Pension Sustainability Consensus Proposal
Presentation to Task Force

January 18, 2013

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Outline

- Background
- Understanding the Gap
- State Proposals
- Benchmarks
- Recommended Plan

Overview

- The plan included in this presentation represents the culmination of the foundational work of the Pension Task Force as well as several weeks of discussions among City representatives, FOP leadership, IAFF leadership, and police and fire retiree representatives
- Although not all parties agreed to all parts of the proposed plan, there was a consensus among the majority of the group to present this tentative agreement to the Task Force and their respective constituencies with a recommendation to approve it

Background

Engagement Timeline

November 1-2, 2012: Initial stakeholder discussions

November 8, 2012: Kick-off presentation to the Task Force

December 5, 2012: Baseline analysis presentation to Task Force

December 20-21, 2012: Discussions with City, FOP, IAFF, and retiree representatives

January 7-8, 2013: Discussions with City, FOP, IAFF, and retiree representatives

January 14-17, 2013: Discussions with City, FOP, IAFF, and retiree representatives

Discussions

- PFM met with representatives from the Lexington-Fayette Urban County Government (including the Police and Fire Chiefs), Fraternal Order of Police, International Association of Fire Fighters, retired police and fire fighters, and Pension Task Force members to discuss concerns, identify goals, and evaluate options
- These discussions yielded several key concepts:
  - Actually **address the problems** and not “kick the can down the road”
  - All parties were interested in providing a **dignified retirement** for public safety officers, particularly those with the smallest annuities
  - All stakeholders needed to **share** in the solution
  - **Addressing risk** was critical. Employees and retirees want guarantee that City will pay required contribution each year. The City seeks to have downside risk better shared among stakeholders

Understanding the Gap

Challenges Faced with Defining the Gap

- Current law does not pay off the unfunded liability – it only requires the employer to pay the normal cost plus the interest on the unfunded liability (“interest only” payments, so no principal is reduced)
- The most common forms of GASB-compliant actuarial methodologies are:
  - Level $: Equivalent to a home mortgage. Payments remain the same each year, with a small amount of principal paid off in year 1, increasing each year
  - Level % of payroll: Equivalent to a student loan option where payments increase with income. This assumes payroll will increase at 3% each year, and sets the dollar amount needed in 2012 to fully fund the liability in 30 years

KRS 67A.520 1-3

“The government shall make contributions to the fund […] contributions shall be equal to the sum of the following:

(1) An annual amount resulting from the application of a rate percent of salaries of active members determined by the entry age normal cost funding method. Such rate percent shall be fixed by the board every two (2) years, within 6 months after the actuarial study required by subsection (6) of KRS 67A.560 (actuarial survey of the fund), and shall be in effect for a period of at least two (2) years

(2) An amount resulting from the application of a rate percent of the salaries of active members which will provide each year regular interest on the remaining liability for prior service

(3) In any event, the total contribution of the government shall be at least seventeen percent (17%) of the salaries of the active members participating in the fund”

