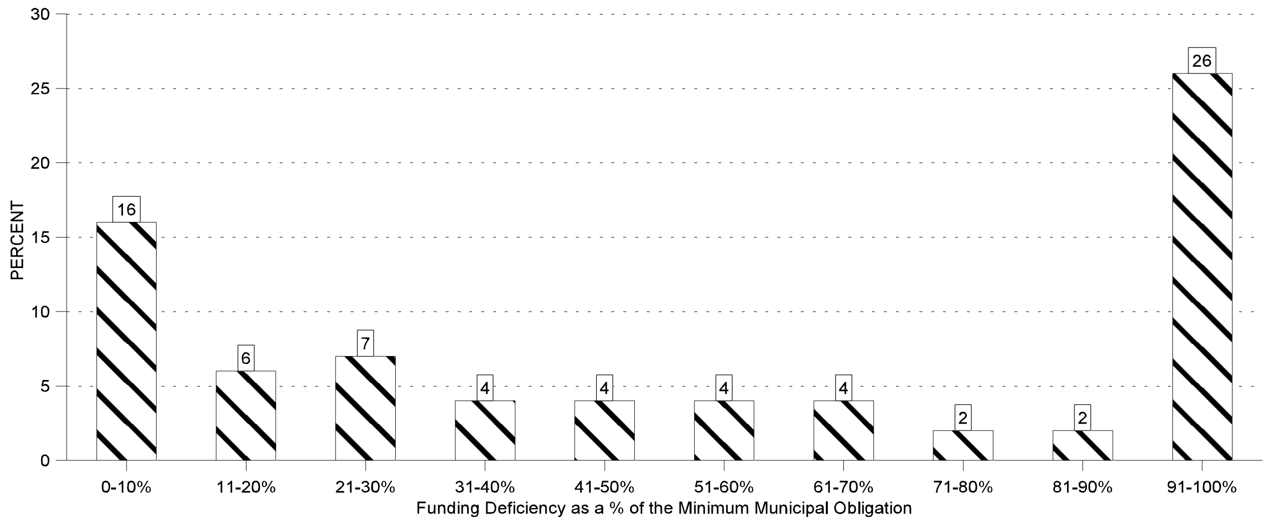
Data on the 75 funding deficiencies that occurred in 2000 is provided in Table V at the end of this report. Table V displays the funding deficiencies as a dollar amount, as a percent of total cost, and as a percent of payroll and discloses the fund ratio of the plan. Total cost, for the purposes of this table, is defined as the normal cost plus amortization contributions required annually. Expressing the funding deficiency as a percentage of total cost without regard to prior period deficiencies or member contributions provides a measure of the significance of the funding deficiency with respect to annual requirements of the pension plan and conveys an impression of the magnitude of the funding deficiency. Expressing the funding deficiencies as a percentage of the annual payroll is a reliable means to evaluate the significance of the funding deficiency and provides a relative comparison among the municipal pension plans possible. The fund ratio is a measure of the sufficiency of funding to date and helps to identify a critical financial position.

Graph XI and Graph XII present information on the distribution of the 75 funding deficiencies. Graph XI shows that only 26 of the 75 funding deficiencies exceeded 90 percent of their individual Act 205 minimum municipal obligations. Expressing the funding deficiency as a percentage of the minimum municipal obligation provides a measure of the effort made to meet the mandated actuarial funding standard. Graph XI also indicates that 37 of the 75 municipalities failing to comply with the actuarial funding standard contributed 50 percent or more of their required funding on a timely basis and that 16 of those contributed at least 90 percent of their required funding. Graph XII, however, shows that funding deficiencies represented only one percent of the respective payrolls in over one-quarter (21) of the instances of noncompliance with the funding standard. Therefore, in addition to becoming less frequent, the reported funding deficiencies have become less significant. The enforcement activities of the Commission are in part responsible for reduction of the frequency and the significance of funding deficiencies from 1986 to 2000. In 1986, Pennsylvania's 1,832 defined benefit municipal pension plans reported 256 instances of noncompliance with the actuarial funding standard (a 14% rate of noncompliance). In the year 2000, even though the number of defined benefit municipal pensions has increased to 2,161, the number of reported funding deficiencies has decreased to 75 (a 3% rate of noncompliance).

