**Goal Development**
**City of Burlington Retirement Committee**
**Prepared by Keith Brainard**

## Goal: Unfunded liability

### Discussion

As of the 6/30/2013 actuarial valuation, the City's unfunded pension liability (UAL) is $63.6 million. The UAL represents the present value of future pension benefits the city is obligated to pay.

Based on its funding and amortization methods, the city is projected to amortize its UAL over the 30 years ending in 2044. Assuming all actuarial assumptions are met, the cost to the city of amortizing this obligation is projected to be approximately $6.0 million annually through 2035, then declining steadily to zero in 2044. This schedule is on page 45 of the actuarial valuation dated 6/30/13.

Per the valuation, roughly 57 percent of the city's UAL is attributable to past service, already accrued by retired and active members; the remainder is attributable to future service, projected to be accrued, for current active members. Thus, a majority of the UAL reflects service that already has been performed; a minority of the UAL reflects service that is expected to be performed.

A UAL, by itself, is not problematic. The UAL becomes a problem when the cost of amortizing it becomes a cause of fiscal stress. Indeed, the real problem with a UAL is not so much the UAL itself, but the cost of paying it off. Identifying a supplemental or alternative means of amortizing the UAL could be considered part or all of a solution to resolving the UAL.

The UAL can be amortized through some combination of the following (these are suggestions for fostering discussion by the committee and are not recommendations):

- Pay down the UAL over a 30-year period on the basis of the plan's amortization methods and actuarial assumptions.
    - This might be considered the "stay on the current path" option.
- Reduce benefits for plan participants who currently are receiving a benefit.
    - Presumably, this option would be limited to making a reduction in future COLAs.
    - Affecting benefits for current beneficiaries is a double-edged sword: it can produce relatively substantial cost savings, but it also affects plan members least able to take corrective action.
- Reduce benefits for plan participants who are currently working.
    - This option could take one or more of multiple forms, including increasing the age or years of service needed to qualify for a retirement benefit, reducing future rates of benefit accrual, reducing COLA provisions, etc.
    - As with the option to affect benefits for those who are currently receiving a benefit, this option also is a double-edged sword: it can produce relatively large cost savings, but also can negatively affect retirement plans for the city's workers.

    - Some states and cities that have implemented this option have made changes that vary based on the member's proximity to retirement, so that those who are near retirement are less or unaffected, and those who are earlier in their career are more affected.
- Reduce benefits for inactive plan participants
    - The same descriptions used for current active members would also apply to this group.
- Increase the amount paid in any one or more years
    - This option could increase short-term fiscal stress for the city, but would reduce the long-term cost of amortizing the UAL.
    - The city could dedicate some or all of any revenues above expected amounts to amortizing the UAL.
- Modify actuarial assumptions, such as the investment rate of return, inflation rate, and rate of expected salary growth.
    - Presumably, the city retirement board believes current actuarial assumptions are appropriate.
- Issue pension obligation bonds.
    - POBs essentially replace "soft" debt, in the form of pension obligations, with "hard" debt, in the form of city-issued debt.
    - A POB is an arbitrage play, in which the plan sponsor, in this case, the City of Burlington, borrows funds at current prevailing taxable rates (currently around 4.5 percent) and invests the proceeds, hoping to generate a rate of return high enough to justify the interest and issuance costs.

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## Goal: Taxpayer's Contribution

### Discussion

Contributions from taxpayers are one of three sources of public pension revenue, complemented by contributions from plan participants and investment earnings. Burlington's retirement ordinance directs the city council to fund the retirement plan on the basis of the normal cost—the cost of benefits accrued each year—plus the cost to amortize the unfunded liability (UAL). Each of these components of the contribution rate can vary depending on the actuarial cost method that is used.

The City of Burlington is to be commended for regularly paying its annual required contribution. This practice is vital to ensuring the plan's long-term financial viability.

In the current fiscal year, the city will contribute approximately $9.0 million to the retirement plan and employees will contribute roughly $2.3 million. This means the City of Burlington is paying approximately 80 percent of total contributions. On a national basis, in FY 2012, employers paid approximately 70 percent of all pension contributions.

Of the city's FY 15 general fund budget, approximately 7.9 percent will be spent on pension contributions. Although reliable comparisons with other cities are difficult to make (for a number of reasons), the city's financial commitment to pensions is likely somewhat higher than the national average for other similar-sized municipalities.

