FROM	
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AGENCY NAME & ADDRESS	Department of Finance Room 448, City Hall (396-4940)
SUBJECT	City Council Bill 10-0519

CITY of BALTIMORE

MEMO

CITY OF BALTIMORE 1797

TO

DATE: June 8, 2010

The Honorable President
And Members of City Council
Room 400 City Hall

Attention: Karen Randle

City Council Bill 10-0519 represents the minimum changes that must be made to the Fire and Police Employees' Retirement System (F&P) given the financial condition of the F&P system and the City. The F&P system is no longer financially sustainable under the current benefit structure. The Bill incorporates several changes to that benefit structure as recommended by a Task Force of the Greater Baltimore Committee that was tasked by the City Council to undertake such a study and "... to make significant recommendations to address the City's long-term pension liabilities." The Pension Task Force membership represented a cross-section of business expertise in human resources and pensions.

The GBC reported that the " . . .Task Force embarked upon its assessment of Baltimore's underfunded pension system with a firm understanding that swift and meaningful action must be taken if the plan is to remain viable over the long run." The report goes on to say that "there is a general consensus among Task Force members that unless all stakeholders agree to reforms of the Retirement System, the current underfunding will continue and further impair the City's ability to provide basic services, attract new businesses and ultimately threaten the ability of the F&P Pension plan to fulfill the commitments that have been made to the retirees." (See attached GBC Task Force Report)

I believe these changes are absolutely necessary to the financial health of the F&P system and the City.

The Context

Your Honorable Body is all too familiar with the City's fiscal situation. Even though the current year's budget, Fiscal 2010, was a very difficult one to balance, unfortunately including layoffs, the Fiscal 2011 budget currently before you, as balanced as it is, is not acceptable due to its significant reductions in service, including public safety, and its unacceptable toll of employee layoffs.

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Such reductions were made necessary to deal with the unprecedented $121 million budget shortfall for Fiscal 2011. It was clear to this Administration that such a shortfall could not be closed with cuts alone. As such, an unusual package of revenue enhancements was proposed to the City Council so as to restore a portion of the significant cuts in public safety and other vital services.

As you are aware, the $121 million short fall does not include the additional $63.9 million for continuation of the variable benefit of the F&P system. The resolution of the variable benefit issue has been before your Honorable Body in one form or another since October, 2008. There was certainly no way the City could afford to budget a $164.9 million or a 101.3% increase in its Fiscal 2011 contribution in order to sustain the continuation of the variable benefit. Surely the 23.3% increase that is already included in the budget represents an extraordinary increase in and of itself. (See Table 1.)

Table 1: F&P Retirement Costs ($ millions)

F&P Cost WITH Passage of Variable Benefit Legislation		F&P Cost WITHOUT Passage of Variable Benefit Legislation	
Fiscal 2011 Contribution	$101.0	Fiscal 2011 Contribution	$164.9
Fiscal 2010 Contribution	$81.9	Fiscal 2010 Contribution	$81.9
$ Increase	$19.1	$ Increase	$83.0
% Increase	23.3%	% Increase	101.3%

(Note: The entries reflect the actuarially required contributions.)

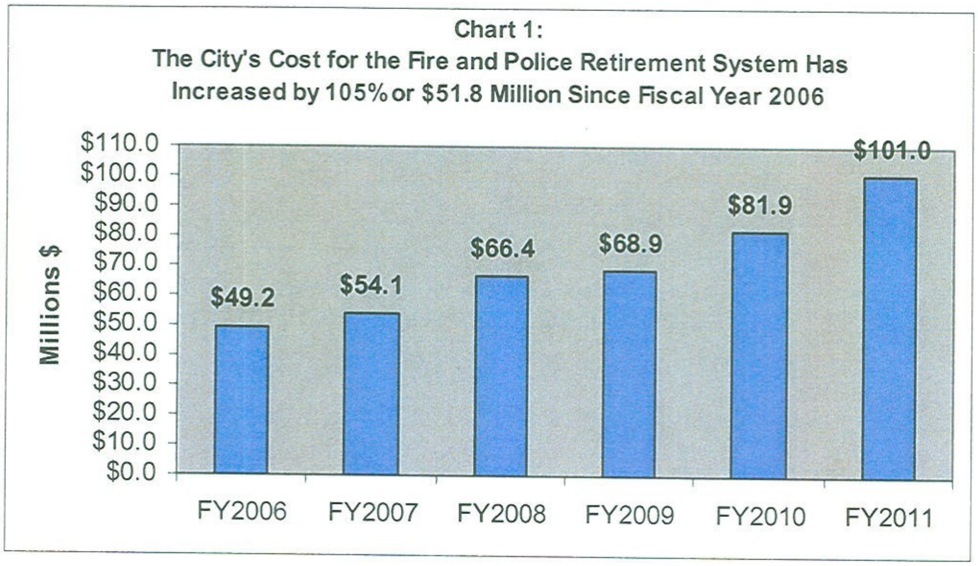
It is important to note that the cost of not fixing the variable benefit, as massive as that is, is not the only problem with the cost of the F&P system. The graph below clearly indicates the rapid, geometric growth that has been experienced since Fiscal 2006. If left unattended, the growth will overwhelm the City budget.

