The PFM Group

June 14, 2010

Councilwoman Helen L. Holton
Committee Chair
Taxation, Finance and Economic Development
Baltimore City Council
Room 518, City Hall
100 N. Holliday Street
Baltimore, MD 21202

Dear Councilwoman Holton:

I have been asked to comment on the proposal to extend the Fire and Police Employees' Retirement System (FPERS) amortization period for unfunded liabilities from the current level of approximately 20 years to a longer period of up to 30 years as presently allowed by governmental accounting standards.

It is my informed professional view that this suggested approach to cash-flow management is directionally incorrect and will create significant complications for the city in just a few years.

This week, the Governmental Accounting Standards Board (GASB) is expected to formally release its preliminary views on pension accounting. That document will reflect tentative conclusions expressed on the GASB website that such unfunded liabilities should instead be amortized over the average remaining service lives of the active employees. Given the eligibility of incumbent safety professionals to retire in twenty years, their average expected service lives are expected to be much closer to 10 years than to 20 years, let alone 30 years. Hence, the proposal to extend the amortization period is heading in exactly the opposite direction of GASB's preliminary conclusions.

As an advisory member of the Government Finance Officers Association's task force on this GASB project, and a former GASB board member myself, I am unaware of anybody in the professional accounting associations who has opposed this publicized view of proper amortization periods, which is consistent with financial accounting standards already in place in the commercial world. Hence, the most reasonable expectation in the professional community at this time is that GASB will incorporate the "average-service-life amortization period" provision in its ultimate pension accounting standards which are expected to take effect in 2013.

If anything, the proposed amendment to mandate GASB accounting standards in the Baltimore FPERS' practices would ironically then cause a more-rapid increase in pension costs than the

proposals now incorporated in the bill as it stands, and would exacerbate the problems discussed and documented in the PFM report submitted to committee last week.

Sincerely,
PFM Group

Girard Miller CFA
Senior Strategist

AON CONSULTING
William B. Fornia, FSA, EA, MAAA | Senior Vice President | Aon Consulting - Denver-CO

June 14, 2010

Mr. James P. Ulwick
Attorney at Law
Kramon & Graham, P.A.
One South Street, Suite 2600
Baltimore, MD 21202

Subject: **BALTIMORE FIRE AND POLICE EMPLOYEES' RETIREMENT SYSTEM ACTUARIAL BASIS**

Dear Jim:

We have reviewed the actuarial basis currently used by the Baltimore Fire and Police Employees' Retirement System. We have several observations about current investment return assumptions and proposed actuarial assumed rate of investment returns.

- Currently, despite the recommendation of the actuary, the actuarial investment assumption used is 8.25% for pre-retirement, and 6.80% for post-retirement. This is an assumption which is optimistic and unlikely to be realized. This is in part due to the segregation of assets for the variable benefit.
- A proposed change to an 8.00% investment return is much more appropriate and much more likely to be realized.
- The current assumption of 8.25% is an outlier and among the more optimistic assumptions used today.
- Even without the variable benefit, an assumption of 8.00% investment return is more likely to be realized than an assumption of 8.25%.
- Proposed changes in Government Accounting Standards are at odds with the optimistic 8.25% return assumption.
- In tandem with a proposal to lengthen the amortization period to 30 years and change the method to payroll based, maintaining an 8.25% return on investments is not recommended.

Current assumption not likely to be realized

The System Actuary has analyzed the anticipated rates of investment return and has thereby recommended that an assumption of 5.0% for post-retirement be paired with the 8.25% assumption for pre-retirement investment returns. These analyses considered that a significant portion of earnings in excess of a 7.5% threshold would be siphoned from the fund and generate additional benefits through the variable benefit mechanism. For example, if the fund actually earns 8.25%, the 0.75% excess above 7.50% would generate additional retiree benefits, resulting in only a 7.50% return allocated toward previously measured benefits.

This can be illustrated by the following table:

Actual Investment Return Rate	Effective Investment Return Rate
25%	15.0%
20%	12.5%
15%	10.0%
10%	7.5%
5%	5.0%
0%	0.0%
-5%	-5.0%
-10%	-10.0%
-15%	-15.0%
Weighted Average = 8.25%	Weighted Average = 5.00%

The Mercer analysis considered the above as-well-as all potential returns and analyzed the actual return and the effective return after reducing for the variable benefits. They determined that the appropriate effective post-retirement rate assumption would be 5%. Although the current statute permits the system to use an assumption of 6.8%, we concur with Mercer that this is optimistic and that an assumption of 5% is much more appropriate and likely to be realized.

