Subcommittee Report to the City of Jacksonville Pension Task Force

Presented on 1/8/14 in Draft Pending Final Subcommittee Review

The Subcommittee expresses its gratitude to David Draine of Pew Charitable Trusts ("Pew") and Robert Dezube of Milliman, who presented analysis and commentary to the Sub-Committee during its discussions. The Sub-Committee respectfully submits its work as the four broad areas detailed in the Discussion section that follows. Key recommendations are summarized immediately below.

EXECUTIVE SUMMARY

Recommendations on how to assess affordability

- When forecasting required contributions, assume investments will earn no more than 5.4%
- Don't rely on economic or inflationary growth in the tax base to solve affordability
- Improve existing longevity / mortality assumptions by using best practices such as generational methodologies and most recent mortality releases in addition to latest ratified mortality tables
- From its review, the Subcommittee believes other actuarial assumptions are reasonable

Recommendations on how to compare costs of alternative plan designs

- Use actuarial "Normal Cost" to compare the expected cost of alternative plan designs
- When computing Normal Cost, require that benefit payments be discounted at a rate of 5.4%

Recommendations on funding strategies

- For actuarial and regulatory reporting, continue to use a 7% investment return assumption
- Initially make level dollar annual contribution amounts that exceed minimum requirements
- Set the initial dollar contribution to be sufficient to fund newly earned benefits as well to fund accrued liabilities by 2036, both assuming only a 5.4% investment return will be achieved.
- When a final benefit plan is recommended, use funding percentage targets to define how contributions will be stepped down to the lesser amounts required if a 7% investment return is achieved. These mechanics were not yet resolved by the Subcommittee.

Preliminary findings as to the affordability of discussed plan designs

- Minimum contributions with a 7% return rise from $140M in 2014 to over $400M in 2036
- Annual fixed payments of $190M would fully fund benefits (1) by 2036, if investments earn 7%
- As an estimate, annual fixed payments of perhaps $220M would fully fund benefits (1) by 2036 if investments earn 5.4%. Pew is completing this work.
- A possible reduction of benefit cost for existing employees, beyond the 1% increase in employee contribution assumed, is to reduce COLA prospectively. This work has been requested.

1) In its modeling, Pew assumed that contributions must address the current unfunded liability, plus new benefits equal those of the MSP but where existing employees increase contributions a further 1% (to become 10%) and where benefits for new employees are defined to have a normal cost of 10% if determined using a 7% investment return.

DISCUSSION

What Benefit Plan Structure is Affordable?

Affordability compares contributions required to satisfy accrued and unfunded pension obligations as well as new retirement benefits, collectively the City's "Retirement Costs," with the City's ability to pay. The Task Force preliminarily suggested the City's practical funding capability should be viewed as an annual amount up to $210 million. This reflected existing budgetary resource allocations of $120 million together with potentially new funding of $90 million, likely from increased tax revenues. The Subcommittee examined how assumptions are used to estimate contributions and recommends that:

1) <u>When forecasting future contributions required, assume investments will earn no more than 5.4%</u> - The most significant assumption in forecasting cash contributions is the investment return assumed to be earned on assets held in the investment trust. Pew's review found that while a return of about 7% might be a median, the following probabilities for a long-term return would be expected:

With 90% probability invested funds will earn at least	3.9%
With 75% probability, invested funds will earn at least	5.4%
With 50% probability, invested funds will earn at least	about 7.0%
With 25% probability, invested funds will earn at least	8.3%

There is public investment commentary today that suggests investment returns of the last 30 years may overstate returns going forward. There also are arguments that such concerns may be too US-centric in view. The Sub-Committee believes that over the long-term, an investment return close to a median 50% expectation is a reasonable assumption; however, the standard of affordability requires that funding of Retirement Costs be sustainable through reasonably expected downside scenarios as well. The Sub-Committee recommends the City should expect the median return from the pension assets' investment strategy for purposes of regulatory and actuarial analysis, but it should limit promised benefits to no more than can be sustained with much higher probability. Using 5.4% for forecasting cash contributions provides assurance for all but the worst 25% of scenarios. This also helps mitigate concern that past returns may not reflect the next 30 years, especially now that pre-recessionary equity values have been restored.