The funding deficiency data provided in Table V should be considered with respect to the magnitude of the funding deficiency. Minimal funding deficiencies should not be cause for concern, although they do represent a means to alert responsible officials that increased administrative attention is necessary. Only in-depth, detailed assessments of the circumstances resulting in the funding deficiencies of the individual plans can authoritatively determine the action necessary to remedy the noncompliance with the actuarial funding standard.

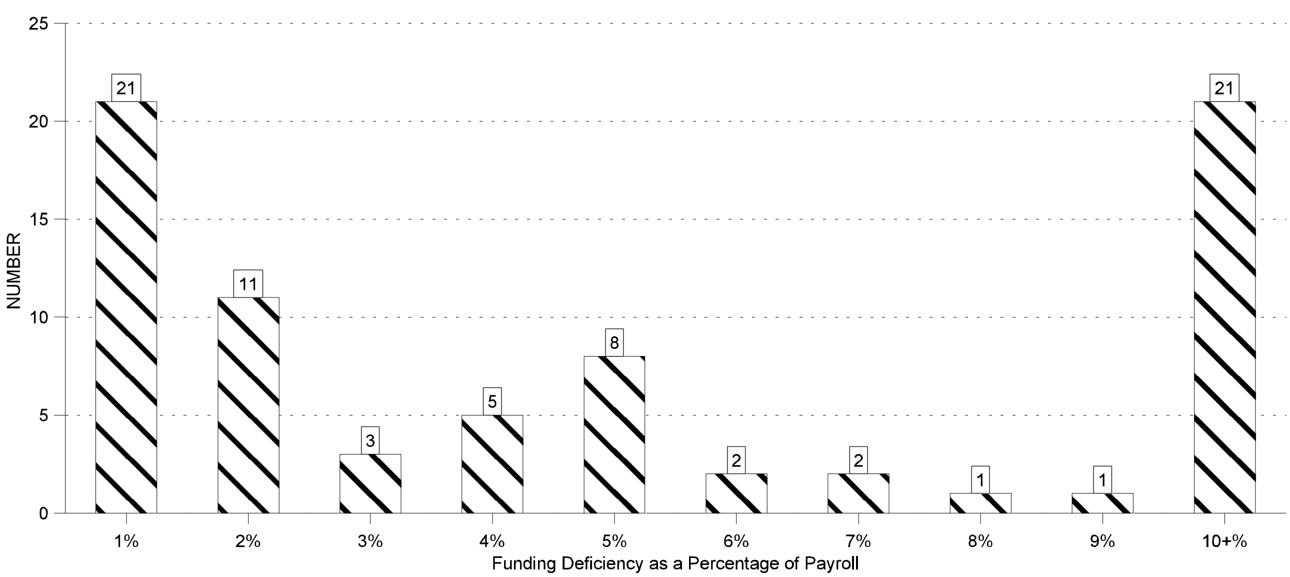
GRAPH XI

DISTRIBUTION OF FUNDING DEFICIENCIES CALCULATED AS PERCENTAGES OF THE MINIMUM MUNICIPAL OBLIGATION



GRAPH XII

DISTRIBUTION OF FUNDING DEFICIENCIES CALCULATED AS PERCENTAGES OF ANNUAL PAYROLL



In addition to the enforcement efforts for self-insured, defined benefit pension plans discussed above, 76 defined contribution municipal pension plans were issued letters indicating a possible funding deficiency in 2000. These letters were based on a significant reported deficiency between the calculated required contribution, according to an ordinance, resolution or plan document, and the reported actual municipal contribution. Enforcement activities by the Commission addressing defined contribution funding deficiencies helps to assure municipal employer adherence to promised funding levels of individual employee accounts and directly impacts employee retirement account balances on a year-to-year basis. The Department of the Auditor General was notified of both the defined benefit and the defined contribution funding deficiencies occurring in 2000.

MAJOR ECONOMIC ASSUMPTIONS

Chart IV is a tabular distribution of the major economic assumptions used by actuaries in the preparation of Act 205 actuarial valuation reports submitted to the Commission during the 2001 filing period. The chart displays the minimum, maximum and arithmetic averages of the interest rate and the salary scale assumptions by plan size along with the frequency of each assumption within specified ranges. Actuarial calculations used to determine annual pension costs and liabilities are necessarily based on assumptions regarding future economic and demographic events.

