

The Funding Crisis in Municipal Pensions

EMPLOYEES WHO PARTICIPATE IN A DEFINED BENEFIT PENSION PLAN look forward to receiving their accrued benefits at retirement. For city employees, these vested, accrued benefits are a contractual obligation between the city and the worker that can't be denied. Unlike participants in private pension plans, municipal employees have no federal agency, such as the Pension Benefit Guaranty Corp. (PBGC), that insures or guarantees their pension benefits. There's no one to bail them out.

Unfortunately, many municipalities in America face the consequences of underfunded pension plans, escalating benefit costs, and reduced income on investments. It's a situation that must be addressed immediately, before a crisis ensues.

The San Diego Situation

According to recent records, the San Diego pension system is saddled with a deficit of at least \$1.4 billion, which was triggered in 1996 by employee benefit boosts and stock market losses. The crisis has become more and more complex, complete with resignations and criminal investigations. Members of San Diego's pension board have been accused of padding their pensions by agreeing to renew the county's underfunding practices.

Pension reform was a platform of San Diego's mayoral race, and suggestions proliferate on how to resolve the problem. They range from putting the pension plan into receivership with a call for reorganization to simply raising the age of retirement for city employees. Many options that are frequently balked at have called for employee contributions to increase the funding.

In Florida, many local municipalities are facing a similarly disastrous situation due to politically increased benefits that were passed without knowledge or consideration for accompanying costs. Long-term benefits have long-term ramifications, with additional costs accruing exponentially. As more and more retirees qualify for benefits, municipal losses complicate the city's ability to comply.

The solutions are difficult. The city can't cut benefits. Tax revenues are keeping the plans alive—but just barely—because of the ad valorem tax increases from higher



real estate values that won't continue forever. And, apart from not having a PBGC to insure benefits, municipal pension plans are also generally not governed by federal law that regulates private pension plans, the Employee Retirement Income Security Act of 1974 (ERISA).

What Are the Options?

There are three clear options, but steps must be taken to avoid a domino effect.

Plans need to earn more money. With rising real estate taxes and insurance premium rebates, the money simply isn't there to fund these plans, particularly with the costs of benefits

rising along with the number of individuals retiring. New investments with higher yields will provide more income.

Most cities are notoriously conservative in their investments because higher returns mean added risk. Recent articles indicate that pension plans in general are considering a venture into the sometimes risky and murky hedge fund market to help increase investment returns—new and uncharted territory for pension funds.

Employees (participants) must contribute more. This makes sense, as it is a funding option common in corporations. The city of Dania, Fla., eager to attract city employees and reduce turnover, has created an incentive program to draw municipal workers to the city and to remain there. Among the incentives is an excellent benefits package, but there's a significant mandatory employee contribution requirement: an 11.66 percent-of-earnings contribution was required before Oct. 1, 1999.

Because of funding issues for promised benefits, the employee mandatory contribution was increased to 19.74 percent after that date. But the city agreed to make 16.08 percent of the mandatory contribution for the employees *in lieu of scheduled wage increases*. The employees are thus bearing a significant part of the cost of plan funding.

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Increased contribution by the municipality. Increasing contributions to the pension plan for a municipality will require reducing budgeted expenses elsewhere or increasing revenues, most likely through local tax increases. The potential political ramifications of this option are obvious.

Although each solution has its drawbacks, cities must recognize the potential for a crisis and begin to take action to avert it. Municipalities can learn from one another's mistakes before the pension financial crisis reaches a critical mass and a point of no return, and they can be proactive in reducing the possibility of a funding crisis.

Action Required

ERISA was passed in 1974 in response to the mismanagement of funds by private-sector defined benefit plans and to provide enforcement rights for participants. As complex as ERISA is, it does provide for

legislation and intervention and requires employers to adequately fund their pension programs.

Employers with defined benefit pension plans must pay premiums to the PBGC for pension insurance coverage. Congress is currently seeking to further tighten pension funding rules, given the recent bankruptcies that have added to the PBGC's ever-increasing deficit.

In addition, ERISA establishes fiduciary responsibilities that must be followed. If they're breached, participants often have a direct cause of action against the trustees or the employer. Municipal plans and their participants have no such protections, except as may be provided by state laws, many of which are not nearly as extensive as ERISA.

Because municipalities aren't governed by ERISA, circumstances have arisen—and will no doubt continue to arise—where government workers,

whose retirement benefits are guaranteed, become jeopardized or where taxpayers will suffer from the lack of supervised plan management.

The resolution of the municipal pension problem is complex. Would federal legislation authorizing action to govern municipal plans violate states' (and cities') rights? Is the ability of taxpayers to vote and remove local government officials a sufficient remedy? Do taxpayers have the information to even make these decisions?

Each state legislature should take the lead to reform laws governing municipal plans; otherwise, cities will have to take action *before* the crisis worsens. One thing appears clear: Defined benefit pension plans in both private and public use are dangerous dinosaurs that should be discontinued and replaced by defined contribution plans (such as 401(k) plans) in future years.

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