

A Presentation of the Pennsylvania Municipal Retirement System (PMRS)

To the Pittsburgh City Council

By James B. Allen, Secretary & Kristine M. Cline, Assistant Secretary

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Good morning members of council and thank you for your very kind invitation to be here this morning. We welcome the opportunity to present our agency to council and more importantly to address your questions relating to what is being referred to in the media as "The State Option." For the record, allow me to introduce myself and our agency's Assistant Secretary. As you can assume, I am Jim Allen, Secretary of the Pennsylvania Municipal Retirement System or PMRS as we refer to ourselves. The secretary is the Chief Administrative Officer of the agency and I have had the privilege of serving our governing Board in that capacity since September of 1984. Our Assistant Secretary, Kristine Cline is with me this morning and while she has not been in that capacity for as long as I, she also started with our agency in 1984. A more direct way of making our point is that sitting before you is over fifty years of PMRS history and experience.

While we are prepared to address your questions this morning, we apologize for not being fully aware of the accepted protocol. We have prepared these written remarks and can deliver them in short order or we can dispense with the reading of the same and jump feet first into your questions. Let me identify that these remarks have been designed to accomplish the following:

1. Explain what the PMRS is and what we do;
2. Address the potential role we have in administering the city's three pension plans;
3. Explain some key concepts like "actuarial valuations," and "Minimum Municipal Obligations (MMOs);"
4. Highlight several key, but often overlooked, provisions of Act 44 of 2009;
5. Make a few observations on the city's pension situation from an outsider's perspective; and
6. Conclude with taking your questions.

Madam President, how would you like us to proceed? Would you prefer we walk you through the above agenda or would you like us to simply answer your questions?

Our Presentation

Over the years I have been advised when making a presentation to do three things -- Tell the audience what you are going to tell them; tell them; and tell the audience what you told them.

This morning we would like to make these points:

1. The Pennsylvania Municipal Retirement System is NOT interested in bureaucracy building or in "taking over" municipalities' pensions. We are a government agency governed in large measure by local government officials and employees focused on helping municipalities "...secure the future retirement of their employees by providing comprehensive, cost efficient and professional pension administration services...". The quote is a part of our Vision Statement.
2. Act 44 of 2009 contains many moving parts, not all of which seem to be understood by the people in the cities of Pittsburgh and Harrisburg. And let us be clear, we include ourselves among the individuals who are still learning about the law's many provisions. We believe dialogues like the one we hope to have here this morning will do much to clear up misconceptions and the associated confusion or else we would not be here.
3. The city of Pittsburgh has a very, very serious problem with its pension plans. That problem is not who should administer them; it is that they are in the aggregate less than thirty percent funded and a consensus plan on how to get them to the 100% funded status has not been developed. More importantly from our perspective, we have been put into a position where we may be forced to help the city, assuming the city doesn't come up with \$200 to \$300 million dollars within the next two and a half months, and as of today, we don't have the numbers to show how serious the financial crisis is. We will have those numbers within three weeks.
4. Finally, we want to work with the city -- the elected officials, the employees, the citizens -- to secure the future of the city's three pension plans. If we leave here today with the city realizing we are partners facing a possible arranged marriage

and not some state bureaucrats out to “take over” the city’s pensions, we will consider our presentation a success.

Now that I told you what I’m going to tell you, let me tell you our story.

What The PMRS Is And What We Do

First and foremost we are a state agency that up until Act 44 of 2009 sought, as our Vision Statement says, “To be Pennsylvania local governments’ pension administrator *of choice*.” It is one of the rare times that the state has ever said to local governments - here we are – use our services if you want and if you don’t want that’s fine by us as well. We had been, until last year, a completely voluntary, full service pension administrator available to Pennsylvania’s local governments. In that capacity we administer over 900 public pension plans; about 25% of all of the state’s municipal plans. Being a state agency conjures up some perceptions that we are here to address. The first is that we are “political” and that we get caught up in the political infighting that seems to be the reputation assigned anyone from Harrisburg. That is not the case.

The fact that I have been able to serve as the agency’s Secretary for nearly three decades and my bosses, the members of the Pennsylvania Municipal Retirement Board have never once asked me my party affiliation should say something about the non-existent role politics has in our operations. Let me also briefly comment on our governing board, the men and women who make the decisions on where the assets are invested, and what the actuarial assumptions should be, and who guide the operations of the system. These are men and women much like you. Not experts in high finance or actuarial science but good people who are good judges of character and who have been appointed by the various governors over the years. We do have on our board state Treasurer Rob McCord, and the Secretary of the Commonwealth Merenda, but the other nine board members are locally elected officials or fire fighters or police officers or retirees.