The two major economic assumptions addressed by Act 205 used in the preparation of actuarial valuation reports are the assumption as to interest earnings and the assumption as to future salary increases. Together these two assumptions are the primary determinant in annual costs and future liabilities. Act 205 specifies a range of economic assumptions that must be used in preparing actuarial valuation reports. The economic actuarial assumption as to interest earnings may not be less than 5 percent or more than 9 percent, and where the pension benefit is salary related, the actuarial assumption as to salary projection may not be greater than the assumption as to interest and not less than the assumption as to interest reduced by 3 percent. If assumptions outside of this range are used, the actuary must document that the specific experience of the plan that caused the actuary and the governing body to conclude that assumptions within the specified range are inappropriate and provide documentation that the particular assumptions chosen are appropriate for that plan. In the 2001 filing period, there were 17 plans with assumptions outside the specified range, down from 20 the previous filing period. Chart IV does not show the change in economic assumptions between Act 205 filing periods. The arithmetic average assumptions (when weighted by asset values) as to interest rate changed from 7.07 percent in 1999 to 7.05 percent in 2001. The average assumptions as to salary scale declined from 5.2 percent in 1999 to 5.1 percent in 2001. Accordingly, the average spread increased by .08 percent to be 1.95 percent during this period.

CHART IV

Interest Rate and Salary Scale Assumptions [1]

Distribution by Asset Size

Asset Size	No. of Plans	Interest Rate			Salary Scale		
		MIN	MAX	AVG	MIN	MAX	AVG
<$100,000	250	5.0%	8.0%	6.5%	3.0%	6.0%	5.1%
$100,000 - $1,000,000	906	5.0%	8.0%	6.9%	2.0%	7.0%	5.0%
$1,000,000 - $5,000,000	641	5.0%	9.0%	7.2%	3.0%	6.0%	5.1%
> $5,000,000	253	6.5%	9.0%	7.6%	4.0%	6.35%	5.2%

Frequency within Specified Ranges

Interest Rate Range	No. of Plans	Percent	Salary Rate Range	No. of Plans	Percent
5.0 to 5.4%	15	0.7	0.0 to 3.9%	34	1.7
5.5 to 5.9%	20	1.0	4.0 to 4.4%	114	5.6
6.0 to 6.4%	166	8.1	4.5 to 4.9%	139	6.8
6.5 to 6.9%	685	33.4	5.0 to 5.4%	1,400	68.3
7.0 to 7.4%	331	16.1	5.5 to 5.9%	234	11.4
7.5 to 7.9%	494	24.1	6.0 to 6.4%	126	6.1
8.0 to 8.4%	321	15.7	6.5 to 6.9%	2	0.1
8.5 to 8.9%	8	0.4	7.0 to 7.4%	1	0.0
9.0%	10	0.5			

[1] Forty-nine defined benefit plans that do not have a salary related benefit and use no salary scale have been excluded from the data.

PART IV

IMPACT OF CHANGES IN STATE AID ALLOCATION

BACKGROUND

Act 205 of 1984 replaced prior, inequitable State aid allocation formulas with a single allocation formula which annually distributes the Commonwealth monies available to aid municipalities in meeting their employer pension costs. The State aid provided under Act 205, General Municipal Pension System State Aid, is allocated to municipalities based on total amount of money available for distribution and the number of employee units reported by the individual municipalities. The State aid must be used at the discretion of the recipient municipalities to defray the costs of their employee pensions. The Act 205 formula limits the State aid allocations to 100 percent of the annual pension costs payable by the municipalities. This limit or "cost cap" on the annual allocations is necessary because of the wide variation in municipal pension costs. In some cases, excessive state funding provided under the prior allocation formulas has substantially lowered or eliminated municipal pension costs for current employees. In other cases, municipal pension costs may be very low because the level of benefits is low relative to the average municipal pension plan. In these and other situations, the allocation of State aid in excess of the annual municipal pension costs would provide funding where none is required and reduce the funding available for other municipalities. Therefore, the "cost cap" in the Act 205 allocation formula functions to ensure the efficient use of the available State aid and supports the program's purpose — offsetting municipal pension costs.