8% assumption more likely to be realized than current

In contrast to the current assumptions, once the variable benefit is eliminated, an assumption of 8.0% is much more likely to be realized. 8% is the assumption used by most public retirement systems throughout the country. Based in part by advice of independent investment experts, many systems are considering lowering their assumption below 8.00%. Mercer has also recommended reducing the actuarial assumption from 8.25% to 8.00%. We concur that this is a much more appropriate assumption than the current assumption of 8.25% / 6.80% and is more likely to be realized than an 8.25% assumption.

8.25% assumption an outlier

According to the Public Fund Survey, the median investment return assumption is 8.00%. Of 126 primarily statewide funds analyzed, only 35 use an assumption as high as 8.25%. 37 use an assumption below 8.00%, and the remaining 54 use the 8.00% assumption. All regional systems included in the survey use less than 8.00%. Maryland Public Employees Retirement System as well as Maryland Teachers use 7.75%; both District of Columbia Funds use 7.25%; Virginia Retirement System uses 7.50%; and Fairfax County Schools uses 7.50%.

8% assumption more likely to be realized than 8.25%

There has been tremendous press recently advocating for funds to decrease their assumed rate of return. This is for a variety of reasons, including reduction in anticipated rates of future inflation. Investment consultants have continued to reduce their expectations for future returns. For example, in March, Wilshire Consulting released their *2010 Wilshire Report on State Retirement Systems*. In that widely publicized report, Wilshire stated that they forecast a long-term median plan return equal to 6.9% per annum. Although I believe that is somewhat pessimistic, clearly the trend is toward return assumptions below 8.0%, not to mention below 8.25%.

Proposed GASB changes

The Government Accounting Standards Board is expected to release its "Preliminary Views" on changes to accounting standards for public pension funds. One item widely discussed and expected is their requirement

that underfunded retirement systems (such as Baltimore F&P's) use a lower assumed rate of return on plan assets to the extent that the plans are underfunded. This is completely consistent with the proposal to reduce the assumption to 8.00% and one more reason in support of the proposal.

Impact of changes in amortization policy

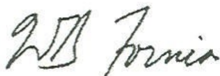
The City currently determines its contributions as a combination of (1) Normal Cost and (2) Amortization of Unfunded Liability. The City proposal of changing the assumed rate of return to 8.00% is a modest step in more responsible funding of the retirement system. It was proposed by the Union to not only maintain the 8.25% assumed rate of return, but to also liberalize the amortization policy. The liberalization would take two forms. First, the period of amortization would lengthen from 20 years to 30 years. Second, the amortization payments would be back-loaded by 3% per year, to be consistent with anticipated growth in payroll. Although this practice is currently permissible under GASB, it is expected that they will no longer be consistent with such accounting standards. These liberalizations would also be a step away from more responsible funding practice, rather than a step in the right direction.

Conclusion

In conclusion, it is my professional opinion that a change in actuarial investment return assumption to 8.00% is much more actuarially supportable and more appropriate than the current assumption of 8.25%.

I am happy to discuss this with you or the City further.

