



CREATIVE SOLUTION TO A COMMON CHALLENGE

# City of Philadelphia, Pennsylvania

## *Philadelphia's Road to Pension Recovery*

BY JACQUELINE DUNN



### About Philadelphia

The City of Philadelphia, the economic and cultural anchor of the greater Delaware Valley, is the largest city in Pennsylvania and the sixth most populous city in the United States.

In 2018, Philadelphia adopted a comprehensive plan to improve the long-term health of its pension system by paying down its unfunded liability more quickly while also reducing the rate at which future liabilities will grow. Its funding ratio has historically been below average compared to peer cities, and the funded level dropped 10 points from 2008 to 2009, to 45 percent. When reform discussions began in 2016, the fund was still only 44.8 percent funded, with just \$4.9 billion available to cover \$11 billion in liabilities.

To combat the underfunding, the city employed a bilateral approach, focusing on reforms that foster effective decision-making and fiscal discipline and wide-ranging partnerships that engage elected officials, union officials, and pension board members. These changes were made to improve the health of the pension fund and to reach full funding by 2033.

### STRATEGY

The city's plan will improve the pension system's funded level to 80 percent by 2029 and 100 percent by 2033 by:

- Dedicating additional assets to the fund.
- Reducing the rate at which future liabilities grow.
- Reducing the plan's risk profile.

Additional funding comes from dedicated city sales tax revenue, additional employee contributions negotiated through collective bargaining, and payment of the full actuarially required contribution every year. The city created a revenue recognition policy to dedicate these revenues to the city's pension liabilities.



Using the additional money *in addition* to the city's full annual actuarially required contribution will improve the city's funded status more quickly than using money *as part* of the payment would have. The policy of making additional payments toward the unfunded liability will also help insulate the plan's funding level and the city's contribution amount from annual market fluctuations. By fiscal 2019, Philadelphia's total contribution was \$752 million, up from \$431 million in 2008. The rapidly increasing costs were not sustainable and crowded out spending on other critical priorities. But the city's funding plan includes continuing dedicating revenues/assets to the pension; pension costs as a share of the budget will remain elevated until the city reaches full funding and is only paying the normal cost.

To reduce the rate at which future liabilities grow, the city administration and union negotiators agreed to create a new mandatory "stacked hybrid" plan for new, non-uniformed hires. The new plan combined elements of a traditional defined benefit plan, which is capped at \$65,000, and a 401(k) plan, in which participation is voluntary. By fiscal 2029, the flat cap is projected to reduce future plan liabilities by more than \$100 million. Total annual employee contributions have increased from \$58.6 million to \$83.3 million between fiscal 2015 and 2018. By offering a stacked hybrid plan, Philadelphia is able to continue providing a defined benefit for its new non-uniformed employees while better managing the rate of growth in future pension costs to ensure the long-term financial health of the system and city.

To reduce the plan's risk profile, the pension board has voted to make some changes in the way the assets are managed. They gradually reduced the assumed rate of return, which affects investment decisions and the amount of the city's contribution, from an all-time high of nine percent ten years ago to 7.55 percent. Lowering the assumed rate of return is fiscally prudent, but because any reductions result in an immediate increase in the city's pension costs, city leadership and the pension board also consider the size of future reductions each year to make gradual but consistent progress. They also shifted assets into passive investments with lower management fees and transferred assets from expensive and often volatile hedge funds into more stable real estate funds. The board also adopted changes to other actuarial assumptions including mortality rate and salary growth to ensure that projections match actual experience. These changes will reduce the likelihood of adding to the unfunded liability in any given year.

Combined, these changes have resulted in two consecutive years of net positive cash flows, meaning the fund is receiving more assets than it is paying out in benefits. The level of total city contributions is unique among public pension plans: The Philadelphia pension

system falls in the 95th percentile among plans in the Public Pension Plan Database (established by the Center for Retirement Research at Boston College and the Center for State and Local Government Excellence, and supported by the National Association of State Retirement Administrators). The plan is 49.7 percent funded as of fiscal 2020.

