Managing Volatility

Detroit Addresses Pension-Related Financial Stress with an IRC Section 115 Trust

BY JAMES L. TATUM III

In bankruptcy, the City of Detroit, Michigan, cut retiree benefits and closed its two pension funds, but it retained a substantial net pension liability. To address the net pension liability that remained, the city created an irrevocable trust fund as authorized under Internal Revenue Code (IRC) Section 115. Detroit's Section 115 trust, the Retiree Protection Trust Fund (RPTF), will help the city smooth out spikes in annual required contributions (ARCs) in the years ahead.

The city filed for bankruptcy on July 18, 2013, after decades of population loss and industrial decline. Over 16 months, it battled with creditors to restructure $18 billion in liabilities. Of the $18 billion, $3.5 billion was owed to city pension funds. In a deal labeled the "Grand Bargain," the city broke contracts, shorted bondholders, and cut pensions. Ultimately, the city was able to reduce its liabilities by approximately $7 billion. Still, Detroit retained a substantial net pension liability post-bankruptcy.

The RPTF has allowed the city to commit additional resources beyond those required by the settlement reached in bankruptcy, or "Plan of Adjustment." Contributions to the RPTF do not represent contributions to its public pension plans. Rather, the RPTF provided a useful mechanism for addressing the city's pension-related financial stress.

Bankruptcy and remaining liabilities

No major American city had filed for bankruptcy before Detroit. No previously filed Chapter 9 case measured liabilities in the amount of Detroit's case (see Exhibit 1).

The city's net pension liability was $3.5 billion—19% of its total liabilities. The $1.4 billion in certificates of participation were also, indirectly, liabilities related to its pension funds. Between 2003 and 2004, the city issued bond-like securities called certificates of participation and used the proceeds to make pension contributions.

EXHIBIT 1: DETROIT'S TOTAL LIABILITIES IN BANKRUPTCY (IN MILLIONS)

Special obligation bonds	$6,400
Other post-employment benefits	5,700
Pension benefits	3,500
Certificates of participation	1,430
General obligation bonds	651
Swap contracts	347
Other	300
Grand total	**$18,328**

EXHIBIT 2: CITY OF DETROIT'S PLAN OF ADJUSTMENT, FY 2015–24 REQUIRED PENSION CONTRIBUTIONS (IN MILLIONS)

General Retirement System and Police and Fire Retirement System	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24
City (Water and Sewer Funds)	$65.4	$45.4	$45.4	$45.4	$45.4	$45.4	$45.4	$45.4	$45.4	$-
Detroit Public Library	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.9
Special assessment tax	4.4	4.0	4.0	3.9	3.7	3.7	3.6	2.3	2.0	1.6
State of Michigan	194.8	–	–	–	–	–	–	–	–	–
Philanthropies	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.3
Detroit Institute of Arts (DIA)	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
City (General Fund)	12.1	20.0	20.0	20.0	20.0	–	–	–	–	111.0
GRAND TOTAL	**$302.5**	**$95.2**	**$95.2**	**$95.1**	**$94.9**	**$74.9**	**$74.8**	**$73.5**	**73.2**	**138.8**

Another $5.7 billion was owed to retirees related to other post-employment benefits, namely the city's promise to pay for retiree healthcare costs. In total, the city had $10.6 billion in liabilities related to employee benefits.

There were two pension funds: General Retirement System (GRS) and Police and Fire Retirement System (PFRS). GRS was 63% funded (FY 2014). PFRS was 83% funded (FY 2014). To reduce the net pension liability, the city broke its promises to plan members and amended the contracts among the three parties. GRS members had their pension income cut by 26%. PFRS members had their pension income cut by 4%.

In addition to cuts in benefits, GRS and PFRS were closed. No further benefits were accrued by current employees, and current and new employees were shifted into new pension plans with skimpier benefits. The Plan of Adjustment—the bankruptcy settlement that dictated who would be paid and how much—resulted in four pension plans: GRS II and PFRS II (the two plans that were closed in bankruptcy) and GRS I and PFRS I, which were opened in FY 2015. (Unless otherwise specified, GRS and PFRS are the two plans closed in bankruptcy).