OPERATION OF THE ACT 205 ALLOCATION FORMULA

Chart V shows the total allocations of State aid and the corresponding employee unit values since 1985, along with the number and percentage of municipalities whose annual pension plan funding requirements were, or were not, fully met by State aid. In the five year period from 1985 through 1989, the unit value, which is used to determine individual allocations, increased from $1,146 to $3,269, an increase of about 185 percent. The total State aid allocated under Act 205 almost doubled during this period. The substantial increase in State aid during this period fundamentally changed the municipal pension plan environment in the Commonwealth. According to data obtained from the Department of the Auditor General, the 1989 State aid allocations fully funded municipal pension obligations in about 96 percent of the 962 recipient municipalities.

Because of the high probability that State aid would fully fund their municipal pension obligations, the orientation of municipal officials to their employee pension plans changed in recent years. Local tax revenues in many cases were not required to finance employee pension benefits; therefore, municipal officials became more likely to grant increased pension benefits. In addition, municipal pension benefits have been increased as an alternative to other forms of compensation because of the expectation that State aid will be increased due to the corresponding increases in employer pension costs. The same inducement exists for reducing member contributions.

However, as shown in Chart V, the General Municipal Pension System State Aid (GMPSSA) available for allocation decreased for the first time in 1990. Between 1990 and 2002, the total State aid allocated has shown an average annual growth rate of only 2.2 percent, almost half of which took place in 2002. In 2002, approximately $3.7 million of revenues that would have been available for allocation to municipalities were utilized by Act 147 of 1988 to provide state mandated cost-of-living increases for retired municipal police and firefighters. Act 64 of 2002 amended Act 147 to provide additional cost-of-living increases to retired municipal police and firefighters beginning in 2003. Initial reimbursement to municipalities under the new amendment will begin to reduce State aid allocations to municipalities in 2005 and succeeding years. The combined reduction attributable to Act 147 and the newly enacted Act 64 in the allocations to municipalities during the initial years of the Act 64 reimbursements may be in the range of $6 to $8 million, gradually decreasing over the succeeding years during the lives of the recipients.

The changes in unit value and the related changes in the percentage of municipalities receiving full funding or unit value is primarily caused by two factors. First, municipal pension costs vary from period to period. Because the distribution formula allocates the unit value <u>after</u> the allocation based on cost, the remaining amount to be distributed based on unit value must change. Second, changes in the numbers of active employees in pension plans impact the number of units, which in turn impact the unit value. If either the number of municipal employees covered by pension plans or the reported pension plan cost changes without corresponding changes in the size of the GMPSSA fund, the employee unit value also changes. Even though the total State aid allocation increased by $16.1 million in 2002 (an increase of 12%), the unit value only increased to $2,763 from $2,698 (an increase of 2 percent). At the same time, pension costs apparently increased such that the percentage of municipalities receiving State aid equal to full pension costs declined from 69 percent to 64 percent.

By statute, the City of Philadelphia receives annually an allocation of 25 percent of the amount of State aid available for distribution. In the year 2002, the City of Philadelphia received $37.6 million, the equivalent of an allocation equal to $984 per unit. The municipalities that are fully funded by State aid tend to be smaller than the municipalities that receive unit value allocations. In 2002, the 916 municipalities that were fully funded by State aid (64%) only employ about 45 percent of the active members of municipal pension plans (excluding Philadelphia).

The GMPSSA program has successfully redressed the inequities and inefficiencies of the prior allocation formulas. But because of the factors outlined above, there is no reason for an individual municipality to rely on State aid provided to fully fund its pension costs or to offset a predetermined portion of its municipal pension costs.

CHART V

Municipalities Receiving State Aid At Full Cost Versus Unit Value

Year	Total Allocation	Municipalities Receiving Full Pension Costs		Municipalities Receiving Unit Value		Unit Value
1985	$62.3 million	758	75%	253	25%	$1,146
1986	$78.4 million	632	63%	371	37%	$1,624
1987	$97.2 million	808	84%	154	16%	$2,173
1988	$109.0 million	922	94%	59	6%	$2,746
1989	$121.7 million	919	96%	43	4%	$3,269
1990	$115.9 million	824	87%	120	13%	$2,501
1991	$119.3 million	874	86%	143	14%	$2,490
1992	$121.4 million	818	78%	228	22%	$2,331
1993	$121.4 million	827	75%	277	25%	$2,310
1994	$122.9 million	783	70%	332	30%	$2,286
1995	$125.6 million	799	69%	361	31%	$2,311
1996	$127.5 million	739	58%	538	42%	$2,200
1997	$131.5 million	663	54%	564	46%	$2,248
1998	$129.2 million	861	65%	457	35%	$2,437
1999	$124.9 million	780	57%	580	43%	$2,217
2000	$133.3 million	983	71%	401	29%	$2,751
2001	$134.5 million	958	69%	436	31%	$2,698
2002	$150.6 million	916	64%	521	36%	$2,763

