CITY OF BALTIMORE
STEPHANIE RAWLINGS-BLAKE, Mayor

DEPARTMENT OF LAW
GEORGE A. NILSON, City Solicitor
101 City Hall
Baltimore, Maryland 21202

June 9, 2010

Honorable President and Members
of the City Council of Baltimore
Room 409, City Hall
100 N. Holliday Street
Baltimore, Maryland 21202

Attn: Karen Randle
Executive Secretary

Re: City Council Bill No. 10-0519 - Fire and Police Employees Retirement System - Benefits

Dear President and City Council Members:

You have requested the advice of the Law Department regarding City Council Bill 10-0519. The preamble to City Council Bill 519 makes legislative findings of fact that making changes to the Fire and Police Employees Retirement System (F&P) is necessary to sustain the viability of the system. Current contributions to the fund are inadequate to fully cover the anticipated liabilities and the escalating cost of the current benefit structure resulting in a required contribution from the City that it can not provide without serious cuts to basic city services. The Greater Baltimore Committee Task Force on Sustainable Funding of Baltimore City's Fire and Police Pension System (GBC Report) concludes that the problem threatens the City's fiscal stability and could result in a reduction in City services, increased taxes, and a decline of the City's bond rating - a combination of adverse circumstances that would result in immediate and long term financial burdens on the City and its citizens." The report further states that "there is general consensus among the Task Force members that unless all stakeholders agree to reforms of the Retirement System, the current underfunding will continue and will further impair the City's ability to provide basic public services, attract new businesses and ultimately threaten the ability of the F&P pension plan to fulfill the commitments that have been made to retirees."

City Council Bill 10-0519 provides for the following changes to the benefits offered to employees who are members of the F&P.

- The bill replaces the current variable benefit, which is dependent on investment performance, with a guaranteed COLA of 1% for retires aged 55 to 65 and 2% for retirees 65 and older that will begin in January 2012. No post-retirement increase will be paid until that time. Unlike the current variable benefit, the COLA, under Sec. 36A(j),

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becomes an obligation of the City of Baltimore and is guaranteed under the provisions of Sec. 37.

- The bill provides for a new minimum annual benefit of $24,000 to all sworn members who retired before 8/1/96 with 20 or more years of service and receive less than $24,000. In addition, a beneficiary of a sworn member who retired before 8/1/96 with 20 or more years of service who receives a annual benefit of less than $12,000 will receive $12,000.
- The age and years of service eligibility requirements are changed for certain groups of employees. Members with at least 15 years of service or age 50 as of June 30, 2010 are grandfathered under the current law and will be subject the current law regarding age and years of service eligibility for retirement. Those who do not fall into the grandfathered group will be subject to a new requirement and will be eligible for retirement after the earlier of 25 years of service or age 55 with at least 15 years of service. Members who are not grandfathered can receive a reduced early retirement benefit.
- The existing DROP 2 benefit will still be available to those members with at least 15 years of service as of June 30, 2010. All other members will be eligible for the DROP 2 benefit at 25 years or more of service.
- The calculation of the "average final compensation" will stay at the average of the 18 consecutive months of regular pay during which the employee's compensation was the highest for members with at least 15 years of service or age 50 as of June 30, 2010. For all other members, the average final compensation will be the member's average annual compensation for the 36 months of service during which his/her salary was the highest.
- Employee contributions to the retirement plan will increase from 6% of his/her regular pay to 10% over the next 4 years. The contributions will increase by 1% each year starting 7/1/2010 through 7/1/2013.
- The F&P Board will be expanded to add the Finance Director and increase the Mayoral appointments from 2 to 3 provided however that one of the 3 shall be chosen from a list of nominees provided by the City Council President.
- The interest assumption with regard to members' contributions will change from 5.5% to 3% and the investment earnings assumption will change from 8.25% to 8%.

