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# Some Cities Struggling to Keep Pension Promises

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**A** few years ago, the city of Houston decided to sweeten its workers' retirement benefits. Along with their traditional pensions, city workers nearing retirement were offered special accounts, fed with money from the city pension fund. Although the accounts would pay generous returns, a study showed that the cost to the city would be modest.

What seemed a good idea then now looks ruinous. Hundreds of older workers will qualify for million-dollar payouts at retirement from these accounts. When their monthly pension checks start coming, some will actually have higher incomes than they did when they were working.

The city pension fund cannot support the payouts and has about \$1.5 billion less than the benefits it owes the work force. The district attorney is looking into possible wrongdoing. City voters will go to the polls on May 15 to decide whether Houston should opt out of a Texas constitutional requirement that all pension promises be kept.

The people of Houston may not know it, but they have plenty of company. Similar pension sweeteners have backfired in Philadelphia, San Diego and Milwaukee. Prosecutors have been investigating the pension plans in each of these cities, though charges have been brought only in Milwaukee, accusing one official of misrepresenting the cost. Still these benefits plans are being promoted to other city officials across the country.

At the heart of the matter is a type of pension benefit that has generally been shunned by corporations but embraced by state and local governments. Known as a DROP, for deferred retirement option program, the strategy has been hailed as a way to keep hard-to-replace teachers, engineers and other public workers on the job as they near retirement.

Advocates say the plans allow workers to get big one-time checks when they retire, at potentially no additional cost. In practical terms, though, DROP's have been abused again and again by naïve or self-interested officials, who have pumped up benefits well beyond what the rank and file expected or what the pension fund could pay. Records show that some of these officials set up rich programs to coincide with their own retirements.

"The administration thought this was a good way to reward the employees," said Houston's human resources director, Lonnie G. Vara, who did not design the sweeteners but now has the job of explaining them. Houston, like many cities, he said, offered big pensions to make up for paying its workers less than they could earn in the private sector. Mr. Vara, with 30 years' service, stands to get a \$1.5 million check from the program when he turns 60 in seven years. In addition, he will receive monthly pension checks totaling about \$110,000 a year, according to an actuary hired by Houston.

Two years ago, San Diego offered individual pension accounts, after promising a cost study that was never done, according to a trustee of the pension fund, Diann Shipione. Some people there, too, stand to earn more by retiring than by working, and the city pension fund has a \$1.1 billion shortfall.

Philadelphia tested the supplementary pension accounts in 1999, saying it would review the program after four years to see whether it was affordable. Last year, the mayor said the benefits were draining the pension fund and had to be abolished. But city pension trustees made them permanent.

In Milwaukee County, residents were so angry to learn that supplementary pension accounts would turn some officials into millionaires that they held a recall election and voted seven county supervisors out of office. The county executive and two of his aides resigned under fire, and another official was prosecuted for misrepresenting the benefits' costs. Other criminal charges may be in the works, and several civil lawsuits are pending.

"When I first saw a DROP I said, 'Oh my God, who came up with that?' " said Sean F. McShea, a managing director at Ryan Labs, an asset-management firm in New York that deals extensively with public pension plans. "Everyone believes it's a free lunch."

In 1982, a handful of police and firefighters in Baton Rouge, La., came up with the idea of tapping their pension fund before they retired, and using the money to create individual escrow accounts. Their pension plan, like most traditional plans, paid their benefits as a stream of monthly checks, called an annuity.

Working with an actuary, they figured out that if they turned down the longevity raises they were entitled to just before retirement, their pension fund could use that money to set up individual accounts. In other words, they could get two benefits for the price of one.

As the stock market boomed in the late 1990's, the idea caught fire, spreading from firefighters and police departments to teachers, judges and all sorts of public workers. The idea of giving up something in exchange faded away.

Today, the basic concept works this way: When an employee becomes eligible to retire, he instead opens an escrow account, and then keeps on working at normal pay. His pension benefit stops growing, just as if he had retired. The pension fund starts sending monthly checks to his escrow account. The escrow money earns interest, and when the employee finally does retire, he gets a lump sum. He also starts

receiving his monthly pension checks, which are based on his benefits before the escrow accounts were created.

Pension specialists have created all sorts of variations on the DROP — the "drip," the "plop," the "backdrop," and so on, allowing workers to come in out of the plans, for example. Financial-services companies began teaching pension officials how to set up the programs at conferences.

In 2002, the money-management and record-keeping firms that sponsor Guns and Hoses, a yearly party for fire and police pension officials, urged delegates to send in the details of their escrow accounts, for compilation in a catalog. Every delegate got a copy to take home, for use in negotiating better benefits. The sponsors got the data.