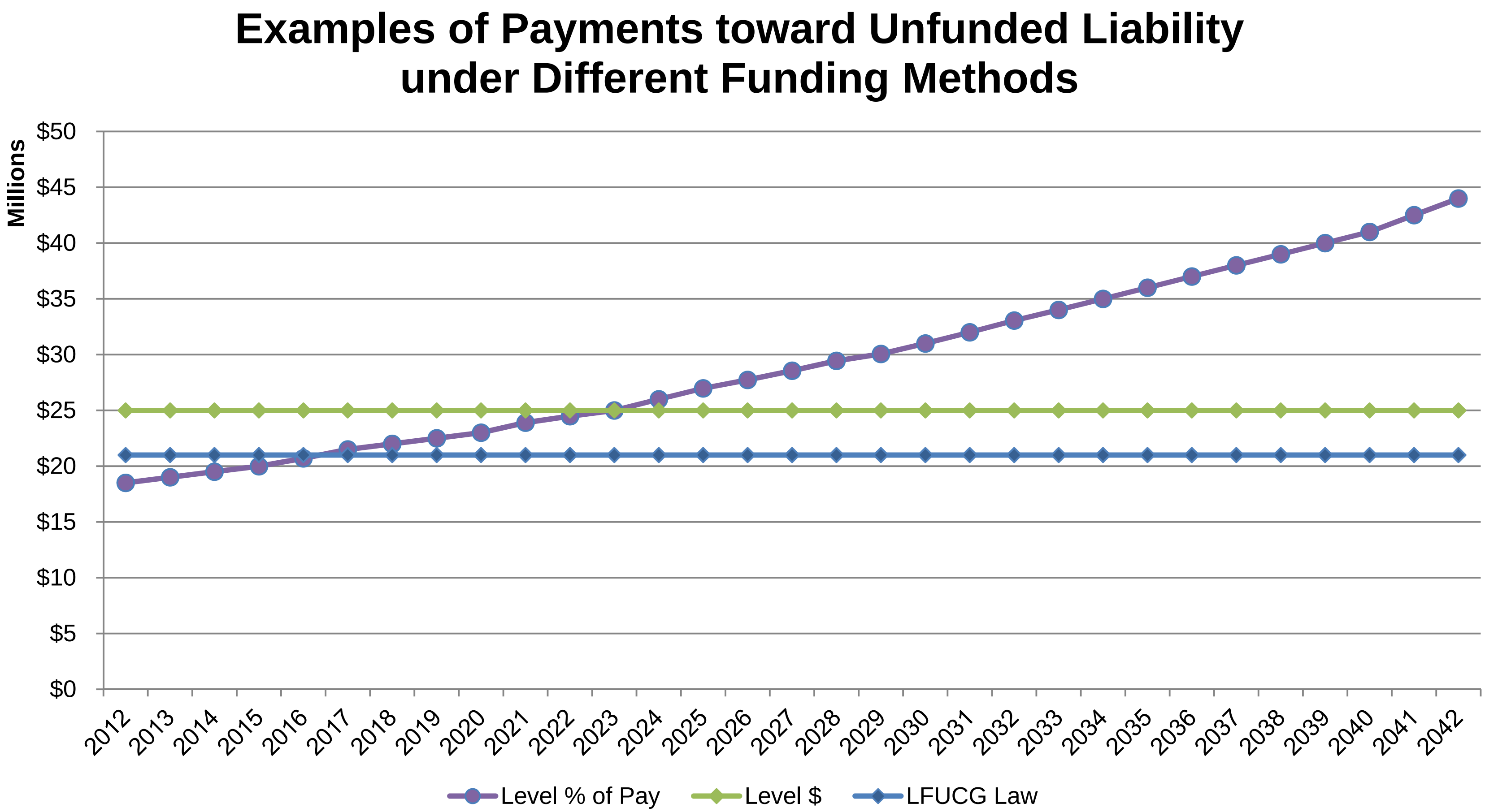
Normal Cost and Unfunded Liability

- The **Normal Cost** funds benefits earned in the coming year. These are future costs accrued by current active employees
- The **Unfunded Actuarial Accrued Liability** (UAAL) is the difference between actuarial accrued liabilities and the value of plan assets
- Required contribution consists of the **normal cost plus an amortized amount of the UAAL**
- Current law requires normal cost plus **interest only** payments on the UAAL

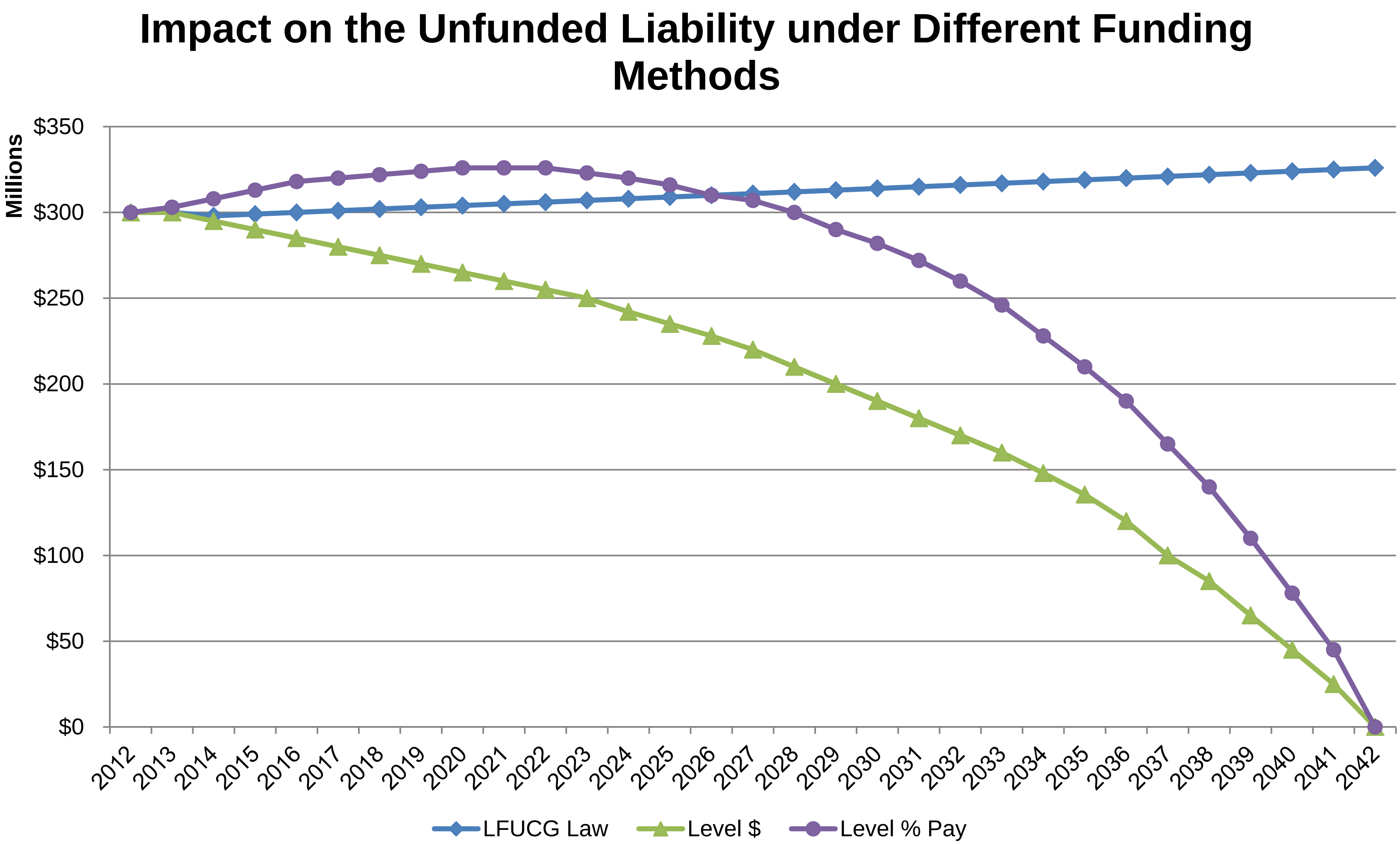
1. Present value of benefits		
a. Active members	$393,178,647	
b. Retired members	$603,280,373	
c. Total	$996,459,020	
2. Present Value of Future Contributions	$173,802,946	
3. Actuarial Accrued Liabilities		
a. Retired members	$603,280,373	
b. Active members	$219,375,701	
c. Total	$822,656,074	
4. Value of Assets	$525,849,582	
5. Unfunded Actuarial Accrued Liability	$296,806,492	
6. Covered Payroll	$54,595,799	
7. Normal Cost		
a. Member	11.00%	$6,005,538
b. Government	19.59%	$10,695,317
c. Total	30.59%	
8. Interest on UAAL	37.93%	$20,707,430
9. Employer Contribution	57.52%	$31,402,747