The legal sufficiency of City Council Bill 10-0519 hinges upon an analysis of whether the law affects a contract right and whether the impact rises to the level of a violation of the U.S. Constitution, Art. I, Section 10, cl 1, known as the Contract Clause. The Contract Clause states that no State shall pass any law impairing the obligation of contracts.

Determining whether a law impinges upon the obligations of contracts involves a three-pronged analysis. See U.S. Trust vs. New Jersey, 431 U.S. 1 (1977) and Allied Structural Steel v.Spannaus, 438 U.S. 234(1978). First, it must be determined whether a contractual obligation is created by the statute. Second, it must be determined whether the proposed law will substantially impair that contract right. Finally, assuming a substantial impairment, it must be determined whether the proposed law is reasonably necessary to serve a legitimate or important public purpose. See Md. State Teachers Assoc. vs. Hughes, 594 F.Supp.1353(1984).

With regard to the first prong, it is clear that no contractual obligation is created by statute with regard to the changes proposed by City Council Bill 10-0519 to the variable benefit for the following reasons.

The variable benefit provided for in Art. 26, Section 36A(e)(ii) provides:

> (e) *Benefit increases to be paid only from Paid-Up Benefit Fund and Contingency Reserve Fund.*
>
> (ii) The granting of any benefit increase under this section is contingent on the performance of the Retirement System's investment funds. The continuation of any benefit increase previously accrued under this section is specifically made contingent on the ability of the Paid-Up Benefit Fund and the Contingency Reserve Fund to provide these benefits in the future. §§ 37 and 42 to the contrary notwithstanding, any benefit increase provided under this section is not and does not become an obligation of the City of Baltimore. In the event of any conflict between this section and either or both § 37 or § 42, this section prevails.

The plain meaning of this section is that the variable benefit under Section 36(A)(e)(ii), is not guaranteed but rather is contingent on funds being available in the Paid –Up Benefit Fund and the Contingency Reserve Fund and is not an obligation of the City of Baltimore. There is therefore no contractual right to that benefit created by the law. The change to a one percent or two percent COLA, therefore, does not effect a contractual obligation and does not violate the Contract Clause

Not only does no contractual obligation exist with respect to the variable benefit, but also, under the second prong of the Contract Clause analysis, there is no substantial impairment of any contract right with regard to the variable benefit for retirees 55 years of age or older, the age and service eligibility changes or DROP2 changes. Not every impairment by a governmental entity of its own contractual obligations is prohibited by the Contract Clause. The "essential attributes of sovereign power necessarily reserved by the States to safeguard the welfare of their citizens impose a limit on the operation of the Contract Clause …." See Md. State Teachers Union v. Hughes, 594 F.Supp.1353(1984)(citations omitted). In Hughes the Court determined that a statutorily created contract for retirement benefits, if irrevocable, would be void *ab initio* since it would have surrendered an essential element of the State's sovereignty because a legislative body cannot bargain away the police power of a State.

Id. Nevertheless, if a governmental entity alters its own contract, it must be reasonable and necessary.

1. While CC 10-0519 proposes to deprive F&P retirees of certain post-retirement increases, and suspends the payment of any increases until January 2011, the bill balances that impairment with regard to retirees 55 years of age and older by the prospect of a new post-retirement increases that will : (1) provide a certain annual benefit increase no longer dependent on market performance (2) be guaranteed by the full faith and credit of the City (3) provide a new minimum benefit for retirees of $24,000 for those receiving less than $24,000 and for beneficiaries $12,000 for those receiving less than $12,000 and (4) helps to preserve the actuarial soundness of the F&P. These new features certainly cannot be characterized as "lesser" though they are different. The current law creates the possibility that in tough economic times F&P retirees will not receive any post-retirement increases for several consecutive years. A guaranteed, annual fixed increase of 1% or 2%, therefore, cannot be considered a substantial impairment of the existing benefit.
2. The changes to the age and service eligibility requirements arguably do not amount to a substantial impairment of a contract right. The bill retains the existing requirements for members (grandfathered members) with at least 15 years of service or age 50 as of June 30, 2010. Members who are not grandfathered will be eligible for benefits at the earlier of 25 years of service or age 55 with at least 15 years of service. Those who are not grandfathered are still able to retire at an earlier date at a reduced benefit. The members who are not grandfathered, therefore, will still receive their retirement benefits but at a later date. The changes to the benefits are therefore not substantial.
3. The change in the DROP2 benefit is also not a substantial impairment as it merely delays eligibility for the benefit by five years for certain members. Those members will still be able to take advantage of the benefit just at a later date.

