JANUARY 2022 REPORT

PROVIDENCE PENSION WORKING GROUP

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EXECUTIVE SUMMARY

THE PENSION WORKING GROUP

The Pension Working Group's ("Working Group") findings and recommendations are summarized in this executive summary and more fully discussed in the body of the report.[1]

In response to having one of the lowest funded pension plans in the nation and limited City-controlled options to address these challenges, Mayor Elorza, the City Council, The Providence Foundation, The Greater Providence Chamber of Commerce, and the Rhode Island Public Expenditures Council convened a Pension Working Group of leaders from the public, private, and not-for-profit sectors to review the pension system, identify risks and benefits of meaningful options to stabilize the system, and provide recommendations to inform policy deliberations for elected and appointed leaders and the public.

SUMMARY OF PRIMARY FINDINGS

Decisions made more than 30 years ago drive challenges. The seeds of the City's pension problems were sown more than three decades ago when the City promised unsustainable benefit increases to members of the retirement system without funding the associated annual Actuarily Determined Contribution (ADC).[2]

The severity of the situation makes Providence an outlier. The City of Providence's Employee Retirement System (ERS) is among the lowest funded pension plans in the nation. Since 1991, the City's unfunded pension liability increased by more than $1 billion. In addition to the pension liabilities, and over and above the pension shortfall, the City's retiree health benefits are underfunded by approximately $1.1 billion.[3]

The unfunded liability of the ERS drives costs to City that outpace revenue growth, limiting investments in other priorities. As of June 30, 2020, the ERS was only 22.2 percent funded.[4] Total pension liabilities equated to $8,518 per resident – of which $6,629 is *not* funded.[5] In the last twenty years, the City's unfunded liability per capita increased by $4,000 per resident.

1 | Please see pages 10-20 of this report for the Pension Working Group's full findings and recommendations.

2 | Actuarially Determined Contribution (ADC): The employer's periodic required contributions, expressed as a dollar amount or a percentage of covered plan compensation, determined under the Plan's funding policy. The ADC consists of the Employer Normal Cost and the Amortization Payment (amortization of unfunded liability).

3 | City of Providence FY2020 Comprehensive Annual Financial Report.

4 | Ibid.

5 | Calculation uses the City's FY2020 Comprehensive Annual Financial Report data and the U.S. Census Bureau's 2020 reported population for the City of Providence.

The size of Providence's unfunded pension liability crowds out other spending priorities and is accelerating faster than City revenues. Required ERS funding consumes a greater share of the City's annual spending each year – growing at approximately 5 percent annually versus the City's revenue growth of about 2 percent annually, which means this trend will continue and get worse. By FY2027, the City's ADC of $120.0 million is projected to consume nearly 21 percent of all City General Fund revenue – an increase of more than $26 million from the FY2022 ADC.[6] By FY2040, ERS contributions are forecasted to nearly $230 million annually if no changes are made.

Incremental reforms have helped, but were insufficient to drive sustainability and affordability. In recent decades, multiple administrations attempted various approaches to address some aspects of the known challenges. However, from FY2010 to FY2020, even with efforts by multiple administrations and advantageous market returns, the ERS's funding level eroded from 34.1 percent to 22.2 percent.

The City has limited options to address the pension system's challenges. The City has limited options to meaningfully address its retiree liabilities given that: 1) the majority of the unfunded liability is tied to current retirees, not active employees – meaning that changes to other plan types (defined contribution or hybrid plan) alone would not resolve the City's funding crisis. Additionally, the Rhode Island Supreme Court issued a series of decisions that essentially removes the City's ability to enact pension reforms for retirees; 2) bargaining with current employees – such as the recent progress with the FOP and IAFF – helps to control future costs, but not the City's retiree liability which is the overwhelming driver of the City's unfunded liability and ADC; and 3) long-term leases or sales of City assets – the proceeds of which could be dedicated to the pension system – have not generated sufficient interest and support from policy makers and the public.

Doing nothing is simply not an option. Combined, these outcomes erode the City's – and the State's – economic competitiveness. Without corrective action, the large and growing unfunded ERS liability will threaten the retirement security of plan members as well as push the City closer to the edge of a fiscal cliff and precluding the ability to provide sufficient services to City residents.

SUMMARY OF RECOMMENDATIONS

There are no simple fixes that will cure the City's retiree liabilities. Addressing the present challenge requires that more City and employee/retiree funding goes into the system and fewer benefits are paid out of the system. Other communities have taken meaningful actions to confront unsustainable retiree liabilities with circumstances that were far less daunting than those faced by Providence. Governments that made changes to provide sustainable, sufficient, and affordable retirement programs have generally addressed both funding and benefit costs. The Working Group believes Providence must follow a similar strategy that addresses funding and benefit costs.

6 | Ibid.

After careful review and significant deliberation, the Working Group provides the following recommendations, which are more fully described and detailed in the full report:

Bankruptcy is not an option. In the face of hard and complex choices, bankruptcy is undoubtedly appealing to some because they think it offers a clear and simple response to the City's problems. It is also wrong. Calls for bankruptcy ignore the important fact that bankruptcy protection is not available to the City. Providence has maintained stable and prudent fiscal positions and is not, nor will be in the near-term, insolvent. Today, the City can pay its current bills, its fiscal outlook is improving (including a rating agency revising the City's outlook from stable to positive), it has closed historical deficits, weathered the COVID-19 pandemic, and – with recommendations in this report – has a pathway to confront its most pressing fiscal challenge, the ERS.

Some local governments entertained brinkmanship with partners in state government and employees to see which party concedes first. We reject this approach and offer our recommendations as a pathway for partnership to address the significant ERS challenges. The City needs to move forward with the strategies outlined in this report – and inaction is not an option. But, given current circumstances, bankruptcy should not be an option either. The Working Group rejects this idea on the substance.

Providence should request state legislative and city voter authorization to issue a pension obligation bond (POB) sized to deposit $500 million into the ERS if advantageous borrowing conditions and terms are met. As the Working Group reviewed potential interventions that had the capacity to meaningfully address the City's unfunded liabilities, it was clear that the City's options are very limited. After much review, discussion, and deliberation, including reviews of differently sized transactions, the Working Group supports the City seeking authorization to issue a pension obligation bond that deposits $500 million into the ERS. To be clear, authorization does not bind the City to issue a POB if market conditions are not favorable. If proper conditions and guardrails exist, a POB of this size appears to best position the City to both increase the funded status of the ERS and match the City's ADC growth (inclusive of POB debt repayment costs) to the City's conservative, realistic projection of revenues – both of which would improve the sustainability of the City's annual budget.

The Working Group spent significant time exploring the necessary POB transaction guardrails and structure to achieve broad consensus and support among members. The associated guardrails and structure are discussed in the full report.

Current retiree liabilities are unsustainable. The City must continue to achieve reforms to retiree liabilities through collective bargaining. In addition to an infusion of funding from a pension obligation bond, the City must continue to pursue strategies to increase the sustainability and affordability of benefits. As it has done with recent collective bargaining, the City must continue to manage expenditures within available revenues. Specific reforms are provided in the body of this report.

Continue and expand strong fiscal stewardship. After determining that the City's current challenges are significant enough to consider a pension obligation bond, the Working Group reviewed ways that the City can continue to meet its current and future obligations while maintaining a sufficient fund balance and positive annual operating results. Two essential recommendations resulted: 1) managing expenditures to match revenue growth, and 2) ensuring predictable and sustainable revenues. Specific options are provided in the body of this report.

REPORT INTRODUCTION AND OVERVIEW

ABOUT THE PENSION WORKING GROUP

The City of Providence's pension system is among the lowest funded pension plans in the nation. The size of the challenge has reached a tipping point and the system's $1.265 billion unfunded liability is the City's most significant obstacle to sustainable economic competitiveness and affordability – and a significant threat to the State's fiscal sustainability.

