City of Ann Arbor
Employees' Retirement System
Board of Trustees

532 S. Maple Rd. • Ann Arbor, Michigan 48103 (734) 794-6710 • Fax (734) 994-9205

Date: September 21, 2017

To Honorable Mayor and City Council

From: Board of Trustees of the City of Ann Arbor Employees' Retirement System

RE: Amortization of Funded Status for Retirement Program and VEBA

The Board of Trustees for the City's Retirement System (System) and Retiree Health Care Trust (VEBA) is responsible for the general administration, management and proper operation of the Retirement System and VEBA. The Board prudently discharges these responsibilities recognizing the complex environment in which the System and VEBA operate. The Board values open communication with the City as the System and VEBA sponsor and with this memo wants to highlight policy changes the Board recently adopted regarding the amortization of the unfunded portion of the liabilities of each fund. The effect of these policy changes will result in a more rapid reduction of the existing unfunded liabilities. These policy changes are not anticipated to result in an immediate impact of required City contributions, but they do provide a structure to accelerate when the System will be fully funded.

Pension Plan – Background

The funded status of the City of Ann Arbor Employees' Retirement System ("pension plan") was last measured as of June 30, 2016 and resulted in a projected 2017 fiscal year funded status of 85.74%. The unfunded liability, based on benefits accrued to-date, was $78 million. The city ordinance requires that the minimum required contribution ("MRC") include the annual cost of providing benefits to employees, which includes the normal cost, and an amortization on the unfunded liability. An unfunded liability exists to the extent that the plan liabilities exceed plan assets. Current board policy amortizes the unfunded liability of $78M over 25 years "open", meaning that each year's gain or loss is amortized over 25 years and the period does not decrease. This results in a plan that will never reach 100% funded status absent actuarial or investment gains.

Separate from the Pension Board's actuarial determination, the City of Ann Arbor has a policy which provides for contributions in addition to the MRC. The City's policy requires contributions based on the current budget year contribution adjusted for future revenue growth with a minimum 2% year over year increase for the General Fund. We will refer to this additional contribution as the "Funding Plan Contribution" hereafter.

The fiscal year 2017 contribution is $12.8 million which consists of $4.6 million in unfunded amortization payment, $6.8 million normal cost and an additional $1.4 million due to the Funding Plan Contribution (2% revenue increase). By contributing the Funding Plan Contribution, the plan is expected to reach 100% funded status in 2043, assuming all other assumptions are met. It is important to note, that the plan contribution is highly sensitive to market and plan performance. Investment return leads to the most volatility, which we will address further below.

Pension Plan – Amortization Method

The Board of Trustees of the Retirement System is amending the current amortization policy from a 25 year open method to a method that reduces the 25 year period to 15 years in one year increments. The Board feels that a 15 year open amortization period is a more prudent method in light of current funded levels and plan demographics; is more in line with current accounting principles under GASB; provides for the plan to become fully funded sooner; and aligns the amortization method with the initial intention prior to the financial collapse (pre-2008).

Moving the amortization period to 15 years over the next 10 years results in the plan being fully funded in 2040 (3 years sooner), but more importantly puts into place a contribution level that better aligns with the financial needs of the plan. The additional Funding Plan Contribution still contributes to the funded status improvement, but to a much lesser extent, as demonstrated in the table below:

(millions)	**2017 Contribution**	**5 Years Later**	**10 Years Later**
Current “MRC”	$11.3	$12.1	$12.6
Funding Plan Cont.	$12.8	$14.2	$15.6
New “MRC”	$11.3	$14.7	$15.6
Funding Plan Cont.	$12.8	$14.7	$16.2

As mentioned above, the funding contribution is highly sensitive to plan experience. One of the most volatile elements is the investment return on plan assets. The plan uses a 5 year smoothing of investment experience, versus market value, but this still leads to contribution volatility. As an example, if we assume that the plan returns 0% during 2018, versus the 7% assumed, the contribution would be impacted as follows:

(millions)	**2017 Contribution**	**5 Years Later**	**10 Years Later**
Current “MRC”	$11.3	$12.1	$12.6
Funding Plan Cont.	$12.8	$14.2	$15.6
0% in 2018 “MRC”	$11.3	$16.8	$19.2
0% Funding Plan Cont.	$12.8	$16.8	$19.7

By moving towards a 15 year amortization period, it will instill a more prudent level of required funding.

VEBA (Retiree Medical) Program – Background

The funded status of the City of Ann Arbor Retiree Health Care Benefits Plan (“VEBA”) was last measured as of June 30, 2016 and resulted in a projected 2017 fiscal year funded status of 51.80%. The unfunded liability, based on benefits accrued to-date, was $141 million. Similar to the pension plan, the city ordinance requires that the minimum required contribution (“MRC”) include the annual cost of providing benefits to employees, which includes the normal cost, and an amortization on the unfunded liability. An unfunded liability exists to the extent that the plan liabilities exceed plan assets. Current policy amortizes the unfunded liability of $141M over 30 years “open”, versus 25 years in the pension plan. Additionally, the City’s Contribution Funding Policy applies to the VEBA as well.

Under the City’s Contribution Funding Policy the plan reaches 100% funded as of 2032. If the Funding Policy were not in place the VEBA would not reach a fully funded position under current assumptions, and in fact would be 45.4% funded in 2032.

VEBA (Retiree Medical) Program – Amortization Method

The Board of Trustees is amending the current VEBA amortization policy from a 30-year open method to a method that moves the 30-year period to an open 15 years in two-year increments. The Board feels that the amortization method should converge to 15 years more rapidly given the closed nature of the plan and the absolute dollar level of the unfunded liability. These policy changes are not anticipated to result in an impact of required City contributions, but provide a structure to ensure the VEBA will be fully funded. All other rationale is similar to that described above for the pension plan.

The above policy changes are anticipated to be included in the independent actuaries June 30, 2017 actuarial report which describes the plan status. Given the strong financial market performance through June 2017, the figures included above will change; however, these policy changes are being implemented because individual annual returns can be volatile, but the long-term funding plan needs to be prudent and robust.

The Board periodically provides information and presentations to City Council. We welcome the opportunity to further discuss the System's status with City Council as deemed appropriate. The Board thanks the City for its continuing commitment to fund these obligations.