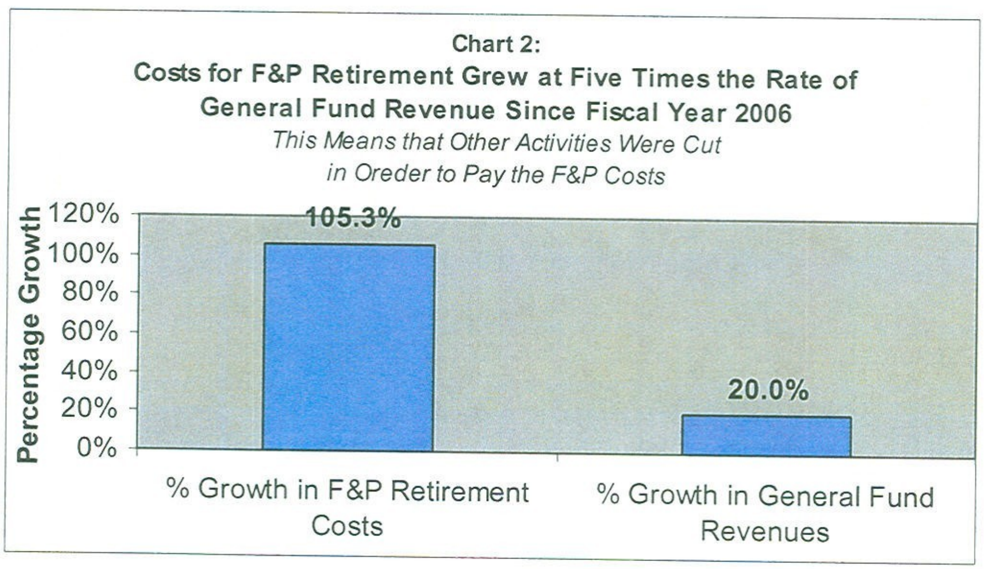
- The City's required annual cost for the F&P Retirement System has increased by $51.8 million since Fiscal Year 2006. This represents more than a doubling of the contribution or 105% from $49.2 million in Fiscal Year 2006 to $101.0 million in Fiscal Year 2011. (See Chart 1)

- This additional $51.8 million that the City is going to be paying in Fiscal 2011 toward the F&P System each year compared to just 5 years ago represents nearly the combined total General Fund budget for the Department of

Recreation and Parks ($17.4 million), State' Attorney's Office ($25.7 million) and Circuit Court ($8.1 million) in Fiscal 2011.

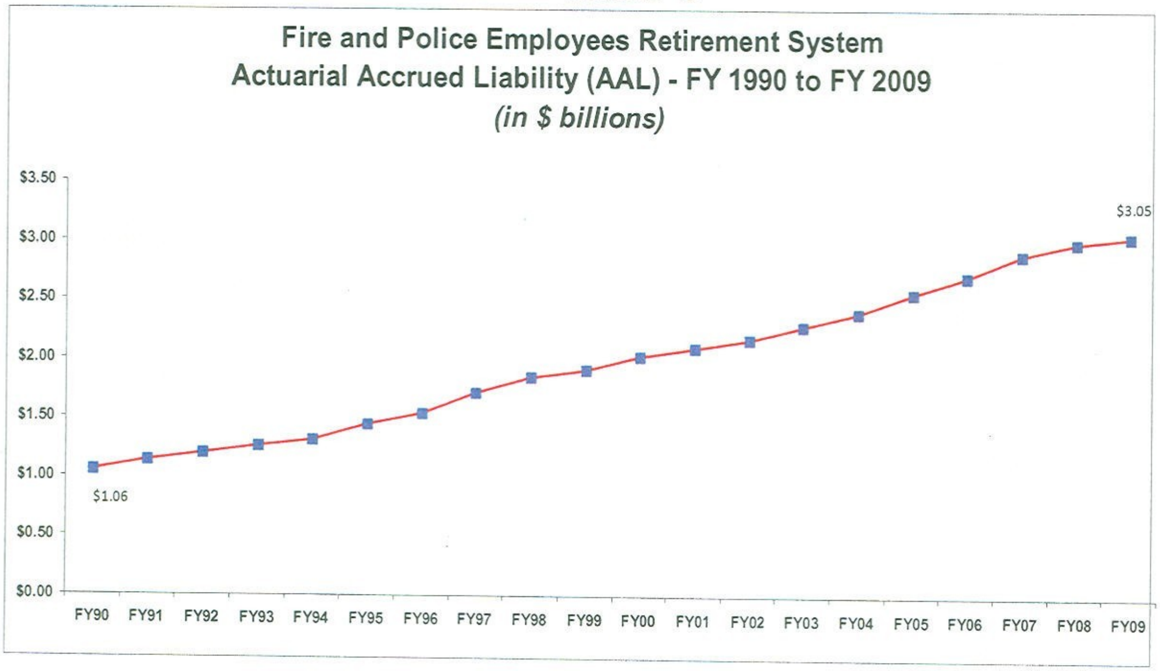
- During the same period from Fiscal Year 2006 through Fiscal Year 2011, total General Fund budgeted revenues have grown by only 20%, magnitudes less than the 105.3% growth in F&P Retirement costs. This means that the City has had to cut costs in other areas in order to accommodate this growing cost in the General Fund. (See Chart 2)