They know that their number one job, their only charge, is being a fiduciary for the assets amassed for the 14,000 members of those 900 plus plans. I want to underscore this point because this is truly what makes us different from the other public plans in this state, be it the

Public School Employees Retirement System, the State Employees retirement System, Allegheny County's Retirement Board, or the City of Pittsburgh's pension boards. Our board members understand that their allegiance is to the individual plan members relying on them to see that they will get the pension benefit that has been promised them. Our board members do not have to worry about how their decisions will impact their next election, or the election of the individual who appointed them to the board. Understanding that they embrace this trust that has been placed in their hands explains in part the reason they tend to make more conservative decisions than other public pension fund trustees.

What we do on a day to day basis is administer 900 plus different pension plans for 14,000 members. We make sure the money is there to pay benefits, we counsel retiring employees, we pay widows, we advise municipal officials on benefit plan design, we prepare actuarial valuations, and invest plan assets – we are a full service pension administrator to those plans that choose to use our services. We are not “The State.”

Addressing The Potential Role We Have In Administering The City's Three Pension Plans

Let us be clear on this next point. We must acknowledge that the PMRS Board and staff did not seek to be the “State Option” you are considering this morning. Approximately two years ago we were approached with the idea that we, PMRS, should be the mandated pension administrator of any municipality's pension plans that are in the aggregate less than 50% funded. Our Board said that we would not advocate for that responsibility and that we should advocate against it if it jeopardized one of two principles: If it placed in question our efforts to become IRS tax qualified or if it harmed in any way the funded status or operations of our existing enrolled plans.

By passage of Act 44 the General Assembly and Governor made the decision to use the PMRS as the mandated administrator in the case of Pittsburgh. As you know, if the city's plans, in the aggregate, are not 50% funded by January 1, 2011, PMRS will assume responsibility to administer all of the city's plans by September 18, 2011. Our role during the debate on this legislation last year was to assure the members of the General Assembly that we could in fact administer the city's plans if required to – we made those assurances to the Legislature and we

are here today to make those same assurances to you. We can and we will do what has been assigned to us, if we have to.

But what has been assigned to us, potentially? The law says that the city is to "...transfer all existing benefit plans established by the city to the Pennsylvania Municipal Retirement Board **solely for administration.**" (Our emphasis added). The law goes on to say "Pension benefits and eligibility requirements shall continue to be subject to collective bargaining, if applicable. Such plans shall not be subject to the control or input of the board." Let us be clear about this. We see our potential role in Pittsburgh no different than that role we take in Monroeville or Wilkins Township – The city will control benefit negotiations; our role is to tell the city how much those benefits cost and to deliver those promised benefits to the employees when it comes time for them to retire. Media reports and certain studies we have seen suggest that we will control the benefits being provided. That is not true. We would be required to administer the benefits agreed to by the city.

In addition to the day to day administrative responsibilities, we must underscore the point that the PMRS would also assume responsibility for establishing actuarial assumptions, investment policy, procedural practices and plan benefit interpretation. These fiduciary duties would become ours. The role of the existing city pension boards would be dramatically changed. This would not necessarily lead to their dissolution – they could play a valuable consulting role to the PMRS and city officials. However their control of day to day decisions would be transferred to PMRS.

Another point around which we have heard some confusion (and I might add I also did not accurately recall this provision of the legislation), PMRS would NOT be required to offer first to the city's existing employees any jobs with the agency. While that was a mandate in the legislation at one point, the final version did NOT retain that requirement. That being observed, we believe that if PMRS were to assume responsibility for the city's pension plans we would need to establish a regional office in the city to service the 7,000 plus employees and retirees added to our care. You have my commitment that we would work with the city's existing employees handling pension matters so as to determine their eligibility on the various state civil service lists. We will consider them for future positions as best we could under the state's Civil

Service Law. We note that of the twenty-seven employees employed by the PMRS Board, only Kris and I are "at will" employees. All other employees have been hired under the state's civil service law. No one in our office has been hired because of their party registration or who they supported in the last election.

Another commitment we give today is to work with you as council men and women, the city employees, the collective bargaining representatives and the city's administration to make that transition as smooth as possible should it be required. Once such a transition is deemed to be required we would devote the resources and staff necessary to ensure that the employees and retirees do not suffer a reduction in service. Frankly we believe that we can bring an increase in services to the city's employees and retirees. But that will be touched upon later in this testimony.