Source: 2012 Draft Valuation, Cavanaugh Macdonald

Funding the Unfunded Liability



Resulting Unfunded Liability



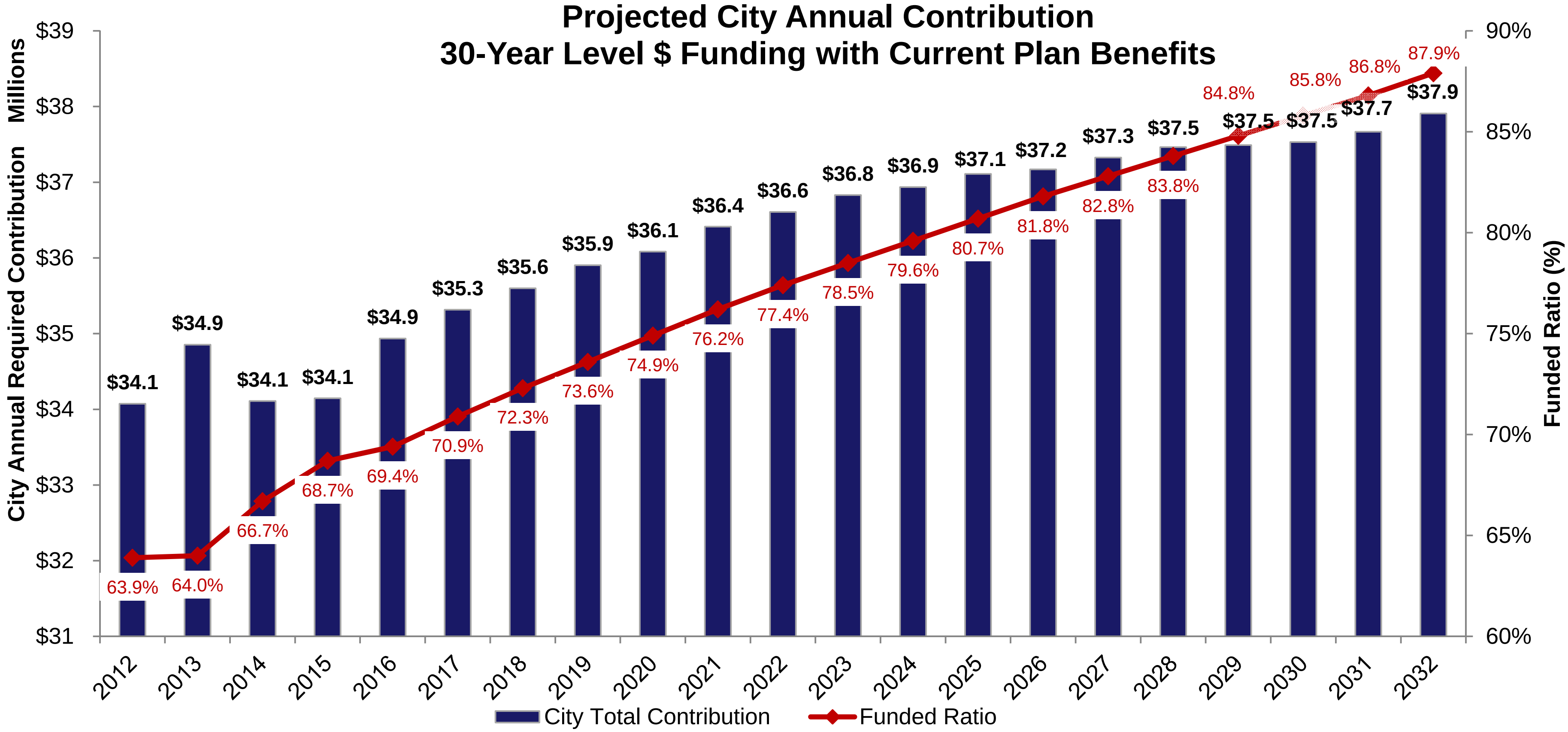
2012 Draft Valuation

- As of the July 1, 2011 valuation, the Lexington-Fayette Police and Fire Pension Fund had a total unfunded actuarial accrued liability of **$257,781,662**, **over 80%** of the City's FY2012 annual budget. The plan was 66% funded:
  - The plan valuation assumed an 8% return on investment and utilized "smoothing"
- In the 2012 draft valuation (has not been approved by Pension Board), by changing the investment return assumption from 8% to 7.5% (which we think is prudent), and with additional changes recommended in the experience study (increased life expectancy), the valuation showed an unfunded actuarial accrued liability $39,024,830 or 15.1% greater than 2011 for a total liability of **$296,806,492**
  - Increase came in spite of additional money from pension bonds

Source: Lexington-Fayette Urban County Government, Policemen's and Firefighter's Retirement Fund, July 1, 2011 Valuation; Cavanaugh Macdonald, "2012 Draft Valuation"

Employer Contributions

- Based on the 2012 draft valuation, Cavanaugh Macdonald (independent pension actuary to fund) estimated the City's total annual contribution based on a level dollar amortization methodology over 30 years. The City's annual required contribution would increase from $34.9M in FY2013 to $37.9M by 2032
- The City has historically budgeted $11M towards the annual pension contribution for the fund. This year the City budgeted an additional $5.2M plus $10.8M in debt service for pension bonds



Source: Cavanaugh Macdonald estimates under current GASB reporting rules

State Proposals

Proposed Changes to CERS Hazardous

Kentucky Retirement System

- The Kentucky Public Pensions Task Force issued a number of recommendations for the Kentucky Retirement System (KRS), including:
  - Zeroing out cost of living adjustments (COLAs). Future COLAs would have to be specifically granted by the General Assembly. Members previously received an automatic COLA of 1.5% unless the Legislature reduced or suspended the adjustment
  - Resetting the current amortization period from 26 years to 30 years effective July 1, 2014
  - Instituting a hybrid cash balance plan for new hires (effective July 1, 2013)

	Current Plan for Actives	New Hire Hybrid Cash Balance Plan
Benefit Description	FAC x benefit factor x YOS <u>Benefit Factors:</u> < 10 YOS – 1.3% 10 YOS < 20 YOS – 1.5% >20 YOS but < 25 YOS – 2.25% >= 25 YOS – 2.5% FAC is average of 3 highest complete fiscal years immediately preceding retirement; excludes compensatory time	Employee accounts include 8% employee and 7.5% employer contributions and are guaranteed a 4% annual return Accounts receive 75% of returns above 4%. Employees vested for employer contributions after 5 YOS Employees can purchase an annuity based on contents of their account. Annuity based on current mortality and investment assumptions used by KRS

Source: Pew Center on the States, "Draft-Proposed Recommendations Changes to Kentucky Retirement Systems (KRS)"

Benchmarks

Current Description of the Benefit

- Lexington-Fayette Urban County Government offers the Policemen's and Firefighters' Retirement Fund (PFRF) for sworn municipal police and fire fighters
  - Benefits levels and employee contributions are determined by the State Legislature
  - The Lexington-Fayette Pension Board sets actuarially recommended annual contributions and determines cost of living adjustments (COLAs) within the state-defined range
- PFRF is funded through a combination of City and member contributions. While plan benefit levels are controlled by state statute, City public safety officers and taxpayers are solely responsible for its funding
- All other sworn municipal police and fire fighters in the Commonwealth of Kentucky are members of the County Employee Retirement System (CERS) Hazardous Pension Plan

	Lexington-Fayette Urban County Government
Plan Name	Police & Fire Retirement Fund
Vesting Period	20 years (includes purchased time)
Normal Retirement Age	Any age
Employee Contribution	11% of pay
Participate in Social Security	No
Basis for Final Average Compensation (FAC)	Highest average 3 complete, consecutive years of salary (no overtime)
Benefit Formula	2.5% x FAC x YOS
Multiplier	2.5%
Post-Retirement COLAs	2% - 5%

Private Sector Data

Defined Benefit Plans

- In 2011, the Hay Group surveyed over 850 public and private organizations to provide a picture of retirement benefit offerings across regions and industries:

	2011 Benefit Prevalence Report – Defined Benefit Plans
Plan Offerings	**43%** (365 employers) offer defined benefit plans
DB Plan Benefit Structure	**74%** of DB plans use Final Average Earnings as the basis for determining an employee's benefit Of plans with Final Average Earnings formulas, **55%** provide a uniform percentage per year of service Of plans using uniform percentage, only **13%** use a multiplier of 2.5% or higher The median multiplier rate was **1.75%**
COLAs	**41%** of DB plans reported providing a COLA in the last 10 years
Retirement Eligibility	**36%** of DB plans have both age and service requirements for normal retirement (**74%** including plans with age plus years of service or "magic number" requirements) Only **11%** of DB plans require a standalone years of service requirement The median age for normal retirement was **56-61 years** (all industries) (only **6%** of plans with any age component have a minimum age below 55)

Source: Hay Group, "2011 Benefit Prevalence Report"

Benchmarking

Police & Fire Pension Plans

- PFM examined pension benefits for municipal police and fire fighters in the Commonwealth of Kentucky and 11 cities:
  - Louisville police and fire are part of the CERS hazardous plan
  - Cincinnati, Columbus, and Toledo police and fire are members of the Ohio Police and Fire Pension Fund for municipal public safety officers
  - Madison and St. Paul public safety officers are members of the state retirement systems
  - Charlotte police are member of the state's municipal police pension fund while fire fighters are in a city plan
  - Knoxville, Lincoln, Nashville, and Omaha have municipal plans

	Police	Fire
Lexington-Fayette Urban County Government	Policemen's and Firefighters' Retirement Fund	
Commonwealth of Kentucky	CERS Hazardous	
Louisville		
Charlotte	North Carolina Local Government Employees' Retirement System (NCLGERS)	Charlotte Firefighters' Retirement System (CFRS)
Knoxville	City of Knoxville Pension System Division C	
Lincoln	Lincoln Police and Fire Pension System Plan A	
Nashville	Nashville Metro Retirement Division B	
Omaha	Omaha Police & Fire Retirement System	
Cincinnati	Ohio Police & Fire Pension Fund	
Columbus		
Toledo		
Madison	Wisconsin Retirement System Protective Services	
St. Paul	Minnesota Public Employees Retirement Association	

Benchmarking

Police Pension Plans

POLICE	Social Security	Employee Contribution	Retirement Eligibility	Vesting	Final Average Salary	Benefit Formula	COLA
LFUCG	No	11%	20 YOS (no minimum age)	20 YOS	Highest average 3 complete, consecutive years of salary (excludes overtime)	2.5% x FAS x YOS	Automatic: 2% - 5%
Commonwealth of Kentucky **Louisville**	Yes	9% (8% pension; 1% retiree health)	Any age with 25 YOS Age 60 with 5 YOS Age 50 with 15 YOS w/ benefit reduction	5 YOS	Average of highest 3 years of salary	FAC x multiplier x YOS <10 YOS - 1.3% per YOS 10 to 20 YOS - 1.5% per YOS 20 to 25 YOS - 2.25% per YOS 25 YOS+ - 2.5% per YOS	Automatic: 1.5% can be reduced, increased, suspended, or eliminated by General Assembly
Charlotte	Yes	6%	30 YOS Age 55 and 5 YOS	5 YOS	Average final compensation is average salary of highest 4 consecutive years (includes overtime, unused vacation, prorated longevity)	1.85% x FAS x YOS	Ad hoc: tied to CPI and available funds
Cincinnati **Columbus** **Toledo**	No	10%	Age 48 with 25 YOS	15 YOS	Average 3 years for which total earnings were greatest (includes overtime, educational allowance, longevity)	2.5% x FAS x YOS (<20 YOS) + 2% for next 5 YOS + 1.5% for >25 YOS (maximum of 72% salary)	Automatic: 3% of original base benefit per year
Knoxville	Yes	6%	Age 50 and 25 YOS	5 YOS	Average 2 highest year annual salaries (non-consecutive, excludes overtime)	2.5% x FAS x YOS	Automatic: 3% of current benefit
Lincoln	No	8%	Age 50 and 25 YOS	10 YOS	Average monthly base pay is sum of highest consecutive 26-biweekly base pay amounts divided by 364 days, multiplied by 365.25 days, then divided by 12 months	YOS/25 x 64% x FAS	Ad hoc: $750 base amount (est. 1995) increased by lesser of 3% or CPI-U Base amount can be increased by City Council Continues if fund in advance of funding schedule and earns return rate > 7.5%
Madison	Yes	6.15%	Age 54 Age 53 w 25 YOS	5 YOS	Final average earnings equal to highest three years compensation	2% x FAS x YOS (maximum 65% FAS)	Ad hoc: dividends linked to fund performance and can be adjusted downward
Nashville	Yes	0%	Age + YOS = 75 Not prior to age 53 (and 22 YOS) Not after age 60	5 YOS	Final average earnings is taxable income from highest 60 consecutive months divided by 5 (includes overtime)	2.0% x FAS x YOS up to 25 + 1.75% x FAS x YOS over 25	Automatic: tied to CPI
Omaha	No	16.35%	Age 55 and 10 YOS Age 50 and 20 YOS	10 YOS	Highest average consecutive 26 pay periods out of last 5 years of service (overtime averaged over employee's date of hire or 1991, whichever is later)	20% x FAS w/ 10-14 YOS at age 55 30% x FAS w/ 15-19 YOS at age 55 50% x FAS w/ 20-24 YOS at age 50 (+1.5% for 6 months after 20 < 25 +1% for 6 months after 25 <= 30) 75% x FAS w/ 30 YOS	Automatic: lesser of 3% or $600 annually
St. Paul	No	9.6%	Age 55 and 10 YOS Age 65 and 1 YOS Rule of 90 if hired prior to 7/1/1989	10 YOS	Average 5 highest-paid consecutive YOS (includes overtime)	3% x FAS x YOS	Automatic: 1% increase in 2012; rate of inflation up to 1.5% annually beyond 2012 (2.5% if fund exceeds 90% funding)

