BALTIMORE COUNTY
FISCAL YEAR 2014 RECOMMENDED BUDGET

RETIREMENT AND SOCIAL SECURITY (041)

BUDGET SUMMARY

$ in Thousands

PROPOSED CHANGE		GENERAL		SPECIAL		TOTAL	% Change Prior Year
FY 2013 - 2014 Change	$	5,553.7		-	$	5,553.7	6.7%
Recommended Reduction		**TBD**				**TBD**	
BUDGET TRENDS							
FY 2012 Actual	$	75,912.4	$	-	$	75,912.4	
FY 2013 Approp.		82,618.8		-		82,618.8	8.8%
FY 2014 Request		88,172.5		-		88,172.5	6.7%
Recommended	**$**	**88,172.5**		**-**	**$**	**88,172.5**	**6.7%**

PERSONNEL

No personnel are funded in the Retirement and Social Security program budgets; rather, Retirement System personnel are paid out of the pension fund.

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BUDGET SUMMARY:

The proposed FY 2014 budget for Retirement and Social Security totals $88.2 million, an increase of $5.6 million, or 6.7%, over the FY 2013 budget. The Retirement portion of the budget increases by $6.0 million, or 9.0%, primarily due to the decrease in the interest rate assumption, which was partially offset by the net proceeds from the pension obligation bonds, and collective asset experience. The Social Security portion of the budget decreases by $400 thousand, or 2.4%, primarily due to greater-than-expected savings from the Retirement Incentive Program. **See Exhibit 1 for additional detail.**

Exhibit 1
FY 2014 Proposed Budget ($ in 000's)

How Much it Grows:	Retirement[1]	Social Security	Total
2013 Appropriation	$ 65,848	$ 16,771	$ 82,619
2014 Request	71,805	16,367	88,172
$ Increase/(Decrease)	$ 5,957	$ (404)	$ 5,553
% Increase/(Decrease)	9.0%	-2.4%	6.7%

[1] Includes the Employees' Retirement System and non-system retirement plans (Judges', Sheriffs', and Volunteer Fire Widows' pension plans).

Why it Changes:

Retirement:		
Employees' Retirement System Employer Contribution:		
Decrease in interest rate assumption, offset by the net proceeds from the pension obligation bonds	$2,987	
Asset experience	2,760	
Increase in Unfunded Accrued Liabilities, experience losses, etc.	2,037	
Retirement Incentive Program (Net additional cost)	31	
Change in appropriation payroll	(667)	
Total – All Funds	7,148	
Less increase attributable to Component Units & Metro. District	(1,204)	
General Government, General Fund Portion of Contribution Increase		$5,944
Non-System Plans (Judges', Sheriffs', and Volunteer Fire Widows') Benefit Payments		13
Total Retirement		5,957
Social Security (primarily due to greater-than-expected ERIP savings)		(404)
Total:		$5,553

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RECOMMENDED BUDGET REDUCTIONS

Description (See detailed explanation below):	Reduction
1. Reduce Social Security Corresponding to Salary Reductions Taken (4107-0741)	TBD

Explanation:

1. To the extent that reductions are made to salary and salary-related expenses in agency budgets, an additional reduction equal to 7.65% of those reductions would be reflected in this account.

ISSUES:

Retirement System

2. New Rate of Return on Investments and Pension Obligation Bonds
   On July 10, 2012, the Board of Trustees (the Trustees) of the Baltimore County Employees' Retirement System (the System) voted to reduce the actuarial assumed rate of return on investments from 7.875% to 7.25%. The County's previous assumed rate of return of 7.875% was adopted in 1993. This reduction was deemed necessary in order to ensure the future stability of the System, because when the assumed rate of return is consistently higher than the achieved rate of return, the System is at risk of being under-funded over the long term. As part of its decision, the Trustees kept the 7.875% rate as the mechanism for funding the Post Retirement Increase Fund (see related Issue #8).

