

MEMORANDUM

TO: Mayor and Council

FROM: Tom Crawford
Chief Financial Officer

CC: Roger Fraser
City Administrator

DATE: May 4, 2009

SUBJECT: Comments on AAPOA and COAM Early-Out Program

The Early-out Program as designed has three primary goals:

1. Goal: To realize financial savings through a permanent decrease in personnel costs
Metric: FY 2010 employee compensation decrease by \$1.6 million
2. Goal: Restructure the Police Department in order to focus on delivering core services in a more efficient manner
Metric: Maintain FY 2010 General Patrol FTEs at 64
3. Goal: Alter Police Department staffing to rely upon less senior officers, with lower salary and benefits costs
Metric: Captured in above metrics

When the program was originally discussed a few months ago, the plan estimated 28 people to be eligible for a total cost of \$4.8 million, which included pension, VEBA and accrued leave pay-outs.

The final proposal now before Council includes 34 eligible employees for a total cost of \$6.7 million (if all employees accept the offer). The increase in the number of eligible employees is primarily due to employees coming forward and exercising their right to purchase military time at their own cost or recognizing their prior reciprocal time for retirement eligibility.

The increase in costs to \$6.7 million is partially due to the higher number of eligible employees and partially to the impact of the Act 312 arbitration settlement, which covered the Police compensation for the past three years.

Approval of this program could require up to \$6.7 million of undesignated General Fund reserves. Currently reserves are projected to be \$15.2 million at FY 2009 (18% of expenditures) excluding the settlement of the Pfizer tax appeal (\$0.9 mil.) and Act 312 additional arbitration costs (\$0.6 mil.). If all of these costs are incurred reserves could

be reduced to \$7.6 mil. (9% of expenditures). This is at the lower end of Council's desired range for reserves (officially 8% - 12%).

The maximum cost of the program (all 34 employees) would be the following:

Pension	\$3.5 mil.	(see attached estimate from actuaries)
VEBA	1.6 mil.	(see attached estimate from actuaries)
Leave Pay-outs	<u>1.6 mil.</u>	(staff estimates)
Total	\$6.7 mil.	

Projected operating cost savings are based on planned reductions of 18 FTEs excluding vacancies:

FY 2010	\$1.6 mil.
FY 2011	1.9 mil.
FY 2012	1.9 mil.
FY 2013	2.0 mil.

The present value of the savings is \$6.8 million for the four years, which means the program pays for itself in less than four years (assuming all employees accept the offer). If less than 34 employees accept the offer, the payback will be even sooner.

In the attached letter from the actuary, they reference a GFOA best practice which recommends early retirement incentives be monitored closely to insure that potential conflicts of interest do not exist among the decision-makers who designed the plan and the beneficiaries. The designers of the City's proposed plan are not eligible for the incentive.

April 29, 2009

CONFIDENTIAL

Mr. Tom Crawford
Chief Financial Officer
City Administrative Office
100 North Fifth Ave.
Ann Arbor, MI 48107


Re: Supplemental Actuarial Valuation for Early Retirement Incentive

Dear Tom:

Enclosed is a supplemental actuarial valuation report for the City of Ann Arbor Employees' Retirement System and the City of Ann Arbor Retiree Health Care Benefits Plan. This report is presented in part to comply with Michigan Public Act 728 of 2002 for the proposed pension benefit changes. There is no similar state requirement for health benefit changes, but it is included here so that the City Council may make a more informed decision.

Please call if you have any questions regarding the calculations enclosed.

