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HB

CITY OF BALTIMORE MEMO

AGENCY NAME & ADDRESS Department of Finance
Room 454, City Hall (396-4940)

SUBJECT City Council Bill 13-0247

TO The Honorable President and Members
Of the City Council
c/o Karen Randle
Room 409, City Hall

DATE: November 6, 2013

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BALTIMORE CITY COUNCIL PRESIDENT'S OFFICE

Introduction

This bill changes the Employees' Retirement System Defined Benefit Plan for civilians employed or reemployed on or after January 1, 2014. The bill places a limit of $40,000 ("pensionable pay cap") on the amount of pay eligible for a Defined Benefit in the Employees' Retirement System; indexed in future years to CPI growth. Earnings above the pensionable pay cap are covered by the Supplemental Savings Plan.

Employees hired on or after January 1, 2014 will not make a graded contribution to the Employees' Retirement System, phased in over multiple years. Instead, employees will begin employment with the City making a 5% contribution on annual, authorized salary up to the pensionable pay cap to support their Defined Benefit. In addition, employees with earnings above the pensionable pay cap will make a mandatory contribution of 5% of pay above the pensionable pay cap to the Supplemental Savings Plan. The City must contribute an amount equal to 80% of the employees' mandatory contribution to the Supplemental Savings Plan. Voluntary employee contributions to the City's Deferred Compensation Plan receive a 50% match by the City with a 1% limit on the City's match.

Fiscal Impact

In FY2013, employee wages and benefits represented over 60% of total General Fund spending. In recent years, these costs have significantly outpaced revenues. Between FY2007 and FY2012, revenues only grew by 3.0% while employee wages and benefits grew by 19.6%. Retirement costs represent the majority of the growth in wage and benefits costs, comprising 89.3% of the growth between FY2007 and FY2012. The City's contribution to the Employees Retirement System has grown by $68.7 million over the period from FY2004 to FY2014. When revenues cannot keep pace with expenditures, the City must make difficult decisions regarding spending cuts and tax increases.

Although the economy is slowly improving, the City still faces significant pension cost risk. Recent changes to the System's amortization method put the affordability of the System more at risk if the System experiences future investment losses. The System moved from an open amortization period to a closed amortization period that requires the City to pay down all of its unfunded liability within a set period of time. This change in amortization methods amplifies the impact of future losses, especially if losses occur in later years of the amortization period because the City is bound to paying off those losses by a certain date.

Closing future budget gaps won't be easy. The City has already made multiple, difficult choices to eliminate over $400 million in cumulative shortfalls, including: unpaid furloughs; wage freezes and containment; hiring freeze; health benefits plan restructuring; significant reforms for Fire and Police Retirement System; curtailment of capital investment; rotating and permanent company closures; closures of recreation centers and Police Athletic League centers; reductions in street maintenance, lighting, building upkeep, prisoner re-entry, mentoring programs, Arts and Culture funding, library hours, book purchases; and an increase in the City's income tax, parking, hotel and energy taxes. These reductions and changes created a new, smaller baseline which the City must operate under. With a smaller operation, future cuts will be even more challenging and deeply felt.

A sufficient, affordable and sustainable pension system for new employees is needed to help place the City on sound financial footing and avoid further deterioration of City services. The City's Annual Required Contribution to the Employees' Retirement System includes both the normal cost and the cost of paying down the unfunded accrued liability. The normal cost is the estimated annual cost of providing retirement benefits for service credit earned by today's employees. Ideally, all benefits are funded through the normal cost. However, when there are actuarial losses such as growth in the number of retirees, improved mortality or market losses when compared to expected rates of return, employer contributions must be increased to amortize these losses.

Since 2001, the Employees' Retirement System has experienced investment shortfalls in 6 years. The growth in the unfunded liability and the City's contribution over this same period demonstrate the dramatic impact of even a few bad years. The magnitude of these losses is demonstrated in the City's cost to amortize the unfunded liability.
Based on 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. On a market value basis, the unfunded liability is close to $900 million.

In FY2014, the City's annual contribution to support the normal cost was approximately 6.75% of payroll, while annual contribution to support the unfunded liability was 16.56% of payroll – almost 2.5 times greater than the normal cost. In dollar terms, the cost of the unfunded liability in FY2014 is $64.7, which is more than the combined operating budgets of Recreation and Parks, Planning, Human Resources and the Law Department.