The Sub-Committee discussed if an investment return lower than 5.4% should be considered. A lower return estimate to reach 90% confidence would further assure obligations can be afforded; however, there also are costs from too conservative a view. Contribution requirements become more onerous; funds are diverted from other essential needs; pressure to increase taxes may hamper economic growth or concentrate sacrifice today with surpluses expected by later generations. The Sub-Committee believes 5.4% addresses a reasonable range of lower return outcomes though not assuring the most severe scenarios would be addressed within the budget limit.

The Sub-Committee also discussed how investment management fees factor into use of the 5.4% return assumption. The 5.4% return does not reflect an adjustment for management fees. Investment in many asset classes can be accessed through index securities with very low

management costs. Should the Pension Plan Trust choose to use active, fee-based investment strategies, it should be accountable to assure the Trust earns incrementally greater investment returns over market indices sufficient to fully recover at least the higher fees paid. As a result, a 5.4% return assumption should be acceptable for either a passive or an active management strategy as long as there is proper oversight of investment performance.

The Sub-Committee also confirmed that existing actuarial assumptions include an estimate for administrative costs such as actuarial services, custody fees, record keeping fees and legal expenses. These costs also require oversight, but do not appear to pose an issue in examining affordability.

2) Don't count on economic or inflationary growth in the tax base to solve affordability issues – Inflation can affect investment returns, benefit costs, and tax revenues. This paragraph focuses only on whether or not the targeted $210 million of maximum budgetary spending levels should be assumed to grow over time through growth in the tax base. The Sub-Committee recommends that while we all hope for successful growth in the tax base, the Task Force should not assume economic growth or inflation will be a solution for sustained affordability. Inflation may occur in the broader economic environment, yet still not translate into a higher Duval County tax base. Additionally, the Subcommittee believed benefits of successful growth in the tax base are better reserved to support increased City resources that may be required upon economic growth, or for other competing budgetary needs.

3) Require longevity / mortality assumptions be estimated using best practices-
Longevity is projected to increase over the coming years and accurately projecting pension costs requires an acknowledgement of those increases. Currently, the Fund uses standard mortality tables and updates those projections through the current year. Actuarial best practices involve projecting not only longevity growth through the current year, but continuing the projection until current employees are likely to retire. This would make it less likely that current contributions fall short of actual costs. Such proactive forecasts include generational projection methodologies. Additionally, some mortality estimates and schedules are released before they are finally actuarially adopted. All likely extensions of mortality should be proactively adopted.

4) The Task Force can expect that other actuarial assumptions are reasonable –
The Subcommittee examined with Pew and Mr. Dezube whether or not other key actuarial assumptions could be a risk in understanding the full extent of future funding costs. Following review and discussion, the Subcommittee did not identify any other areas of significant concern:

Inflation & Salary Growth – Inflation as it affects investments and the tax base were earlier considered. Inflation also affects COLA impacts and the assumptions used for salary growth rates. Salary costs assumptions are back-checked periodically by examining actual experience versus estimates. Thoughtful oversight in this area is required on an ongoing basis, but these estimates do not appear to be a source of significantly understated cost estimation. Additionally, the actuarial forecast assumes COLA, currently capped at 3%, will be fully incurred.

Withdrawal and Retirement Rates – These assumptions also are periodically back-checked against actual experience. Mr. Dezube indicated at the current time these do not appear to be a likely source of underestimation of costs for the City. Jacksonville Police and Fire personnel generally stay in their employment for longer career periods. To the extent benefit structure changes cause employees to retire or leave earlier, revised estimates would be required.

DROP assumptions - While the Subcommittee was not able to fully evaluate this area, Mr. Dezube believes the DROP program overall has a cost, thus, revising it or eliminating it should not adversely affect projected affordability.

How do costs of alternative retirement benefit plans compare?

5) Use Normal Cost to compare costs of alternative plans –
Normal cost is actuarial cost of a retirement benefit earned for one year of employment and it is expressed as a percentage pay, such as 10%. Normal cost estimates depend on a range of assumptions regarding investment performance, salary growth, workforce dynamics, and longevity. Actual costs may be more or less than projected. By comparison, the cost of a defined contribution would be fixed by the City's contribution to a defined contribution account, say also at 10% of the current base pay. While the Task Force, with its Subcommittee's review, must rely on assumptions in cost estimates, Normal Cost is still the best way to compare plan alternatives.