Omaha: Police rate of contribution scheduled to decrease to 15.35% on January 1, 2014
Ohio Plans: Employee contributions will increase to 10.75% in July 2013, 11.5% in July 2014, and 12.25% in July 2015

Benchmarking

Firefighter Pension Plans

FIRE	Social Security	Employee Contribution	Retirement Eligibility	Vesting	Final Average Salary	Benefit Formula	COLA
LFUCG	No	11%	20 YOS (no minimum age)	20 YOS	Highest average 3 complete, consecutive years of salary (excludes overtime)	2.5% x FAS x YOS	Automatic: 2% - 5%
Commonwealth of Kentucky **Louisville**	Yes	9% (8% pension; 1% retiree health)	Any age with 25 YOS Age 60 with 5 YOS Age 50 with 15 YOS w/ benefit reduction	5 YOS	Average of highest 3 years of salary	FAS x multiplier x YOS <10 YOS - 1.3% per YOS 10 to 20 YOS - 1.5% per YOS 20 to 25 YOS - 2.25% per YOS 25 YOS+ - 2.5% per YOS	Automatic: 1.5% can be reduced, increased, suspended, or eliminated by General Assembly
Charlotte	No	13%	30 years Age 50 and 25 YOS Age 60 and 5 YOS	5 YOS	Highest average two consecutive years of service earned within last 5 years of employment (excludes overtime, maximum salary for calculation is $150,000)	2.6% x FAS x YOS	Ad hoc : Receive bonus if actuary and Board of Trustees determine that retirement system can support such payment
Cincinnati **Columbus** **Toledo**	No	10%	Age 48 with 25 YOS	15 YOS	Average 3 years for which total earnings were greatest (includes overtime, educational allowance, longevity)	2.5% x FAS x YOS (<20 YOS) + 2% for next 5 YOS + 1.5% for >25 YOS (maximum of 72% salary)	Automatic: 3% of original base benefit per year
Knoxville	Yes	6%	Age 50 and 25 YOS	5 YOS	Average 2 highest year annual salaries (non-consecutive, excludes overtime)	2.5% x FAS x YOS	Automatic : 3% of current benefit
Lincoln	No	8%	Age 50 and 25 YOS	10 YOS	Average monthly base pay is sum of highest consecutive 26-biweekly base pay amounts divided by 364 days, multiplied by 365.25 days, then divided by 12 months	YOS/25 x 64% x FAS	Ad hoc: $750 base amount (est. 1995) increased by lesser of 3% or CPI-U Base amount can be increased by City Council Continues if fund in advance of funding schedule and earns return rate > 7.5%
Madison	No	6.15%	Age 54 Age 53 w 25 YOS	5 YOS	Final average earnings equal to highest three years compensation	2.5% x FAS x YOS (maximum 85% FAS)	Ad hoc: dividends linked to fund performance and can be adjusted downward
Nashville	Yes	0%	Age + YOS = 75 Not prior to age 53 (and 22 YOS) Not after age 60	5 YOS	Final average earnings is taxable income from highest 60 consecutive months divided by 5 (includes overtime)	2.0% x FAS x YOS up to 25 + 1.75% x FAS x YOS over 25	Automatic: tied to CPI
Omaha	No	15.4%	Age 55 and 10 YOS Age 50 and 20 YOS Age 45 and 25 YOS	10 YOS	Highest average consecutive 26 pay periods out of last 5 years of service	20% x FAS w/ 10-14 YOS at age 55 30% x FAS w/ 15 -19YOS at age 55 55% x FAS w/ 20-24 YOS at age 50 (+ 2% for 6 months after 20 < 25) 75% x FAS w/ 25 YOS at age 50	Automatic: lesser of 3% or $780 annually
St. Paul	No	9.6%	Age 55 and 10 YOS Age 65 and 1 YOS Rule of 90 if hired prior to 7/1/1989	10 YOS	Average 5 highest-paid consecutive YOS (includes overtime)	3% x FAS x YOS	Automatic: 1% increase in 2012; rate of inflation up to 1.5% annually beyond 2012 (2.5% if fund exceeds 90% funding)