Sincerely,



William B. Fornia, F.S.A.
Senior Vice President

BC FPERS Projected Contributions ($millions)
$250
$200
$150
$100
$50
$0
FY'09
FY'10
FY'11
FY'12
FY'13
FY'14
FY'15
FY'16
FY'17
FY'18
FY'19
FY'20
FY'21
FY'22
93.5
118.0
107.5
133.0
107.5
144.0
115.5
115.0
155.0
125.0
123.0
163.5
133.5
132.5
169.5
143.0
140.5
174.0
148.5
146.5
177.0
153.0
152.0
179.0
157.0
156.0
180.5
161.0
159.0
181.0
165.0
161.0
181.0
169.0
163.0
City Proposed Program
Union Proposed Program (30-%)
Adjusted Union Program (20-$)
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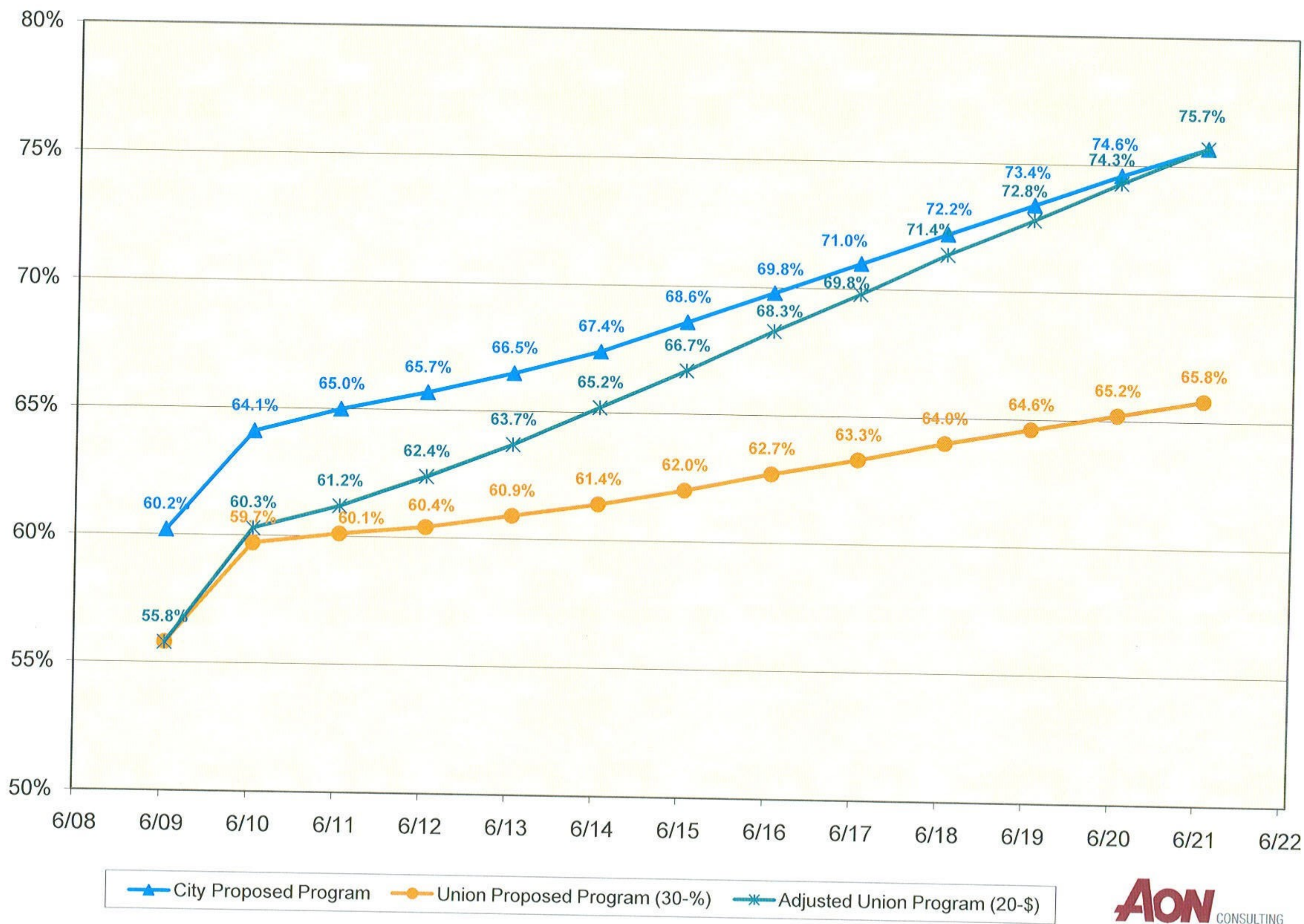

BC FPERS Projected Funded Ratio ($millions)
(Based on Market Value)
80%
75%
70%
65%
60%
55%
50%
6/08
6/09
6/10
6/11
6/12
6/13
6/14
6/15
6/16
6/17
6/18
6/19
6/20
6/21
6/22
60.2%
64.1%
65.0%
65.7%
66.5%
67.4%
68.6%
69.8%
71.0%
72.2%
73.4%
74.6%
75.7%
55.8%
60.3%
61.2%
62.4%
63.7%
65.2%
66.7%
68.3%
69.8%
71.4%
72.8%
74.3%
59.7%
60.1%
60.4%
60.9%
61.4%
62.0%
62.7%
63.3%
64.0%
64.6%
65.2%
65.8%
City Proposed Program
Union Proposed Program (30-%)
Adjusted Union Program (20-$)
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