   The County's actuary calculated that lowering the interest rate assumption to 7.25% increased the accrued liability of the portion of the Employees' Retirement System that was effectively closed to new membership as of July 1, 2007 by an estimated $255 million (present value). In order to fully fund this increased obligation, on October 15, 2012, the Council approved the issuance of up to $260 million in pension obligation bonds (POBs). The Office advised that the final cost of the bond issuance totaled $256.3 million, consisting of $255 million in bonds, an underwriter's discount of $936,730, and issuance costs of $353,270. The County was able to get an interest rate of 3.43% on its POBs, lower than its anticipated rate of 4.25-4.50%.

The borrowed funds increase the System's assets and are invested along with the other funds in the System, decreasing the County's annual required contribution. The Administration expects that the System's investment returns will significantly exceed the 3.43% cost of the borrowed funds, reducing the long-term (30-year) pension costs associated with the pre-2007 plan by an estimated $342,932,479. The annual County contribution to the System plus debt service on the POBs is expected to be less than what the annual County contribution would have been in the absence of the POBs, resulting in estimated savings of $7.1 million in FY 2014. For FY 2014 the combined cost of the retirement contribution plus the debt service cost of its POBs, which includes both the 2012 and 1988 issuances, is $88.1 million. The Administration advised that the proposed financing will have no impact on the pension benefits currently available to pre-July 2007 employees, post-July 2007 employees, or retirees.

The Office should be prepared to discuss any plans for considering a further reduction in the assumed rate of return and another issuance of POBs.

3. <u>Retirement Incentive Program</u>

On October 17, 2011, the Council approved Bill 67-11, establishing the Retirement Incentive Program. Participants in the program retired from County service as of February 29, 2012. Last year the Administration advised that of the 673 program applicants (excluding Revenue Authority employees), 114 rescinded their applications, 37 were not eligible, 310 were approved, and 212 were not approved. The salaries of the program's participants totaled $22,152,690. The Office advised last year that FY 2013 salary savings from positions deleted as a result of the program totaled $19,447,275, including $15,215,169 in General Fund savings. The Office had also expected that the program would save the County $1,135,650 in healthcare costs and $1,248,912 in FICA costs in FY 2013, partially offset by additional Retirement System contributions and Other Post Employment Benefit (OPEB) costs of $555,857 and $168,000, respectively. The Office advised that the projections it made last year remain largely unchanged, although FICA savings may be slightly higher.

The Office should be prepared to discuss:

- ***Any issues that have resulted from remaining County employees being asked to take on additional responsibilities and do more with less; and***
- ***Any additional costs or savings anticipated in FY 2014 as a result of the program.***

4. Investment Strategies and Rate of Return on Investments

The System's investments are diversified in order to maximize returns while minimizing the risk of significant losses. The System's investments are allocated in the following asset classes:

- U.S. Equities
- International Equities
- Private Equities
- Fixed Income
- Real Assets
- Hedge Funds
- Real Estate
- Global Asset Allocation
- Cash

