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	AGENCY NAME & ADDRESS	Department of Finance Room 454, City Hall (396-4940)
	SUBJECT	<b>Change to Grow: Ten-Year Plan – Retirement Savings Plan</b> <i>CC# 13-0047</i>

CITY of  
BALTIMORE  
**MEMO**



**TO**

DATE:

Honorable President and  
Members of the City Council

August 12, 2013

**Introduction**

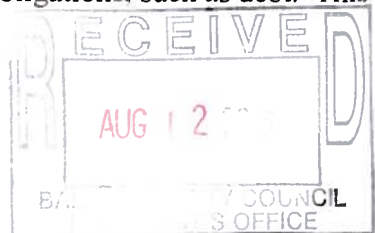
This bill closes the current Employee Retirement System Defined Benefit Plan to civilians employed or reemployed on or after January 1, 2014 and creates a new Defined Contribution Plan for civilian employees hired on or after that date. This Plan is intended for new employees hired after January 1, 2014 only. Current employees will remain in the Defined Benefit Plan.

This new Defined Contribution Plan sets forth a mandatory employee contribution of 5% of annual, authorized salary per year with a mandatory City match of 4% of annual authorized salary per year. Additional voluntary contributions up to a certain percentage of salary are permitted with a complementary match.

**Fiscal Impact**

Retirement system costs are a growing liability for the City, creating pressure on the City's annual budget. Based on the ERS Comprehensive Annual Financial Reports, the System's unfunded actuarial liability has grown by \$493.1 million over the past 5 fiscal years from \$188.5 million in FY2008 to \$681.6 million in FY2012. Since FY2001, the City's required contribution to the Plan has more than quadrupled from \$17.7 million in FY2001 to \$85 million in FY2014. If all ERS members had been in a Defined Contribution Plan instead of a Defined Benefit Plan, between FY2008 and FY2014, the City's contribution would have grown by only \$3.7 million. In FY2014 instead of an Annual Required Contribution of \$85 million, the City's contribution would be \$65.5 million lower – at \$19.5 million. These increased contribution requirements decrease the funding available for services to citizens such as recreation facilities, afterschool programs and parks.

Even with the increased City contributions, the Plan's funded ratio continues to decline. In FY2003, the Plan was solvent with a funding level of 103%. Today, the Plan's funded ratio has decreased below 68%. While the Plan is slowly recovering from the recession, new accounting standards have been put in place that will reduce the amortization period of the unfunded actuarial liabilities and change the actuarial method used to calculate the unfunded liability. Already, Baltimore's ERS has taken steps to align with the new Governmental Accounting Standards Board pension plan standards. These changes will produce an increase in the reported balance sheet liability which is akin to other long-term obligations, such as debt. This liability is reported to the Rating Agencies on an annual basis.



*Favorable*

In addition to these System specific challenges, the City is facing a \$745 million projected operating deficit over the next 10 years. In past years, the City has made difficult choices to close nearly \$300 million in shortfalls, including unpaid furloughs, hiring freezes, layoffs, curtailments of capital investment and service cuts. Although unpopular and not sustainable, these measures were necessary for the City to remain afloat during the financial crisis.

Looking forward, the goal is to eliminate the \$745 million structural deficit proactively through the implementation of a series of initiatives. On the expenditure side, workforce expenditures represent over 60% of total General Fund spending and have outpaced the growth of revenues. Between FY2007 and FY2012, revenues grew by 3.0% while wages and benefits grew by 19.6%. The largest component of wage and benefit expenditures is pensions, which comprised 89.3% of the total growth during this period.

### **Analysis**

In June 2013, City Council passed a bill that changed the Employees' Retirement System for current employees. This Bill is the second step in the two-step process to address Baltimore's growing ERS pension liabilities and avoid adding cost to City taxpayers who already carry the highest real property tax burden in the State. This approach (to introduce a new civilian plan for employees hired after a certain date) was chosen to minimize the impact on current employees of pension changes necessary to moderate City financial exposure.

The principal reason for the Employees Retirement System funding shortfalls is plan type. The Defined Benefit Plan is unaffordable because it guarantees civilian employees a specific benefit regardless of investment performance. A Defined Contribution Plan only guarantees that the City makes a contribution toward the employees' pension. The final benefit is not guaranteed by assumed returns that can be counter to reality. Instead, the final benefit is based on actual market returns over the period of employment with the City. The purpose of this Bill is to shift the risk away from City taxpayers and provide a best-in class and sustainable pension system for new civilian employees while maintaining the current Defined Benefit Plan for all employees hired prior to January 1, 2014.

Over the past few years, a greater number of government employers have been exploring the option of moving to a Defined Contribution Plan. There are many reasons why public employers are moving in this direction, including; affordability, risk avoidance and meeting the demands of a changing workforce. Another reason for migrating to a Defined Contribution Plan for future employees is changes in the way outside entities important to the City's financial future will value governmental pension plans. Previously, public pensions unfunded liabilities were evaluated based on the discount rate established by the board of the pension plan. For ERS, that rate is 7.75% for active members. Due to the number of states and cities in financial trouble, Moody's Rating Agency has stated that in the future, it will use a long-term bond rate when assessing public employers' pension liabilities for the purpose of rating bonds. Because the

long-term bond rate is much lower than the rate set by the ERS board, Moody's assessment of the City's pension liabilities will be based on a much higher unfunded liability.

Additionally, the Governmental Accounting Standards Board rules on pension have changed. This change is related to the City's future contribution to the System. In the future, when a government plan reaches a crossover point – when projected benefit payments for current employees and inactive employees exceed projected plan net position related to those employees then benefit payments projected to be made from that point forward will be discounted using a high-quality municipal bond interest rate. All other factors being equal, the less well-funded a plan is, the more likely it is to reach a crossover point and therefore have to discount some projected benefit payments using the municipal bond index rate. If this happens, the City's annual required contribution to the System will grow.