Analysis

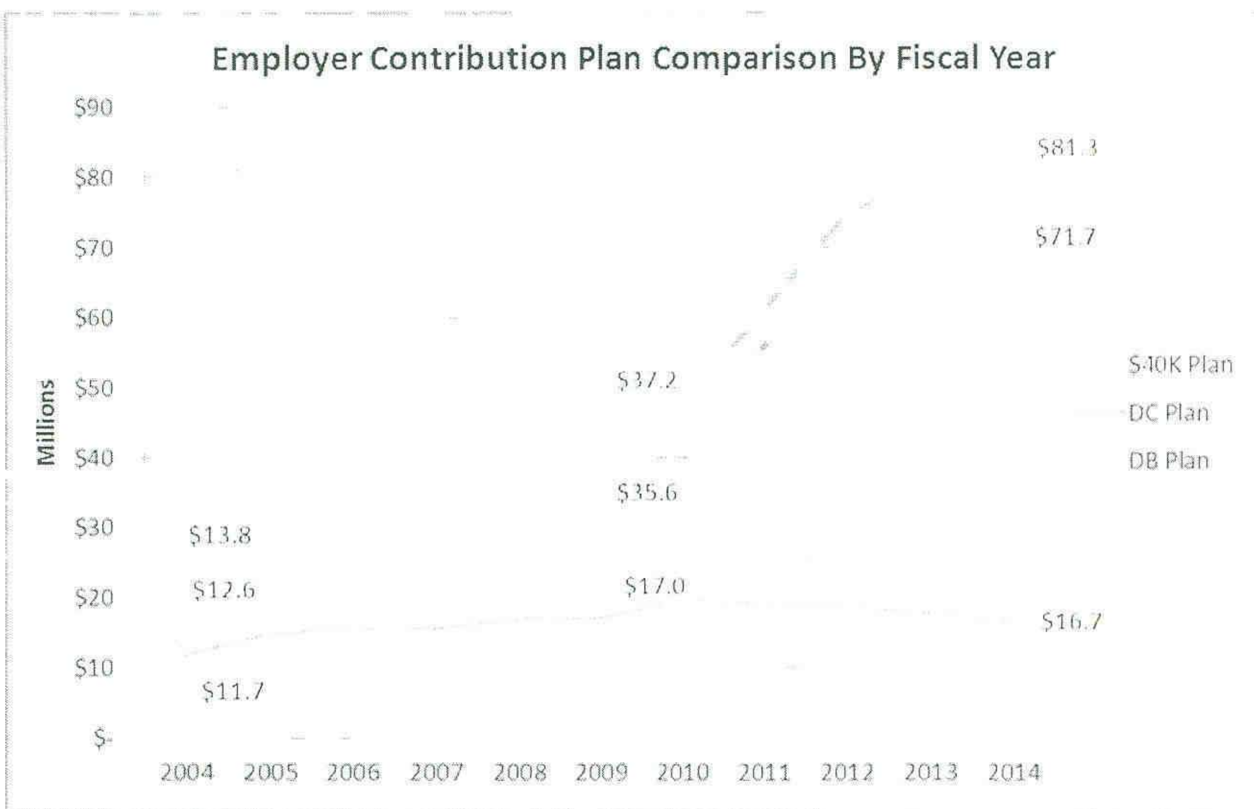
Cost of the Proposed Plan
The City must create a sustainable pension system for new employees that reduces the City's exposure to accruing unfunded liabilities and provides certainty in the City's ability to fund future retirement benefits and City services. This bill is a "hybrid" proposal because it combines elements of a Defined Benefit Plan and a Defined Contribution Plan (also referred to as supplemental savings plan in 13-0274).

A $40,000 penisonable pay cap means that new employees who make $40,000 or under will be placed in the current, unsustainable Defined Benefit Plan with no changes. If the provisions of 13-0274 were applied to the current Employees' Retirement System membership, an estimated 55% of employees would not participate in the "hybrid" plan.

Over 71% of pay would not be covered by the Defined Contribution "supplemental retirement savings" portion of this bill.

Well-designed hybrid plans can be an effective means of reducing risk, but the proposed hybrid pension system in 13-0274 significantly increases the City's normal costs and does not go far enough to reduce the City's risk. The City is willing to pay more in terms of normal costs in exchange for reduced risk, but the ratio of risk reduction to normal cost increase has to be sustainable and affordable.

The proposed plan increases normal cost by almost 150% and reduces risk by approximately 30%. This equates to only an approximate 18% reduction in total City cost. Looking back over the past 11 years, if all Employees' Retirement System members had always been members of the plan proposed in this legislation, the required contribution to the System this fiscal year would have been $71.7 million instead of $81.3 million.



If all Employees' Retirement System members had always been members of Defined Contribution Plan, the City's required contribution to the System would be $16.7 million instead of $81.3 million. The difference between the required contributions under both plans illustrates how important the element of risk avoidance is to reducing City costs and how little the plan in this proposed legislation contributes to the future sustainability and affordability of a plan for new civilian employees.

Technical Issues

The proposed legislation states that the current Employees' Retirement System Board will have oversight of the entire plan for new employees. The Administration's Defined

Contribution Plan proposal designated a new board because there is an increase in fiduciary responsibility when an employer decides to implement a Defined Contribution or hybrid plan like the one in this proposed legislation.

All pension plans require Board members to be committed to fiduciary responsibility. When the risk of a guaranteed pension benefit is transferred from the employer to the employee, there is an even stronger obligation to ensure financial decisions are vetted thoroughly. For this reason, the Administration recommended a board structure that included investment professionals who had no interests in City investments to be appointed to the Board. The current Employees' Retirement System board does not include investment professionals. Finally, the proposed legislation changes the time for the notice of an appeal from one year to five years. The Administration believes that one year is more than enough time for an employee to come forward with an appeal. Extending the appeal period past one year is an administrative burden for the plan administrator.

Conclusion

No matter what changes are adopted for new civilian employees' pensions, the City will still have to pay down the unfunded liability of the current Employees' Retirement System Plan, which could grow substantially even without new members. Investment losses in later years of the Plan's closed amortization period will put even greater stress on the City's ability to provide services because losses have to be paid over a shorter time horizon. Moving forward, the question is how much risk is the City and taxpayers are willing to take on for future retirees knowing that this risk can translate into a large negative impact on the City's ability to fund services.

The proposal outlined in this legislation is too expensive and too risky to be a sustainable and affordable pension system for new employees. The City's goal is to create a system that provides a sufficient benefit to employees; is affordable in terms of projected future costs; is sustainable so that it won't grow a large and unmanageable unfunded liability and provides flexibility that will help attract the next generation of employees, who don't see themselves working at any job for ten years. There are ways to design a pure Defined Contribution or "Hybrid" pension system to meet these goals. Unfortunately, this proposal falls short of meeting them. The Administration's pure Defined Contribution plan is portable, meaning that employees can take their pension savings with them when they leave City employment. The Defined Contribution Plan provides a more than adequate income replacement for employees while reducing all future risk to the City's taxpayers. For these reasons, the Finance Department does not support Council Bill 13-0274.

Cc: Harry Black
Angela Gibson