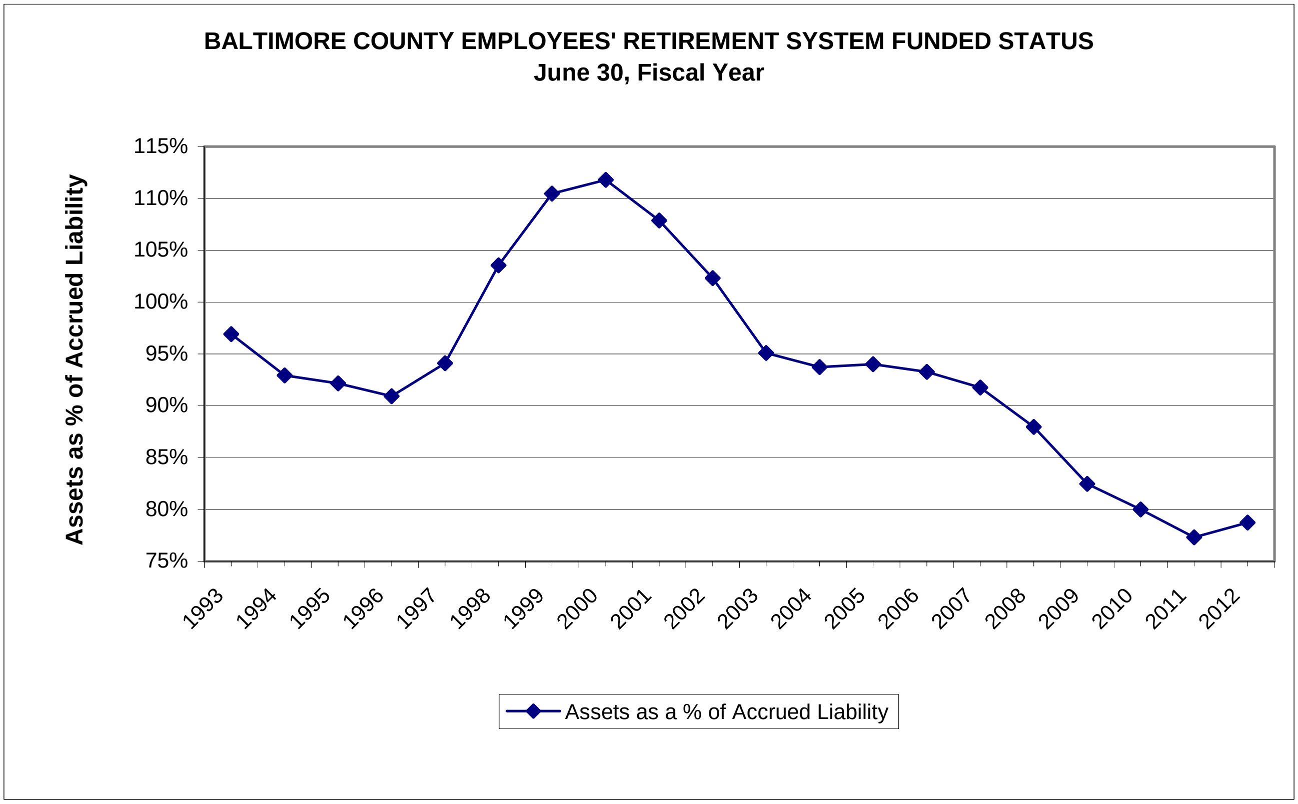
The System's Trustees employ investment managers within each asset class. During FY 2012, the Trustees conducted an annual asset allocation review that resulted in a 2% increase to emerging market equities and a 2% additional allocation to emerging market debt, both of which were funded from their U.S. counterparts. In addition, the Trustees made four new private equity commitments.

The System experienced a 1.7%, gross-of-fee return on investments for FY 2012, which ranked in the 43rd percentile of the Independent Consultants Cooperative (ICC) Public Funds Universe. The market value of the System's combined assets fell from $2.09 billion on June 30, 2011 to $2.00 billion on June 30, 2012. This decrease was driven primarily by minimal investment gains, which were more than offset by net withdrawals.

The System's 1.7%, gross-of-fee return on investments, when taken with the losses and gains over the last 10 years as well as the $255 million in net proceeds from the pension obligation bonds, is only 5.837%, which is still significantly less than the new actuarial assumed rate of return of 7.25%. Had the County not changed its smoothing methodology from 5 years to 10 years during this period, the smoothed rate of return would have been even less. Other local jurisdictions with pension plans employ similar rate-of-return assumptions, including Baltimore City and Anne Arundel, Howard, and Carroll counties, which used actuarial assumed rates of return of 7.75%, 8.0%, 8.0%, and 7.0%, respectively. The State uses an actuarial assumed rate of return of 7.75%.

The Office should be prepared to discuss any changes to the System's investment strategy that occurred during FY 2013 or which are planned for FY 2014.

5. <u>The System's Financial Condition</u>



Expressing plan net assets as a percentage of the actuarial accrued liability provides one indication of the System's funded status. Analysis of this percentage over time indicates whether the System is becoming financially stronger or weaker. Generally, the greater this percentage, the stronger the System.

The funded status of the System at the end of FY 2012 was 78.7%, up slightly from 77.3% at the end of FY 2011, but considerably lower than the funded status at the end of FY 2000 when it reached a peak of 111.8%. The slight increase in funded status in FY 2012 is attributable to the contribution of the net proceeds from the pension obligation bonds, which was partially offset by experience losses.