With limited City-controlled options to address the pension challenge, the Mayor, with the partnership of City Council, created and convened a Pension Working Group ("the Working Group") of leaders from the public, private, and not-for-profit sectors to:

- Review the pension system's current financial status and future projections
- Assess the risks and benefits of meaningful options that exist to stabilize the affordability and sustainability of the system
- Provide recommendations to inform state and local elected and appointed officials' policy deliberations and to provide context to the public

Over the course of five months, the Working Group held four public meetings; received presentations from City financial staff, actuaries, financial advisors, investment advisors, legal counsel, and other outside experts; and reviewed and deliberated options to remedy the City's pension challenge.[7] The process yielded considerable discussion and deliberation. This interim report is the product of that work.

The Pension Working Group is co-chaired by Michael DiBiase, President, Rhode Island Public Expenditure Council (RIPEC), Laurie White, President, Greater Providence Chamber of Commerce, and Cliff Wood, Executive Director, Providence Foundation.

7 | Ibid. Pension Working Group sessions and materials are available in the Appendices of this report and at: https://www.providenceri.gov/controllers-office/pension-wg/.

Members of the Working Group include:

- Helen Anthony, Councilperson Ward 2, City of Providence, City Council President John J. Igliozzi's designee
- Jorge O. Elorza, Mayor, City of Providence
- Pedro Espinal, City Council President Pro-Tempore, City of Providence, City Council President John J. Igliozzi's designee
- Kristin Fraser, Partner, KPMG
- Macky McCleary, Director, Energy Sustainability and Infrastructure, Guidehouse
- Camille Vella-Wilkinson, State Representative District 21, Speaker of the Rhode Island House of Representatives K. Joseph Shekarchi's designee
- Rico Vota, Deputy Director of Legislative and Intergovernmental Affairs, Governor of Rhode Island Daniel J. McKee's designee
- Stephen Whitney, Fiscal Advisor, Rhode Island State Senate, President of the Rhode Island State Senate Dominick J. Ruggerio's designee
- Samuel Zurier, State Senator District 3, Rhode Island State Senate

Outside experts that presented and discussed findings with the Working Group included: Hilltop Securities, Inc. (financial advisor), Wainwright Investment Counsel LLC (investment advisor), Segal Company (actuary), PFM (budget advisor), Adler, Pollock and Sheehan P.C. (labor counsel), and Locke Lorde LLP (bond counsel).

OVERVIEW OF PROVIDENCE EMPLOYEE RETIREMENT SYSTEM CHALLENGES

As of July 1, 2019, the City of Providence's Employee Retirement System (ERS) covered 2,891 active employees, 533 inactive employees entitled to, but not yet receiving, benefits, and 3,234 retirees/beneficiaries collecting benefits, for a total of 6,658 individuals.[8]

Significant Unfunded Liabilities Drive Costs to City that Outpace Revenue Growth, Limiting Investments in Other Priorities

As of the same date, the ERS held $360.6 million in assets to meet $1.6 billion in liabilities – a 22.2 percent funded ratio.[9] The City's total pension liabilities equate to $8,518 per resident – of which $6,629 (or 77.8 percent) is *not* funded.[10] In the last twenty years, the City's unfunded liability increased by nearly $810 million – seeing the per capita unfunded liability grow by 152.1 percent, or $4,000.

ERS Per Capita Pension Liabilities				
FY2001 (as of 6/30/2001)	**FY2006** (as of 6/30/2006)	**FY2011** (as of 6/30/2011)	**FY2016** (as of 7/1/2015)	**FY2020** (as of 7/1/2019)
$4,731	$5,953	$7,421	$7,284	$8,518

Source: City Comprehensive Annual Financial Reports; Actuarial Valuation Reports of the ERS; U.S. Census Bureau Decennial Census.

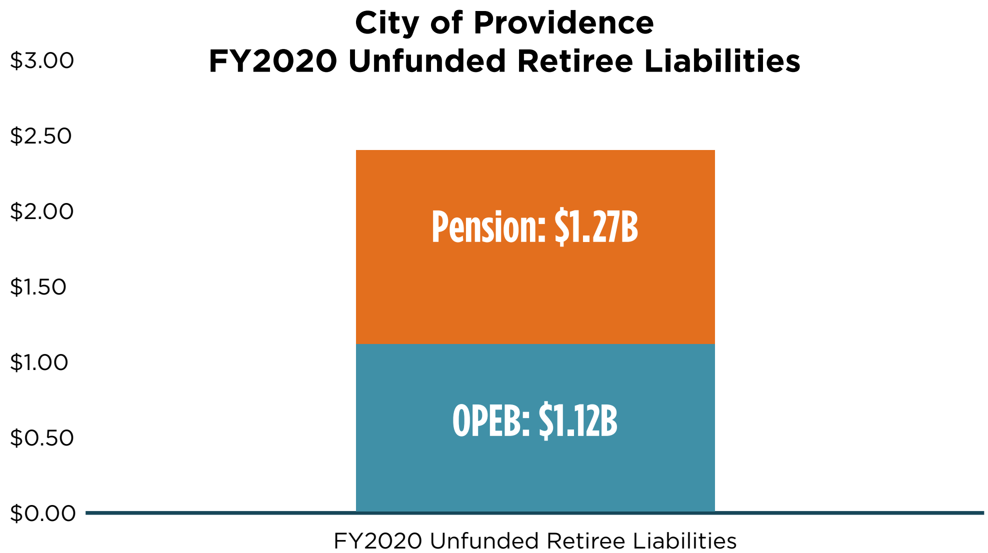
Note: After FY2011, the City's Actuarial Valuation Reports shifted from "as of June 30" of every given year to "as of July 1" of every given year. As a result, there was not Actuarial Valuation Report conducted in FY2012.

8 | City of Providence FY2020 Comprehensive Annual Financial Report.

9 | Ibid.

10 | Calculation uses the City's FY2020 Comprehensive Annual Financial Report data and the U.S. Census Bureau's 2020 reported population for the City of Providence.

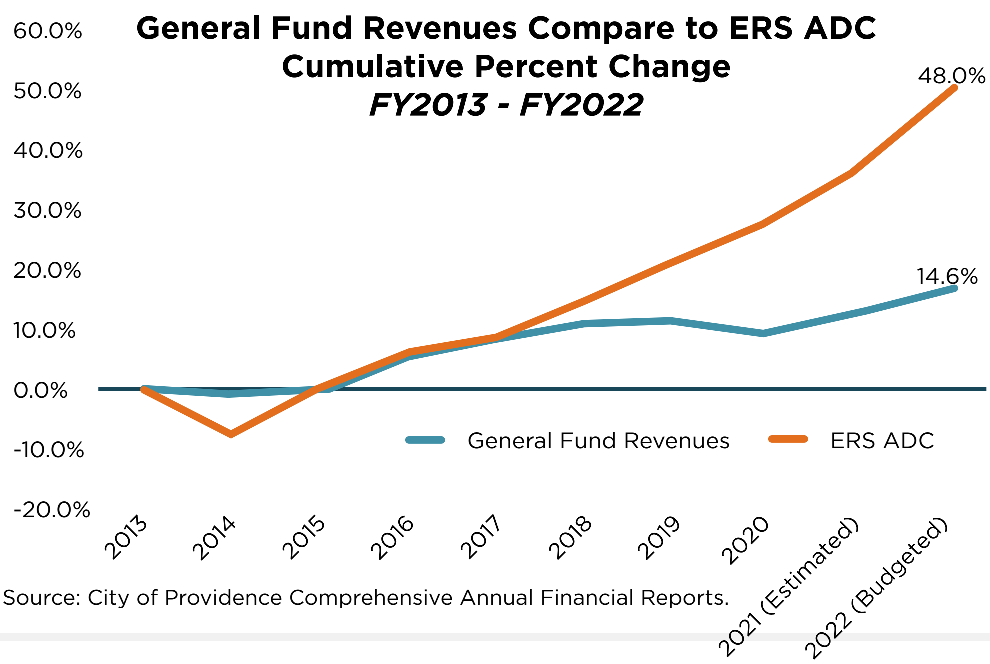
In addition to the pension liabilities, and over and above the pension shortfall, the City's retiree health benefits are underfunded by approximately $1.1 billion.[11]



Source: City of Providence FY2020 Comprehensive Annual Financial Report.