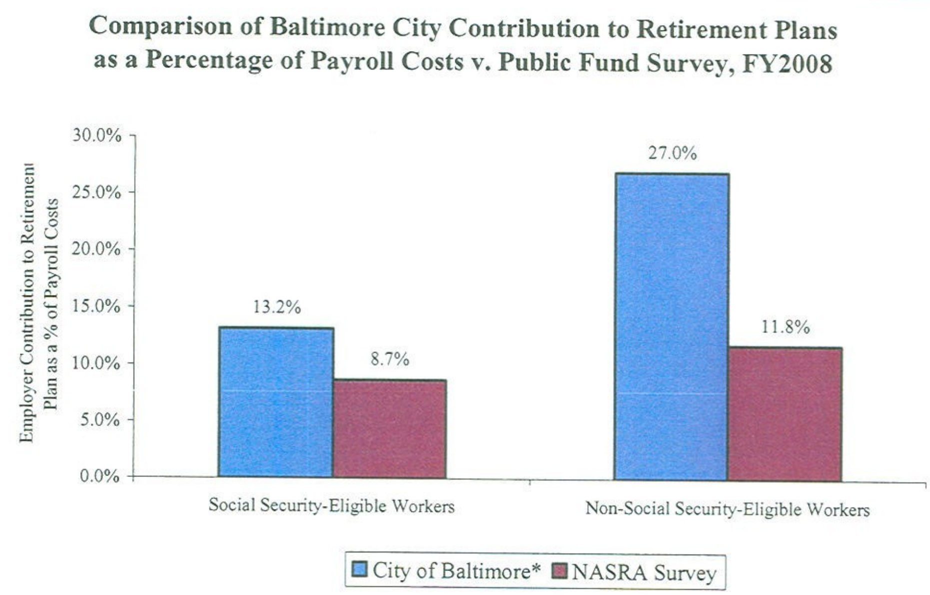
It is most noteworthy to consider just how much the F&P system's Actuarial Accrued Liability (AAL) continues to grow. The AAL represents the present value of future pension plan benefits attributable to service rendered as the date of the plan valuation. Effectively this is the actuarial estimate of what the City already owes to its retirees and current plan participants, even if the City were to shut down on the date of the plan evaluation. As seen in the following graph, the AAL has almost tripled since FY 1990 from $1,059,516,680 to $3,050,887,000.

Chart 3



And finally, consider as well, a survey of the National Association of State Retirement Administrators (NASRA), Public Fund Survey comparing the Fiscal 2008 employer's contribution as a percent of payroll costs for social security eligible workers and non-social security eligible workers (i.e., F&P system) compared to the City of Baltimore's contributions. Specifically it found that the City of Baltimore's contribution to the F&P system as a percentage of payroll costs far exceeds benchmarks for public plans in excessive of a factor of two (27.0% vs. 11.8%).

Chart 4



*The City of Baltimore data for Social Security-eligible workers represents the City's contribution to the ERS; the data for non-Social Security-eligible workers represents the City's contribution to the F&P.
Source: ERS Actuarial Valuation Report 6/30/08; F&P CAFR 6/30/08; National Association of State Retirement Administrators, Public Fund Survey, FY08 (published October 2009).