Sincerely,



Brad L. Armstrong, ASA, EA, MAAA



David T. Kausch, FSA, EA, MAAA

BLA/DTK:lr
Enclosures

cc: David Hoffman, GRS

**CITY OF ANN ARBOR EMPLOYEES' RETIREMENT SYSTEM
CITY OF ANN ARBOR RETIREE HEALTH CARE BENEFITS PLAN
EARLY RETIREMENT INCENTIVE SUPPLEMENTAL VALUATION
AS OF JUNE 30, 2008**

Requested By: Tom Crawford, City Finance Director
Date: April 29, 2009
Submitted By: Brad L. Armstrong, ASA, EA, MAAA & David T. Kausch, FSA, EA, MAAA
Gabriel, Roeder, Smith & Company

This report contains an actuarial valuation of a proposed change in benefits for members of the City of Ann Arbor Employees' Retirement System (Pension) and the City of Ann Arbor Retiree Health Care Benefits Plan (VEBA). The actuaries issuing this report are Members of the American Academy of Actuaries and meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein.

The date of the valuation was June 30, 2008 with projections to June 30, 2009. Supplemental valuations do **not** predict the result of future actuarial valuations. Rather, supplemental valuations give an indication of the probable long-term cost of the **benefit change only** without comment on the complete end result of the future valuations.

Actuarial assumptions and methods were consistent with those used in the regular actuarial valuation of the Retirement System on the valuation date, unless otherwise noted. Actuarial assumptions are adopted by the Retirement Board of Trustees. In particular:

- The assumed rate of interest was 7%.
- Payroll was assumed to increase 3.5% per year.
- Medical inflation was trended from 9% to 3.5% over 10 years.
- Changes in Unfunded Actuarial Accrued Liability were amortized over 15 years for the pension plan and 30 years for the VEBA using current amortization policies of the respective Boards. Results are also shown amortized over 5 years should either of the Boards deem this to be a more appropriate period.

It is our understanding that benefits for current inactive or retired members would not be affected by the proposed benefit changes. They were excluded from this study.

**CITY OF ANN ARBOR EMPLOYEES' RETIREMENT SYSTEM
 CITY OF ANN ARBOR RETIREE HEALTH CARE BENEFITS PLAN
 EARLY RETIREMENT INCENTIVE SUPPLEMENTAL VALUATION
 AS OF JUNE 30, 2008**

A brief summary of the data, as of June 30, 2008, used in this valuation is presented below. A listing of eligible active members was provided by the City.

	<u>General</u>	<u>Police</u>	<u>Fire</u>
Number of active members:	564	149	92
Total payroll:	\$ 33,287,512	\$ 11,448,056	\$ 6,551,762
Average age:	45.5 years	41.3 years	40.6 years
Average service:	11.0 years	14.7 years	11.9 years
Average annual pay:	\$ 59,020	\$ 76,833	\$ 71,215
Number of eligible active members:	2*	32	-
Payroll of eligible active members:	\$ 117,138	\$ 2,689,706	\$ -

* Reported as covered by AAPOA.

**CITY OF ANN ARBOR EMPLOYEES' RETIREMENT SYSTEM
CITY OF ANN ARBOR RETIREE HEALTH CARE BENEFITS PLAN
EARLY RETIREMENT INCENTIVE SUPPLEMENTAL VALUATION
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PRESENT PROVISIONS: General members are eligible for regular retirement (unreduced pension) at age 50 with 25 years of service, or age 60 with 5 years of service. Police members are eligible for regular retirement (unreduced pension) at 25 years of service, or age 55 with 5 years of service. General and Police members are eligible for early retirement (reduced pension) at age 50 with 20 years of service.

PROPOSED PROVISIONS: General members are eligible for regular retirement (unreduced pension) at age 50 with 25 years of service, or age 60 with 5 years of service. Police members are eligible for regular retirement (unreduced pension) at 25 years of service, or age 55 with 5 years of service. General and Police members are eligible for early retirement (reduced pension) at age 50 with 20 years of service. Members in COAM or AAPOA meeting the age requirement (if any) and within two years of meeting the service retirement conditions (unreduced or reduced) by June 30, 2009 are granted 2 additional years of benefit and eligibility service if they retire on or before June 30, 2009.