Ohio Plans: Employee contributions will increase to 10.75% in July 2013, 11.5% in July 2014, and 12.25% in July 2015

Recommended Plan

Principles

- Actually **address the problems** and not “kick the can down the road"
- All parties were interested in providing a **dignified retirement** for public safety officers, particularly those with the smallest annuities
- All stakeholders needed to **share** in the solution
- **Addressing risk** was critical. Employees and retirees want guarantee that City will pay required contribution each year. The City seeks to have downside risk better shared among stakeholders

Summary of Proposed Plan

- 30-year level dollar ($) amortization
- Minimum age requirement (to draw pension) of 41 for actives
- Occupational Disability reduced from 60% to 50% of FAS with current increases for catastrophic injuries
- Increase employee contribution from 11% to 12%
- Tiered COLA structure based on pension amounts with 2-5% COLAs resuming when Plan reaches 85% funding level (inclusive of COLA) for current retirees and current actives. No COLA for pensions $100,000 and above until January 1, 2016
- Requirement of 5 years or age 50 (whichever sooner) for new retirees to receive a COLA
- New hire defined benefit plan:
  - 2.25% multiplier
  - Vesting after 25 years; Age 50 requirement to draw pension
  - 12% employee contribution
  - Same tiered COLA structure and 5 years or age 50 as proposed for retirees; COLA rate of between 0-3% once plan reaches 85% funding level (inclusive of COLA)
  - Elimination of ghost time purchases (no change to military time purchase)
- Increase line of duty death benefit
- Increased required City contributions
- Conduct annual actuarial valuation (currently every two years)
- LFUCG pension will remain governed by Kentucky Revised Statutes (KRS)

Minimum Age Requirement for Actives

- **Provision:** New retirees must reach age 41 before they may start collecting their pension
  - If an individual retires prior to age 41, he or she receives a certificate granting pension at age 41
- **Rationale:**
  - Plan requires a minimum age requirement to collect pension
  - Proposed by fire working group
  - Although PFM would normally recommend a minimum age 50 requirement given benchmarks, there is a significant litigation concern about applying this requirement to active employees
    - Proposed new hire plan includes age 50 requirement

Occupational Disability Reduced from 60% to 50%

- **Provisions:** Change base from 60% to 50%
  - If disability reaches 20%, base moves to 60%
  - In addition, employees receive ½% per 1% disabled above 20%
  - Maximum disability to remain at 75%
- **Rationale:**
  - Proposed by Pension Board and working groups
  - Way to address disability issues

Changes to Occupational Disability Justification:

"Current disability formula perceived to create an incentive for some to seek disability prior to 20-year service minimum

Major concern with changing disability is care of the severely disabled

These changes decrease monetary incentive to leave for those with minimal disability ratings while maintaining protection for those truly unable to work"

Source: Fire Working Group

Increase Employee Contribution from 11% to 12%

- **Provision:** Active and new hire employee contributions increase from 11% to 12% of salary (no change to definition of salary)
- **Rationale:**
  - Provides additional money for fund
  - Shared sacrifice towards solving goal

COLA Changes

- **Provision:**
  - Provide following COLAs based on pension annuity until fund is 85% funded (inclusive of COLA grant):

Pension	COLA Benefit	# of Retirees	%
$100,000 and above	No COLA until January 1, 2016, then 1%	17	1.7%
$75,000-$99,999	1%	48	4.7%
$40,000-$74,999	1.5%	410	40.2%
$39,999 and Below	2%	544	53.4%