Proposed Bill

City Council Bill 10-0519 represents a package of changes to the F&P system which follow in many respects the recommendations of the Task Force of the Greater Baltimore Committee. It does not however, completely relieve the extraordinary pressure on the City budget the F&P system has become. More will need to be done, especially as it relates to future employees who become members of the system. The legislation does recognize that fact as is ordained in Section 4 of the legislation.

In summary, the proposed changes include:

Repealing the variable benefit and replaces it with an age-based COLA guaranteed by the City which becomes effective January 1, 2012. Effective July 1, 2010 the system will also provide a minimum benefit of $24,000 for pre-DROP retirees with 20+ years of service as well as a minimum benefit of $12,000 for their beneficiaries.

Changing the benefit eligibility requirements for members who have less than 15 years of service and are under age 50 as of June 30, 2010. The new benefit eligibility is the earlier of 25 years of service or age 55 with at least 15 years of covered service. The Bill also provides for a reduced benefit for early retirement.

Those active members having 15 or more years of service (or are already age 50) will be grandfathered under the current law.

Adjusting DROP2 eligibility to meet retirement eligibility standards. Current DROP2 eligibility (after 20 years of service) will continue for active members with 15 or more years of service. Those having less than 15 years of service by June 30, 2010 will not become eligible for DROP2 until having completed 25 years of covered service.

Changing the average final compensation calculation from the average of the 18 consecutive months of earnable compensation to 36 months of earnable compensation for those members who have not completed 15 years of service by June 30, 2010. Those members who have completed 15 years of service (or who are 50 years old) as of June 30, 2010 will be grandfathered under the current law.

Increasing members contributions over a 4 year period from the current 6% to 10% in 1% increments effective 7/1/10.

Changing the rate of interest earnings on the members' contributions from 5.5% to 3.0%.

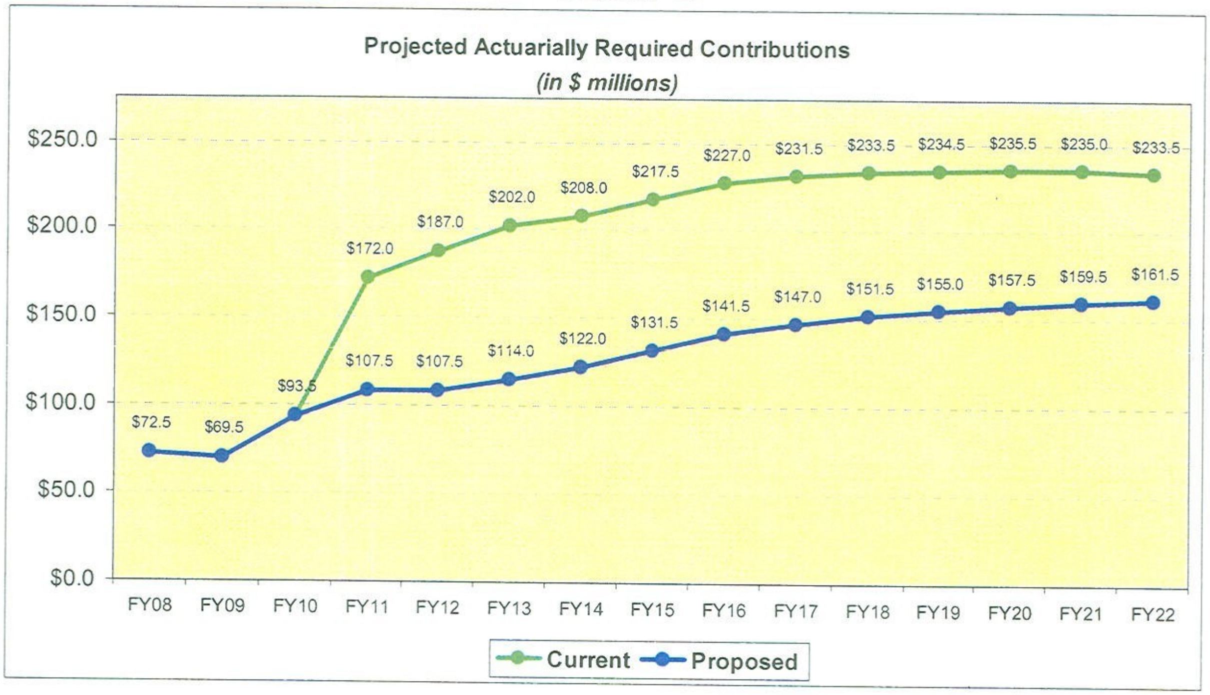
Changing the system's investment assumption from 8.25% per year to 8.0% per year.