Actuarial Statement

The financial effect of the proposal is shown below (\$ in millions):

	Increase in Unfunded Actuarial Accrued Liability	First Year Employer Contribution to Amortize Increase		
		Over 5 Years	Over 15 Years	Over 30 Years
Pension	\$ 3.52	\$ 0.78	\$ 0.30	N/A
VEBA	1.57	0.35	N/A	\$ 0.08

The figures shown above are based on the June 30, 2008 actuarial valuation projected to June 30, 2009. Please remember that these changes, if adopted, would likely impact the June 30, 2009 valuation. That valuation is completed in the fall of 2009 and is based on member data and financial results as of June 30, 2009, neither of which is available to us at this time.

**CITY OF ANN ARBOR EMPLOYEES' RETIREMENT SYSTEM
CITY OF ANN ARBOR RETIREE HEALTH CARE BENEFITS PLAN
EARLY RETIREMENT INCENTIVE SUPPLEMENTAL VALUATION
AS OF JUNE 30, 2008**

Comments

Comment 1 — The results on page 3 in the supplemental valuation are measured as an increase in Unfunded Actuarial Accrued Liability (UAAL). The increase in Present Value of Future Benefits (PVFB) is \$2.31 million for pension and \$1.10 million for the VEBA. The difference between the increase in the present value of accrued benefits and the increase in UAAL represents the change in Present Value of Future Normal Cost (PVFNC) normal cost PVFNC the System anticipated receiving for the affected members prior to the adoption of this ERI.

	(All \$ in millions) Pension			(All \$ in millions) VEBA		
	Current	Proposed	Change	Current	Proposed	Change
	Present Value of Future Benefits	\$ 23.51	\$ 25.82	\$ 2.31	\$ 8.90	\$ 10.00
Present Value of Future Normal Cost	(1.21)	-	1.21	(0.47)	-	0.47
Entry Age Accrued Liability	22.30	25.82	3.52	8.43	10.00	1.57

Comment 2 — This report is intended to describe the financial effect of the proposed plan changes on the retirement system and the VEBA. Except as otherwise noted, potential effects on other benefit plans were not considered. For example, a reduction in payroll could reduce fringe benefits and the City's Social Security payments.

Comment 3 — The probabilities of retirement and health care election were adjusted in connection with this proposal to assume that all affected members retire and 95% elect health care coverage as of June 30, 2009. If members retire or elect health care differently than our assumptions as a result of this benefit change, then the cost of the benefit change will be different. For example, if only half of affected members were to retire we would expect more than half the cost because members whose pension is increased by the highest margin may be more likely to retire under the special window.

Comment 4 — This supplemental valuation is based on data for the affected members as report by the City without further audit.

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Comments

Comment 5 — It is important to note that these results are only applicable if applied for a limited window period for the proposed group. Providing a similar early retirement provision for **all** future retirements or for other employee groups would increase costs considerably.

Comment 6 — The calculations are based upon assumptions regarding future events, which may or may not materialize. They are also based upon present and proposed plan provisions that are outlined in the report. If you have reason to believe that the assumptions that were used are unreasonable, that the plan provisions are incorrectly described, that important plan provisions relevant to this proposal are not described, or that conditions have changed since the calculations were made, you should contact the author of this report prior to relying on information in the report.

Comment 7 — If you have reason to believe that the information provided in this report is inaccurate, or is in any way incomplete, or if you need further information in order to make an informed decision on the subject matter of this report, please contact the author of the report prior to making such decision.

Comment 8 — No statement in this report is intended to be interpreted as a recommendation in favor of the changes, or in opposition to them.