For the pensioners and current workers who are members of the ERS, the reliability and security of these retirement programs are paramount. At the same time, the ERS and retiree health care represent a significant investment for Providence's taxpayers, and their affordability and financial sustainability bear strongly on the capacity of the City to address other critical public needs.

The size of Providence's unfunded pension liability requires elevated levels of required contributions. Despite the City's 10 consecutive years of fully funding its actuarially determined contributions (ADC),[12] the trend in the City's budget allocation for pensions has been for pension expenditures to increase much faster than the rest of the budget – and faster than revenues – significantly crowding out other spending priorities.



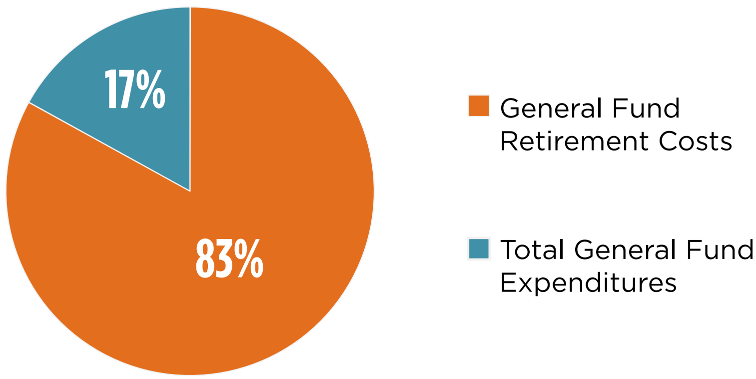
Source: City of Providence Comprehensive Annual Financial Reports.

11 | City of Providence FY2020 Comprehensive Annual Financial Report.

12 | Actuarially Determined Contribution (ADC): The employer's periodic required contributions, expressed as a dollar amount or a percentage of covered plan compensation, determined under the Plan's funding policy. The ADC consists of the Employer Normal Cost and the Amortization Payment (amortization of unfunded liability).

As a result, the City has a smaller portion of its annual budget to meet resident and stakeholder priorities (e.g., youth investment and education, infrastructure improvement, tax rate competitiveness, viable economic development, public safety, and meaningful compensation to attract and retain qualified employees to deliver services). Additionally, the very sustainability and viability of the ERS itself creates meaningful concerns for active employees and retirees.

FY2022 General Fund Retiree Contributions as Share of General Fund Expenditures



Source: City of Providence FY2022 Budget.

Given the importance of the ERS and retiree health care, and the severe pressures the systems face, a status quo approach is untenable.

HISTORICAL AND COMPARATIVE CONTEXT

The Severity of the Situation Makes Providence an Outlier

The ERS is, by nearly all measures, one of the most distressed pension plans in the nation. In FY2020, the ERS had the 6th lowest funded ratio (23.9 percent) among the 196 national public pension plans tracked by The Center for Retirement Research at Boston College (CRR).[13] This is not a new challenge. In FY2001, CRR reported the funded status for 195 national pension plans, and the ERS ranked 2nd lowest at 41.6 percent.

To provide additional context to the ERS challenges, the Working Group also reviewed comparative benchmark data from other regional pension plans.[14] Among primary findings, the data reinforced Providence's perilous pension status with much higher results for ADC per capita and unfunded liability per capita and a significantly lower funded ratio.[15]

13 | See: https://publicplansdata.org/public-plans-database/browse-data/. CRR used the actuarial value of assets to determine the funded ratio. The funded ratio cite on page 4 uses the market value of assets. The actuarial value of assets is a hypothetical asset value that smooths annual investment gains and losses over a five-year period, and is used by the Plan actuary to determine the City's actuarially determined contribution rate.

14 | Selected benchmarks included: other mid-sized New England cities (Bridgeport, New Haven, Springfield, Stamford, Waterbury, Worcester), a regional capital city (Hartford), the second largest municipality in Rhode Island (Warwick), and the State of Rhode Island.

15 | Additional information may be found in the Appendices.

Decisions Made More than 30 Years Ago Drive Challenges

The seeds of the City's pension problems were sown more than three decades ago when the City promised generous benefit increases to members of the retirement system without funding the associated ADC on an annual basis. For instance, in 1989, the City's Retirement Board granted unsustainable 5 percent and 6 percent annual cost of living adjustments (COLAs) to certain retiree groups without the City funding the requisite amount in the ERS.[16] After protracted litigation, the City entered into a Consent Decree in 1991 formalizing elements of the 1989 COLAs.

In years that followed, the City rarely made its full ADC – frequently contributing 60 percent or less of required ADC and never contributing the full ADC between FY1996 and FY2007– which served to compound the system's unfunded liability: costs escalated at an unsustainable pace (well above recurring revenue growth) and, at the same time, funding going into to the system decreased.

For perspective, in 1991, the City's unfunded pension liability was approximately $137 million. Since that time, the City's unfunded pension liability increased by more than $1 billion (June 30, 2020 unfunded liability and the ERS system has approximately 22 percent of assets necessary to cover promised pension benefits.

Incremental Reforms Were Helpful, But Insufficient, to Drive Sustainability and Affordability

In recent decades, multiple administrations attempted various approaches to address some aspects of the known challenges:

- The Cicilline administration reinstituted full contributions.
- The Cicilline, Tavares, and Elorza administrations have, collectively, made 10 consecutive years of full ADC payments.
- The Retirement Board has strengthened the enforcement and improved the structure of the disability pension process which has resulted in fair, judicious, and responsible outcomes.
- The Elorza administration successfully worked with the Fraternal Order of Police (FOP) and International Association of Firefighters (IAFF) to negotiate significant changes to achieve sustainable normal costs[17] for current and future retiree costs and – for the first time – begin employee OPEB[18] cost-sharing.
- The Elorza administration also reduced the City's actuarially assumed investment return assumption[19] from 8.5% to 7.0%.

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16 | A 2017 WPRI12 report provides additional historical context and background. Available at: https://www.wpri.com/news/how-buddy-cianci-predicted-providences-pension-crisis-and-then-made-it-worse/.

17 | Normal Cost: The portion of the Actuarial Present Value of Future Benefits and expenses allocated to a valuation year by the Actuarial Cost Method. Any payment with respect to an Unfunded Actuarial Accrued Liability is not part of the Normal Cost. For pension plan benefits that are provided in part by employee contributions, Normal Cost refers to the total of member contributions and employer Normal Cost unless otherwise specifically stated.

18 | OPEB (or Other Postemployment Benefits) are "benefits other than pensions that U.S. state and local governments provide to their retired employees. These benefits principally involve health care benefits, but also may include life insurance, disability, legal and other services." https://www.gasb.org/jsp/GASB/Page/GASBBridgePage&cid=1176164129754.

19 | Investment Return: The rate of earnings of the Plan from its investments, including interest, dividends and capital gain and loss adjustments, computed as a percentage of the average value of the fund. For actuarial purposes, the investment return often reflects a smoothing of the capital gains and losses to avoid significant swings in the value of assets from one year to the next. *Of all actuarial assumptions, a public pension plan's investment return assumption has the greatest effect on the projected long-term cost of the plan. This is because, over time, a majority of revenues of a typical public pension fund come from investment earnings. Even a small change in a plan's investment return assumption can impose a disproportionate impact on a plan's funding level and cost. Source: Public Fund Survey, National Association of State Retirement Administrators ("NASRA"), November 2021.*

However, even with these efforts across more prudent plan management by multiple administrations, from FY2010 to FY2020, the ERS' funding level eroded from 34.1 percent to 22.2 percent. From FY2010 to FY2020, the City's annual ADC costs increased by approximately 5.4 percent on average, outpacing the City's 2.2 percent average annual revenue growth during the same period.

PROSPECTIVE IMPACT

By FY2027, the City's ADC of $120.0 million is projected to consume nearly 21 percent of all City General Fund revenue. This growth represents a significant increase from the FY2022 level of $93.6 million. The FY2027 ADC represents a 28.2 percent increase, or $26.4 million, from the FY2022 level.[20] This growth does not include potential recessionary impacts, investment risks, and deferred losses.