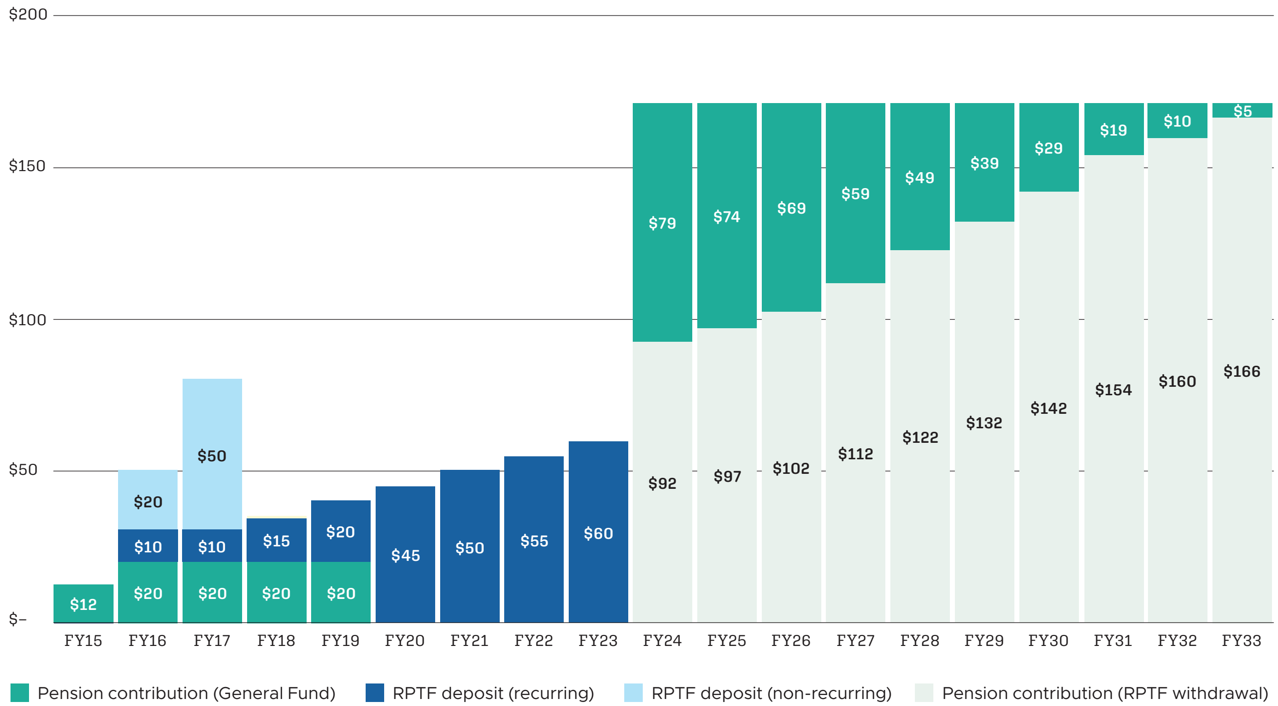
Like General Motors and Chrysler, which filed for bankruptcy in 2009 and reinvented themselves afterward, the city's Plan of Adjustment adjusted debt but also provisioned for recovery. The plan lists many reinvestment initiatives, including demolition of vacant structures, computer system modernization, and park refurbishment. To ensure the city's ability to pay for these reinvestment initiatives, the Plan of Adjustment allowed Detroit to take on new debt but also allowed for a "holiday" from actuarially required contributions (ARC) between FY 2020 and FY 2023.