Any diminution in the F&P benefits proposed by CC 10-0519 is intended to preserve the integrity of F&P by enhancing its actuarial soundness as a whole while providing offsetting new benefits and therefore is reasonably balanced by the countervailing benefits. See City of Frederick v. Quinn, 35 Md.App.626 (1977). Consequently, there is no substantial impairment of any contract right.

Finally, City Council Bill 10-0519 is reasonably necessary to serve a legitimate and important public purpose. The City's actuary has noted that current structure of the F&P has and will continue to have detrimental effects on the City's contribution and the F&P Board has been regularly admonished regarding the growing cost of the current structure and its exacerbation by low market rates of interest, and volatile investment performance. The situation is now to the point where it is no longer sustainable and the City cannot maintain its contributions as the cost continues to escalate.

The GBC Report has also concluded that the City cannot afford to preserve the current benefit structure and the continuing escalation of the City's pension costs. CC 10-0519 is the culmination of the City's efforts to shore up its escalating annual contribution to F&P so as to preserve the City's financial stability. The court in MSTA v. Hughes, 594 F. Supp 1353(D.Md. 1984), aff'd No. 84-2213(4th Cir. Dec. 5, 1985) noted even if the Plan is currently actuarially sound :

> [T]his court observes that neither *Baker v. Baltimore, supra*, nor *City of Frederick v. Quinn*, supra, requires as a matter of State law that the legislature wait until a pension system is actuarially unsound before making changes in that system. Certainly, there is no such federal constitutional requirement. Such a requirement would jeopardize the pension benefits of current and future retirees, would require that the trustees of the Retirement Systems abdicate their role as fiduciaries, and would impose an irrational limitation on the legislature's police power. A pension system need not be actuarially unsound before a legislature may move to change the system and the benefits it provides its members. *Id.,* at 1368.

The passage of this Bill will serve a legitimate and important public purpose of preserving the City's pension system for current and future retirees before the system becomes unstable and is a valid exercise of the City's sovereign powers.

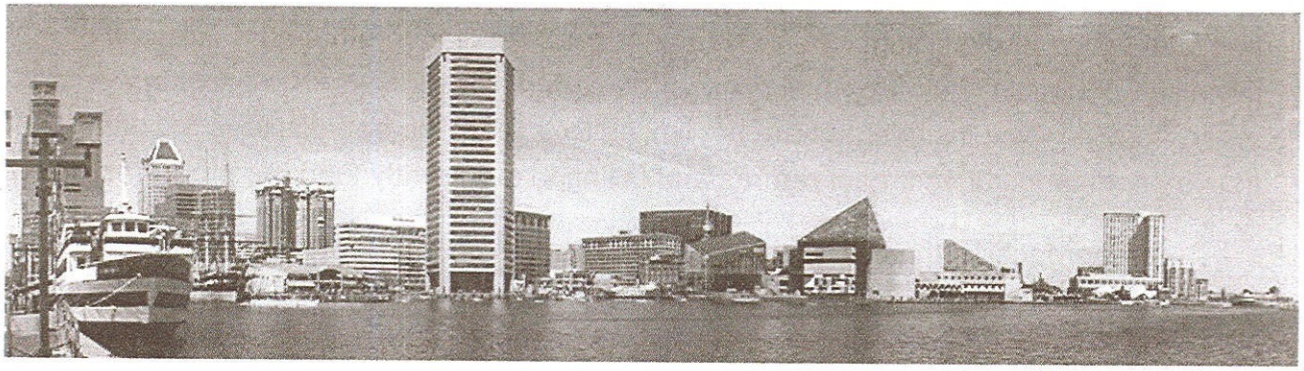
For the above-stated reasons, the passage of CC 10-0519 would not unconstitutionally impair the pension rights of F&P members and retirees. Accordingly, City Council Bill 10-0519 is consistent with the authority of the City Council. The Law Department, therefore, approves the City Council Bill 10-0519 for form and legal sufficiency.