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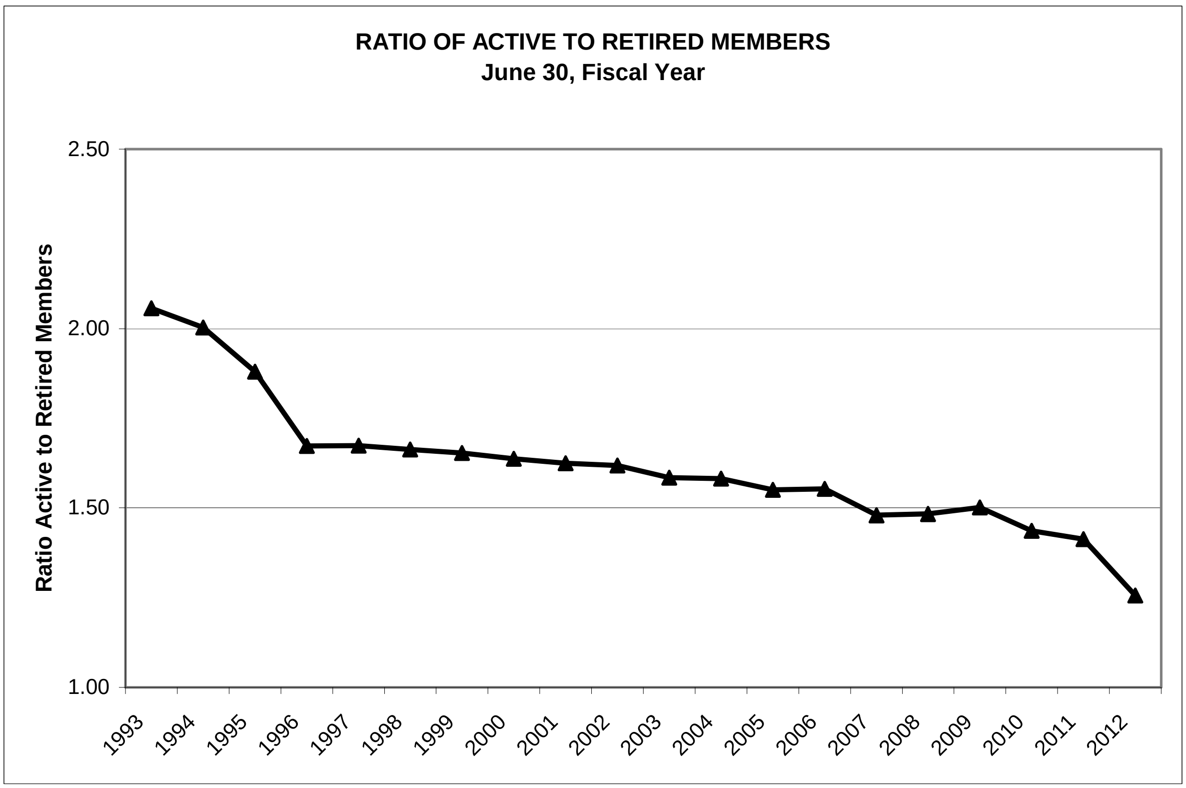
A factor that contributed to the decline in the System's funded status during the last decade is the active to retired member ratio. The retirement system is maturing with 9,082 active members and 7,231 retirees (a ratio of 1.26 to 1) as of June 30, 2012. The 311 employees (including one Revenue Authority employee) who retired under the Retirement Incentive Program caused this ratio to decline significantly between June 30, 2011 (when the ratio was 1.41 to 1) and June 30, 2012. The following graph illustrates the ratio of active to retired members in the System over the past 20 years.



A second measure of the System's financial health is an expression of the unfunded actuarial accrued liability (the difference between liabilities from prior years and the value of current assets to fund those liabilities) as a percentage of annual covered payroll. This measure approximately adjusts for the effects of inflation and aids analysis of the System's progress made in accumulating sufficient assets to pay benefits when due. Generally, the smaller this percentage, the stronger the System. The unfunded actuarial accrued liability as a percentage of annual covered payroll increased to 133.8% as of June 30, 2012, up from 123.7% as of June 30, 2011.