Expanding the membership of the governing board from 9 trustees to 11 trustees to include the Director of Finance or his or her designee (Deputy Director of Finance or the Budget Director) as ex officio and 1 Mayoral appointee that is from a list of 3 recommended candidates submitted the City Council President. The trustees appointed by the Mayor will have to have commercial banking, investment banking accounting, actuarial, auditing, investment management, investment consulting, or financial legal expertise.

Fiscal Impact

Our concerns about rising pension costs and their increasing and disproportionate impact on the budget are borne out by the work of Public Financial Management, Inc. (PFM), and Aon Corporation (Aon). PFM was retained to assess our budget, develop multi-year budget projections for varying pension scenarios, and evaluate what changes, if any, are reasonable and necessary to preserve the long-term sustainability of the system and the ability of the City to provide basic services. Aon was retained to provide actuarial support for PFM's work and to analyze the F&P program structure and estimates of projected cost structure for the purpose of assessing the sustainability of the system.

Chart 5



This graphic, based upon the work of PFM & Aon, clearly and definitively indicates the fiscal impact of City Council Bill 10-0519 (proposed) when compared to the current law with the F&P system's actuary recommended contribution is to be if the variable benefit were to continue and the recommended post-retirement investment return was reduced from the 6.8% to 5.0%.[1]

There is a 5 year cumulative differential in annual contributions of $404.0 million (averaging $80.8 million/year) and a 10 year cumulative differential in annual contribution of $813.5 million (averaging $81.4 million/year).

Make no mistake about it, from the City budget perspective, the proposed plan still has challenging contribution growth in Fiscal years 2013 - 2016, averaging over 7.1% per year. Certainly the General Fund will not experience that type of revenue growth.

You will see in the executive summary of PFM's financial evaluation, directly following this report, that PFM has concluded that corrective action is necessary and that the adjustments proposed in City Council Bill 10-0519 are reasonable in the current context.

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[1] The proposed contributions in the chart for Fiscal 2010 and 2011 include contributions above and beyond the actuarially required contributions to help address the system's unfunded liability

I have also attached for your review:

- Fire and Police Employees' Retirement System Financial Evaluation, June 7, 2010, by Public Financial Management, Inc., with support from Aon Corporation (Full Report);
- The Greater Baltimore Committee Task Force on Sustainable Funding of Baltimore City's Fire and Police Pension System, May 2010(Full Report); and
- Written testimony of Andrew Kleine, June 8, 2010, concerning budget cuts made in FY 2009 and 2010 and proposed in FY 2011

<u>Conclusion</u>

It should be clear that the cost of the F&P system is out of control.

It should be clear that the costs of the significant benefit improvements that have been added to the system over the years are no longer sustainable.

The City Council reached out to a community of experts on pensions and those experts told the City Council that ". . . unless all stakeholders agree to reforms of the Retirement System, the current underfunding will continue and further impair the City's ability to provide basic services, attract new businesses and ultimately threaten the ability of the F&P Pension plan to fulfill the commitments that have been made to the retirees."

It should be clear from the context outlined above that the City's ability to finance the current benefit structure it not possible, and has already affected the City's ability to financially support basic City services for the taxpayers, who after all are paying the bill. The Fiscal 2011 proposed Ordinance of Estimates currently before the City Council should leave little doubt of that.

Fixing the variable benefit, although a critical component of this bill, is not at all sufficient to deal with the future financing of the F&P retirement system. The City Council needs to seriously consider and adopt the changes included in City Council Bill 10-0519 in order to protect the assets of this system and those of the City, both now and over the long term.

The City Council, as fiduciary of the assets of this great municipality, has as its primary responsibility -- although not its only responsibility -- the responsibility to protect the financial health and well being of the City of Baltimore.

The Department of Finance recommends that the Taxation, Finance and Economic Development Committee recommend a favorable report on City Council Bill 10-0519.