Some Key Actuarial Concepts

We hope not to appear condescending but we would like to proceed with this next portion of our testimony with a very simple assumption – that that the individuals serving on council know absolutely nothing about pensions or how they are funded. We would like to provide a three minute introduction to several key actuarial concepts/terms so that after a few minutes, everyone will be comfortable with our next discussion – how the state requires municipalities to fund their pensions.

Let me really get into trouble by sharing my personal favorite definition of an actuary. I tell people who are unfamiliar with the actuarial science to think of an actuary as nothing more than a high priced bookie. The actuary "lays odds" on the plan's members' life expectancy, career growth, salary increases and the plan's investment return - among a number of other variables. By laying down those odds, an actuary tells the fiduciary (the pension board) how much money needs to be set aside now to pay the future benefits. This process is undertaken by way of an actuarial valuation.

Act 205 of 1984 requires all municipalities in the state, whether they are administered by PMRS or not, to take a snapshot of their pension plans as of January 1, of the odd year (2009, 2011). That valuation, typically filed in March of the even year with our sister state agency, the Public Employees Retirement Commission (PERC), becomes the basis for preparing the next two years' municipal obligation or funding requirement, also known as the Minimum Municipal Obligation or MMO. The city's January 1, 2007 Act 205 Valuations were used to create the city's 2009 and 2010 MMOs. The January 1, 2009 Act 205 Valuations will be used to create the city's 2011 and 2012 MMOs no matter what happens on January 1, 2011.

For a number of reasons we need not go into here, the staff at PERC saw a train wreck coming with the January 1, 2009 valuation and worked with PMRS and the Legislature to attempt to ease that disaster. That was the genesis of Act 44 of 2009. One set of provisions in the new law was designed to provide temporary relief to all of Pennsylvania's municipal pension plans suffering from the devastating affects of the Great Recession. We will not go into more detail on this point today but we did want to take you this far down the road so we could explain what we are now doing for the city.

As of yesterday afternoon, the city's administration and consulting actuary has provided to our consulting actuary all the data we believe we need to replicate the city's January 1, 2009 Act 205 Valuations. We are doing this so that we can provide the city administration, the council members, and even the staff of the General Assembly who have requested that we share our results with them, an accurate assessment of the city's funded status and MMOs under several very different sets of assumptions.

We have committed to all that within three weeks of today, we will provide four sets of numbers. The first set will be a replication of your existing January 1, 2009 Act 205 Valuations. We do this so we know we are starting at the same place in the discussions. Next, we will provide a set of numbers showing the application of the Act 44 relief measures to the city's valuations. This will show the impact of the Act 44 versus the non-relief MMOs and funded status.

The third set of numbers will apply the PMRS assumptions to the city's data while also applying the city's selected Act 44 relief measures, including the ability to use an assumed investment rate

return of 7.5% instead of PMRS' regular 6.0% assumption. The result will be a prediction of the city's future MMOs with PMRS as the administrator based upon a mandated assumption of this responsibility. This will assume a January 1, 2011 database that mimics the January 1, 2009 database. This is a false assumption but one that will allow an accurate apples-to-apples comparison of projected costs and funding requirements.

The fourth and final set of numbers will be similar to the third set BUT the investment return assumption will be only 6.0%. This set of numbers will show what a voluntary enrollment in PMRS would cost. Let us emphasize this option because some have talked about whether it is better to enroll in PMRS voluntarily at some point in the future or to do so under the Act 44 mandate. There will be a funding difference due to the investment assumption break the Legislature provided under the mandate. This is only a once and done break and everyone needs to be aware of that. You will be provided with the dollar value of this 1.5% difference in the investment assumption.

We promise to provide these numbers within three weeks. We also give you our commitment to have access to our consulting actuary once we have shared the numbers. This is not as an enticement to join the PMRS; this is the service the Legislature requires us to provide all potential municipalities seeking to enroll.

Several Key, But Often Overlooked, Provisions Of Act 44 Of 2009

We have already talked about some of the many provisions of Act 44 of 2009, but there are several more that we at least have to mention because to our knowledge, they have not been discussed before. At least not in this type of setting.