Sincerely yours,

Elena R. DiPietro

Elena R. DiPietro
Chief Solicitor

cc: Honorable Bernard C. Young
Angela Gibson
George Nilson, City Solicitor
Ashlea Brown
Hilary Ruley
Terese Brown



TASK FORCE ON SUSTAINABLE FUNDING OF BALTIMORE CITY'S FIRE AND POLICE PENSION SYSTEM

By THE GREATER BALTIMORE COMMITTEE

The City of Baltimore is facing a serious fiscal challenge. Current contributions to fund the City's Fire & Police Employees' Retirement System, (referred to elsewhere in this report as the F&P Pension plan or system) are inadequate to fully cover the existing and anticipated liabilities required under the pension system. The most recent Comprehensive Annual Financial Report[1] states, "negative investment performance of 21.9%, the recognition of additional accumulated losses from the separate reserves used in previous years to provide benefit improvements to members and retirees, contribution reductions by the City, and costly post-retirement benefit increase provisions, will drive the employer contribution requirements to unsustainable new highs." Meanwhile, the City's unfunded liability continues to grow. Currently, the actuarial funded ratio of the F&P system is 84.8%, while the funded ratio according to market value stands at only 58.2%. The problem threatens the city's fiscal stability and could result in a reduction in City services, increased taxes, and a decline of the City's bond rating – a combination of adverse circumstances that would result in immediate and long term financial burdens on the City and its citizens.

The Task Force quickly recognized that Baltimore City is not alone in its predicament and that state, city, and municipal pension plans across the country have similar underfunding problems. The Pew Center on the States recently released a survey of state-administered pension plans, retiree health care and other post-employment

[1] Comprehensive Annual Financial Report, A Component Unit of the City of Baltimore, Maryland; Thomas P. Taneyhill and David A. Randall, June 30, 2009.

benefits, which found that as of 2008 states had $2.4 trillion to meet $3.4 trillion in promised benefits.[2] The report identifies a number of reasons why the pension systems are in trouble which include, but are not limited to, expanding benefits, overly optimistic assumptions about investment returns and failing to sufficiently fund the programs.

In approaching the complex issues related to the retirement system for public safety employees, the Task Force members conclude that in addition to recommending steps to conserve financial resources of the system and to ensure its long-term fiscal stability, it is absolutely essential to also provide a retirement benefits plan that is fair, equitable and competitive for the public safety employees of Baltimore City.

EXECUTIVE SUMMARY

The Retirement System for Baltimore's public safety employees is a defined benefit retirement plan. A defined benefit plan offers lifetime pension benefits and disability benefits -- as well as benefits for surviving spouses and dependents. The benefits offered in Baltimore's F&P pension plan are part of a comprehensive employee compensation package comprised of salary, personal leave, health care and retirement benefits that public safety personnel earn by reason of their dedicated service to protect the lives and property of City residents and business owners. Unlike other public sector employees, police and fire employees are not included in the social security system. Thus, a sustainable pension system is a critically important benefit for these public servants.

