FROM

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AGENCY NAME & ADDRESS	Bureau of the Budget and Management Research Room 432, City Hall
SUBJECT	City Council Bill 24-0532 – Fire and Police Retirement System

CITY of BALTIMORE

MEMO

TO

DATE:

The Honorable President and
Members of the City Council
City Hall, Room 400

July 24, 2024

Position: No Position

The Department of Finance is herein reporting on City Council Bill 24-0532, Fire and Police retirement system, for the purpose of amending certain provisions of the Fire and Police retirement system. The bill as written would increase the City's annual cost and the F&P Fund's liability by providing four benefit enhancements:

1) Shorten the average final compensation (AFC) calculation from the highest 36 months to the highest 24 months, to be effective for retirees beginning July 1, 2025
2) Eliminate the two-year waiting period for cost-of-living-adjustment (COLA) eligibility for members retiring on or after July 1, 2025.
3) Increase the interest rate accrual for DROP2 account balances from 3.0% to 5.5%, effective July 1, 2025.
4) Provide a new deferred vested benefit at 10 years to be drawn at age 60, for new members hired on or after July 1, 2025.

Background

The Fire and Police Retirement System (F&P) was established to protect and ensure members financial future by providing a pension benefit upon a members' retirement from City service. The F&P system covers sworn Fire and Police Department personnel. As of the end of Fiscal 2023 there were 3,482 active employees and 6,487 retirees that are covered by F&P. The F&P Pension Fund (the "Fund" or "F&P Fund") is funded by a combination of City contributions, member contributions, and Fund investment returns. As of the end of Fiscal 2023 the Fund had $3.1 billion of assets under its control. Investments are managed by the F&P Employees Retirement System with oversight from a Board of Directors that includes City, active member, retired member, and appointed representatives.

2010 Reform

The last major reform to the Fund plan design and benefit structure was in 2010. Entering Fiscal 2010 the City faced an extraordinary budget challenge – a $121 million budget shortfall due to the early effects of the real estate crisis and the Great Recession, plus a $63.9 cost increase for continuation of the F&P Fund variable benefit. The variable benefit provided larger COLA adjustments to F&P retirees during years when the Fund experienced large positive investment returns but held retirees' pension benefits flat during market losses. This arrangement created a "no-lose" provision for retirees and shifted a large and unsustainable cost burden onto the City's budget.

In 2010 the City Council asked a Task Force of the Greater Baltimore Committee to undertake a study to address the City's long-term pension liabilities. The Task Force membership represented a cross-section of business expertise in human resources and pensions and was supported by two firms, Public Financial Management (PFM) and Aon, with extensive experience in public pensions. The Task Force concluded that fixing the variable benefit alone was not sufficient; additional changes would be needed to set the Fund up for long-term viability. In turn, City Council Bill 10-0519 was introduced on behalf of the Administration, proposing the following changes:

1) Replace the variable benefit with a fixed age-based COLA
2) Extend the years of service requirement for full retirement from 20 years to 25 years.
3) Extend the average final compensation (AFC) calculation from 18 months to 36 months.
4) Reduce the interest rate accrual for DROP2 account balances from 5.5% to 3.0%.
5) Increase required member contributions from 6% to 10% of salary.
6) Reduce the Fund's investment assumptions from 8.25% to 8.0% per year.

Notably, the legislation grandfathered in members that had already reached 15 years of service. These "grandfathered" members were still eligible for the pre-legislation benefits including full retirement at 20 years of service. "Non-grandfathered" members, defined as those with less than 15 years of service, were governed by the new benefit structure as required by the legislation.

CCB #10-0519 passed the City Council and was signed by the Mayor in June 2010.

Union Litigation

Following the 2010 legislation, several City Police and Fire Department members filed a lawsuit against the City challenging the legality of the new legislation. That case, *Cherry vs. Mayor and City Council of Baltimore,* wound through the Federal and State court systems until it was ultimately resolved by a decision of the Maryland Court of Appeals in 2021. The Court of Appeals upheld the reforms made to the Fund via the 2010 legislation for the "non-grandfathered" members. The Appeals Court also agreed with a lower court's ruling that certain members' vested benefits were unfairly reduced. The City was required to make a one-time distribution of $31 million to those impacted members. By comparison, BBMR estimates that the reforms have already saved the City **over $1 billion** in pension contributions

The final ruling by the Court of Appeals vindicated the City and spoke to the financial necessity of making the changes to the F&P Fund. In his final opinion, Judge Jonathan Biran wrote: "The City was faced with a lose-lose proposition: either change the terms of the plan and incur the wrath of its members, or allow the unsustainable plan to consume itself from within, harming the plan members and all city residents. The City opted for the former approach."