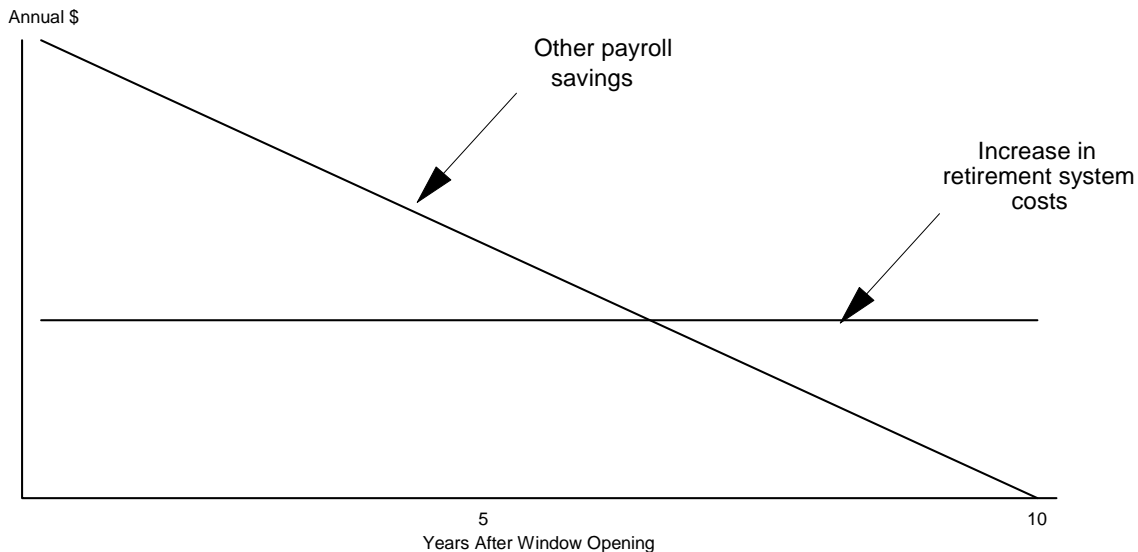
Comment 9 — The reader of this report should keep in mind that actuarial calculations are mathematical estimates based on current data and assumptions about future events (which may or may not materialize). Please note that actuarial calculations can and do vary from one valuation year to the next, sometimes significantly if the group valued is very small (less than 30 lives). As a result, the cost impact of a benefit change may fluctuate over time, as the demographics of the group changes.

Comment 10 — Please refer to the supplementary illustration and GFOA recommended practice included for important comments regarding early retirement windows.

Appendix

**Illustration of the Relationship Between
Increases in Retirement Plan Costs
and Net Payroll Savings
Resulting from an Early Retirement Window**

An employer offering retirement enhancements during a window period will generally incur additional retirement costs. These are often offset by a combination of (i) a reduction in the number of active employees, (ii) lower pay levels of replacement employees, or (iii) a reduction in other fringe benefits for replacement employees. Employees leaving during the window period would eventually have retired anyway. Therefore, the real payroll savings gradually declines over the period between the date of the window and the date the last retirement among the window group would have otherwise occurred. The timing of those “normal course” retirements is not knowable with precision, but the pattern may be illustrated as follows:



If the window program is successful, the cumulative payroll savings will substantially exceed increased retirement system costs.

Amortization of Window Liability Increases. Increases in retirement system liabilities associated with window programs are generally amortized over a period of years. The graph illustrates the declining nature of other payroll savings. A reasonable match between the amortization period for window liabilities and the likely period of other payroll savings is important in evaluating the potential value of a program. What period provides the best measure? There is no single correct answer. Amortization periods of from 5 to 10 years are often used.



GFOA Recommended Practice

Evaluating Use of Early Retirement Incentives - 2004

Background. Governments occasionally offer early retirement incentives (ERIs)¹ to employees as a strategy to reduce payroll costs or stimulate short-term turnover among staff. ERIs are temporary, offered during a window that usually covers a period of months. They increase the economic value of the standard retirement benefit. Historically, ERIs rarely have succeeded, since costs are often greater than initially anticipated by the government offering the incentive, and savings are lower than projected.

Recommendation. GFOA recommends that governments exercise extreme caution if considering ERIs. Governments should take several actions prior to the decision to offer an ERI in terms of (1) goal-setting, (2) cost/benefit analysis, and (3) budgetary analysis. Governments should also develop an implementation plan.

1. Goal-Setting for ERIs

Governments should be explicit in setting documented goals for the ERI. Goals can be financial in nature, such as realizing permanent efficiencies in staffing or achieving budgetary objectives. ERIs can also be designed to achieve human resource goals, such as creating vacancies that allow for additional promotion opportunities and allowing management to bring in new staff. Any ERI goals should not conflict with other retirement plan goals (e.g., features to reduce turnover or increase retention).