In fiscal year 2009, the F&P Pension Plan paid out retirement, disability and death benefits totaling $184,178,112 to 5,929 fire and police department retirees and their beneficiaries. Included in the total benefits were $143,864,108 to retirees and beneficiaries based upon age and service, $7,102,447 for line of duty and non-duty death benefits, and $33,211,557 for disability benefits. The retirement benefits cited for 2009, include $10,379,493 in payments under the F&P system's Deferred Retirement Option Plan (DROP), an incentive plan intended to retain experienced and well trained personnel within the ranks of Baltimore's fire and police departments.

The GBC 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 term. From the outset, the Task Force has been

[2] Pew Center on the States, The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform, February 2010.

committed to a search for solutions rather than engaging in an exercise in fixing blame for a problem of serious proportions. Our discussions have been -- and remain – sharply focused on finding fair, equitable and creative solutions that fully address the growing unfunded liabilities of the City's retirement system. We saw our mission as four fold:

1. To research and understand the funding issues of the Retirement System, the source and scope of the problems and the level of urgency required to resolve them.

2. To consider and analyze a variety of steps that will result in a long-term plan to restore and maintain the financial stability of the City's pension plan for public safety employees.

3. To meet with stakeholders and solicit their input and consider their perspectives in devising solutions that restore the pension plan's fiscal integrity and ensure a continuing capacity to recruit and retain an experienced, well trained corps of police officers and fire fighters.

4. And finally, to develop a report providing "fiscally sustainable" recommendations – both short and long term – that truly address the underfunding of the City's police and fire fighters pension liabilities.

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 will further impair the City's ability to provide basic public services, attract new businesses and ultimately threaten the ability of the F&P Pension plan to fulfill the commitments that have been made to retirees. Absent mutual assent or a negotiated resolution, the savings estimated in this report may not be fully realized. The City contribution may change based on demographics of plan members, economic conditions and plan experience in relation to the recommendations below. Also, legally negotiated employment agreements may prevent the application of some of these principles retroactively thus affecting the level of savings realized. Nevertheless, failing to act decisively will make it difficult to maintain the quality of life the citizens of Baltimore expect and deserve. In addition, it may increase the cost of borrowing – a consequence that could result in higher taxes or further budgetary pressures on the City.

In its search for solutions, the members of the Task Force ultimately narrowed its focus and distilled from numerous options and potential remedies those options that offer the best hope of a fair and effective approach to the problem presented. In particular, the

Task Force recommendations fall into three broad categories- PLAN MANAGEMENT, FUTURE BENEFIT STRUCTURE and RETIREMENT SYSTEM GOVERNANCE, as follows:

PLAN MANAGEMENT

1. **A realignment of the plan's asset management structure** by the marshalling of pension plan assets into a single, tightly managed fund, eliminating the 6-part asset allocation currently used. The Task Force believes this recommendation will ultimately lead to better overall asset returns and lower plan administration costs with limited, if any, increase in risk to retiree benefits.

2. **Require the City to make the required actuarial contribution each year from its General Fund and not use money already in the trust to mitigate their contribution obligation**. In the past, the City has used the System's unallocated earnings to meet its contribution[3] as determined by the plan's actuary. The Task Force believes it is important to the long-term sustainability of the Plan for the City to refrain from satisfying its obligation to the plan by using plan excess earnings.

FUTURE BENFIT STRUCTURE

3. **Replacing the current "variable benefit"** for retired members of the plan with an annual increase based upon a cost-of-living with an annual cap. This would allow the Plan's actuary and the City Finance Director to more closely project future expenditures for cost of living increases and provide a more stable increase for retirees. This would further conserve pension fund assets by allowing positive earnings on plan assets to fund current benefits. A simple acceptable approach would be a cost of living tied to the annual increase of social security. Any imposed cap should not exceed 3% per annum. Due to the challenging economic times there is no cost of living allocation afforded under the social security index.