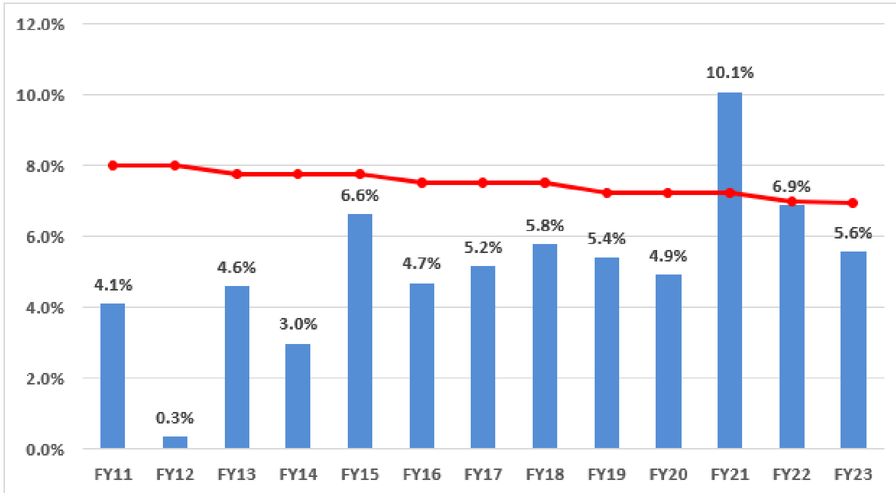
Recent Stabilization Efforts

The 2010 GBC Task Force Report and the 2010 City Council legislation called on the City to continue efforts to monitor and stabilize the F&P Fund via two additional actions – further investment return assumption reductions, and a new hires pension plan.

A lower assumed rate of return results in higher annual City contributions but provides a more honest estimate of the Plan's true cost to the City. The City and the F&P trustees have successfully reduced the rate of return with small incremental reductions, resulting in a reduction from 8.0% in Fiscal 2011 to its current 6.95% in Fiscal 2023. Another small reduction has already been approved by the F&P trustees and will further reduce the investment return to 6.9% in Fiscal 2024. However, despite this concerted effort to make the actuarial assumptions more realistic, the Fund's actual rate of return (on an actuarial basis) has exceeded the target rate of return only once over the past thirteen years. The chart below compares the actual rate of return against target.

F&P Pension Fund

Actual Investment Return on an Actuarial Basis vs. Target Return for Valuation

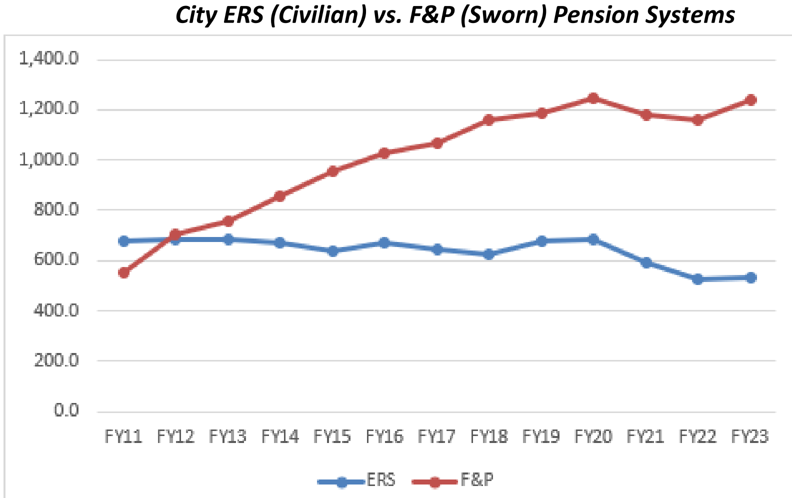


Next, the City proposed a new hires plan in 2014 that was not enacted by City Council. The City's plan would have created a "hybrid" pension benefit for new Police and Fire hires with a partial Defined Benefit (DB) and a partial Defined Contribution (DC) component. The proposed plan would have resulted in income replacement of 67% in retirement with some investment risk shared with the employee. For comparison, the current F&P plan provides 70% income replacement in retirement with all of the investment risk borne by the City.

The failure of the new hires legislation, along with investment returns that have consistently fallen short of target, has resulted in growing unfunded liabilities in the F&P Fund. In Fiscal 2011 F&P had $552.6 million of unfunded liabilities; by Fiscal 2023 liabilities had more than doubled to $1,240.3 million. Meanwhile, the City's ERS system for civilian employees, which reformed both the existing system ***and*** created a new hires plan, saw a sharp decline in unfunded liabilities during that time.