6) When computing a Normal Cost, require use of a discount rate of 5.4% -
Actuarial estimates discount promised future pension benefits to express the benefit in today's dollars for comparison with today's salary. There are various approaches to discount a future benefit payment. Government Accounting Standards and actuarial estimates use the rate of return expected to be earned on the pension assets. Financial Accounting Standards use the return that can be earned today on safer investments, such as the yield on AA quality bonds selected with maturities to match the period before benefits are paid out. A third approach is to use the City's interest rate for borrowing, because the employees' agreement to take a retirement benefit in the future in lieu of greater salary or a defined contribution today confers a financing benefit to the City.

The Subcommittee fully rejects the use of median expected investment return, such as 7%, to compute and compare the Normal Cost of alternative benefit plan choices. To use an investment return of 7%, which could be overstated 50% of the time, understates the City's real cost. It leaves the City with too high a likelihood that costs will be greater than anticipated. Further it mistakenly captures returns from investment risk borne by the City in a defined benefit arrangement that would be avoided in other defined contribution arrangements.

At this date, AA bond rates remain low by historical measures. *The Wall Street Journal* on 1/3/14 quoted a Towers Watson report and noted "high quality" corporate bond yields in 2008 were over 6%, while in 2013 they averaged below 5%. The Subcommittee recognizes that by recommending a discount rate of 5.4%, it also is using the same rate recommended for an investment return. This is a nod to simplification and is limited to the current inquiry. The 5.4% rate coincidentally falls in an area that, in the view of the Subcommittee, is reasonable to assume high quality bond yields may return if a longer term view is applied. This rate also is in the interest rate area cited by Jonathan Trichter as an expected taxable borrowing rate by the City. As the Task Force seeks to recommend a plan design sustainable over the long-term, the Subcommittee believes using a 5.4% discount rate is acceptable even though it is higher than current returns possible on high quality bonds.

What is an appropriate funding strategy and how do we build commitment into a framework?

7) <u>The City initially should make contributions for amounts greater than the minimum actuarially required. Contributions should at least equal the level amount annually necessary, if a 5.4% return is assumed, to fund newly earned benefits and to fully fund accrued costs by 2036</u> -
Pew modeled contribution requirements across alternative investment return scenarios. The benefits modeled were a place holder for benefit decisions yet to be made, but they represented the requirements of paying off the existing unfunded obligation, new benefits determined as in the MSP for existing employees but where existing employee contributions increase to 3%, and where new employees earn a benefit equal to a 10% normal cost, if a 7% investment return was preliminarily assumed. Further work is expected to be presented to the Task Force on the impact of reducing COLA benefits for existing employees.

If the City only pays the minimum actuarial contribution required, it starts at $140 million in 2014 and increases annually to reach more than $400 million in 2036. The Subcommittee recommends that the City focus on a stable annual contribution amount that also will fund more money in in the early years. This has benefits. First, it makes greater progress against the unfunded liability, and second it provides a buffer against increased contributions that otherwise would be required if assumed investment performance does not reach the 7% return expected with 50% confidence.

- Pew found that a level payment of $190 million would be required through 2036 to fully fund Retirement Costs if a 7% return could be achieved.
- Pew preliminarily estimated if an investment return of 5.4% were used, the annual level payment required increases to about $220 million. This computation is still underway.

Pew also analyzed how one-time, up-front payments would affect annual level funding amounts. With a 7% investment return, $800 million up front reduces annual payments from $190 million to $120 million. This provides some sense of scale. With a 5.4% investment return assumption, a greater upfront payment would be required to have the same annual reduction impact.

In summary, the Subcommittee recommends that:

- The Task Force determine whether to reduce the cost of any plan design if level payments assuming a 5.4% investment return are expected to exceed $210 million. The alternative would be to commit greater annual or one-time funding resources
- The Task Force use 5.4% to understand the normal cost of any final benefit arrangement that is proposed for prospective benefits of existing and new employees, and
- The City continue to use a 7% expected investment return for its actuarial and regulatory projections
- The Subcommittee continue to work with the Task Force to recommend a plan for how initially increased payments might decrease over time as the plan becomes better funded. Specific funding targets and levels of step down were not yet developed by the Subcommittee and may be more easily addressed once recommended benefits and related contribution requirements are better defined.