### Open vs. closed group

As illustrated by the city's actuarial consultant in its draft discussion of the use of the open group method, the city's cost of the pension plan under the current, closed group method, is projected to trend gradually downward until dropping sharply in 2034 and again in 2038.

The actuarial cost method does not affect the cost of the pension plan; the method affects the timing of the costs.

As the actuary's analysis shows, were the city to adopt the open group method, the city's cost would drop immediately, by some $2.5 million (28 percent), but then is projected to climb steadily until leveling off in around 2034. As a percentage of city payroll, the open-group method produces a more stable contribution rate, remaining at around 13% to 14% throughout the measurement period.

If the city is seeking immediate fiscal relief from current pension costs, but also seeks to avoid the persistently higher contribution rates in out years, the city may wish to consider exploring with its actuary a hybrid approach between the closed- and open-group methods. For example, the city could switch to the open-group method while making a larger contribution than that method requires. This approach would reduce the city's current pension cost immediately and

in the near-term, while, by virtue of paying more than is required, also lower costs below the levels projected for this method in out-years.

Such a hybrid approach may be structured to both produce immediate cost savings while also producing a relatively stable rate, and/or one that declines gradually over the funding period. Such a "hybrid" approach could be further complemented with other strategies, such as a) the use of the entry age normal actuarial cost method, rather than the projected unit credit method; b) reductions in the UAL through benefit reductions; c) higher employee contribution rates; and/or d) a city policy to commit a portion of any "excess" or "surplus" revenues in future years to amortizing the UAL.

**Employee contributions**

Burlington employees contribute a fixed rate of pay: Class A workers contribute 10.8 percent; Class B workers contribute 3.05 percent. By national standards, Class A workers' contribution rate is roughly commensurate with the rate paid by public safety workers who do not participate in Social Security. Compared with other general employees, i.e., non-public safety personnel, Burlington general employees page less than the median comparable worker in the U.S., who contributes 5.7 percent.

As discussed in the Unfunded Liability discussion paper, the employer cost of the city's retirement plan is tied closely to the size of the plan's UAL. Reducing the size of the UAL would reduce the annual plan cost. The UAL discussion paper presents a number of options that would reduce the UAL and thereby reduce the plan cost.

Another way to reduce the taxpayer's cost of the plan would be to increase the employee's contribution rate. Each one percent of additional contribution paid by Class A and Class B workers would produce approximately $900,000 and $300,000 annually in taxpayer's savings. (This estimate reflects the fact that a dollar of employee contribution is less valuable to the plan than a dollar of employer contribution, because some employees will terminate prior to retirement, taking their contributions with them.)

**Social Security**

Because Class A members do not participate in Social Security, neither they nor the city contribute the 6.2 percent of pay that is paid by Social Security participants and their employers. Likewise, Class A members also will not receive Social Security benefits for the work they perform for the city.

Class B members do participate in Social Security, and they contribute 6.2 percent of pay for that benefit. This means Class B members contribute a total of 9.25 percent of pay toward Social Security and the city's pension plan.

Since Class A members may retire with an unreduced benefit at age 55, they may be able to work in a position after retirement (employed by the city or elsewhere) that is covered by Social Security, thereby enabling them to qualify for Social Security benefits when they reach an age of eligibility.

## Overview of variations to typical cost-of-living adjustments among public retirement systems

**Prepared by Keith Brainard, August 2010**

A majority of retired public employees participate in a pension plan that offers some form of automatic cost-of-living adjustment (COLA). A COLA is intended to offset the effects of inflation on a pension benefit.

A typical automatic COLA provides an annual benefit increase beginning within the first year of retirement, compounded, based either on a specified percentage of the benefit, such as 2.0 percent or 3.0 percent; or on the Consumer Price Index, a measure of inflation published by the U.S. Bureau of Labor Statistics. Most plans that link their COLA to the CPI also place a limit on its size, such as one-half of CPI, or not to exceed 3.0 percent.

According to Paul Zorn at Gabriel, Roeder, Smith, & Co., an automatic COLA of 2.0 percent, compounded annually, will increase the cost of the benefit by 16 percent. To alleviate this cost, or to achieve other retirement plan objectives, or both, some public pension plans have established COLAs different from the typical compounded percentage increase that begins in the first year of the retirement of the plan participant. Some of these variations are described below, with one or more examples of plans that use such methods.

It is generally considered good pension plan policy to pre-fund benefits, including COLAs. This means that the cost of a COLA should be paid during the working life of the plan participant who will receive it. If a COLA is not paid for in advance, a mismatch may result between those who receive public services, and those who pay for them.