Attachments

EXECUTIVE SUMMARY

Given fast-rising pension contribution requirements during a period of severe City budget strain, Public Financial Management, Inc. (PFM) was engaged in April 2010 to assist the City of Baltimore and its Fire and Police Employees' Retirement System (FPERS) with evaluating what changes, if any, are reasonable and necessary to safeguard the public welfare and the long-term sustainability of the system. The following highlights key findings from the overall review:

- Public employers nationally are experiencing a retiree benefit funding crisis, driven by increasing life expectancy, a growing number of retirees as the "baby boomers" end their working careers, generous benefits, and asset erosion following recent market downturns. At the end of FY2008, even before taking into account the full effects of recent investment losses, state retirement systems alone were estimated to face a $1 trillion funding shortfall.
- In Baltimore, as in other older cities with declining populations and workforces, benefit funding challenges are compounded by an increasing number of retirees relative to the active employees (and tax base) still contributing into the system. As of June 30, 2009, FPERS had 4,690 active members and 5,929 recipients of benefits – a ratio of 0.79 to 1.0 that contrasts sharply with the median among public pension systems nationally of 2.02 active members for every 1 annuitant.
- In FY2009, FPERS payments for retirement and deferred retirement option plan (DROP) benefits of $184.2 million were more than double the combined contribution into the system by active members and the City. To make up this difference, FPERS relies largely on investment earnings on its assets. In FY2009, the system's managed investment total rate of return was a negative 21.9%, and overall plan net assets fell by $457.4 million.
- Taking a longer term view, FPERS actuarial accrued liability has grown from $1.1 billion in FY1990 to nearly $3.1 billion as of June 30, 2009, and the unfunded component of this liability in actuarial terms has grown from under $100 million in FY2005 to nearly half a billion dollars in FY2009.
- Actuarially, asset smoothing practices that recognize market losses over a five-year period, as well as the continued amortization of negative balances from two expired funds within the system, result in "paper" funded ratios that do not yet fully reflect the true FPERS funding pressures. Using actual market value of system assets as a measure of resources available to meet projected liabilities, FPERS' funded ratio fell from 74.2% in FY2008 to 58.2% as of June 30, 2009.
- As a result of these trends, the City's actuarially required contribution to FPERS has grown from 19.8% of covered payroll in FY2005 to 30.5% for FY2010 – and would rise to 58.85% in FY2011 using the actuarial assumptions recommended by the plan actuary and trustees if no benefit adjustments are adopted.
- In dollars, the required employer contribution to FPERS grew from $48.3 million in FY2005 to $81.9 million in FY2010 (excluding supplemental payments made to reduce certain liabilities). Of this amount, the City pays more than 99%, with the State of Maryland covering less than 1% for a small group of state employees at the BWI airport dating back to past City operation of this facility. With no corrective action, under the recommended actuarial assumptions, the total FPERS employer contribution requirement would rise to $166 million in FY2011.
- For FY2011, the City's Budget allocates $101 million to the FPERS annual required contribution (All Funds), plus another additional $5.7 million to pay down unfunded liabilities, assuming that benefit adjustments will be adopted to reduce the employer contribution. If no benefit changes are made, a more than $64 million hole will open in the FY2011 proposed Board of Estimates Budget, of which $61.9 million would be within the combined General and Motor Vehicle Funds.
- Following two years of revenue decline, the City's FY2011 Budget has no capacity to absorb this additional cost without severe, adverse impacts:
  - Even without this additional $61.9 million in FPERS costs, the proposed Board of Estimates Budget already included the elimination of nearly 1,000 positions (600 of which are currently filled), a second year of employee furloughs, a reduction in transportation and crossing guard subsidies to the Baltimore City Public Schools, rotating closures of seven fire

companies, elimination of police aviation, marine, and mounted units, closing of 29 of the City's 55 recreation centers, elimination of bulk trash pickup, and reduced building maintenance, park maintenance, street paving, and vacant property boarding and cleaning.

- Further revenue increases are constrained by the City's relatively weak tax base, which generates only 52% of the statewide average from equivalent tax rates, and Baltimore's already high tax burdens. Looking at the City's largest revenue source of property taxes, the City's current rate is more than twice the statewide average. Overall, the City's "tax effort" – a measure of how much a government is drawing on its local tax base – has been found to be the highest in the state by a considerable margin.
- On the expenditure side of the Budget, the City has limited control over large, and fast growing cost centers. For example:
  - The majority of the City's contributions to the Baltimore City Public Schools (BCPS) are subject to State maintenance of effort (MOE) requirements;
  - Existing debt service is effectively fixed, and new capital investment is critical for maintaining basic infrastructure;
  - Retiree medical costs are rising separate and apart from any spending for current services; and,
  - Pension contribution requirements are increasing even faster.
- As of FY2011 (Proposed), the four cost centers listed above are projected to have grown by an aggregate 20.7% from FY2008, while City revenues are projected to have fallen 5.5% across this same period. As a result, these areas of the Budget will have increased from less than one-third to over 40% of total spending in just three years – squeezing out other services, which are slated to be cut by more than 16%.
- Further, among the municipal services experiencing significant reductions – including police and fire protection, road and other infrastructure maintenance, and recreation and library programs – certain components of total cost (e.g., utilities from $27.5 million to $31.9 million, and active employee health premiums) have also been growing faster than City revenues. As a result of such rising unit costs, even deeper cuts in core operations and current services are required to achieve the net savings needed.
- To put the scale of the potential FPERS budget gap in perspective, $61.9 million is greater than the $59.4 million FY2011 General Fund and Motor Vehicle Fund budgets for the Sheriff's Office, Baltimore Parks and Recreation Department, and City Libraries *combined*.

