Editorial:
How Detroit came to betray its retirees

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Detroit's pensioners are right.
The city's financial problems aren't their fault, nor is the city's deep budget hole caused by the checks it issues to retirees, most of whom get about $1,600 a month.

But it is true that the funds are not generating enough income to keep pace with the projected number of retirees and structural costs of the system over the next 30 years.

So why is this a problem now?

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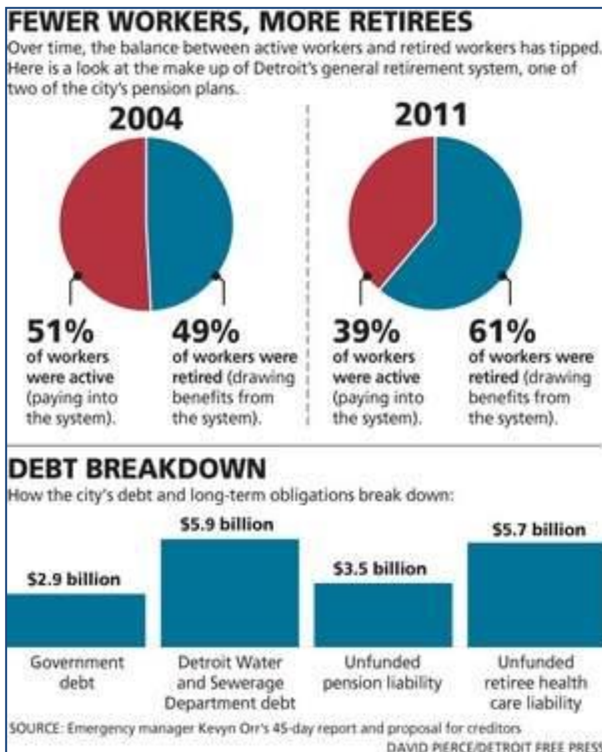
The number of retirees drawing benefits from the fund continues to increase, hastened by layoffs or workers retiring ahead of feared pension changes, so the number of workers paying into the fund continues to shrink. Meanwhile, the city's annual contribution to the funds keeps getting bigger. And because the city's revenues have fallen so dramatically, that means the city's growing pension contributions are consuming a greater and greater percentage of the city's cash — or they would, if the city were even able to make the payments.



As it is, the cost of providing pensions for Detroit's 21,000 retirees is the second-biggest drain on the city's bank account, second only to the tab for police and fire services. The estimated $3.5 billion that the city owes its pension funds is a little more than one-sixth of the $18 billion in long-term debt and obligations that consumes about 46 cents of every dollar Detroit has for basic services.

All that means we've hit the end of the road: The city can't pay what it owes the funds this year, much less make up its arrearage.

As emergency manager Kevyn Orr mulls how to restructure Detroit's pension costs and even considers altering payouts, it's more important than ever to be clear about how the city's pension funds got into this fiscal mess: Decades of mismanagement and bad practices, coupled with catastrophic market declines, have altered the pensions from a reliable way to assure retirees' futures into a massive financial burden.

Unfunded liability

There wasn't any one thing that brought Detroit's pension funds to this low point. Bad decisions were compounded by bad luck, and sometimes decisions that seemed sound wound up causing more problems than they solved.

The city operates two pension funds, the General Retirement System and the Police and Fire Retirement System; each has its own set of rules and conditions that dictate when an employee can retire and how much compensation that employee will receive.

Accounting guidelines require pension costs to be accounted for over a 30-year period, allowing funds to project earnings, income and payouts, spreading risk and reward over decades to help correct for market ups and downs.

When times are good and the pension funds are managed well, investments generate a significant return, and the city's contribution can be minimal.

But when things don't go well, and investments don't pay off, the city has to carry more of the burden.

For Detroit, times have rarely been good.

The city has struggled to meet its pension obligations since the 1950s. Post-war Detroit invested heavily in infrastructure, shortchanging the pension funds to pay for those improvements. Then came the auto industry recession of the late 1950s, leaving city finances in a tailspin, and leading to the first city income tax imposition.

For elected officials, frequent defaults on pension obligations to save operating cash became something close to standard operating procedure. So far, it hasn't affected pension checks, which are paid out of money that was invested years before. But it blows a hole in the 30-year projections and long-term solvency, and it requires bigger payments from the city than would originally have been necessary.

By 1991, for instance, a Wayne County Circuit Court judge was forcing then-Mayor Coleman Young to make $53 million in overdue payments to the pension funds. Young, attempting to plug a $50-million deficit, had delayed the payment pending a tax-credit sale.

Detroit officials have also made a habit of convincing unions to accept pension sweeteners — shorter terms of employment required, more generous multipliers, or a “13th check,” essentially an annual bonus — rather than pay increases. But that has raised pensions costs and had the unintended effect of shrinking the city's work force to the point where employee contributions can't keep pace with the needs of current pension recipients. The city has just 9,700 workers but 21,000 retirees drawing benefits.

