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Public Employee Benefit Review

Pension Legislation May Provide Financial Relief to Local Governments

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The Senate passed House Bill No. 2467 *(HB 2467)* on July 2, 2004 amending Act 205 of 1984 to extend amortization periods for certain actuarial losses. The bill is expected to become law within two weeks.

Immediate relief may come from the section of the bill permitting municipalities to revise 2003 actuarial valuation reports for their defined benefit plans to reflect a longer amortization period for the investment loss. This revised valuation report could then be used to recalculate the plan's 2004 Minimum Municipal Obligation (MMO) as well as to calculate the 2005 MMO this fall. State Aid for both years would not be affected by the revised valuation.

Municipalities electing to revise 2003 actuarial valuation reports will need to act quickly. Revised Act 205 reporting forms must be filed with the Public Employee Retirement Commission by Sept. 30, 2004.

Valuation reports for plans with no unfunded liability *(and therefore no amortization payment)* could not be revised under HB 2467 regardless of the magnitude of investment losses or increase in contribution requirements. Defined contribution plans would not be affected at all by this legislation.

The other change HB 2467 makes to Act 205 is an extension of the amortization period for future actuarial losses incurred by Act 600 police plans due to payment of killed in service benefits.

The Jan. 1, 2003 actuarial valuation reports for many pension plans showed large actuarial losses primarily due to investment returns in 2001 and 2002 that were significantly below the interest rate assumed by the actuary. Not only did most plans fail to achieve the assumed rate of return *(typically 7 – 8 percent)*, but many also had negative returns for one or both years.

Staggering investment losses have resulted in drastically increased pension contribution requirements for 2004 statewide. In many cases, these increases will be mostly or solely assumed by the municipality. While state aid may be used to fund the minimum contribution requirements, many municipalities' pension costs will exceed the maximum allowance from the state, leaving the municipality on the hook to make up the difference.

HB 2467 would allow the increase in a plan's unfunded liability specifically attributable to the 2001 and 2002 investment losses to be re-amortized over a 30-year period. Currently, actuarial gains and losses are amortized over a period of up to 15 years. Such a change could be thought of as switching from a 15 to 30-year mortgage, but only for that specific loan *(or "loss")*. The payment period for the amortization of all other gains, losses, benefit changes and assumption changes, whether established in 2003 or a prior valuation, will remain as originally established.

The 2003 valuation report for some plans included a reduction in unfunded liability and amortization credit for a change to an asset smoothing method. Actuaries and plan sponsors recognized that the actual fair market value of plan assets on Jan. 1, 2003 could significantly understate the worth of a plan's assets due to depressed stock prices and low interest rates. Under asset smoothing, recognition of losses and gains are generally spread out over a four or five year period. This change offset some of the investment losses for those plans.

In the short-term, this legislation may provide an opportunity to ease the burden of super-stretched budgets or reduce the gaps in budget deficits. However, plan sponsors should also carefully consider the long-term effects of extending annual payments on actuarial losses by 15 years or more.

Many are optimistic that investment gains in 2003 and 2004 will offset the losses from the Jan. 1, 2003 valuation, or perhaps completely eliminate the unfunded liability. Pension plans with half or more of their assets invested in equities posted returns in 2003 of nearly 20 percent, or more. If we see similar returns for 2004, it may be possible for plans to return to their pre-recession heyday, but that appears to be unlikely at this time. It may take a number of years for most plans to recover. And, for plans that are now valued under an asset-smoothing method, only a portion of the 2003 investment gain and 2004 gain or loss will be recognized in the 2005 valuation, along with a portion of prior years' losses that were deferred.

If your municipality's 2004 MMO was calculated using the 2001 actuarial valuation report rather than the 2003 report, revising the valuation may only provide relief for 2005.

Another important factor to consider is that although state aid allocations for 2004 and 2005 will not be affected by the extended amortization period, allocations for subsequent years may be.

The member contribution rate for many Borough and Township police plans was established, whether by decision of the governing body, or through negotiations or arbitration, based on the amount of the 2004 MMO calculated in 2003. If the 2004 MMO is now revised, could it affect the employee contribution rate already established for 2004? Lower MMO payments could certainly impact the negotiation of contribution rates and benefit improvements for future years. Going to arbitration could be dangerous if all parties aren't fully aware of the long-term impact of making benefit improvements at a time when payments on the unfunded liability are artificially low.

Under HB 2467, you may now be able to reduce one of the largest expenses in this year's budget. But before you pull out the red pen, contact your actuary to determine your savings and find out other factors needing consideration before authorizing a revised valuation.

IN BRIEF

Other Legislative Activity:

The DROP legislation, now House Bill No. 2269, was passed by the House on June 29, 2004; but as of July 2, it had not yet been assigned a committee in the Senate.

The Senate passed Senate Bill No. 985 on May 10, 2004, which would abolish common-law marriages contracted after Jan. 1, 2005. This bill has been referred to the House Judiciary Committee. If this law is passed, it could impact on surviving spouse benefit entitlements in Pennsylvania governmental pension plans.

Reminders/Deadlines for Remainder of 2004

Sept. 1 (approx.): ......Act 147 (ad hoc COLA) reimbursement checks mailed

Sept. 30: ....• Revised 2003 valuations under HB 2467 must be filed with Public Employee Retirement Commission
• 2005 MMOs must be submitted to the governing body

Oct. 1 (approx.): ....State aid checks for 2004 will be mailed

Oct. 31 (approx.): ......State aid must be deposited to pension funds (30 days after receipt)

Dec. 31: ....2004 MMO deposit is due

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Next Issue: GASB's proposed statement on disclosing the cost of post-retirement medical benefits

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