MEMORANDUM

TO: Mayor Lewis and City Council Members

FROM: Gregg Guetschow, City Manager

SUBJECT: Pension Corrective Action Plan Background

DATE: August 22, 2019

Council members are aware from discussions over the past few months that the City's pension plan funding level has fallen below 60%, triggering a notification from the state that the City must file a corrective action plan by the end of October. The purpose of this memorandum is to provide Council a comprehensive background on this topic so that it can make an informed decision about approving the corrective action plan.

There are two important factors that Council must consider when examining the corrective action plan. First, does plan demonstrate that the City will achieve 60% funding within the next 20 years. Second, will the City have the financial resources necessary to make the payments required to achieve 60% funding within the next 20 years.

Types of Pension Plans. For purposes of our discussion, we will group pension plans into three types: defined benefit, defined contribution (DC) and hybrid. The discussion below simplifies the calculation of retirement benefits but will serve to explain the differences among the plans the City offers.

Defined benefit (DB) plans promise retirees a benefit upon retirement that is a calculated by considering three factors: years of service, final average compensation, and a flat percentage multiplier. The defined benefit plans offered by the City have formulas with percentages that range from 2.5% to 3.0%. By way of example, a Charlotte police officer who retires with 25 years of service and a final average compensation of $60,000 would receive a basic annual benefit of $45,000. (25 x $60,000 x .03).

DC plans are traditional pension plans and, until 2012, were the type of plan offered to the vast majority of City employees. They are, in essence, promises made to employees that, if they fulfill certain service requirements to the City, they will receive a guaranteed benefit at some future date.

As Council member Ridge noted during the previous Council meeting, there was never a legal requirement that the assets of defined benefit plans must equal the actuarial value of these promises of future payments. A variety of factors can influence pension plan funding levels on a year-to-year basis. Although some cities have maintained funding levels at or above 100% of the present value of these promised payments, most, including the City of Charlotte, did not.

Defined contribution (DC) plans operate very differently from DB plans. As the name implies, these plans provide for a specific dollar or percentage contribution each year. The term that most people will recognize as associated with DC plans is 401k. This is a reference to a specific section of the IRS code but is not the only such provision in the code to provide for tax-deferred contributions to a retirement savings vehicle. Others are 401a and 457.

From an employer standpoint, DC plans are advantageous because the total cost is paid in the current year. The benefit the employee receives upon retirement is a function of the total of all such contributions over the years plus any investment earnings or losses. Unlike DB plans, there is no guaranteed amount that they employee will receive upon retirement. On the other hand, DC plans do not typically include vesting provisions (minimum lengths of service before an employee qualifies for a benefit) and the assets are portable from employer to employer.

The City offers DC benefits to employees in some administrative positions. At present, only two administrators, including me, have DC plans as the sole plan to which the City is making contributions. In my case, the City makes a contribution equal to 10% of my base salary to a 401a plan.

Hybrid plans, as the name implies, fall between DB and DC plans, combining elements of both. They include a DB portion, with a lower multiplier, and a DC portion as well. The hybrid plans the City instituted in 2012 have DB benefits with multipliers equal to 1.25% or 1.75%, the higher being provided to employees without social security benefits, and DC contributions. The City plans further limit contributions by capping total employer contributions to no more than 10% or 16.2% of wages, again depending upon whether or not the employee qualifies for social security benefits. Each year, the percentage contribution to the DC portion of the plan is adjusted to reflect changes in the required DB contributions so as to equal the employer contribution caps. All employees hired after July 1, 2012, except those who choose participation in a DC plan, are enrolled in a hybrid plan.