Viewed over a longer-term, using the City's current funding schedule, the City's ADC is projected to grow at an annual rate of approximately 5 percent through FY2040 when it will be $227.5 million – or nearly 2.5 times greater than the FY2022 ADC, and $133.9 million more in total.[21]

Separately, but relatedly, even without pre-funding the City's OPEB obligation and continuing to use the current pay-as-you-go approach, retiree health expenses are projected to rise sharply to over $55 million per year by FY2029 – a 66 percent increase over FY2020 (and a compound annual growth rate of 5.2 percent).

LIMITED OPTIONS TO ADDRESS THE PENSION SYSTEM'S CHALLENGES

Without corrective action, the large and growing unfunded ERS liability will threaten the retirement security of plan members as well as the fiscal stability of the City.

Yet, the City has limited options to meaningfully address its largest obstacle to affordability and sustainability:

- Most the City's unfunded liability is tied to current retirees, not to active employees. The Rhode Island Supreme Court issued a series of decisions which, effectively, provide that any prospective plan changes impacting current retirees may only be achieved by mutual agreement between the City and each *individual* retiree whose benefits would be impacted by the changes.
- Bargaining with current employees – such as the recent progress with the FOP and IAFF – helps to control future costs, but not the City's unfunded liability which is the overwhelming driver of the City's unfunded liability and ADC. The City is committed to continuing this progress with remaining bargaining agreements, but the impacts to current pension costs are relatively small.

20 | City of Providence FY2019 Employee Retirement System Actuarial Valuation Report.

21 | Ibid.

- Long-term leases or sales of City assets – the proceeds of which could be dedicated to the pension system – have not generated sufficient interest and support from policy makers and the public.

These constraints were a fundamental reason for the formation of the Pension Working Group. With these realities and the preceding context, the following section details the Working Group's recommendations.

WORKING GROUP RECOMMENDATIONS

There are no simple fixes that will cure the City's retiree liabilities. Addressing the present challenge requires that more City and employee funding goes into the system *and* a continued partnership with bargaining units to ensure sustainable benefits for future employees and retirees.

Sustainably addressing the City's unfunded retiree liabilities – which are decades in the making – will require a resolute commitment for multiple decades in the future and span multiple mayors, councilors, and state leaders. Solutions require the engagement, commitment, and leadership of multiple stakeholders and levels of governments – anything less will likely lead to the system's insolvency with significant collateral impact.

Nationally, regionally, and locally, other communities have taken meaningful actions to confront unsustainable retiree liabilities with circumstances that were far less daunting than those faced by Providence.

While there is no "one-size fits all" approach – as state and local governments have very different starting points, structures, and constraints – governments that made changes to provide sustainable, sufficient, and affordable retirement programs have generally addressed both funding and benefit costs. Governments that are successfully on a path toward sustainable pension and OPEB plans do not rely on benefit adjustments alone. While benefit cost containment is very often a part of the solution, consistent funding above pay-go levels – preferably on a full actuarial basis – is also important where meaningful coverage is to be maintained.

The Working Group believes Providence must follow a similar strategy that addresses funding and benefit costs. The following recommendations are intended as the first steps on a path to better share the risks and benefits between Providence's taxpayers, active employees, and retirees. The Working Group's proposed recommendations cannot – and do not – represent Providence's last steps necessary to create an affordable, sustainable, and sufficient retirement system.

RECOMMENDATIONS

1. Bankruptcy is not an option.

In the face of the City's significant unfunded retiree liabilities there have been calls for the City to simply declare bankruptcy and sort out the pension issues through associated court proceedings. In the face of hard and complex choices, bankruptcy is undoubtedly appealing to some because they believe it offers a clear and simple response to the City's problems. It is also wrong.

While it is true that Providence must confront its serious retiree liabilities, calls for bankruptcy ignore the important fact that bankruptcy protection is not available to the City. Providence has maintained stable and prudent fiscal positions and is not, nor will be in the near-term, insolvent. Today, the City can pay its current bills, its fiscal outlook is improving,[22] it has closed historical deficits, weathered the COVID-19 pandemic, and – with recommendations in this report – has a pathway to confront its most pressing fiscal challenge, the ERS. Even if the City were to reach any of these criteria – which, today, it does not – the State would have to authorize Providence to file for bankruptcy which, at best, would be an uncertain result.

Bankruptcy is a process that can work when a government has exhausted *all* other options, cannot pay bills, cannot obtain credit, does not have a plan to address fiscal challenges, lacks willing partners locally and in state government, and when there is no civic infrastructure to make tough decisions. This Working Group and its findings provide proof that those criteria are not met in Providence.

At best, calls for bankruptcy are an irresponsible recommendation.[23] Bankruptcy is not a magic wand that can simply rid Providence of its retiree liabilities. Much sacrifice would be necessary – additional revenue, significant cost-cutting, layoffs, and employee and retiree benefit reforms would likely result. With bankruptcy, decision making would be left to a federal bankruptcy court rather than being carried out by the City's democratically elected leaders – relegating Providence's residents and stakeholders to spectators rather participants in the process.

In addition, bankruptcy is expensive and would stain the City's (and State's) reputation as it competes for prospective residents and businesses that would be uncertain of the city's future – not to mention the potential negative impact to the State and region. Bankruptcy would also limit the City's access to credit necessary for investment in infrastructure to attract and retain residents and businesses.

Some municipal entities have entertained brinkmanship with partners in state government and employees to see which party concedes first. We reject that notion and offer these recommendations as a pathway for partnership to address the City's significant ERS challenges. There is no question that there is hard work ahead to confront the City's ERS and OPEB challenges. Confronting problems that are decades

22 | For example, in a November 2021 annual surveillance rating, Fitch Rating Services revised Providence's rating outlook from "stable" to "positive" – the first positive rating outlook in nearly nine years. Fitch noted, "[f]inancial resilience has improved recently, reflecting adequate gap-closing capacity. Fitch believes continued slow and gradual improvement is possible post-pandemic, supported by tax base growth and improved budget practices."

23 | "Filing for bankruptcy protection should be considered a last resort, to be used only after every effort has been made to avoid it...the problems that brought the municipality to the point of filing will have to be solved anyway, so it is far better to resolve them, if possible, outside of bankruptcy." https://media.orrick.com/Media%20Library/public/files/insights/municipal-bankruptcy-green-book-second-edition.pdf.

in the making means there are no easy answers. The City needs to move forward with the reforms outlined in this report – and failure is not an option. But, given current circumstances, bankruptcy should not be an option either. The Working Group rejects this idea on the substance.

2. ***Providence should request state legislative and city voter authorization to issue a pension obligation bond sized to deposit $500 million into the ERS if advantageous borrowing conditions and terms are met.***

After much review, discussion, and deliberation, the Working Group supports the City being granted the ability to issue a pension obligation bond (POB) that results in the addition of $500 million to the ERS.

The Working Group did not come to this recommendation easily or lightly; however, the City's current unfunded liability is unsustainable and, if unaddressed, will decrease investment in City services and increase costs to taxpayers. Combined, these outcomes erode the City's – and the State's – economic competitiveness. Without corrective action, the large and growing unfunded ERS liability will threaten the retirement security of plan members as well as pushing the City closer to edge of fiscal instability and precluding the ability to provide sufficient services and services. Though, to be clear, it is always preferable to fund retirement obligations with cash from the budget, however, there can be scenarios where the issuance of POBs may make sense.

As the Working Group reviewed potential interventions that had the capacity to meaningfully address the City's unfunded liabilities, it was clear that the City's options are very limited. Thus, the Working Group's attention turned to a POB to explore the pros and cons and whether it could serve as a viable solution to the City's pension crisis.

The Working Group initially reviewed the impact and efficiency of multiple sizes of POBs – specifically, those that would deposit $700 million, $500 million, and $300 million into the ERS to determine the most efficient structure to meet three goals: 1) removing the ERS from 'critical funded status' – meaning above 60 percent funded, 2) Quickly increasing the funded status of the plan; and 3) aligning growth of ADC expenditures and POB repayments with the projected growth in the City's revenues, assuming re-amortization.

