MEMORANDUM

TO: Mayor and City Council

FROM: Tom Crawford, Interim City Administrator

DATE: May 4, 2020

SUBJECT: Pension De-Risking Report

REFERENCES: Final Pension De-Risking Discussion by Aon Consulting (January 2020)

PURPOSE: This memorandum provides a brief summary of the results of the Pension De-Risking report prepared for the City of Ann Arbor by Aon Consulting, Inc.

BACKGROUND: The City has a retirement system for which employees hired prior to 2011-2012 generally have a defined benefit while employees hired after 2011-2012 have a hybrid plan comprised of ½ defined benefit and ½ defined contribution. As of June 30, 2019, the plan had approximately $601 million in liabilities and $513 million of assets, resulting in the plan being 85% funded. The plan pays the retirement benefits for retired employees from the proceeds of investments made via the trust fund which invests the assets plus annual city contributions. City contributions are affected by the financial performance of the plan, so City Council requested an outside professional review of alternatives for de-risking the plan to the plan sponsor. One idea that has been raised was the purchase of an annuity (from an insurance company) to take over the responsibility of making benefit payments. The report evaluated this scenario and considered other alternatives.

GOALS AND OBJECTIVES: The goal of the professional review was to evaluate and consider alternatives to reduce the financial risk to the city from fluctuations in the financial markets and their impact on annual city contributions to support the plan.

RESULTS:

Purchasing an Annuity: The report considered the financial impact of the city purchasing and annuity from an insurance company to take over the financial responsibility for paying retirement benefits. Aon determined that a subset of employees (existing retirees) would be the most marketable to sellers of annuities. This sub-group had liabilities totaling approx. $409 million. The city's pension fund assumes an average annual return of 7%, which it has achieved over a long period of time. However, insurance companies utilize the latest corporate debt rate (approx. 2.5% at the time of the report) for their pricing decisions. When interest rates have a large spread, the city must pay more for the annuity than the liability itself. For example, if the City were to sell $200 million of retiree liability, it's estimated the city would need to pay $355 million over the next 30 years to an insurance company to assume the financial responsibility.

Borrowing Money to Purchase Annuity: Since the above strategy is so expensive, Aon also considered issuing debt at today's low interest rates to fund the purchase of the annuity. In doing so the cost is estimated at $255 million, but there are increased financial risks to the city, some of which can be mitigated if the purchase of the annuity occurs close in time to the issuance of debt.

Combination of Borrowing Money & Utilizing Pension Bond Investments: Aon further considered an annuity purchase with a combination of borrowing funds and utilizing a portion of the pension trust's investments bonds. This scenario technically produced a cost of $209 million but has a high level of complexity, a high level of difficultly to implement, and does not include potential costs to restructure the remaining investments in the pension system.

Retiree Lump-Sum Window: Recognizing the challenges of the above alternatives, Aon offered a concept whereby a voluntary buy-out window is offered to retirees, and/or terminated vested employees, to receive a lump sum payment in lieu of future defined benefit payments. No specific scenarios were priced-out given the assumptions that must be made and the fact the terms are subject to collective bargaining. This alternative is utilized in the private sector but is not common in the public sector.

Retiree Healthcare: Aon also reviewed the city's retiree healthcare plan. The City's plan is comprised of two groups. The first group is a defined benefit plan, which was closed to include employees hired before 2011/2012. All newer employees receive a flat defined benefit of between $2,500 and $3,500 per year of service at retirement. Aon offered two ideas for consideration 1. For employees receiving Medicare, transition to an exchange-based program and 2. Offer prescription drug coverage under an EGWP program.

NEXT STEPS:

Pension: At the time the report was prepared, staff did not recommend proceeding with purchasing an annuity either directly or with borrowed funds. The situation should be monitored so that in future years if the corporate interest rates are closer to 7%, the idea should be re-visited. The subsequent impact of the coronavirus has not changed this recommendation from staff.

The city may consider offering a lump-sum buyout to retirees at a future date, but the difficulty and implications of doing this with a group that has their benefits guaranteed under the State Constitution makes it very challenging.

Retiree Healthcare: Transitioning to an exchange-based program may be very challenging given the impact to retirees. It's a strategy that may be considered further once a permanent HR Director is in place. Separately, the EGWP program is something that staff has periodically evaluated with its outside benefits consultant over the years. To-date it has not been an alternative that was feasible to implement. The city's benefit consultant along with staff continues to monitor this option.

No Attachments