- At the time this report was being drafted, Baltimore City Council was considering modest adjustments and/or additions to existing revenue streams for the FY2011 Budget to mitigate the most severe service cuts proposed. Given that a competitive tax structure and the preservation of core municipal services at an acceptable level are both critical for retaining a locality's economy, tax base, and community vitality, such tradeoffs may be necessary in difficult times.
- At the same time, however, such increased tax burdens carry their own adverse consequences for Baltimore's economic competitiveness, and are particularly corrosive if not linked directly to compensating service benefits for taxpayers. While some additional revenues may be generated at the margins through such actions, no large-scale sources have been identified that would resolve the City's fiscal difficulties – just as no remaining cuts are available to close a nearly $62 million gap without damage to the public welfare.
- As part of this evaluation, PFM has worked with the City Finance Department to develop multi-year budget projections under varying pension funding scenarios:
  - If no action is taken, under the actuarial assumptions recommended by the plan actuary and FPERS trustees, the $61.9 million FY2011 gap relative to the proposed FY2011 Budget will grow to $126.6 million by FY2015, the cumulative 5-year gap would total $455.2 million, and the cumulative 10-year gap would reach nearly $1.3 billion.

- In contrast, under a proposed City Council ordinance to adjust FPERS benefits for improved plan sustainability, Baltimore's Budget would be projected to remain in balance for FY2011 and FY2012, enabling further supplemental investments into FPERS to pay down unfunded liabilities. Nonetheless, by FY2013, continued growth in required contributions, in conjunction with overall budget trends, would still be projected to result in an $8.2 million gap that would rise to $44.0 million by FY2015.

- Accordingly, the proposed City Council ordinance does not advance more benefit adjustments than necessary to address the current funding crisis. In fact, the bill by itself is not projected to fully resolve the FPERS funding deficit within even a five-year timeframe. The City Council approach does, however, reduce the scale of the remaining problem to a more manageable level – from a $455.2 million five-year problem to a $67.4 million five-year problem, and from $1.3 billion to $514.7 million over ten-years. In addition, the proposed City approach provides a 2-3-year window within which Baltimore can develop additional approaches – such as a restructured plan for future hires – that can improve FPERS affordability and sustainability going forward.