- A transaction that would deposit $700 million into the ERS would improve the ERS funded status above critical status (at least 60 percent funded) nearly immediately, but would have the highest amount of proceeds deposited into ERS. Thus, it would have the highest market timing risk. As the largest bond size considered, it would provide the largest amount of funding, have the largest expected reduction in future contributions, and have the highest bond debt service – meaningfully above the City's annual revenue growth projections.
- A transaction that would deposit $300 million into the ERS was forecast to improve the ERS funded status above critical status by FY2035. The associated ADC and debt service would have less impact on getting the system to a healthy position in an expedient manner, with a smaller reduction in the ADC.
- Finally, a transaction that would deposit $500 million into the ERS would improve the ERS funded status above critical status by FY2029 and, when combined with re-amortization, align ADC and POB debt expenditure growth with the City's annual revenue growth projections.

The Working Group determined that the most efficient transaction was one that matched expenditure growth with revenue growth, while also quickly bringing the ERS out of 'critical status.' In order to issue a bond that provides $500 million of proceeds to the ERS, costs of issuance, underwriters' discount, and other costs could be approximately $4 million to $10 million, depending upon the details of the bond issue. It is possible that bond insurance could be used to reduce interest rates on the bonds. For current estimates, a preliminary amount of $2 million to $3 million in bond insurance is used. In total, the amount to be authorized by the Legislature and residents is estimated to be no more than $515 million.

POBs are fundamentally a funding opportunity that can, in the right market conditions provide benefit, but which are not without risk. The concept is that a government issues POBs and deposits the proceeds in its pension fund to increase the available assets. The retirement system invests the pension fund assets which are projected to earn a given rate of return – in Providence's case 7.0 percent annually. This rate of return, if higher than the interest due on the bond principal, results in potentially lower annual costs. For example, if a government issued a POB and earned, on average over the life of the bond repayment schedule, a 7.0 percent rate of return and paid interest on the bond at an annual average rate of 4.0 percent during the repayment period, it would have generated an annual 3.0 percent positive benefit, on average. However, as the City's internal and external financial team notes – and good fiscal practice dictates – taking on a fixed-debt service like a POB to invest in variable pension system assets should never be considered a zero-risk approach because there are market and other risks to weigh.[24]

In 2015, the Government Finance Officers Association (GFOA) published a document related to pension bonds that noted several concerns. The following table provides an overview of those concerns and observations on how the current pension bond environment has evolved and where the features of POBs in 2021 differ from those that raised some of GFOA's 2015 concerns.[25]

24 | Some of the risks the City faces could be alleviated by the POB proceeds allowing for an investment strategy that would better align with the system's reduced cashflow needs.

25 | https://www.gfoa.org/materials/pension-obligation-bonds.

The GFOA View (in 2015)	Current Pension Obligation Bonds
Invested pension bond proceeds might earn less than the borrowing costs	Instead of the expected earnings rate of 7.0%, lower actual returns could occur. The chances of long-term returns below ~ 2.50-4.25% borrowing costs for recent POBs are anticipated to be low, but do exist. The City and its finance team should "stress test" options to better quantify this risk.
"Pension bonds are complex instruments that carry considerable risk… and may include swaps or derivatives…"	Nationally, current pension bond issuances are fixed rate bonds that do not include swaps or other derivatives. To our knowledge, there have been no variable rate or auction rate long term pension bonds since 2012. Similarly, to our knowledge, there have been no swaps or derivatives on pension bonds since 2012.
"Issuing taxable debt to fund the pension liability increases the jurisdiction's bonded debt burden and potentially uses up debt capacity…"	Pension bonds convert one type of long-term liability to another type at a lower interest rate. From a rating agency perspective, the City is required to make this payment whether it is an appropriation for the actuarial contribution or a debt service appropriation for a pension bond. With a Special Act of the General Assembly, the pension bonds will not be included in the City's 3% debt limit.
Pension bonds are "typically issued without call options" making it more difficult to refund bonds if interest rates fall or a different debt service structure is desired in the future.	Current practice is that most pension bonds are issued with a 10-year par call feature, allowing the City to refinance them in the future. The City of Providence would most likely elect to have a call provision on at least a portion of the bonds after evaluating the cost.
"Pension bonds are frequently structured in a manner that defers the principal payments…"	The term of pension bonds can be shortened, lengthened, or stay the same. All options currently under consideration for Providence would begin paying bond principal within one year. Elsewhere, there are a few recent pension bonds with interest only periods of three years or longer.
"Rating agencies may not view the proposed issuance of Pension bonds as credit positive…"	Rating agencies generally view responsible pension bonds as neutral to positive and an enhancement to long term affordability. A survey of recent POBs showed that upgrades after POBs were more common than downgrades. Rating agencies also recognize the implementation of prudent strategies to address pension liabilities, instituting Pension Funding Policies and long-term forecasting, and changes in contributions or benefits. In the current interest rate environment (December 2021) the spread between borrowing costs and retirement system expected returns is higher than normal. Interest rates could move substantially by the time approvals are secured from the Legislature and City voters.

26 | "Pension Obligation Bond Issuances Continue to Increase In 2021," S&P Global Ratings, October 14, 2021.

Nationally in 2021, the prevalence of debt issuances to address unfunded pension liabilities continues to increase due to the low-interest-rate environment. From Jan. 1, to Sept. 15, 2021, S&P Global Ratings (S&P) rated 64 new POB issuances in the U.S. Public Finance sector totaling nearly $6.3 billion. According to S&P, this represented a 113 percent increase in rated POB issuance over the $3.0 billion issued in the entire 2020 calendar year.[26]

Primary findings from the S&P report are consistent with the understanding of the Working Group:

- Pension and other postemployment benefit (OPEB) obligation bond (POB and OOB) issuance is accelerating in the U.S.
- Factors driving issuances include a favorable interest-rate environment and issuers' desire to control contribution escalation.
- Key credit concerns, while unique to each U.S. public finance issuer, primarily include market returns falling short of expectations and pension contribution increases pressuring budgets.
- Obligations that aim to address pension liabilities might come in different forms, but with similar credit risks.

The Working Group believes that the risks associated with irresponsible fiscal stewardship can be mitigated to a significant extent with sufficient legal and policy guardrails. Investment risk, however, cannot be eliminated. A fundamental factor in the Working Groups recommendation, described on following pages in more detail, is the fact that a POB be structured to match the City's recurring General Fund revenue growth projections of approximately 2.0 percent with both the annual cost of the debt service associated with the POB *and* the most advantageous funding infusion for the City's pension system, assuming re-amortization.

The Working Group received presentations and fiscal projections from the City's financial advisor detailing the potential sizes, repayment schedules, and interest rates of multiple POB options based on the outlined prior assumptions.

After significant discussion and modeling, the Working Group determined that while smaller or larger bond issues could result in positive benefits, the most efficient transaction size that balances these criteria is one that deposits $500 million into the ERS. This allows the City to best positioned itself to increase the funded status of the ERS *and* match associated POB debt repayment costs to the City's conservative, realistic projection of revenues – and enhance budget sustainability.

The Working Group spent significant time exploring the necessary POB transaction guardrails and structure to achieve broad consensus and support among members. Those conditions of support and recommendations are described on the following pages. Taken together, the Working Group believes the conditions and recommendations are a prudent and necessary path forward to an affordable and sustainable pension system that can stabilize long-term City finances and allow it sufficient budgetary flexibility to ensure Providence's continued economic competitiveness serves as an engine for Rhode Island's economy.