PART V

ADDITIONAL REFORM NEEDED

FIDUCIARY RESPONSIBILITY AND LIABILITY LAW FOR LOCAL GOVERNMENT EMPLOYEE PENSION PLANS

Fiduciary responsibility and liability standards and regulations for private sector retirement systems are primarily provided by the Employee Retirement Income Security Act of 1974 (ERISA). ERISA is applicable to private sector retirement systems and includes a broad class of private sector retirement system officials. It addresses investment diversification, establishes a prudent expert standard of care, provides that the operation of retirement systems be solely in the interest of and exclusively for the benefit of participants and beneficiaries and requires that pension plan documents be consistent with applicable law. ERISA also establishes civil remedies and sets liability for fiduciary breaches.

Government and public employee retirement systems have, however, been excluded from application of most ERISA provisions, including the fiduciary responsibility and liability provisions. Pennsylvania's 3,000 local government pension plans currently have over $16 billion in actuarial assets and have 135,000 active members, and taxpayer contributions to these retirement systems now exceed $350 million annually. Yet, there is not a comprehensive standard for the conduct of local government retirement system administration, and there is no legislatively established responsibility for fiduciary breaches.

Fiduciary responsibility and liability legislation does exist in Pennsylvania that is applicable to the two statewide public employee retirement systems, the State Employees' Retirement System and the Public School Employees' Retirement System. However, the only statute addressing fiduciary responsibility for local government retirement systems in the Commonwealth is the Probate, Estates and Fiduciaries Code. This law was originally intended only to direct the actions of persons managing estates and trusts. It was amended in 1982 and 1999 and incorporates a "legal list" of approved municipal pension investments, defines an administrator of a municipal pension plan as a fiduciary and subjects such administrator to a prudent person rule. In addition to the legal list (some of which may not be prudent investments for public employee pension plans), the Act authorizes an investment if "purchased or retained in the exercise of that degree of judgment or care . . . which men of prudence, discretion and intelligence exercise in the management of their own affairs . . . ." The Act does not set general or specific standards for fiduciary conduct, nor does it establish liability or remedies in the event of fiduciary breach.

In order to properly safeguard local government public pension fund investments and to provide a standard against which performance or breach can be judged, legislation establishing fiduciary standards and liability must be enacted covering all local government retirement systems in Pennsylvania. Clear performance standards, administrative responsibilities and the identification of whom to hold responsible for local government pension investments, such as was established by ERISA, should be legislatively imposed. Such legislation should include, at a minimum:

- Both general and specific standards of fiduciary conduct. The general standards should establish both the prudent person and the prudent expert rule. The prudent expert rule would be applicable to persons having particular expertise or specialized knowledge.

- Liability and remedies in the event of fiduciary breach. The liability for fiduciary breach should reflect recognition of inadvertent, negligent or intentional breach and, accordingly, should address an appropriate range of remedial damages.

- The responsibilities and liabilities of co-fiduciaries should be clearly established and joint responsibility of all the fiduciaries of the system should be identified.

- Authorization to obtain protection should be afforded to the system through both insurance and bonding of fiduciaries or any other officers or employees who participate in the management of system assets.

Fiduciary standards protect active and retired public employees by requiring that their retirement systems be administered exclusively for the purpose of providing promised retirement benefits. Clear fiduciary responsibilities protect taxpayers by increasing the probability that the retirement systems will be prudently run and that funds will be properly invested. Fiduciary standards help retirement system administrators by establishing in advance what these officials are to do and what constitutes acceptable behavior. The lack of an administrative standard to assure fiduciary responsibility and liability standards among Pennsylvania's local governments must be legislatively addressed to establish a comprehensive and clear standard applicable to all classes of Pennsylvania local governments.