**Delayed onset/minimum age of eligibility**

- Kansas PERS - For those hired after 6/30/09, automatic 2% beginning at age 65 or the 2nd July 1 after retirement date.
- NM PERF – Automatic after retiree has been retired two full calendar years (i.e., January 1 through December 31), or upon reaching age 65, whichever is sooner
- WY RS - Automatic, lesser of 3% or the increase in the cost of living as determined by the board, effective each July 1 after two full years of retirement
- RI ERS - Based on CPI, up to 3%, (for those hired after 6/30/05, lesser of 3% or CPI) compounded; effective after 3rd anniversary of retirement.

**Simple, not compounded**

- OH PERS and STRS, CalSTRS and Michigan PSERS – Automatic 3.0% based on original benefit
- Hawaii ERS – Automatic 2.5% percent increase based on original benefit
- Michigan SERS – Automatic 3.0% simple, up to $300 annually

*According to Zorn, a 3.0% simple COLA costs about the same as a 2.5% automatic COLA*

**Simple until age certain, then compounded**

- MS PERS – automatic 3.0% simple until reaching age 55; compounded thereafter

**Tied to investment performance**

- AZ SRS and AZ PSPRS – When actuarial investment return exceeds assumption, a proportionate share of "excess earnings" are calculated and distributed as a permanent benefit increase based on years of service (not benefit amount)

**Combination automatic and investment performance**

- Los Angeles County ERS – automatic based on CPI, up to 2%, plus a component based on investment performance
- Louisiana SERS - lesser of 2% or CPI, plus up to 1% additional based on investment returns

**Tied to funding level**

- SD RS - COLA is linked to CPI or plan funded status as follows: if funded status is 100% or more: 3.1%; if funded status is 80-99.9%, COLA indexed to CPI; 2.1% minimum, 2.8% maximum; if funded status is less than 80%: 2.1% COLA

**Funded by employee at employee's discretion**

- LA TRS – Allows retiring participants to take an actuarial benefit reduction to fund a permanent, annual 2.5% COLA. Retiree must be age 55 to begin receiving COLA.

**Applied only to a portion of base benefit, with delayed onset**

- NY STRS -- Automatic, equal to one-half of CPI, with a minimum of 1% and a maximum of 3%, compounded, applied to the first $18,000 in annual benefits. Retirees must be age 62 and retired 5 years or 55 and retired 10 years to qualify.
- NY SLRS – Automatic, based on one-half the CPI, applied to first $18,000, compounded. Must be age 62 and retired 5 years, or 55 and retired 10 years, to qualify.
- Massachusetts - Automatic, based on CPI up to 3% on first $12,000 of benefit

**Minimum increase and minimum age**

- New Mexico Teachers - One-half of CPI up to 4%, with a 2% minimum; annuitant must be 65 to qualify for a COLA

**Lifetime cap**

- Missouri Teachers - automatic based on CPI, not to exceed 5%, compounded, with a lifetime cap of 80% above base benefit.

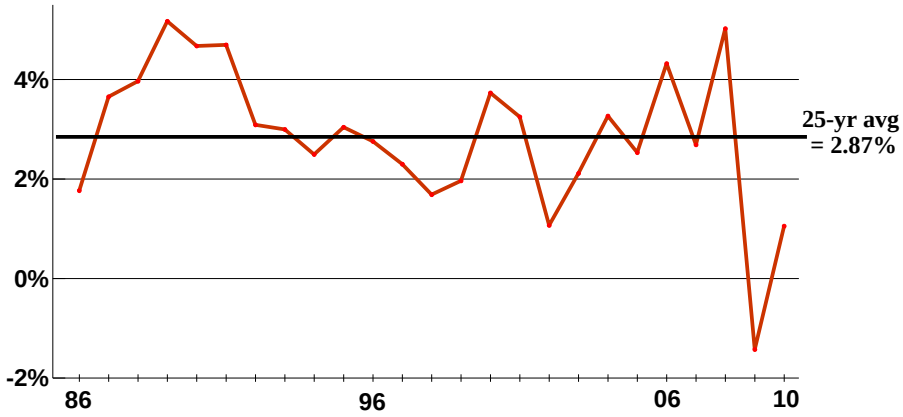
**Employer option**

- TN CRS, TX MRS, TX CDRS

**In-state residence requirement**

- AK TRS – retirees must reside in state to receive COLA

**Figure A: Twenty-five year history of inflation in the U.S., 12-month periods ended June**




*U.S. Bureau of Labor Statistics*