That has meant larger and larger payments by the city to keep the funds solvent.

In the flush later years of the 1990s, returns were higher, and the systems were more stable. In 2000, the police and fire fund was actually overfunded by $622.1 million, meaning the fund's earnings had exceeded their projected rate of return.

But by 2005, pension fund practices, questionable investments and the city's deteriorating financial position had put Detroit so far underwater on its debt to the pension funds that it borrowed $1.4 billion to catch up. It was a temporary fix, and one that had the net effect of digging the city deeper into debt, struggling to pay both its creditors and its pension obligations.

The 2008 stock market crash dealt devastating blows to both funds — the general system lost $429 million in the 2008 fiscal year; police and fire lost $507 million, and losses continued into 2009 as the market reeled.

In 2009, the police and fire fund sued the city to compel a $45-million payment.

By last year, the city's finances had deteriorated so badly that it could make only partial payments to the funds. As of June 30 of this year, the city owed the funds a combined $103 million; when the city defers or postpones payments, it's charged 8% interest.

For a city to have to spend more than it has budgeted is bad enough, but when the city can't even afford to make that payment, the problem snowballs.

That's what happened in Detroit. And because neither the pension funds nor the city have changed the way they operated, the problems just kept getting worse.

Pension practices

Over the years, the funds' operational practices have worsened the problems.

The funds' managers assume a rate of return on their annual investments between 7.9% and 8%.

When the money doesn't come through, the city has to make up the difference — but in the general fund, better-than-average returns, or "excess earnings," were distributed into employees' annuity accounts.

Police and fire annuities support pension benefits, but general fund employees' annuities' earnings are held separately. Retirees can either cash in the annuity for a lump sum payment, or take an annual distribution. So excess earnings — which should be banked to help leaven the effect of lean investment return years — leave the system entirely. That practice ended in 2011, but the damage was done: Between that distribution and the 13th check, a report by the city's fiscal analyst found that $1.9 billion had left the system.

A report by actuarial auditor Milliman, commissioned last year, found that the pension funds used a few other accounting practices that — while legal — downplayed the brewing problems in the systems. One example is a 30-year open-ended repayment schedule for missed or delayed city payments. Because the schedule is recalculated every year, the city's payments never significantly impact the principal of the debt. Milliman also questioned the assumed rate of return.

Another wrench in the works is the funds' alternative investments, which consist mostly of real estate deals such as the new Meijer shopping center at 8 Mile and Woodward. The pension funds invested $28 million in that project.

In 2012, 12% of the general system's assets were alternative investments; the police and fire fund's total was 8%. These alternative investments, the funds' annual reports note, don't have a ready market value. So the value is determined by the pension systems' managers, and that means the actual value could be significantly lower than what's estimated.

Retirees and union representatives have condemned the Milliman report, saying that the picture it paints of the funds is too grim. Orr's response, meeting with the Detroit Free Press Editorial Board last month, was simple: If the Milliman report is wrong, then there's nothing to worry about.

That's not much consolation for retirees like Detroit resident Juanita Scott.

Scott, 86, retired from the immunization program in the city's health department in 1988.

“I just wonder, what am I going to do?” Scott said last week. “When I retired, I had a nice bank account, but here the last couple of years, I have to go in my little savings every month. Everything just goes up.”

Scott raised five children, working part-time until her children were older. She started working full-time for the city in 1971. Her husband died in 1976. He worked at a small plant, and when he died, Scott received nothing — her late husband’s Social Security benefits were just enough to see her youngest child through college. It was hard to save, she said, on a small income with five children. So Scott’s pension, plus her Social Security check, is what she relies on.

Her pension check is small — just $594 a month — but coupled with the $1,100 she receives each month from Social Security, it’s enough to get by.

“I live in the old neighborhood, and (my) house is depreciated, so I only had to pay $480 in property taxes. Still, they’re going to be due. I just paid off my car note, but I still have my car insurance. Last month, I paid $186 a month for it, next month I have to pay $209. Then my house insurance went up; my house insurance is going to be $106 a month,” she said, ticking off a list of bills. “Then I have to pay all of my bills. I don’t go out a lot. I’m on the Internet, and I have to pay every month for that. Then there’s my gas bill, my water bill ... I don’t live a fast life. I don’t go out a lot.”

Scott said she’s trying to take it all in stride.

“At my age, I’m not going to let my blood pressure get up worrying about it. I have children, they’re not going to let anything happen to me,” she said. “I don’t want to rely on them. But it will take all the money I can get to get by.”

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http://www.freep.com/article/20130714/OPINION01/307140047/detroit-pensions-financial-crisis-retirees=