Forecasts included in the Plan of Adjustment (see Exhibit 2) projected the city's (general fund) pension contribution to be $111 million once payments resumed in FY 2024. (Exhibit 2 also details the "Grand Bargain," a settlement scheme in which city-owned art in the Detroit Institute of Arts was transferred to nonprofit ownership; the State of Michigan and philanthropic community provided money for the city's pension funds; and pensioners had their benefits reduced.)

Retiree Protection Trust Fund

Forecasts of city pension contributions in FY 2024 and thereafter almost immediately became obsolete. In 2015, the plans' actuary, Gabriel, Roeder, Smith, revised estimates produced under the Plan of Adjustment and as a result the net pension liability increased. The required pension contribution for FY 2024 rose by 75 percent to $194.4 million. Further, while the initial increase in the projected city pension contribution was due to updated data on mortality, subsequent failures by the pension funds to earn the plans' set rate of return of 6.75% has meant the cost has fallen onto the city. (Because GRS and PFRS are closed plans, the pension funds do not receive employee contributions.)

EXHIBIT 3: DETROIT'S FY 2017 CONTRIBUTION AND WITHDRAWAL PLAN (IN MILLIONS)



In response, the city created a Section 115 trust in FY 2017 and named it the Retiree Protection Trust Fund. Instead of the intended reprieve from ARCs, the city volunteered to set aside money between FY 2017 and FY 2023 to make the ARCs that would resume in FY 2024.

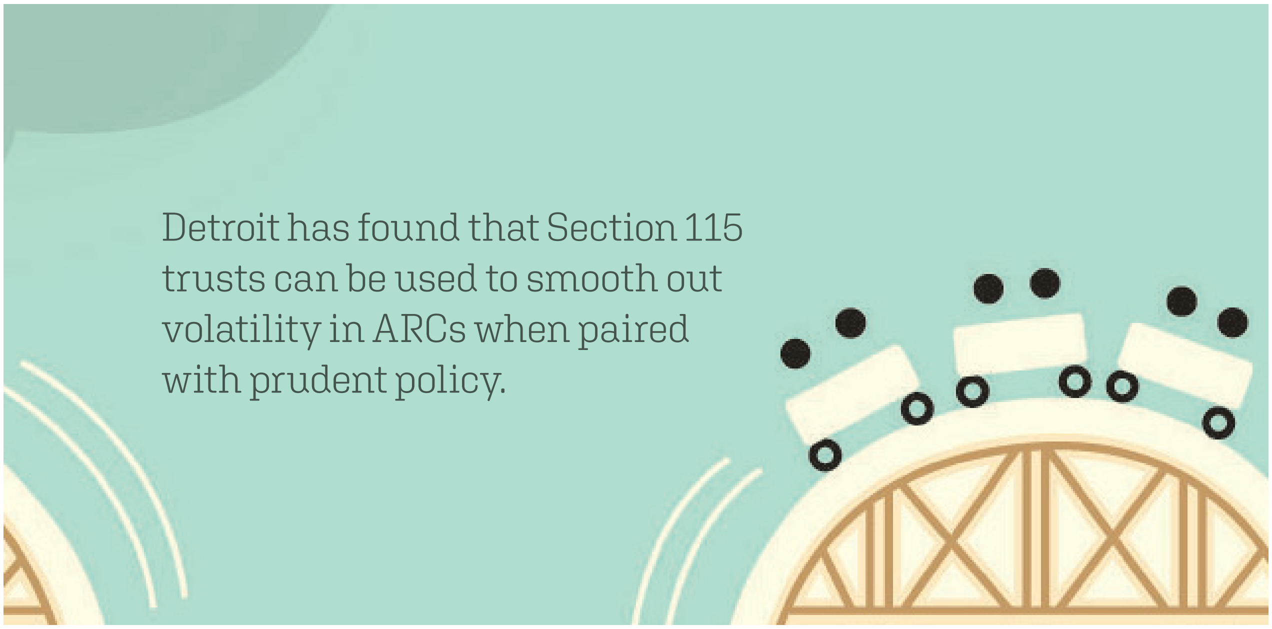
For tax purposes, Section 115 excludes the income earned from money set aside by a municipality when that money is used for the "exercise of any essential governmental function," according to the IRS code. Exhibit 3 is a forecast of RPTF contributions and withdrawals; it illustrates the city's plan (as of FY 2017) to use the RPTF to pay its ARCs.