4. **A lengthening of the age and service requirements** for determining eligibility for pension benefits. Currently, pension system members can retire at age 50 if they have at least 10 years of service or at any age if they have completed 20 years of service. The Task Force believes consideration should be given to increase the

[3] The System's unallocated earnings have also been used to enact reductions for active employee contributions and retiree increases.

age and/or service requirement so that the combination of the two equates to at least 75 in order to receive full benefits. A number of plan options exist to implement the Rule of 75. For example, the Rule of 75 could require a member to reach a minimum age of 55 years, earn a minimum of 25 years of service or simply attain the sum of age and service totaling at least 75 with no age or service year minimum.

5. **Terminating the provisions of the Deferred Retirement Option Plan (DROP2) for those members who have not yet achieved 15 years of service.** The plan as currently structured allows experienced fire fighters and police officers with 20 years of service to suspend their participation in the F&P plan for three years during which they remain on the job, but earn no service credits toward their pension. During the three-year DROP period, participants can channel the contributions they would have made to the F&P Pension system into a personal retirement account that earns guaranteed interest at the rate of 5.5% until the member's last day of covered City employment as well as their frozen annual retirement benefit. This recommendation would apply to all employees with less than 15 years of service.

6. **Revision of the calculation method for the average final compensation** (AFC) by increasing the service period used in the calculation. The AFC is currently based on compensation earned during the last 18 months of service. The Task Force believes by increasing the number of months used in calculating final average compensation, the plan will achieve a more equitable retirement benefit among all beneficiaries entering retirement while better aligning retirement benefits with earnings during an employee's period of service. The Task Force recommends increasing the service period used in the calculation to a minimum of 36 months and a maximum of 60 months.

7. **Increase the employee contributions supporting the F&P system** from the current 6% to no more than 10%. Union representatives who appeared before the Task Force indicated a willingness on the part of their memberships to explore increases in the mandatory employee contributions. The Task Force believes that higher employee contributions are warranted by the retirement benefit amount earned coupled with the period over which such benefit will be paid when compared with other public plans.

8. **Consideration of a Defined Contribution Plan for future hires.** The Task Force believes serious consideration should be given to converting from a defined benefit

plan to a defined contribution plan for future fire and police officers. This form of system is under consideration in many other jurisdictions and is consistent with private sector plans. In reaching this policy decision it is imperative to consider both the cost, the ability to attract and retain high quality fire fighters and police officers, and the competitiveness of the total employee compensation package offered to the City's public safety officers.

RETIREMENT SYSTEM GOVERNANCE

9. **A re-structuring of the F&P Pension system governance**. The ultimate solutions to the problem now confronting the system depend on experienced, effective, long-term, decision-making about the benefit structure and about the marshalling of assets to support it. The members of the Task Force are in general agreement that the governance of the Fire & Police pension system could greatly benefit by expanding the membership of the Board of Trustees to include individuals with broad experience in finance and budgeting. It is recommended that the citizen representation on the board must have a background in one or more of the following: accounting, actuarial, auditing, investment management, investment consulting and financial law. The Task Force recommends expanding the Board to include the Director of Finance and the Budget Director or their designees, as well as, an additional citizen member. In addition, it was considered of utmost importance that the communication between the Board of Trustees and the City of Baltimore increase through at least semiannual hearings before the appropriate City Council committee.

The focus of this report is limited primarily to retirement benefits for Baltimore's fire fighters and police officers. The Task Force recognizes that there are other major provisions of the F&P pension system concerning the process for receiving death and disability benefits, the purchase of service credits for previous employment and military service, and the retiree health coverage plan. Although an important part of the overall benefit structure of the F&P plan, these additional benefits are each costly to the plan and should be reviewed further by the Mayor and City Council to assess their relevance and quantify their cost benefit. For that reason the Task Force has elected to save for future study any assessment of those benefits not directly related to retirement.

The Greater Baltimore Committee is grateful to the City for the opportunity to participate in this effort to assist in resolving one of Baltimore's more pressing challenges.