An explicit statement of goals is needed to judge the ultimate success of the initiative and to develop performance measures. Further, having a statement of goals promotes transparency. Inappropriate goals such as rewarding a select group of staff should be explicitly rejected. Potential conflicts of interest among decision-makers who design an ERI should be monitored closely, since any self-dealing is costly and could harm the long-term credibility of the government entity.

2. Cost/Benefit Analysis

In judging whether an ERI should be offered, governments should assess the potential costs and benefits of ERI proposals, and the cost/benefit analysis should be linked to the goals of the ERI. For example, if a government sets a financial goal of obtaining long-term staffing efficiencies, then an independent cost/benefit analysis should determine whether the ERI will actually bring about such staffing efficiencies.

A cost/benefit analysis should be comprehensive. It should take into account direct and indirect impacts, such as the impact on the government for providing retiree health care and additional contractor costs. In addition, it should take into account the effect upon both the plan sponsor and the pension fund (if the pension fund is a separate organization). Governments should retain an actuary to assist in conducting a cost/benefit analysis.

¹ The scope of this recommended practice does not cover deferred retirement option plans (DROP) or partial lump-sum option plans (PLOP), which often promote employee retention. The CORBA Committee may address this issue separately.

Material changes to the ERI proposal during the legislative process should trigger adjustments to the cost/benefit and budgetary analyses.

Regarding financially-driven ERIs, a cost/benefit analysis should compare long-term benefits and costs against the “default” scenario of a hiring freeze. Most financially-driven ERIs project financial benefits based on payroll savings related to staff departures. However, any such savings should be discounted, because a hiring freeze also creates payroll savings (owing to the normal rate of staff departures). Thus, the ERI benefit is limited to the marginal increase in staff departures attributable to the ERI. Governments that attribute all staff departures to an ERI would over-state the ERI benefit, thus distorting the cost/benefit analysis.

Financially-driven ERIs may also obtain savings by replacing highly compensated staff with lower-paid staff. Analysis of such ERIs must take into account the fact that newly hired staff tend to experience faster salary increases than other employees.

If early retirement incentives are offered, they should be offered very infrequently and without a predictable schedule to avoid the expectation that another ERI will be offered. Such an expectation would distort normal employee retirement patterns.

The incremental costs of an ERI should be amortized over a short-term payback period, such as three to five years. This payback period should match the period in which the savings are realized. To calculate the incremental costs of an ERI, governments should conduct an actuarial analysis that discloses the present value of the liabilities associated with an ERI. Governments that have over-funded pension plans should avoid allocating any actuarial surplus to finance the incremental costs of the ERI.

3. Budgetary Considerations

In order to develop accurate budgetary estimates for the ERI, it is necessary to estimate the incremental cost of the ERI, which will vary according to the level of employee participation. Any budgetary analysis should project multiple scenarios for employee participation levels.

A budgetary analysis should be comprehensive. It should take into account direct and indirect impacts, such as the impact on the government for providing retiree health care and additional contractor costs.

Because a collective bargaining agreement may affect potential ERI costs and benefits, it should be reviewed prior to developing budgetary estimates.

4. Implementation Considerations

If implementing an ERI, at a minimum, governments should take into account the following points:

- A communication plan is desirable to help employees understand the ERI in the context of overall retirement planning;
- It may be necessary to gain input from collective bargaining units;
- Governments should consider the impact upon service delivery after employees retire, with identification of critical personnel whose services must be maintained;

- The duration of the window should take into account the ability of retirement staff to manage retirement application workloads, among other factors; and
- Performance measures should be used to ensure ERI goals are met. For financially-driven ERIs, governments should track and report direct and indirect costs and benefits to determine if goals are met, such as for vacancies and contract costs.

References:

A Primer on Early Retirement Incentives, GFOA, 2004.

Approved by the GFOA Executive Board, October 15, 2004.