All municipalities in the state have been evaluated as to their pension plans' level of distress. This evaluation happened this summer: Pittsburgh, to no one's surprise, was determined to be a Distressed Level III municipality – the most severely distressed level. This determination based upon the January 1, 2009 Act 205 valuations is not the determination that may force PMRS into

the city's future. This determination does require and authorize the city to take a number of steps to help it get the plans better funded. These include:

1. Expanding procedures and ranges surrounding asset smoothing methods in valuations – Pittsburgh has utilized this provision.
2. Voluntarily: a) change member contribution requirements; b) escape certain municipal contribution level restrictions; c) utilize special taxing authority (this is not the parking tax provision); and d) reduce the amortization requirement to 75% of regular required payment for the next six years.
3. Required: a) aggregate pension funds for administrative and investment purposes (already done in Pittsburgh); b) establish a new benefit plan for new hired employees (See comment below); c) submit a plan for administrative improvement.

The decision on what voluntary actions the city has selected is not known to us this morning. Those decisions may have been conveyed to us BUT frankly we have not had the opportunity to examine all the materials provided to PMRS during the last several days. The city council, however, should be made aware of the actions being taken under these provisions of the law. They will impact future funding patterns.

The comment we wanted to interject is that while the law requires new plans to be established, ironically the law does not require the new plans to have lesser benefits or cost less. We have also been asked whether the provision allows the city to establish a defined contribution plan for new hires. While we have our opinion, we are not attorneys and would not want to be seen as giving the city legal advice on this issue. We would be happy to participate in discussions with the city's solicitors and consultants should they want to hold such discussions. We also must close by observing that these provisions are to be read in conjunction with the labor relation laws and collective bargaining agreements entered into by the city.

The city is aware of the Act 44 provision that requires our possible administration of the city's plans. We do know that there are questions as to whether this is a once and done window/requirement. The answer is yes. This determination will be made once based upon the

city's submitted Act 205 valuations prepared as of January 1, 2011 and filed with PERC by September 1, 2011. If we are to assume administrative control of the city's plans it will be by September 18, 2011.

Another provision often overlooked is the new bidding requirements found in Act 44. There are extensive disclosure requirements and transparency provisions found in the new law. These provisions also apply to PMRS. We have undertaken three money manager searches under the new law. We entertained over 180 applications from potential money managers. The successful applicants' application forms and disclosure forms are available on our website. To anyone who thinks "pay-to-play" can be found in Harrisburg, we can assure you that it won't be found at PMRS. We invite you to examine our existing portfolio of money managers. We are sure you will find them, as you will find our board and staff, above reproach. We trust the city is aware of these new requirements and is addressing them with equally diligence.

Finally, we would note that the new act requires PMRS to establish a Deferred Retirement Option Plan or DROP. Our Board has adopted a new plan provision which will be available to enrolled plans as of January 1, 2011. This benefit is also independently available to the city if they so want to establish a DROP.

A Few Observations On The City's Pension Situation From An Outsider's Perspective

We have imposed upon your patience enough already this morning so we will conclude with several brief observations that weren't asked for but are offered.

1. The focus of the city's pension crisis should not be about who administers the city's pension plans; it should be on how they get fully funded.
2. There is a crisis that we observed two summers ago that has yet to really get the attention it needs. While the funding levels are frightening low, the real problem is the negative cash flow being experienced by the plans. In 2009, the plans paid out \$30 million dollars more in benefits and administrative costs than they took in

from municipal and employee contributions. At that rate the plans would be bankrupt in ten years.

3. It doesn't seem to be understood by anyone that regardless of whose assumptions the city uses to fund the pension plans, the cost of paying out the required benefits will be exactly the same. The reality is that a retiree entitled to receive \$1,000 a month for the rest of her life will have to be paid that \$1,000 whether the city assumes an 8.0% investment return or a 6.0% investment return. It truly is a case of pay me now or pay me later. Eventually the city is still going to have to pay each retiree his or her promised benefit. That pay out will be exactly the same no matter what the investment assumption was used to fund the projected pay out. Failure to acknowledge this key point is only an invitation to participate in a generational shift of responsibilities. In the popular vernacular, you will be kicking the can down the road.

Time For Your Questions

There are many, many things that should be discussed. We have run out of time to explain how PMRS insulates our enrolled plans from the markets' volatility, or our very low administrative costs (and, yes, we believe our numbers will show we administer our 900 plans more economically than the city). We do want to address these and other issues but we most importantly want to answer your questions.

We ask that you view this presentation as our open invitation to continue a dialogue regarding the city's pension problems and our possible position in helping the city address them. Madam President, we are happy to take council's questions.