

PUBLIC EMPLOYEE RETIREMENT COMMISSION

ACTUARIAL NOTE TRANSMITTAL

Bill ID: House Bill Number 1432, Printer's Number 1778

System: All Municipal Pension Systems

Subject: Deferred Retirement Option Plans (DROPs) and
Technical Amendments to Act 205 of 1984

SYNOPSIS

The bill would amend the Municipal Pension Plan Funding Standard and Recovery Act (Act 205 of 1984) to provide for the establishment and administration of Deferred Retirement Option Plans (DROPs), to be known and cited as In-Service Retirement Option Plans (IROPs) in local governments in the Commonwealth of Pennsylvania, and to make certain necessary technical amendments.

The In-Service Retirement Option Plan (IROP) provisions of the bill would:

Authorize a local government with a defined benefit pension plan to establish an IROP as part of the plan;

Permit a member of such a pension plan who is or will be eligible for normal retirement to elect to participate in the IROP;

Provide for IROP election forms;

Provide for early termination of IROP participation by a member without a penalty;

Require that IROP participation begin the day after normal retirement and continue for the period specified in the IROP ordinance;

Require that the normal retirement benefits of an IROP participant, together with interest, be credited to a separate subsidiary account;

Require payment of the balance in the account to either the member or a beneficiary within 45 days after termination of IROP participation as either a lump sum or a tax-sheltered rollover distribution;

SYNOPSIS (CONT'D)

Provide protection of IROP benefits to IROP participants including protection from State and municipal taxation but permitting claims under the Public Employee Pension Forfeiture Act and qualified domestic relations orders;

Require that an IROP participant be eligible for all postretirement benefits and for most pre-retirement benefits that are restricted to active employees;

Provide for the crediting and payment of benefits if an IROP participant dies during the period of IROP participation;

Permit a former IROP participant to be re-employed by the local government after the elected participation period ends;

Require the establishment of an IROP participant account and its separate, subsidiary accounts that are to be held in trust;

Provide for the establishment of IROPs by the Pennsylvania Municipal Retirement System for its participating local governments;

Provide for a transition period for existing plans to conform with the IROP provisions;

Provide for rectifying future noncompliance with the IROP provisions; and

Prohibit IROP participants and their compensation from being reported as active members and active member payroll for purposes of actuarial valuation reporting under Act 205.

The technical amendments contained in the bill would:

Provide for the Commission to certify pension cost data based on the latest report required to be filed under Chapter 2 of Act 205;

Explicitly provide authority to the Auditor General to withhold State aid in instances of funding deficiencies until the deficiencies are resolved;

SYNOPSIS (CONT'D)

Upon the expiration of the Supplemental State Assistance (SSA) Program in 2003, provide for the cessation of determinations of distress for municipalities, provide for the cessation of certifications to the General Assembly of needed SSA appropriations, and provide for the cessation of certifications to the Auditor General of the SSA for each eligible municipality; and

Authorize continuation of any Recovery Program remedy previously elected and implemented that is being used by an eligible municipality on December 31, 2003.

DISCUSSION

Under Act 66 of 1981, the General Assembly created the Public Employee Retirement Commission (Commission) and directed the Commission to give priority to formulating and recommending passage of legislation, within one year of the initial meeting of the Commission, to mandate actuarial funding standards and establish a recovery program for municipal pension systems determined to be financially distressed. The resulting statute was the Municipal Pension Plan Funding Standard and Recovery Act (Act 205 of 1984).

Act 205 of 1984 affects every borough, city, incorporated town, township, municipal authority, and council of governments in the Commonwealth of Pennsylvania. The Act requires actuarial reporting by municipal retirement systems, establishes a minimum funding standard for every municipal pension plan, provides for the allocation of General Municipal Pension System State Aid, and establishes a recovery program for financially distressed municipal retirement systems.

Act 205 Technical Amendments

In addition to the annual distributions of General Municipal Pension System State Aid (GMPSSA) to municipalities, Act 205 provides for a Supplemental State Assistance (SSA) Program for municipalities participating in the Recovery Program for Financially Distressed Municipal Pension Plans. Under the Act, the SSA program began in 1988 and is scheduled to terminate after 15 years. To be eligible for assistance, municipalities participating in the SSA program must file annual actuarial valuation reports with the Commission. The program is financed by annual general fund appropriations. The allocations under the program were

DISCUSSION (CONT'D)

intended to accelerate improvement in the actuarial condition of financially distressed municipal retirement systems. The amount of assistance is directly related to the degree of financial distress in the individual municipal retirement system.

The bill makes necessary technical amendments to Act 205 in connection with the scheduled expiration of the SSA program in 2003, by providing for the cessation of determinations of distress to municipalities, providing for the cessation of certifications to the General Assembly of needed SSA appropriations, and providing for the cessation of certifications to the Auditor General of the SSA for each eligible municipality.