The Appendices include pro forma calculations that show estimates of costs with and without a POB that deposits $500 million into the ERS if interest rates are 4.39 percent, the bonds are paid off in FY2047, and debt service is a level dollar amount. In this scenario, the increases in estimated transaction-related-debt service plus the re-amortization of unfunded liability results in annual payments that increase by an average 1.9 percent per year if all actuarial assumptions are met.[27]

The Working Group's conditions of support and recommendations for POB that deposits $500 million into the ERS include:

- *The need to have the tools in place to act when there are favorable market conditions.* It is possible that interest rates and market conditions will move substantially by the time of any approvals by the State Legislature and City voters. While it is common to issue POBs shortly after authorization, in some circumstances such issuance might be delayed in hopes of lower borrowing costs. Examples potentially include: overall taxable bond borrowing costs have risen; the City anticipates a bond rating upgrade; or some emergency or disaster may delay issuance (e.g., there were bond issuance delays related to Hurricane Sandy).
- *The current market.* Results in projected interest rates well below the assumed rate of return for the ERS. As market conditions permit, the City should maximize the difference between the assumed rate of return in the ERS and the interest on the POB.[28]
- *The risk tolerance threshold.* There are no simple strategies or absolutes with a POB. Any discussion and issuance must include sufficient guardrails to mitigate risk, even though risk cannot be eliminated. In this instance, the Working Group determined that the associated risks of a POB – if structured and mitigated in a prudent manner with sufficient guardrails – are less than the risk of doing nothing.
- *The need to match efficiency of borrowing with annual revenue growth.* The Working Group and the City's financial advisors sought to structure a hypothetical POB to match a conservative estimate of the City's projected annual revenue increases over a multi-year horizon – approximately 2.0-2.1 percent. A POB that deposits $500 million into the ERS generates the most significant funding for the pension system while maintaining annual POB debt service payments at a 2.0-2.1 percent annual growth rate.
    - The City's revenue projections use conservative long-term assumptions and do not include likely and known opportunities to increase revenues (e.g., revaluations, TSAs, local PILOT renegotiation, tax rate changes, etc.)

27 | Normal costs will not change as a result of the POB transaction and are excluded from this calculation. If normal costs are included in this calculation, the annual average annual growth is 2.1 percent. Should a POB transaction move forward, as appropriate, all data related to the transaction should be updated closer to the time of an actual transaction and be shared to inform final policy decisions.

28 | Please see Appendices the rolling (by month) 25-year returns for a 60 percent equity/40 percent fixed income portfolio from January 31, 1926 through December 31, 2020. This analysis shows that all historical rolling time periods over this nearly 100 year period have exceeded 4 percent – with many observations well above the 4 percent rate. Thus, the current spread between the assumed rate of return and projected borrowing rate may be considered attractive relative to history.
Additionally, Appendices shows that the City's realized returns on the pension portfolio have been comparable to the State of Rhode Island's returns over multiple time periods during the last 20 years even with far higher liquidity demands. In many years, nearly 25 percent of ERS fund assets must liquidate to fund retiree payments.

    - Taken together, the growth rate of debt service related to a POB and ADC payments would, in sum, be structured to be equal to or less than the City's conservative revenue growth assumptions.
    - Additionally, a POB that deposits $500 million into the ERS would allow the City's pension system to leave critical status (defined by the State as less than 60 percent funded) by FY2027 – assuming a transaction occurs late in FY2022 or early in FY2023.
    - 10-year par call. Any POB is expected to include a 10-year par call. A par call is the option for the City to pay off its debt early and/or refinance the debt at more attractive interest rates. If refinanced, the City could also shorten, lengthen, or make other modifications to the debt service pattern. Par call options are built into the figures that the City's financial advisors presented to the Working Group.
- *Expert Advice and Counsel.* Given the complex nature of considering – let alone issuing – a POB, the City should engage outside experts to provide counsel from the start, much as it has done with the Working Group process. In addition to financial advisors on the structure and underwriting of a potential POB, the City should engage: investment advisors to evaluate a strategy to balance the necessary investment rates of return with market risk and any changes in asset allocation that are desirable given additional assets, bond counsel to ensure that policy decisions are made based on legally prudent analysis and structure, and retiree benefits experts to identify reform options and associated savings to partner with the POB funding to drive long-term ERS sustainability.
- *Timing of transaction.* If a transaction is pursued, the issuance – subject to the advice and guidance of the City's financial advisors and bond counsel, could likely occur over a multi-week period to balance market risks and investment opportunities.[29] The finance team expects that a bond could close 60-90 days after legislative approval if it does not require approval by City voters. If approval by City voters is required, a bond could close 60-90 days after the approval. From an investment standpoint, the ERS could deploy its adopted asset allocation strategy in stages over a multi-month period to mitigate specific period timing risks.
- *Investment strategy.* An investment advisor could work to structure an asset allocation profile that takes advantage of the increased level of funding and reduced cash flow needs relative to the size of the portfolio. Thus, a more efficient strategy could be employed to utilize a wider array of potential investment solutions more commonly used by other institutional investors/pension plans as they strive to meet their required rates of returns.
- *Repayment schedule.* The City should structure a POB to provide annual ADCs (plus debt service payments) that are no less than the current ADC at time of issuance, unless alternative structures provide greater fiscal benefit and sustainability without meaningful impact to long-term ERS funding and/or continued fiscal sustainability is achieved. If a POB is issued in FY2022, that figure would be $93.6 million. If a POB is issued in FY2023, that figure would be $98.5 million.

29 | Some issuers are considering a combined public offering and private placement with different settlement dates and a potential drawdown schedule which could extend as along as a year.

- *The desire for voter approval*. A transaction of this type essentially seeks to trade a portion of the ADC for debt service on a fixed rate bond. Again, this is not without risk. Given the potential risks discussed in preceding parts of this report – and to incorporate public and General Assembly feedback, the Working Group believes that addition to receiving State enabling legislation, the City should hold an election to seek voter approval. To be clear, voter and General Assembly authorization does not mandate the City to issue a POB, but grants it the authority and flexibility to do so if it deems market conditions are sufficiently favorable.

Taken together, the Working Group believes that a POB that deposits $500 million into the ERS inclusive of the criteria above – and assuming appropriate market conditions exist at the time of issuance – could benefit the City's long-term fiscal sustainability and stability.

3. ***Current and future retiree liabilities are unsustainable. The City must continue to achieve reforms to active and retiree liabilities through collective bargaining.***

The Working Group believes that improving Providence's pension funding is a necessary component of a long-term solution for the City's fiscal health; however, alone it is insufficient. In addition to an infusion of funding from a pension obligation bond, the City must continue to pursue strategies to increase the sustainability and affordability of benefits. To be clear, an infusion of funding without continued work to manage expenditure growth is inadequate to address the long-term challenges and does not properly balance the risk-reward proposition between taxpayers and employees/retirees.

In recent years, the City has made meaningful progress partnering with its employee bargaining units to achieve pension, health care, and OPEB cost reductions. Collective bargaining agreements dictate many of terms that drive retiree liabilities and, as a result, the City must have a cross-cutting and comprehensive strategy for its labor negotiations. Outside of the collective bargaining process – and absent State intervention – the City has little ability to make significant benefit changes.

The City should continue to manage expenditure growth in concert with the issuance of a pension obligation bond. Strategies may be implemented in isolation but are likely best achieved in tandem as part of comprehensive approaches to manage expenditures within available revenues. For instance, it may be preferable for the City to set a comprehensive target over a multi-year period to improve its long-term fiscal sustainability while ensuring sufficient resources to fund its retiree obligations.

It is important to note that within these options, the Working Group notes strategies for different cohorts of employees necessarily will vary.[30]

Strategies may include, but are not limited to, the following:

- *Increase pension cost sharing for bargaining unit employees.* Before recent changes in FOP and IAFF contracts, City employees contributed 32 percent (Class B Police), 36 percent (Class B Fire), or 80 percent (Class A) of total normal costs. The City has made significant progress with the FOP contract and the IAFF contract that each

30 | For instance, Class A employees (civilians) contribute to social security (as does the City at a matching rate). Class B employees (sworn police and uniformed firefighters) do not contribute to social security (and neither does the City). As a result, the percentage of active salary to pre-fund retirement income should be greater among Class B employees.

increase employee pension contributions to 13.5 percent and 16 percent respectively over a multi-year period. Additional collective bargaining agreements should follow this pattern. As part of that work, the City should implement an employer normal cost cap and employee normal cost floor. The intent behind this cost-share certainty is to ensure that the long-term risks and benefits are better balanced between taxpayers and employees.

- *Continue to modify pension plan design.* Over multiple decades, the City has taken multiple steps to introduce new pension plan designs for existing and newly hired employees, such as changing retirement eligibility age and requisite years of service. New pension plan designs and modifications – similar to what the State of Rhode Island achieved – could be an important component of a broader strategy that continues to rebalance risk and benefit sharing; however, alone any such changes would be far less than what is necessary to meaningfully move the needle on the City's pension challenges. This is because the majority of the City's pension liability stems from retirees, not active participants.