Table 1. Pension Plan Participants

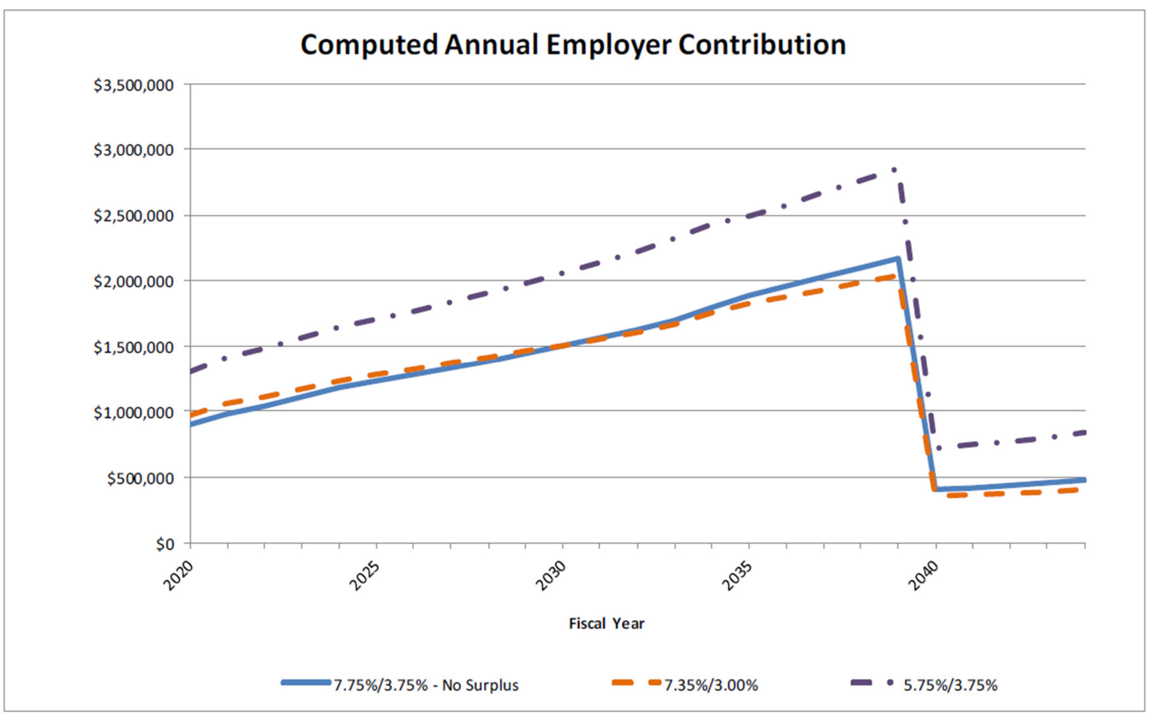
	Defined Benefit	Defined Cont.	Hybrid
Police	6	1	7
Fire	5		1
DPW/Clerical	6		14
Other	6	1	1
Total	23	2	23

Table 1 above shows the breakdown of active employees in various classifications by pension plan as of December 31, 2018. Staffing changes in the Fire Department since January 1 have shifted an additional three employees from defined benefit to hybrid plans.

Funding Pensions. An actuarial valuation of the City's pension plans is prepared each year. This valuation determines the amount of the annual required contribution (ARC) that the City must make to the pension system. Changes in the ARC over time reflect factors such as mortality estimates, benefit changes, wage increases, and investment returns.

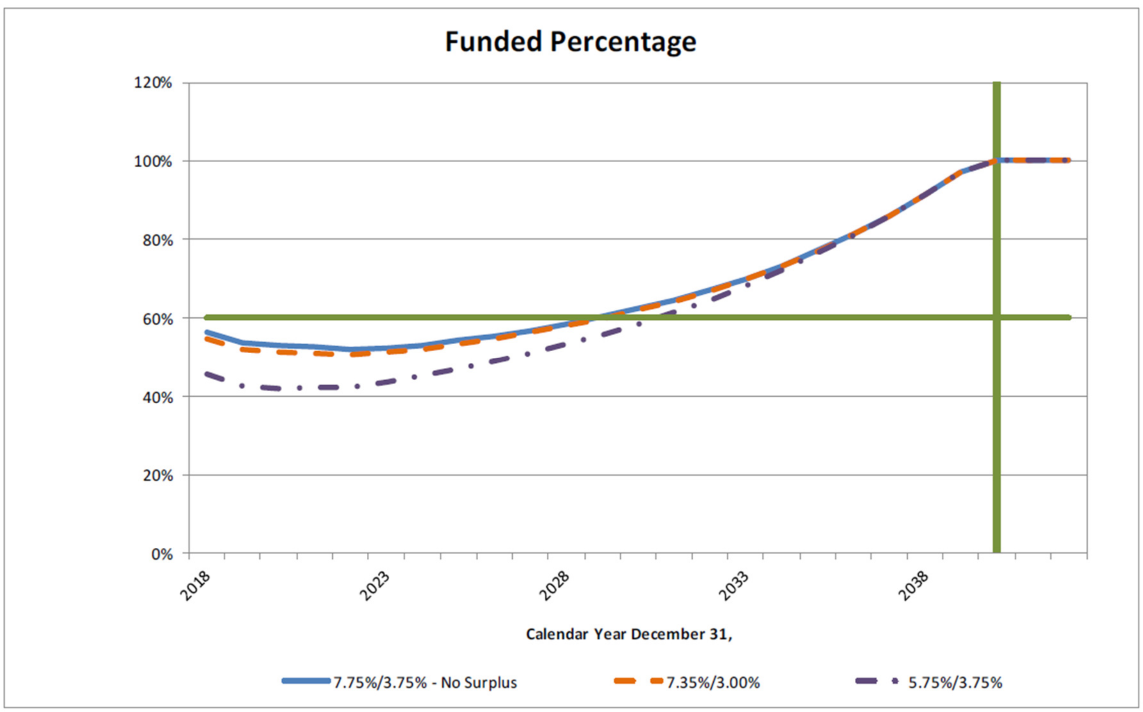
The pension plan administrator, the Municipal Employees Retirement System (MERS) applies factors to smooth annual fluctuations in an effort to achieve more level funding on a year-to-year basis. In the past, smoothing typically occurred over a thirty-year period. In recent years, however, MERS has implemented policy changes intended to move all employers to fully-funded pension plans.