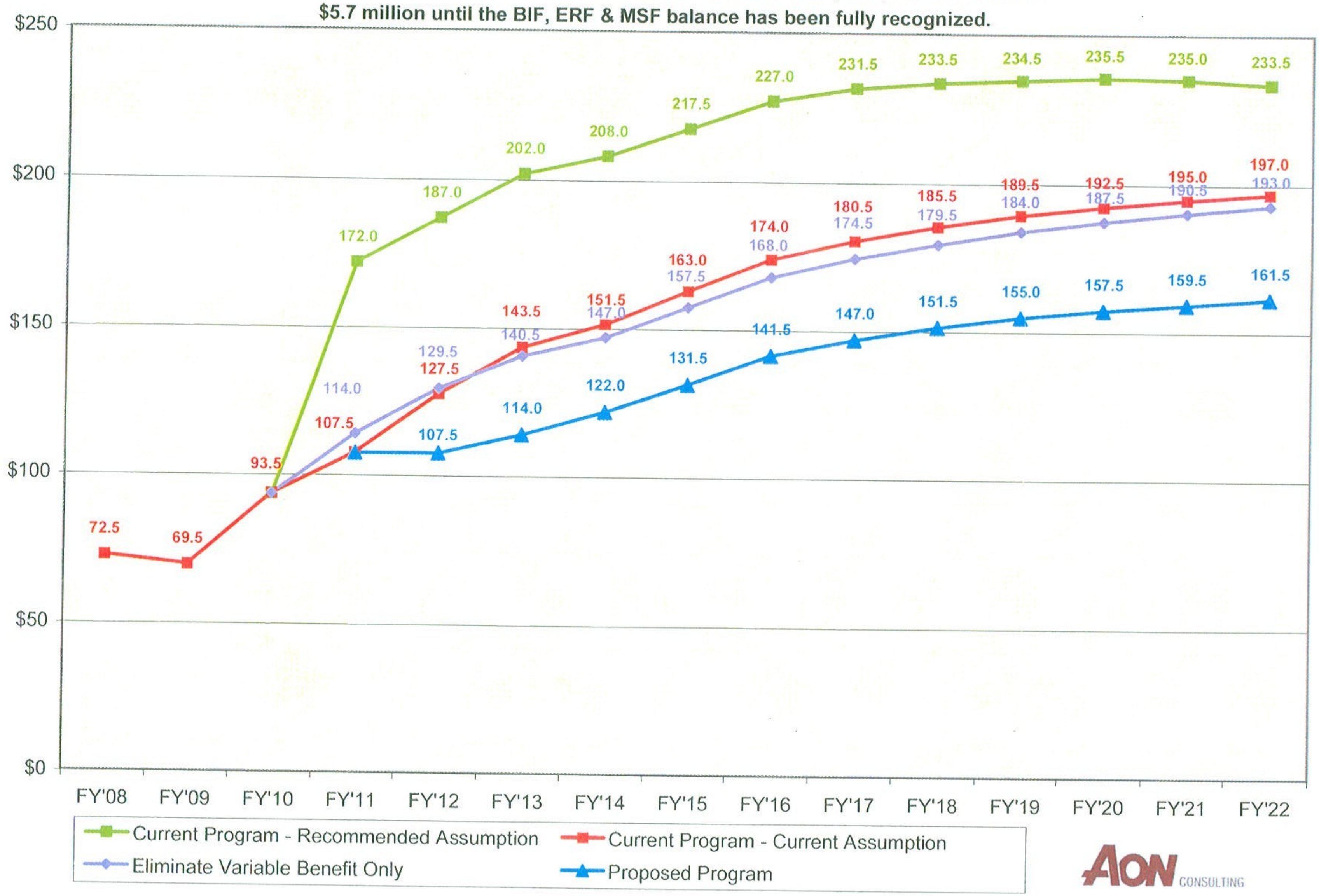
- Alternative approaches, such as benefit adjustments limited to restructuring the FPERS "variable benefit" only, were considered, but did not provide the same 2-3 year window of time for the City to develop plans for further, necessary action, and left the remaining deficit at a far greater level. Based on actuarial and budget projections, replacing the variable benefit without additional measures would result in a deficit of more than $8 million as soon as FY2012 and a 5-year gap over $100 million above that under the proposed City Council ordinance.

- The full package of benefit adjustments included in the proposed Council ordinance would maintain Baltimore police and firefighter pensions well within the mainstream for public safety employees regionally and beyond, and other police and firefighters in some comparable communities already receive similar or less generous benefits.
  - Replacing the "variable benefit" with a regular COLA would be more consistent with the common practices among other public employers nationally and regionally. At the same time, this approach would provide retirees with more predictable post-retirement increases better aligned with expected cost-of-living growth, and would enable establishment of an enhanced minimum benefit for long-term retirees.
  - Modifying age and years of service requirements to earn full benefits would be consistent with national and local trends. According to the National Conference of State Legislatures (NCSL), ten states increased the age and/or service eligibility requirements for a normal service retirement between 2005 and 2009. Among surrounding local governments, Baltimore County recently increased police officer retirement eligibility requirements from 20 years of service at any age to 25 years of service, or age 60 with a minimum of 10 years of service, and increased the requirements for firefighter retirements to even higher levels.
  - Increased employee contributions would also be consistent with broader trends, and foster more realistic labor-management partnership, as employee awareness regarding costs is increased. Overall, from 2005-2009, the NCSL reported that 12 state governments increased employee contributions, while regional governments including Baltimore County, Anne Arundel County, and Prince George's County have also increased public safety employee pension contributions in recent years.
  - Extending the period of time used for calculating average final compensation in the pension benefit formula (from 18 months to three years), would also be consistent with recent trends and existing practice elsewhere. As of July 1, 2010, Anne Arundel County, Howard County, Montgomery County, and Washington, DC pension calculations are among regional governments that base public safety pensions on 36-month calculations.

In sum, given Baltimore's General Fund and Motor Vehicle Fund deficits and constraints, a further $61.9 million cost increase is untenable, and corrective action is necessary. Within the context of the City's particular funding crisis, the adjustments proposed for FPERS – all consistent with mainstream practices and trends – represent a reasonable approach toward improving the system's long-term sustainability.

BC FPERS Projected Contributions ($millions)

Assumes that actuarially required contribution is made each year plus an additional $5.7 million until the BIF, ERF & MSF balance has been fully recognized.



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