FROM

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| NAME & TITLE | Harry Black, Finance Director HB |
| AGENCY NAME & ADDRESS | Department of Finance<br>Room 469, City Hall (396-4940) |
| SUBJECT | **City Council Bill No. 13-0223 – Change to Grow: 10-Year Plan - Employees' Retirement System - Benefits** |

CITY of BALTIMORE

**MEMO**

TO

DATE:

The Honorable President and
Members of the City Council

May 22, 2012

**Introduction**
This bill modifies the Employees' Retirement System (ERS) Plan to provide for a phased-in pre-tax employee contribution starting at 1% of gross pay and increasing by 1% per year to reach an ultimate 5% as well as the elimination of the variable rate benefit. If the employee separates from service prior to vesting, the full employee contribution will be paid to the employee at the time of separation with interest. The effective date of this change is the date of enactment.

**Fiscal Impact**
Based on the 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. Since FY2008, the City's required contribution to the Plan has more than doubled from $40 million in FY2008 to $81 million in FY2014. These increased contribution requirements decrease the funding available for services to citizens such as recreation facilities, afterschool programs and parks. The implementation of this legislation along with the cost of a 2% pay increase for all employees will yield approximately $55 million in savings. The savings from the changes in the proposed legislation increase over time – for FY14, the City will be spending $0.18 million more than the savings to implement the 2% pay increase.

Even with the increased City contributions, the Plan's funded ratio continues to decline. In FY2003, the Plan was solvent with a funding level 103%. Today, the Plan's funded ratio has decreased below 68%. While the Plan is slowly recovering from the recession, new accounting standards have been put in place that will reduce the amortization period of the unfunded actuarial liabilities and change the actuarial method used to calculate the unfunded liability. Already, Baltimore's ERS has taken steps to align with the new Governmental Accounting Standards Board pension plan standards. These changes will produce an increase in the reported balance sheet liability which is akin to other long-term obligations, such as debt. This liability is reported to the Rating Agencies on an annual basis.

In addition to these System specific challenges, the City is facing a $745 million projected operating deficit over the next 10 years. In past years, the City has made difficult choices to close more than $400 million in budget shortfalls, including unpaid furloughs, hiring freezes, layoffs, curtailments of capital investment and service cuts. Although unpopular and not sustainable, these measures were necessary for the City to remain afloat during the financial crisis.

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Looking forward, the goal is to eliminate the $745 million structural deficit proactively through the implementation of a series of initiatives. On the expenditure side, workforce expenditures represent over 60% of total General Fund spending and have outpaced the growth of revenues. Between FY2007 and FY2012, revenues grew by 3.0% while wages and benefits grew by 19.6% - including an 89.3% increase in pension costs.

This bill advances two 10-Year Plan initiatives intended to curtail fast-growing liabilities and redirect future dollars toward wages.

**Analysis**
Public Financial Management's (PFM) review of Baltimore City employees' total compensation package revealed that the City's retirement benefit design features several characteristics that exceed the norms even among other regional governments. Among larger Maryland counties with traditional Defined Benefit (DB) plans, Baltimore's ERS is the only plan that does not require an employee contribution.

In addition, from 2009 to date, 47 of 50 states enacted pension reforms for broad groups of state civilian employees. The most common actions taken were increases in employee contributions and adjustments to post-retirement benefit increase formulas.

Of the 42 states with a DB pension plan, the employee contribution averaged 6.1% of pay among jurisdictions that participate in Social Security. Baltimore County and the State of Maryland require employee pension contributions that exceed the national average by approximately 1% of pay. Both systems employee contribution is 7% of pay.

PFM's analysis highlighted the need for Baltimore to rebalance the total compensation portfolio. Because benefits that City employees receive already exceed the national average, the focus should be shifted to employee wages. The passage of this legislation by July 1, 2013 will mean that employees will be able to receive a regular, 2% salary increase each year. Even with the proposed employee contribution deducted from employees' paychecks, the net increase in gross pay, assuming an annual 2% increase and a 0.5% annual increase for levels and longevity will be 7.5% between FY13 and FY18.

The evidence demonstrates that the City should not increase retirement benefits as a result of an employee contribution requirement – the City cannot afford to add more liability to an already underfunded system and the current ERS retirement benefits are already more generous than the market. Instead, the City will invest in employee wages which helps retention and recruitment and rewards our employees now for the hard work that they do. The salary increases today will increase employees' future retirement benefits.

Currently, ERS retirees are entitled to the greater of an annual 1.5% cost of living adjustment (COLA) or the COLA granted to Fire and Police employees. Because the current Fire and Police employee system provides a COLA of 2% for employees 65 years of age and older, ERS employees less than age 65 receive an annual 1.5% COLA increase, while ERS retirees 65 and over receive an annual 2% COLA increase.

In addition to the annual COLA described above, retirees are entitled to a variable benefit. The variable benefit siphons off earnings in favorable investment years to be distributed to retirees instead of being reinvested in the Plan. In 2007, the City Council took steps to limit the total COLA received by ERS retirees by the CPI, but the variable rate benefit remains a costly provision in the Plan. Because the Plan is less than 68% funded, the System needs all of the earnings in "good" years to go toward making the employee benefits solvent instead of giving retirees an added benefit on top of their annual COLA increase.

The variable benefit provision is unique to Baltimore because it siphons off investments in favorable earnings years but does not provide a mechanism that balances this distribution in years when earnings are unfavorable. Most systems do not have a variable benefit provision that links the COLA to investment returns, but among the few systems that do provide a variable benefit, COLA increases are based on a sliding scale and can be reduced or eliminated if investment earnings fall short of system expectations – that is not the case for Baltimore.

It has been suggested that the legislation be changed to reinstate the variable rate benefit once the Plan's funded ratio reaches 85%. In order to ensure future benefits for all employees, the Plan needs to be held to the standard of achieving and maintaining a 100% funding level, similar to the Elected Officials Retirement System. Choosing a funding level of 85% to reinstate the variable benefit is counterproductive to the ultimate goal. As soon as the variable benefit is added back into the Plan, the funding level will drop below 85%. Essentially, reintroduction of the variable benefit at an 85% funding level will put the City back on the path of increasing unfunded liabilities and decreasing funding levels.

Not only is full 100% funding always better than 85%, but funding below 100% is particularly problematic after passing the bottom of the business cycle. At the low point, there may be reason to reasonably expect investment returns to bounce back and bolster the funding level. Now, however, the City has already experienced some recovery from the depths of the recession and would ideally be building a position somewhat in excess of 100% funding in anticipation of the next downturn in the business cycle.

**Recommendation**

The Finance Department recognizes the efforts of civilian employees as well as the need to balance the retirement benefits of those employees with overall fiscal health. The City has goals of achieving a balanced budget, lower long-term liabilities, greater tax competitiveness, increased infrastructure investment and better service delivery for Baltimore's citizens. City pension benefits represent a large and growing liability that hinders our ability to make other critical investments in services for citizens and wages for employees. This bill brings employee benefits more in-line with the market, allows the City to provide pay increases to employees and helps ensure a future retirement benefit for all employees in the ERS System. For these reasons, the Finance Department supports this bill.

cc: Angela Gibson