  Plan design changes that may be considered as part of broader pension affordability and sustainability efforts include (but are not limited to): increasing Class B normal retirement age to 55 and 25 years or service or 60 years of age and 10 years of service, adopting a 2.0 percent multiplier for new Class B employees, implementing an average final compensation based on the average of an employee's highest five years of service, eliminating the Class B, option four subsidy, removing longevity from pensionable compensation, and introducing COLAs on the first $15,000 of pensionable income for new retirees.

- *Achieve health care reforms for active employees and retirees.* Providence has made strides to reduce the cost of active and retiree health insurance while ensuring quality, affordable access to health care. Recent changes include: increased medical co-share for actives and retirees, implementing dental co-shares for most active employees, implementing Coordination of Benefit (COB) programs and ensuring compliance with participation, ensuring all those retired and age 65 transition to Medicare as their primary source of coverage, and implementing opioid strategies (as well as other pharmacy strategy programs) to ensure coverage for proper prescriptions. Prospectively, the City should continue to work with its bargaining units and health care consultants to identify strategies to reduce costs. These strategies may include plan design changes, buy-up levels of coverage from a base City plan, changes to contributions based on dependent coverage levels, and more.

- *Address long-term OPEB liability to the City.* The Working Group's primary focus for its recommendations are related to the City's pension system; however, significant discussion also centered on the need for the City to reduce its $1.1 billion unfunded OPEB liability. Taking actions to stabilize the pension system should not – and cannot – come at the cost of tackling the City's OPEB liabilities. In fact, the two efforts should be pursued in tandem. The Working Group recommends that the City take meaningful actions to both increase funding to OPEB (see below) and reduce costs. Cost reduction strategies may include buying out or buying down OPEB benefits, increasing OPEB eligibility to 25 years of service, providing retiree-only medical coverage with buy-ups for dependent coverage, tiering or eliminating OPEB coverage for non-vested employees and/or new hires. Strategies to increase OPEB funding could include incrementally phasing-up the City's annual pre-funding for

OPEB on a predetermined schedule, adopting a practice of dedicating the a given percentage of excess revenue (beyond budgeted expenditures) to OPEB, and/or identifying one-time funds that can be dedicated to pre-fund future benefits when opportunities exist. For instance, if the City does not require all of the American Rescue Plan Act (ARPA) revenue replacement funds identified for general assistance to the General Fund, it will use a portion of remaining funds to seed an OPEB Fund. Additionally, if the POB generates sufficient premiums, the City could consider dedicating some of the premiums to pre-fund OPEB liabilities without affecting the amount available for the ERS.

- *Create an OPEB Fund for employee contributions for all collective bargaining units.* A core component of the City's long-term strategy to confront its OPEB liabilities must be to create an OPEB Fund to receive contributions for all collective bargaining units. The City successfully negotiated OPEB contributions from current FOP employees. A Fund – or Funds – would create a mechanism to ensure prudent fiduciary responsibilities and begin to invest contributions in a similar manner to pension funds. As additional employees contribute to pre-funding retiree health care, the City can explore long-term opportunities to invest and gradually subsidize its current paygo approach to OPEB with proceeds from the Fund(s). This strategy would result in gradual improvements that would take a long-term commitment over multiple years to provide material impact.

4. Continue and expand strong fiscal stewardship

After determining that the City's current challenges are sufficient to consider a pension obligation bond, the Working Group reviewed, discussed, and considered the criteria necessary to best position the City for long-term fiscal sustainability. Fiscal stewardship rose to the top of this list.

In recent years, the City's fiscal management and practices have been responsible and prudent. The City eliminated its historical deficits, matched expenditures to annual revenues, managed the tax rate in a predictable manner, and implemented polices and operations that are considered best practices.

The City's finances have improved and its financial management, policies, and practices are noted by rating agencies. In November 2021, Fitch revised its rating outlook for the City from "stable" to "positive" and affirmed the "A-" rating on the City's General Obligation debt, stating:[31]

> *"The Revision of the Outlook to Positive reflects recent revenue growth trends and expenditure controls, which have contributed to surplus results over the last four fiscal years and elimination of Providence's negative general fund balance earlier than planned. Fitch expects management to continue recent efforts to manage expenses, including negotiating higher employee pension contributions, above natural revenue growth overtime, although the city's elevated long-term retiree costs are expected to remain a burden on the budget. Maintenance of adequate financial resilience could lead to an upgrade."*

31 | Fitch Rating Services revised Providence's rating outlook from "stable" to "positive" – the first positive rating outlook in nearly nine years. Fitch noted, "[f]inancial resilience has improved recently, reflecting adequate gap-closing capacity. Fitch believes continued slow and gradual improvement is possible post-pandemic, supported by tax base growth and improved budget practices."

In the recent years, the City was well-served by its informal adoption of a series of financial management tools that guide the decision making process. However, the life of a pension obligation bond will stretch beyond the current fiscal leadership and beyond the term of any one mayor and council membership. As a result, there is an opportunity to formally adopt and institutionalize some aspects of the City's current processes and pursue additional tools to inform the decision-making of future leaders on fiscal issues to help ensure budgetary stability.

As a result, the Working Group believes it is imperative that the City adopt sufficient guardrails not only within the transaction itself – many of which are discussed in the preceding POB recommendation – but also the way the City manages its finances. For instance, Providence cannot choose expenditure control over revenue collection or revenue collection over tax base expansion – it must simultaneously maximize the efficient operation of government, collect enough revenue to maintain quality of life, and make strategic investments to grow the tax base.

To that end, the Working Group identified ways that the City can continue to meet its current and future obligations while maintaining a sufficient fund balance and positive annual operating results. Two essential recommendations resulted: 1) managing expenditures to match revenue growth, and 2) ensuring predictable and sustainable revenues.

THE CITY MUST MANAGE EXPENDITURES TO MATCH REVENUE GROWTH

The Working Group believes that the most important principle is also the most basic one – the City should evaluate every budgetary decision, collective bargaining proposal, new program, hiring initiative, and tax question based on how it impacts recurring revenues and recurring expenditures over a multi-year period.

At a high level, the City should regularly evaluate whether growth in recurring expenditures is covered by growth in recurring revenues, separate from any one-time events that skew either side of the financial ledger. Recurring retiree expenditures and debt expenditure calculations should include pension contributions – regardless of whether a pension obligation bond is issued – that at least match the actuarially recommended levels, regular investments in capital projects, and annual contributions to retiree medical care – ideally including some amount of pre-funding in addition to paygo funding.

Recurring revenues should exclude one-time events that boost tax revenues or fee levels, whether those events are driven by City policy or external factors and should not include use of the City's fund balance.

As the City approaches policy and operational decisions, if the fiscal analysis indicates that the decision would result in an imbalance between recurring revenues and expenditures, it does not necessarily mean the action needs to be discarded. In those cases, the City should identify realistic and practical initiatives to maintain balance between recurring revenues and expenditures, whether through increasing revenues, reducing other types of expenditures, or both. Identifying solutions should be actions that the City can take on its own, not prospective ventures that require action from others or good fortune.

The City has managed to constrain its expenditures to meet revenues in a responsible manner in recent years; however, those efforts will be increasingly challenged by out-year pension costs. Yet, long-term structural balance – with or without a pension obligation bond – is unlikely to be achieved solely through expenditure reductions. Thus, it will be important for the City to focus not just on opportunities to continue to manage and control expenditures, but also on opportunities to enhance revenues.

Providence and every other town and city in Rhode Island must annually adopt a balanced budget, though adoption of a balanced budget does not guarantee ending the year in balance. As a result, the Working Group suggests that that the City review actions to help it to manage expenditures to match revenues every year. Strategies may include, but are not limited to, the following:

- *Continue and expand strong fiscal stewardship through transparent engagement with State officials and City stakeholders.* The City provides monthly reports to the State of Rhode Island on its fiscal performance and meets with the Auditor General, Director of the Department of Revenue, and the Chief of Municipal Finance to discuss all aspects of the City's financial and fiscal affairs. There is an opportunity to use this foundation to expand transparency and understanding of City finances to a group of other senior officials and stakeholders.