STATEWIDE PENSION PLAN FOR MUNICIPAL POLICE EMPLOYEES

Overview

Excluding Philadelphia, Pennsylvania currently has 911 pension plans for municipal police employees. Those plans have a total of 11,492 active members – an average of about twelve (12) active members per plan. There are, however, 288 plans with three or less members and 166 plans that had only one or no members on the most recent Act 205 valuation date. Municipal police pension plans represent about 1/3 of all municipal pension plans in the state and about 22 percent of active municipal membership. In total, municipal police pension plans are paying benefits to 7,607 retired members and beneficiaries.

Administration

The inefficiency and ineffectiveness of the administration of large numbers of very small plans in comparison to a centralized single pension plan is evident. Municipal governments are increasingly required to react to multiple levels of state and federal legislation concerning tax and other employment related issues. Among Pennsylvania's decentralized system, the availability and accuracy of reliable data is accordingly becoming more critical. The maintenance of plan documents, as well as demographic, earnings and payment records must be maintained over the active and retired life of employees, which often exceeds fifty years. Small municipalities most often lack the administrative continuity to perform these functions on a long-term basis. Most municipal pension plans in Pennsylvania are too small to achieve actuarial predictability and as a result are not reliably funded. One example of actuarial instability that results from Act 600 (the Municipal Police Pension Law), as recently amended by Act 30, is the mandatory killed-in-service benefit to be provided to families of police officers. Municipalities subject to Act 600 must now pay a killed-in-service benefit equal to 100 percent of the member's salary. The probability of an officer being killed in service is low and, accordingly, annual actuarial funding requirements are minimal. However, if an officer is killed in service the financial effects to a small pension plan would be severe. The benefit may be payable for more than twenty years and, at the current average salary of a police officer, would result in a total payout of more than a million dollars. The average assets of municipal plans with three or less active members is only $394,000.

The administrative costs of maintaining many small pension plans is economically wasteful. During the most recent Act 205 filing period, the reported administrative costs for municipal police pension plans exceeded $15 million ($1,347 per member). If the per-member administrative costs of a single statewide plan could be reduced to the current per-member administrative costs of municipal pension plans with 500 or more members ($210), the annual savings would be about $13 million. In addition to the obvious cost advantages of a single administrative system, such a system would enhance employee communication, retirement counseling and legal services.

Portability

With the existence of more than 900 police pension plans, the absence of portability in Pennsylvania among municipal police employees is one of the most commonly cited deficiencies. This lack of portability prevents an employee from transferring pension rights and benefits from one municipal employer to another in conjunction with job changes. Accordingly, many police employees are restricted in their ability to achieve their full career potential. Employers also lose significant flexibility because of the impediment lack of portability imposes on the selection of employees from other municipalities. When an employee moves from one municipality to another under the current decentralized system, it is impracticable to establish an equitable method to value and transfer assets and service credits among municipalities with the varying benefit structures, funding mechanisms and funded conditions that currently exist. A single, statewide system would provide complete portability among all municipal employers and allow professional police employees the retirement advantages of a single statewide employer.

Benefit Structure

Much of the benefit disparity of municipal police pension plans is because of the disjointed and sometimes conflicting state laws governing police pension benefits. There are more than a dozen state laws, many of which have been amended repeatedly that directly impact the benefits to be provided to municipal police officers. In small borough and township police forces, there is no legislation at all governing the specific benefit structure of police employees. In many cases, benefit levels are not fully understood by the employer or the employee and the plan may not provide the expected levels of benefits when an employee retires. The benefits provided in some instances are determined solely by the amount of General Municipal Pension System State Aid received by the municipality and result in either unpredictably low or high retirement income. There are about 50 money purchase police pension plans, where the ultimate pension benefits are determined solely by the balance of the individual's account when he or she retires. Most municipal police pension plans, however, have a defined benefit structure with a basic benefit of 50 percent of final average salary. Some plans, however, provide benefits as low as 20 percent of final salary and some are as high as 80 percent of final salary. The normal cost rates among defined benefit municipal police plans also vary greatly and are another indicator of the disparity in benefits. Normal costs, when stated as a percentage of payroll, during the 2001 reporting period were as low as 2.8 percent of payroll and as high as 49.5 percent of payroll. These inconsistent levels of retirement benefits provided to police officers clearly result in cases of both inadequate and excessive retirement income.