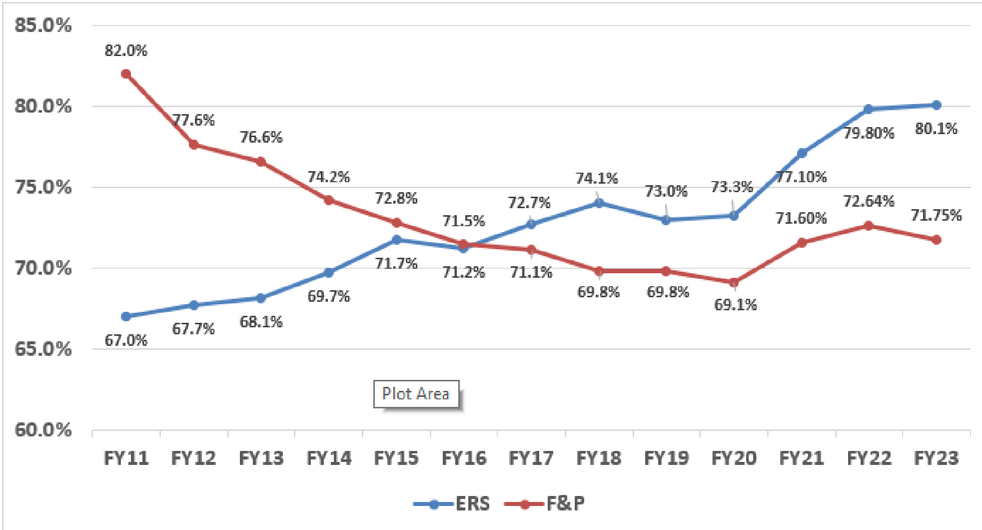
Unfunded Liabilities

City ERS (Civilian) vs. F&P (Sworn) Pension Systems



Similarly, the funded status of the F&P Fund continued to decline over the last decade while the funded status of ERS improved dramatically.

Funded Status
City ERS (Civilian) vs. F&P (Sworn) Pension Systems



The conclusion we have reached is that the F&P Fund, even after the aggressive 2010 reform, is still on unstable ground and is putting a significant burden onto the City's General Fund. The Fund is not yet in a strong enough position to absorb additional benefit increases.

Fiscal Impact

The annual fiscal impact is driven by market rate assumptions. BBMR projects the City's contribution to the F&P Fund to increase by **$7.0 million to $9.1 million annually**, with a cost impact of **$70 million to $91.0 million** over a ten-year period.

The estimates are based on an actuarial analysis performed by the F&P Fund's actuary, Chereion. Chereion used the Fund's current investment return assumption (6.95%) to evaluate the cost impact. However, as mentioned previously, the F&P Fund has only met the assumed actuarial rate of return once in the past thirteen years; the average actuarial return during that time is only 5.16%. As such, BBMR asked Chereion to estimate the cost including both a 5% and a 6% assumed rate of return. The table below shows the range of possible cost under each of the investment return scenarios. We believe that, given the recent history, the long-term costs are much more likely to match the higher cost (5% return) scenario.

Budget Impact of CCB# 24-0532 at Different Investment Returns
$ in millions

	@ 6.95%	@ 6.0%	@ 5.0%
AFC from 36 to 24 months	$2.7	$3.1	$3.7
Eliminate 2-year COLA wait	2.5	2.8	3.2
DROP2 accrual from 3.0% to 5.5%	1.8	2.0	2.2
Deferred vested benefit at 10 years	0.0	0.0	0.0
Annual Total	**$7.0**	**$7.9**	**$9.1**

It is important to note that these basic scenarios do not account for the possibility, and even the likelihood, of a large market correction with a loss of 15% or greater. Since the 2010 reforms, over a thirteen-year period, the F&P Fund only experienced two negative return years on a market basis – a 0.56% loss in Fiscal 2020 and a 7.85% loss in Fiscal 2022. However, going back to 1970, the S&P 500 has returned a loss of greater than 15% five times, or an average of approximately once a decade. **A loss of that magnitude would create a drag on the F&P Fund's actuarial return for many years and would further exacerbate the impact of CCB #24-0532, adding additional City costs and unfunded liabilities.**

Other Considerations

CCB# 24-0532 must also be evaluated in the context of how it affects the City's overall compensation package for sworn Fire and Police members vis-à-vis other jurisdictions, as well as how it could impact the City's bond rating.

Compensation: From FY 2007 to FY 2012 the City's total workforce costs grew by 19.6% even though the actual headcount was declining due to multiple years of hiring freeze actions and furloughs. During this time, healthcare costs for active employees grew by 38.7% while pension costs grew by 89.3%. Significant benefit cost increases made it nearly impossible to fund salary increases that were central to the City's recruitment strategy. Annual benefit increases were slowed through F&P Pension reform along with broader benefit reforms outlined in the 10-Year Financial Plan that was published in February 2013.

Twelve years later the City faces new pressure surrounding recruitment and retention with growing demand to bargain significant salary increases as part of labor negotiations. If adopted, this policy change will limit the ability for the City to offer competitive wage packages both for sworn and civilian employees. The proposed cost of this policy equates to an additional 1.5% to 2.0% that could be offered as part of annual salary increases through negotiations.

Bond Rating: The City currently holds a Aa2 bond rating. This rating is based indicators that fall into the following categories: Economy, Financial Performance, Institutional Framework, and Leverage. The City underperforms its current bond rating in the Economic and Leverage indicators while outperforming on Financial Performance and Institutional Framework indicators. Policy changes that further add to long-term liabilities and fixed costs are in direct conflict of maintaining our current Aa2 rating. It is also worth noting the City has little direct control over the Economic indicators making it even more critical to carefully manage around the remaining factors.

Conclusion

The Department of Finance is taking no position on this legislation.

cc: Michael Mocksten
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