Speakers at these pension conferences usually state that the accounts can be "cost neutral," but warn local officials not to sweeten the benefits too much.

But when stock prices were booming, that caveat did not always register. Many pension officials assumed they could pack their programs with extras, and if it all cost too much, investment returns would make up the difference. Only later, when markets soured, did the magnitude of what they had promised become apparent.

"In my experience, the majority of DROP's have not been cost-neutral," said Joseph Esuchanko, the actuary hired by Houston to help it cope with its pension morass. Most of the programs were made too rich, he said. "That's definitely true in Houston. They've got this fantastic benefits formula."

For example, Houston's pension trustees decided the escrow accounts should pay a guaranteed annual interest rate of 8.5 percent — even more in years when the pension fund's investments did very well. In today's low interest rate environment, this has turned out to be a bonanza for the workers. Houston offered other sweeteners as well.

Other cities have made their own mistakes. Milwaukee County's pension officials guaranteed 9 percent returns on their escrow accounts, and took other steps to enlarge both the lump sums and the monthly annuity checks. They placed no limits on how long the accounts could stay open, for example, allowing them to compound into jackpots.

In October 2001, milwaukeeworld.com, a local news site, described how elected officials were qualifying for million-dollar retirement payouts. Existing retirees, who were ineligible for the new benefits, were outraged. They feared the big payments would suck money out of the pension fund, putting their own, smaller benefits at risk.

County officials said they did not know how the big payouts came to be. But then state law enforcement agents seized documents from the office of the county personnel director, Gary Dobbert. They showed that he had traveled to at least six pension conferences, at Pebble Beach, Calif.; Lake Tahoe, Nev.; and

other resorts, learning how to create supplementary pension accounts. His notes, included in court documents, show that the speakers stressed the need to design the programs frugally.

The court documents also show that back in Milwaukee, at least some officials were contemplating their own retirements as they put Mr. Dobbert's findings into practice. There were, for example, handwritten projections of how new benefit setups would affect the retirement of the county executive, F. Thomas Ament, depending on when he retired and other circumstances. One projection showed that if new benefits were put in place and Mr. Ament worked until 2008, he could receive an annual pension payout of about \$35,000 more than his yearly pay. He also stood to get a seven-figure one-time payout in some projections.

John D. Finerty, a lawyer for Mr. Ament, said that it was normal for public officials to check the effect of pension changes on their own benefits, and that Mr. Ament had not intended to withdraw the maximum. Mr. Ament stepped down in 2002 and did not earn the payout in any case.

Mr. Dobbert's lawyer, Craig W. Albee, said that Mr. Dobbert had designed large pension benefits because he anticipated a tough round of union negotiations and could not raise wages without overwhelming the county budget.

In March, Mr. Dobbert pleaded no contest to one felony count of misconduct in public office and two misdemeanor counts, stemming from stating in a memo to other county officials that the escrow accounts could be added onto the pension plan at no additional cost. A judge fined him \$11,000 and imposed a 60-day sentence, which he has already served, at a work-release center in downtown Milwaukee. He elected not to take his lump sum.

In Houston, it is not yet clear how the retirement account program came to be so generous. The City Council has asked the executive director of the pension fund, David L. Long, to appear and answer questions, but he has refused. Now the Council is trying to determine whether it can subpoena him.

Towers Perrin, the actuary for the pension fund, has issued a statement saying it is not to blame, even though it underestimated how many people would opt for the program. The statement pointed out that cost projections are often wide of the mark, "because those costs ultimately depend on a number of factors that cannot be predicted in advance." The statement also noted that even though the city had been informed that these were very optimistic projections, it went ahead anyway.

Charles A. Rosenthal Jr., the district attorney for surrounding Harris County, declined to discuss his inquiry, saying he was still gathering data and had not drawn any conclusions. But he noted that after the new benefits were approved, the pension fund's board was reconfigured to remove three trustees who had represented the city and its taxpayers.

"All the members of the board at this time stand to benefit from increases in the pension plan," he said.

In addition, the Legislature approved a constitutional amendment barring cities in Texas from reducing pensions. It was made law in 2003. The amendment includes a provision giving municipalities one chance to decide, in a referendum, whether to opt out. Houston will decide this at the polls on May 15.

Despite the uproar, Mr. Esuchanko said the DROP concept and its promise were still being promoted elsewhere. He went to an actuarial conference in March, he said, just as the scandal was breaking in Houston. The supplemental plans were discussed and the discussion of costs "probably took about five minutes," he said. No one mentioned the places where costs had exploded.