As I have noted, this policy change, in combination with modifications to expected investment returns, has resulted in a projection that the City's ARC will increase from approximately $900,000 in 2020 to $2.1 million in 2040. This is the amount necessary to addressed the $10 million unfunded accrued liability in the pension system.



A convenient way to think about this is to liken it to using your credit card to make purchases. For many years, the minimum payment on the pension promises we charged to our pension credit card was fairly modest but that was all we paid. We also continued charging all of our pension costs. Moreover, we made additional promises without considering whether we would have sufficient cash on hand to make the increased payments. We have, in essence, maxed out our pension credit card. Beginning in 2012, we scaled back how much we were charging but credit card payment policies have changed. Now, we must pay all of the past debt we accrued for employees that have since retired. Once we are paid off the balanced owed, each credit card payment will keep us fully funded.

Achieving 60% Funding. As noted, one of the issues the corrective action plan must address is whether the assets in the City's pension account will be equal to at least 60% of the present value of the benefits that the City has promised through its DB plans and the DB portion of the hybrid plans. As the chart below shows, we will achieve that level of funding in 2030 if the City continues to make the annual required contribution.



The challenge we face is in finding the resources necessary to make the ARC payments. As noted above, the ARC is expected to increase by approximately $60,000 annually over the next 20 years.

The largest share of City expenditures is for wages and benefits. Eliminating $60,000 annually would require the elimination of about two positions every three years. By the time we reach 2040, then, it will have been necessary to cut more than 13 positions or roughly 25% of the City's work force. This is in addition to the 10 to 12 positions that have been eliminated over the last decade. It is not possible to achieve the savings through reduction in force and still accomplish the work of providing essential City services. Further complicating this approach to cost cutting is the recognition that labor costs represent differing fractions of various funds budgets. For example, wages and benefits account for 55% of the general fund budget but 26% of the utility fund budget. Cutting positions, then, would need to fall more heavily in the general fund where the majority are involved in performing police and fire functions.

A more fiscally prudent course of action would be to increase the amount of contributions the City is making now. Spreading the funding of the $10 million unfunded accrued liability over 20 years would require an additional annual contribution of $500,000. To obtain that amount of revenue through a property tax increase would require an additional levy of 2.5 mills.

As we have advised Council, we continue to explore opportunities for cost reductions in pension and health insurance benefits by restructuring the programs that we offer. We do not yet know what savings, if any, might be achieved by doing so. It is inconceivable, however, that the City would save the $10 million dollars over the next 20 years necessary to eliminate the current unfunded accrued liability in the pension program.

In short, additional revenue will be required to address the pension funding challenge. In order to identify a meaningful revenue source for the corrective action plan, my recommendation is to use public safety special assessments to fund police and fire pension costs. This source of funding might be replaced in time with a voter approved millage as part of a larger package of funding proposals to address the issue of fiscal stability.

There is much additional information about the City's pension plans contained in the December 31, 2018 actuarial valuation. A copy of that valuation can be found at www.charlottemi.org/path-to-fiscal-stability.