  As a starting point, the Working Group intends to continue its efforts to support the City's fiscal health in perpetuity by meeting – perhaps on a quarterly basis – to provide written and verbal insights, enhance communications and understanding, ensure a seamless transition between the current City administration and the next administration, and provide ongoing advice and reports on the City's long-term liabilities – including pension and OPEB.

- *Continue to grow the Rainy Day Fund and General Fund fund balance while preserving core City services and performance.* The City has made prudent investments in its assigned fund balance to grow its rainy day fund. Additionally, the City increased its unassigned (flexible) fund balance in recent years. Both activities are best practices. The City should formalize these strategies in an adopted assigned and unassigned fund balance policy. The Working Group understands that the City has a draft policy that it will present to the City Council in Spring 2022.[32]

- *Create a consensus revenue estimate every Spring.* Revenue estimating is, at its core, an imperfect science. A variety of known and unknown variables, many of which are outside of the City's direct control, affect the City's annual revenue generation. Many state and local governments across the nation use an approach that includes representatives from the executive branch, legislative branch, and outside experts to create a foundation for transparent and predictable revenue estimates.

  Providence already has solid revenue estimating processes to achieve its revenue estimates. Formalizing its approach with a group of internal and external experts to set (and, as necessary, revise) the adopted revenue projection on an annual basis would be a continuing best practice. The consensus revenue estimate should include at least a five-year projection of revenues similar to what the City already submits on an annual basis to the State of Rhode Island and City Council. To the extent that any revenue projection adjustments are necessary after budget adoption, the City – with

32 | The draft policy identifies a range of minimum reserves based on a comprehensive risk model. The draft policy states that excess fund balance may be used for capital investments, paying off long-term debts, or maintaining City services during a recession. The draft policy also recommends that the City sustain investments that support vulnerable communities and low-income residents.

the help of the broader estimating committee – should identify the adjustments in sufficient time such that expenditures can be matched to revenues.

- *Identify a prudent maximum percentage of General Fund debt service as a percentage of total General Fund expenditures.* In practice and informal policy, Providence already limits its debt service as a percentage of total General Fund expenditures. As part of the POB process, the City should formalize its practices by adopting a prudent maximum percentage of General Fund expenditures to be spent on debt service. These policies – which will span multiple Mayors and City Councils like the POB – can help the City to guard against increasing fixed, mandated expenditures and help to ensure financial flexibility and predictability.

PREDICTABLE AND SUSTAINABLE REVENUES ARE NECESSARY FOR THE CITY'S FISCAL HEALTH

As the City takes action to improve the health of its pension system and reduce long-term retiree liabilities, it will require recurring predictable and sustainable revenues that grow, on average, at least as fast as expenditures. The City should continue to pursue opportunities to diversity its revenue streams.

Predictable and sustainable revenues will help the City continue and expand its efforts to grow the Rainy Day Fund (which, due to prudent cash flow management, was not needed during the COVID-19 pandemic), ensure a healthy fund balance, and invest in priorities to ensure economic competitiveness – all while diversifying the significant reliance on taxpayers to fund City government and services.

In recent years, the City's revenues have grown by slightly more than 2 percent. Since FY2008, the City's revenues have grown at a compound annual growth rate (CAGR) of 2.0 percent. The Great Recession was most acutely felt in City revenues in FY2009 through FY2011 – when actual revenues decreased slightly before policy changes and recovery expanded revenues. In the five fiscal years prior to the COVID-19 pandemic (FY2014-FY2019), the City's total revenues grew at a CAGR of 2.3 percent – or by nearly $55 million in total. Property taxes accounted for less than half of this growth as State Aid and City-generated revenues drove the growth.

The increased diversification of City revenue, particularly non-property tax revenue, is a positive trend and important for the City's fiscal health. Yet, like other Rhode Island municipalities, Providence raises most of its revenue from property taxes – equaling nearly two-thirds of all General Fund revenue in FY2022. Thus, more action is needed to ensure predictable, sustainable revenues to meet the needs of residents and businesses.

The Working Group suggests that the City explore and take steps to continue expanding its revenue generation from non-property tax sources to prevent crowding out budget priorities due to retiree liabilities and other cost drivers. Strategies to increase City revenue could include, but are not limited to:

- *Not-for-profit payments in lieu of taxes (PILOTs).* The City's agreements with several not-for-profit entities expire on June 30, 2022. Coupled with a State Senate committee reviewing local PILOTs in Rhode Island, this creates a critical opportunity to re-examine the amount and value of tax-exempt property and strengthen partnerships and commitments to ensure Providence remains a world-class City for these iconic entities while ensuring fair and appropriate contributions to City revenues. For the purposes of this report, any potential increase in not-for-profit PILOT payments could be, at least partially, dedicated to long-term liabilities like pension and OPEB.

- *Tax Stabilization Agreements (TSAs).* As has been done in recent years, the City should continue to examine the value of new TSAs – particularly for large commercial and industrial properties. In certain instances, these agreements can provide certainty for both the taxpayer and the City. TSAs can present an opportunity for the City to engage the taxpayer and determine the viability of new proposed projects that include job training and apprenticeship opportunities, compliance with MWBE goals, and prevailing wage opportunities in addition to tax base expansion.
- *State Payments in Lieu of Taxes (State PILOTs).* Rhode Island's State payments in lieu of taxes compensate cities and towns for a portion of the tax revenue that would have been generated if non-profit educational institutions, hospitals, and certain state-owned facilities were not tax exempt. Currently, the State's reimbursement rate is approximately 27 percent. The City – along with other cities and towns – should continue to advocate for a higher share of compensation. The State of Connecticut recently increased its share of a similar type of state aid.

SUMMARY

Providence's retiree liabilities are a stark challenge – sufficient to make it among the worst funded pension plans in the nation. With limited options to alter the current course that consumes increasing shares of current and future budgets, the City – with State and resident approval – must act. Doing nothing is not an option.

The Working Group finds that there is meaningful opportunity to take actions that can both protect current and future taxpayers and ensure that current and future retirees can have a dignified retirement. This report identifies a comprehensive approach that balances an infusion of funding through a pension obligation bond with continued retiree benefit reforms – striving to properly balance the interests of taxpayers and employees/retirees.

The Working Group respectfully recommends that this report form the basis for local and state authorization to remedy the City's serious retiree liability challenges. The City, its taxpayers, and its past and present employees can afford nothing less.

APPENDICES

APPENDIX A: GLOSSARY

APPENDIX B: REPORTS AND PRESENTATIONS, AND MATERIALS PRESENTED TO THE PENSION WORKING GROUP

APPENDIX A: GLOSSARY

Actuarial Determined Contribution (ADC): The employer's periodic required contributions, expressed as a dollar amount or a percentage of covered plan compensation, determined under the Plan's funding policy. The ADC consists of the Employer Normal Cost and the Amortization Payment (amortization of unfunded liability).

Normal Cost: The portion of the Actuarial Present Value of Future Benefits and expenses allocated to a valuation year by the Actuarial Cost Method. Any payment with respect to an Unfunded Actuarial Accrued Liability is not part of the Normal Cost. For pension plan benefits that are provided in part by employee contributions, Normal Cost refers to the total of member contributions and employer Normal Cost unless otherwise specifically stated.

OPEB (or Other Postemployment Benefits): benefits other than pensions that U.S. state and local governments provide to their retired employees. These benefits principally involve health care benefits, but also may include life insurance, disability, legal and other services.

Investment Return: The rate of earnings of the Plan from its investments, including interest, dividends and capital gain and loss adjustments, computed as a percentage of the average value of the fund. For actuarial purposes, the investment return often reflects a smoothing of the capital gains and losses to avoid significant swings in the value of assets from one year to the next.

APPENDIX B: REPORTS AND PRESENTATIONS, AND MATERIALS PRESENTED TO THE PENSION WORKING GROUP

All reports, presentations, and materials presented to the Pension Working Group are available online through links to source documents. This information is accessible at:

https://www.providenceri.gov/controllers-office/pension-wg/