The bill also provides for the Public Employee Retirement Commission to certify pension cost data to the Department of the Auditor General for use in the determination of State aid (GMPSSA) allocations and for the Department of the Auditor General to withhold State aid in instances of funding deficiencies under Act 205. In both cases, the language simply reflects current practices.

Deferred Retirement Option Plans

Deferred Retirement Option Plans (DROPs) provide an optional way to pay retirement benefits. They permit an employee who is eligible for normal retirement to continue employment and continue to receive wages or salary as usual. But, instead of deferring retirement, the employee's regular monthly retirement payments commence and are deposited into an interest bearing account. At the conclusion of employment, which coincides with the end of the DROP participation period, the employee leaves service, receives the balance in the interest bearing account and begins to receive regular monthly retirement benefit payments. The ability to continue employment at full salary, after retirement benefits commence, allows the employee to accumulate resources for use in retirement that would otherwise not be available.

A DROP benefits employers by allowing the employer to retain more senior/skilled employees who might otherwise retire. Also, the transition and replacement process for retiring employees is more predictable, and the employer is able to provide employees with a desirable retirement benefit option at little or no cost. From an employee perspective, the ability to accumulate additional resources to be used in retirement is the primary attraction. Also, during the DROP period, employees may experience increased take-home pay because pension contributions typically are not required. DROPs are particularly advantageous to employees

DISCUSSION (CONT'D)

who are members of pension plans that do not provide for additional benefit accrual after retirement eligibility.

Most DROPs increase employer administrative costs and all delay the reduction of payroll costs associated with replacing retired employees at lower salaries. Incorrectly designed DROPs or those created in the absence of statutory guidance have the potential to be unexpectedly expensive and conflict with municipal codes, Act 205 and the Municipal Police Pension Law. In the absence of carefully crafted legislation, compliance with federal anti-discrimination rules and the Internal Revenue Code could be problematic as well. Under a DROP, the employee forgoes somewhat higher ultimate monthly pension benefits, but gains the right to accumulate lump-sum pension benefits while still employed.

Because DROPs established by both public and private sector employers are undefined by statute, the individual design features of DROPs are extremely diverse in nature. Usually, a member must be eligible for full retirement in order to participate. Maximum DROP participation periods between two and five years are common. Typically, neither benefit accruals nor contributions take place during the DROP participation period. Most DROPs allow for the lump-sum payout of the balance in the accumulation account and many allow the participant to choose between various payout methods.

Because of the potential diversity of DROPs, it is unlikely that, in the absence of enabling legislation, DROPs created in Pennsylvania would conform to existing State statutes. While compatibility with State statutes in many states may pose no significant problem for municipal pension plans, non-conformance with Pennsylvania's Municipal Pension Plan Funding Standard and Recovery Act (Act 205), for example, would have the potential to cause inequitable allocations in the annual distribution of more than \$130 million in General Municipal Pension System State Aid. Pennsylvania currently has no enabling legislation or guidelines for the implementation of DROPs administered by local governments. The bill would amend Act 205 by adding a chapter specifically addressing this issue by creating a uniform Pennsylvania local government DROP structure known as the In-service Retirement Option Plan.

SUMMARY OF ACTUARIAL COST IMPACT

The Commission's consulting actuary reviewed the bill and determined that adding an IROP to a local government defined benefit plan could either increase or decrease the long-term cost of the defined benefit plan. Key factors will be:

- 1) the extent to which members would elect an IROP in the future relative to the extent to which members currently defer their retirement past first eligibility for normal retirement;
- 2) the rate of interest credited on IROP accounts;
- 3) anticipated (or already negotiated) salary increases; and
- 4) the level of continued benefit accruals under the plan after normal retirement for members who do not participate in the IROP.

POLICY CONSIDERATIONS

In reviewing the bill, the Commission identified the following policy considerations.

Substantial Conformance with Policy Guidelines. (+) In March 2002, the Commission released a special report entitled, *Deferred Retirement Option Plans (DROPs): Authorization and Guidelines for Implementation of DROPs by Local Governments in Pennsylvania*, a report recommending policy guidelines for authorizing, designing and implementing Deferred Retirement Option Plans (DROPs) in Pennsylvania local governments. The bill conforms to the policy recommendations contained in the Commission's special report.

Statutory Authority and Guidance. The bill would provide necessary statutory authority and guidance by providing statewide legislation specifically authorizing the implementation of DROPs by Pennsylvania local governments.

Uniform Design. The bill would provide a single, uniform, statewide DROP program that fully integrates DROPs into existing statutes.

POLICY CONSIDERATIONS (CONT'D)

Program Nomenclature. The bill would provide that DROPs established by local governments in the Commonwealth be cited and referred to as In-service Retirement Option Plans (IROPs).

COMMISSION RECOMMENDATION

The Commission voted to attach the actuarial note to the bill, recommending that the General Assembly and the Governor consider the policy issues identified in the Commission's actuarial note transmittal and favorably consider enactment of the bill.

ATTACHMENTS

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