CONTRIBUTION POLICY ISSUES FOR THE ERS

Prepared for Pension Task Force

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Background: Contribution Policy

1. Three sources of funding for the ERS
   - Investment return—80%
   - Member contributions-fixed by Charter
     - ✓ Invariable, regardless of funded status
     - ✓ Most are still employer-paid
     - ✓ For City government ~ 38% of the normal cost
   - Employer (plan sponsor) contribution
     - ✓ Dependent on funded status
     - ✓ No contribution when funded status is 102% or > (“full funding limit”)
     - ✓ For city government ~ 62% of normal cost unless absorbed by Plan surplus
     - ✓ Established via annual valuation pursuant to “funding policy”
     - ✓ Charter requires full payment of actuarially-required contribution (ARC)—no discretion by Plan Sponsor
2. Following a 2-year hiatus, employer contributions projected to return in 2013
   - Projected average of ~ $70 million annually for foreseeable future
   - Despite Employers’ reserve balance, => destabilizing impact on Plan sponsor finances
     - ✓ ~ 28% of total projected tax levy
     - ✓ 2012 voluntary tax levy contribution => ~ 10% of total levy
     - ✓ Levy limits, Shared Revenue reductions, lack of home rule over local finance => severe limits on Plan sponsor flexibility

Multiple, Potentially Competing Contribution Policy Objectives

1. Substantial Plan liquidity=> capacity to meet benefit obligations during good times and bad ("ability to pay benefits")
2. Fund total benefit by time employe retires (pay for "current services with current taxes"=> intergenerational equity)
3. Sustainable & predictable Plan sponsor expenses

Current Contribution Reality versus the Objectives

1. Asset/liability coverage is very strong: assets = ~ 150% of retired lives' liabilities
2. "Currency" objective compromised via amortization period change
   - "Closed" approach is working to restore currency
3. Plan sponsor contributions are not sustainable & subject to significant deviation from projections
   - Contribution volatility => biggest threat to defined benefit plans

Potential Concepts for Reconciling the Objectives

1. Strong asset/liability ratio/recent reserve budgets/solid ERS investment program=> create an opportunity
2. "Deconstructing" the currency objective:
   - "Normal cost": the true "current cost"
   - Unfunded {past service} liability can result from =>
     - ✓ Improving benefits without funding them
     - ✓ Deliberate avoidance of making contributions or…
     - ✓ Investment returns fall short of targets
     - ✓ City's challenge primarily due to 2008 market results…but
     - ✓ 1995-2009: reliance on fund surplus for ~ 60% of staying current
3. City's ERS has avoided the shortcomings many other major plans have exhibited

Thinking About Intergenerational Equity

1. “Inequity” of market cycles
2. Implications of unfunded liability on contribution increases
   - Infrastructure deferral
   - Service solvency
   - A “lost generation” for taxpayers??!!??
   - “100% funded” for whom?
3. If it’s about “generations”=> let market cycles be part of the solution??!!??

A Conceptual Road Map
{for discussion purposes}

1. Maintain strong asset/liability coverage
   - Avoid decline in funded ratio below 80-85%
   - Reduce trend growth in future liabilities
2. Fund the normal cost as a recurring budget item
   - Perhaps set some limit, say 125% funded
   - Actuary's "declining contribution" formula combined with elimination of full funding limit?
   - Consider required contributions to reserve as a stabilizer
3. Stabilize/moderate annual growth in employer contribution
   - Let market cycles do their job
   - Accelerate contributions if asset/liability coverage or funded ratio fall below a certain threshold
4. "Right size" the normal cost via experience study and plan design changes for new entrants