A Defined Contribution Plan eliminates the future growth of these risk factors because Defined Contribution plans by definition cannot amass an unfunded liability. If the Council passes this bill into law, employees hired after January 1, 2014 will never be able to add to the current unfunded liability. Washington, DC, Fort Lauderdale, FL, Orlando, FL, San Diego, CA, and Gwinnett County, GA are among the larger municipal and county employers that have migrated new employees to a Defined Contribution Plan.

In the proposed Defined Contribution Plan, the employee will be required to make a mandatory contribution of 5% of annual authorized salary each pay period. The City will make a matching contribution of 4% of annual authorized salary. Under this minimum mandatory requirement, the employee and the City's combined contribution will be 9% of the employee's salary each year.

For employees who want to invest more than the required annual contribution, the plan has the flexibility to allow an additional voluntarily contribute with a complimentary match from the City. An employee can elect to contribute up to an additional 2% of annual authorized salary with an up to 1% match from the City. If an employee chooses to maximize the benefits of the proposed defined contribution plan, the employee and the City will be making a contribution equal to 12% of the employee's pay toward retirement on an annual basis. These contributions to the employee's account will build investment income during the employee's period of service with the City.

The employee contributions to the plan plus investment earnings will be payable at the time of separation from City employment. In addition, the employer contributions plus investment earnings will be payable at the time of separation from the City if the employee has met the five (5) year minimum vesting requirement.

In a Defined Contribution Plan, only the employer and employee contributions are guaranteed. There is no guaranteed final benefit as there is in a Defined Benefit Plan. The amount of the employees' benefit at the time of separation from service depends on the contributions and

investment income. Employees will be able to choose from a menu of investment options selected by a plan governing Board.

While the final benefit is not guaranteed, the 40-year rolling average S&P 500 return is 10.88% since 1965. Using a conservative investment earning return assumption of 5.25% (well below the average 10.88%), an employee who commences employment with the City at age 25, earns a starting salary of \$25,000 and contributes only the mandatory minimum 5% will have approximately 49% of their income replaced by the Plan at their retirement age of 65. If Social Security is added to this amount, the employee will have 96% of income replaced in retirement. If this same employee makes the 5% mandatory contribution plus the 2% voluntary contribution, the Plan will replace approximately 66% of their income in retirement. Inclusive of Social Security, the retiree will have approximately 113% of income replaced in retirement. If a higher investment return assumption of 6.75% is used, the employee making the mandatory contribution only will have approximately 69% of income replaced in retirement without Social Security benefits included and approximately 116% of income replaced in retirement with Social Security included. If the employee makes the mandatory and voluntary contributions throughout the employment period, the employee will have approximately 92% of income replaced in retirement by the Plan without Social Security benefits included and approximately 139% of income replaced in retirement with Social Security included.

The proposed legislation contains several plan design choices made by the Administration to protect the interests of the employees in the Plan. The first design choice (mentioned above) is the requirement of an annual contribution. Legally, the City is not forced to require a mandatory contribution from employees. The mandatory contribution ensures an adequate benefit in retirement to *all* employees because it requires employees to invest in their future. Similar to the mandatory contribution, the City made the plan design choice to prohibit employees from taking loans or making withdrawals from the plan prior to retirement. This prevents erosion of the retirement benefit. The money invested in a retirement account should be used for retirement purposes only. When surveyed, other plans cite allowing loans and withdrawals as a reason for degradation of the integrity of the retirement benefit. Finally, the intent of the plan is to offer investment options that protect employees with little or no investment experience from market downturns. The Defined Contribution Plan will offer options such as target date funds that allow an employee to choose a future retirement date and sit back as a fund manager rebalance their asset mix as they get closer to retirement. This type of fund requires no employee intervention - the employee does not need to worry about rebalancing their portfolio as they age. The fund manager recalibrates the risk of the investments, putting more money in cash as the employee nears retirement, thus protecting them from market downturns.

Several workforce studies have shown that younger workers expect to change employment more often than their older counterparts. Millennials will comprise roughly 50% of the USA workforce by 2020. The sheer size of this demographic segment will force organizations to re-think many of their policies and practices. According to *Future Workplace*, a multi-generational

survey of workers, 91% of Millennials expect to stay in their job for less than 3 years. The Defined Benefit Plan could be discouraging to future workers who have to wait ten years to vest in the Plan and have to wait 30 years to achieve higher accrual rates. The Defined Contribution Plan provides employees with a portable benefit and a lower entry barrier for receiving employer benefits from the Plan.

According to the most recent data from the U.S. Bureau of Labor Statistics, the median time all workers are with their current employers is 4.6 years. Aside from Millennials, the Defined Contribution Plan is a useful recruitment tool for people recruited mid-career and late-career and don't have 10 years to vest in the Defined Benefit Plan or who are coming from a private sector plan and prefer to roll-over their current Defined Contribution account and continue to build it.

The Bill is expected to generate approximately \$40 million in savings over the 10-Year Plan period and be a strong recruitment tool for new workers with greater mobility during their careers.

### **Recommendation**

The City has goals of achieving a balanced budget, lower long-term liabilities, greater tax competitiveness, increased infrastructure investment and better service delivery for Baltimore's citizens. City pension benefits represent a large and growing liability that hinders the City's ability to make other critical investments in services and wages for employees. The Finance Department recognizes the need to provide an adequate pension benefit to new civilian employees. This bill ensures an affordable, sustainable, best-in class pension system for new employees that is positioned in the reality of market returns.

### **Attachment**

cc: Angela Gibson, Mayor's Legislative Liaison