In its first iteration, the RPTF contribution and withdrawal plan projected that the city would contribute $335 million in total between FY 2017 and FY 2023, annually earn 4% in investment income, and withdraw a total of $427.7 million across fiscal years until the fund was exhausted in FY 2033. The city's first iteration of the plan was predicated on a projected city pension contribution of $173.5 million in FY 2017. Much like what occurred post-bankruptcy, this number became obsolete in subsequent years.

Based on the FY 2019 data (the latest data included in the city's basic financial statements), GRS is 63% funded and PFRS is 70% funded. Combined, the net pension liability is $2.2 billion. Once ARCs resume in FY 2024, the cost to the city's general fund is projected to be $177.9 million. The amount is less than the $194.4 million projected immediately post-bankruptcy, but it is still $66.9 million more than anticipated by the Plan of Adjustment.

The COVID-19 pandemic and the economic fallout caused not only by the virus but by public health measures to stop its spread have led to reduced tax receipts and sustained losses in state and local pension funds. In the February 2020 Revenue Estimating Conference held by Detroit, the city projected general fund revenue of $1.1 billion in FY 2021 (pre-COVID-19 pandemic). In the September 2020 Revenue Estimating Conference, the city projected general fund revenue of $840.7 million, a loss of $244.1 million, or 23%.

The city initiated cutbacks to account for lower revenues; notably, it canceled a $20 million deposit to the RPTF planned for FY 2021. Still, the city has committed enormous resources to the RPTF, and based on the latest iteration of the plan (see Exhibit 3), found in a 10-year financial forecast report published on July 31, 2020, the city plans to contribute even more.



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To date, Detroit plans to contribute $335 million to the RPTF. The current balance, as of FY 2020, is $184.7 million. RPTF assets are held in cash, cash equivalents, and short-term marketable securities, and so the Federal Reserve's decision to lower interest rates in response to the COVID-19 pandemic has likely lowered RPTF investment income for the foreseeable future. Under the most recent iteration of the RPTF contribution and withdrawal plan, the RPTF will be exhausted in FY 2031.

Conclusion

Detroit has found that Section 115 trusts can be used to smooth out volatility in ARCs when paired with prudent policy. The plan sponsor could, for example, estimate a mean or median required pension contribution and base its contributions to and withdrawals from a Section 115 trust on this estimated amount. In times when the required pension contribution is less than the estimated mean or median, the plan sponsor can contribute the amount of the incremental difference to the Section 115 trust. In times when the required pension contribution is above the estimated mean or median, the plan sponsor can withdraw that money from the Section 115 trust.

Section 115 trusts may be an appropriate response to pension-related financial stress for some plan sponsors because they are irrevocable and allow plan sponsors to set aside additional resources for their pension plans. Furthermore, the fact that a plan sponsor has set aside reserves to handle spikes in ARCs is likely to lead to favorable views of creditworthiness when those municipalities issue bonds, as ample reserves are indicative of financial health.

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[1] The Police and Fire Retirement System and General Retirement System of the City of Detroit, 2019, Annual Actuarial Valuation of Component II (GRS and PFRS separate reports).

[2] Mary Williams Walsh, "Coronavirus Is Making the Public Pension Crisis Even Worse," The New York Times, April 2, 2020.

[3] Changes to the FY 2021–FY 2024 Four-Year Financial Plan (Revised), City of Detroit, Office of the Chief Financial Officer, 2020.

[4] Jeanna Smialek, "Fed Pledges Low Rates for Years, and Until Inflation Picks Up," The New York Times, September 16, 2020.