Recommended Statewide Municipal Police Pension Plan

The establishment of a statewide municipal police pension plan would remedy the problems of ineffective and inefficient administration, lack of portability, and disparity in benefit structure. In addition, a statewide system would substantially reduce pension costs, provide for reliable actuarial funding, enhance the membership services, and provide equitable retirement benefits to police officers at reduced costs.

The funded condition of police pension plans has continued to improve since the passage of Act 205. The January 1, 2001, Act 205 Actuarial Valuation Reports for all municipal police pension plans (except Philadelphia) in Pennsylvania, in millions of dollars, reported in the aggregate:

$3,722	Present value of future benefits
$2,844	Actuarial accrued liabilities
$3,086	Actuarial Assets
$ (242)	Unfunded actuarial accrued liabilities

As of that date, when viewed as a single entity, police pension plans were about 109 percent funded. Actuarial assets exceeded accrued liabilities by $242 million dollars. In other words, these plans, if viewed as a single entity, on a current basis were fully funded and had $242 million in excess assets.

If all assets, liabilities, and active and retired memberships were transferred to a single statewide system, such as an integral, but separately distinguishable component within the State Employees' Retirement System (SERS), an expected increase in investment returns would occur. During the 17 years ending with the 2001 Act 205 filing period, the average rate of return for all municipal pension plans, excluding Philadelphia, was approximately 7.8 percent. During the same 17 year period, SERS achieved an average rate of return of 13.1 percent. Even a one percent increase in future investment returns, based on the current assets of all municipal police pension plans, would yield additional annual revenues of approximately $31 million. Further, the average actuarial assumption rate as to investment returns of the individual police pension plans is now 7.13 percent. In a single statewide system, an increase in the actuarial investment assumption rate would be justified. A one percent increase in the aggregate investment assumption rate would result in a funded condition where the actuarial assets of the plans would exceed both the accrued liabilities (by about 36 percent) and the present value of future benefits.

However, upon transfer to a statewide plan, it would be necessary to establish a more appropriately designed benefit structure, which would increase aggregate liabilities. Additionally, transferring assets equal only to accrued liabilities would alleviate the concern of over-funded plans subsidizing under-funded plans. Upon establishment of a single statewide plan, benefits could not legally be reduced, and in some instances benefits would need to be increased in order to reach one of several available benefit tiers. As a result, aggregate benefits would be higher than those in the present decentralized system.

Municipal, member and State contributions to municipal police pension plans currently total $68 million. With the potential for an additional $31 million in increased investment returns and an additional $13 million in administrative savings, the total resources that could be available to fund a statewide municipal police pension system would be $112 million. Because the current ongoing normal costs of municipal police pension plans are only $80 million, the establishment of a statewide municipal police pension system would generate $32 million in annual resources that would be available to effect necessary benefit modifications and reduce required municipal contributions. In addition to this significant ongoing funding resource, the most recent data indicates that over $500 million would remain in individual municipal police pension funds after entry into the statewide system is fully funded. These residual monies would be available to municipalities to offset future contribution requirements under the statewide system, which would in turn reduce the State revenues required by the affected municipalities. These data suggest that even a conservative evaluation would evidence that a statewide retirement system for municipal police employees would reduce the State and local government revenues needed to finance police pension benefits while effecting an improved benefit structure for the police members that is equitable and uniform.

DATA TABULATIONS

The following tables are self-explanatory with the exception of columns labeled “PLAN TYPE”. To indicate the type of employee covered by the pension plan, the plan column uses “P” for police officers, “F” for firefighters, and “N” for nonuniformed employees. In instances where more than one pension plan is maintained for an employee type, a numeric code is appended to the letter code for employee type to identify the individual pension plan. To indicate the type of benefit plan, the type column uses a letter code (A, B or C). The letter code “A” indicates a defined contribution pension plan or a pension plan without a defined benefit structure or defined contributions. The letter code “B” indicates a defined benefit pension plan that is fully-insured. The letter “C” indicates a defined benefit pension plan that is self-insured in whole or in part. And the letter code “U” indicates a Taft-Hartley Act collectively bargained, jointly trusteed, multi-employer pension plan governed primarily by the federal Employee Retirement Income Security Act of 1974 (ERISA). An asterisk in a data column indicates a value that cannot be calculated or data that is not applicable.