## BENEFITS

Taking a comprehensive approach involving all stakeholders has enabled Philadelphia to address the root cause of the underfunding and to achieve the buy-in needed to sustain funding progress over time. Additionally, developing a funding policy that requires additional payments toward the unfunded liability helps improve the funding status more quickly than otherwise, and it insulates Philadelphia from the impact of periodic market fluctuations on its annual contributions.

The city's approach has improved the health of its chronically underfunded pension fund and, in turn, improved the city's overall financial condition. Pension costs had grown to consume increasingly larger shares of the city's budget, meaning fewer resources were available for other critical priorities. In 2002, seven percent of the city's budget was allocated to pension contributions. Currently, about 15 percent of the city's budget is dedicated to pension costs. The reforms the city put in place have stopped this ever-increasing rate of growth. As the city's reform plan dedicates additional assets to the pension fund beyond the required contribution, the share of the budget dedicated to pensions is projected to remain constant at 14 to 15 percent over the next five years. The city has more predictability around future pension costs, and the continued practice of providing more than the actuarially required contribution will help the city reduce the unfunded liability over time.

## LESSONS LEARNED

Philadelphia successfully engaged critical stakeholders in a collaborative process to implement and ensure a long-term solution. Philadelphia Mayor James Kenney was clear coming into office that improving the health of the pension fund was a top fiscal priority. During negotiations and arbitration, the city analyzed alternate proposals for employee contribution levels and benefit structures, ultimately modifying the reform plan to respond to stakeholder concerns while still reaching its stated funding targets. Where possible, the city also codified components of reforms in legislation and its union contracts. The city is required to use the additional employee contributions to reduce the unfunded liability, limiting the ability of future stakeholders to deviate from the funding plan.



## GFOA BEST PRACTICES

The city looked to several GFOA Best Practices in implementing its pension strategy.

### *Defined Benefit Retirement Plan Design*

This Best Practice defines the appropriate elements of a defined benefit (DB) plan, which provides employees with a predictable retirement benefit for life. DB plans are based on an established formula and are defined by a legal plan document. These plans may be funded by employee and employer contributions and investment returns. The investment-related risks are typically borne by the plan sponsor. The benefits formula is calculated by multiplying the benefit percentage based on the years of service times the final average compensation.

### *Defined Contribution Retirement Plan Design*

This Best Practice defines the appropriate elements of a defined contribution (DC) plan as the primary retirement vehicle. A DC plan provides funds for retirement based solely on the assets available in an employee's individual account, and all investment-related risk is borne by the employee. Defined contribution plans can be offered as the primary retirement plan or as a supplemental retirement plan.

### *Hybrid Retirement Plan Design*

GFOA recommends that governments that choose to provide a hybrid retirement benefit plan, address key points related to plan design, funding policies, board governance, plan conversion, and participant education. The fundamental goal of retirement plan design is to adequately meet the needs of employees, consistent with the plan sponsor's available resources.

### *Sustainable Pension Benefit Tiers*

Jurisdictions that are considering new benefit tiers should examine the following issues: A government's authority to revise its pension benefits, the overall goals it wants to accomplish by doing so, and the effect of such changes on the workforce; and the financial impacts resulting from changes to pension plan design, as well as the effects on employees. GFOA further recommends that as governments consider new benefit tiers they solicit input from actuaries during the analysis, design, and implementation related to forecasting benefit costs, determining funding adequacy, and making decisions regarding employer and employee contribution rates.



## CONCLUSION

Many cities and states have pension funding challenges that place a strain on their operating budgets and threaten to jeopardize retirement security for beneficiaries. Improving the health of the pension fund requires budgetary tradeoffs and support from a wide-ranging group of stakeholders. Elected officials, union officials and pension board members were all willing to make sacrifices today to improve the future health of the fund. The breadth of that partnership will help ensure that the pension changes stay in place in the future.

**Jacqueline Dunn** is first deputy city treasurer for the City of Philadelphia, Pennsylvania.