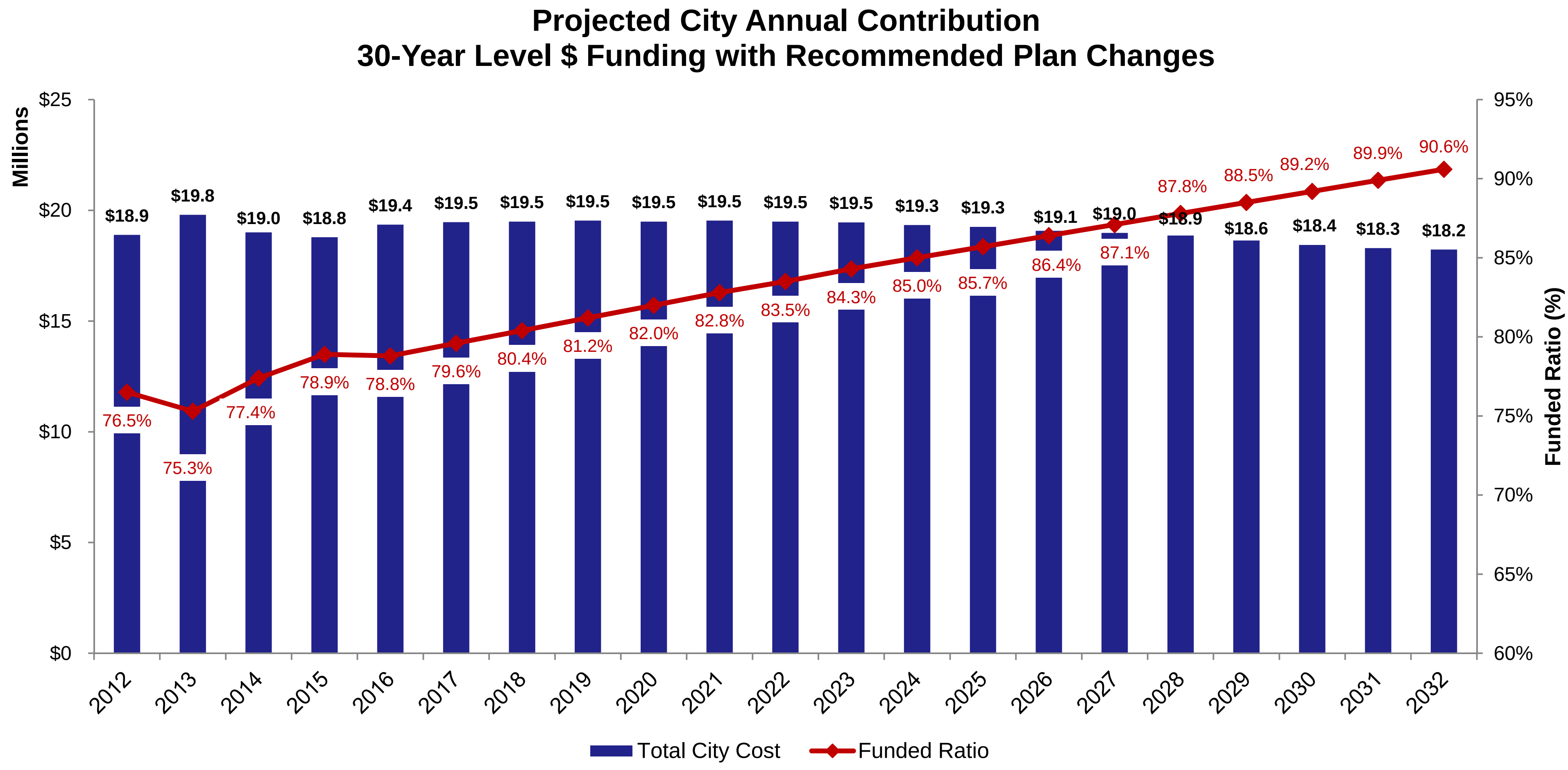
  - Additionally, new retirees do not receive a COLA for 5 years or until age 50, whichever comes first
- **Rationale:** Recognition by the parties that COLA change had to be part of solution, but a desire to minimize the impact on those least able to absorb it

New Hire Plan

- **Provision:**
  - 2.25% multiplier (currently 2.5%)
  - Vesting after 25 years (currently 20); Age 50 requirement to draw pension (Age 41 proposed for current actives)
  - 12% employee contribution
  - Same tiered COLA structure and 5 years or age 50 as proposed for retirees; COLA rate of between 0-3% (set by Pension Board) once plan reaches 85% funding level (inclusive of COLA)
  - Elimination of ghost time purchases (no change to military time purchase)
- **Rationale:** Recognition by the parties that new hires should share in the sacrifice of addressing unfunded liability

Impact of Changes on Employer Contribution

Implementing recommended plan will reduce projected unfunded actuarial accrued liability from $296,806,491 to approximately $161,960,044 – a $134,846,447 or 45% reduction



*Note: Analysis assumes that assumptions are met. Gains or losses will be amortized each year based on the remaining years left in the 30-year amortization period. Also assumes new hire defined benefit plan with 2% multiplier and 25 years of service. Does not include savings from no COLA for over $100,000 until 1/1/2016 or costs from line of duty death

Source: Cavanaugh Macdonald estimates under current GASB reporting rules

Increase Line of Duty Death Benefit

- **Provision:**
  - Increase line of duty death benefit from 60% to 75% of member's last rate of salary
  - Increase maximum combined payments to member's widow and children from 75% to 100% of final rate of salary (KRS 67A.440 (1))
- **Rationale:**
  - Pension Board recommendation
  - Desire to protect families of service members killed in the line of duty
  - Very low cost item

City Requirements

- City will fully fund annual required contribution under this methodology and will contribute a minimum of $20M toward pension contributions per year where annual required contribution is less than $20M
  - City will also continue to make debt service payments on pension bonds ($10.8M this year)
- LFUCG pension will remain governed by Kentucky Revised Statutes (KRS)

Summary

- Tentative agreement reduces City unfunded liability by approximately $134.8M or 45.4%. City contribution (excluding debt service) is reduced from $34.1M to $20M this year
- All stakeholders share in sacrifice of addressing unfunded liability in the short term and the long term while providing dignified retirement benefits for public safety retirees
- City will not need to float additional pension bonds

Next Steps

- Discussion of plan by Task Force. Parties respectfully recommend approval
- Presentation to FOP and IAFF for discussion by membership with recommendation for approval

Questions