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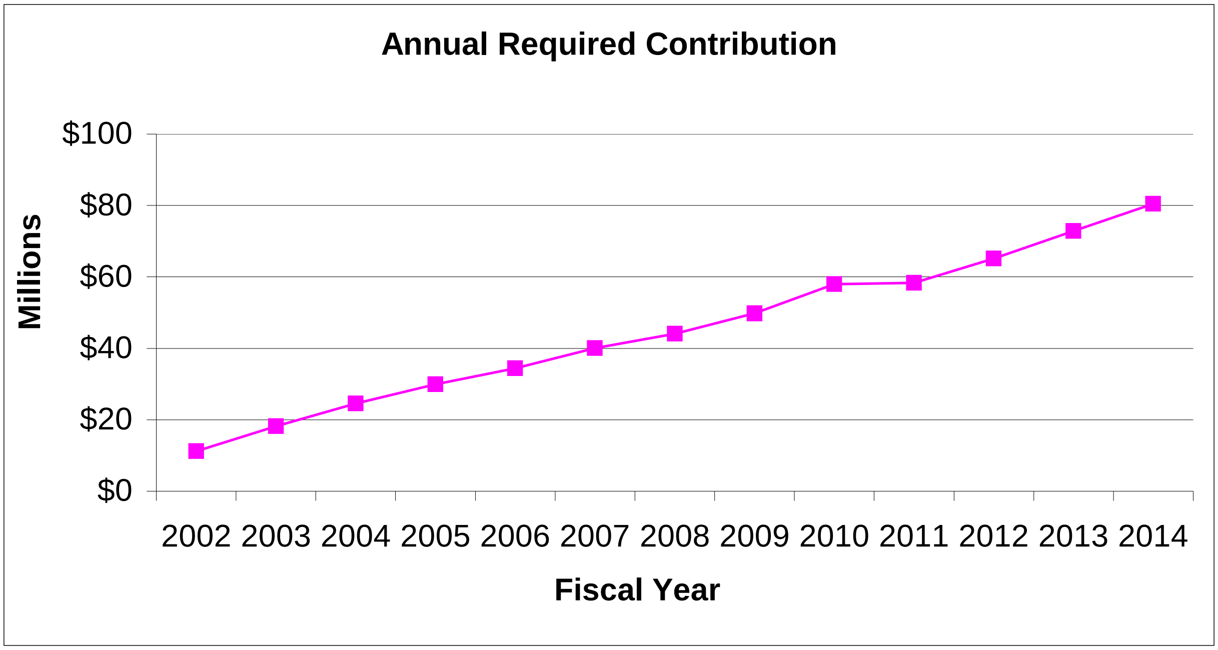
As the System has grown financially weaker, the total annual required contribution (ARC) has increased more than seven-fold since FY 2002 to $80.1 million in FY 2014, as shown in the following chart.



On May 23, 2013 the Council is scheduled to vote on a bill that will affect the Retirement System. Bill 28-13 decreases the amount of sick leave a Pay Schedule VII employee (Police captains, majors, colonels, and deputy chief) may accrue from 15 days per year to 11 days, and changes the number of unused sick days that equate to one month of membership service from 22 days to 16 days. The bill also increases contributions of Pay Schedule VII employees by 1% for those hired before July 1, 2012 and institutes a 10% contribution rate for those hired after that date. The Administration expects that the additional annual contributions to the retirement system will approximate $40,000.

The Office should be prepared to discuss:

- ***The long-term outlook for the System's financial condition and the contribution costs to the County and employees;***
- ***Additional changes that will be necessary in order to ensure the System is able to meet all of its future benefit obligations, particularly if the types of changes proposed under Bill 28-13 will be extended to other employee groups; and***
- ***The impact that the DROP has on the System and the contribution cost to the County.***

6. Loan to Fund the Single Stream Recycling Facility

On July 10, 2012, the Board of Trustees (the Trustees) of the Baltimore County Employees' Retirement System (the System) approved a 15-year, $25 million loan with an interest rate of 7.875% from the System to the County. The Administration requested the loan in order to finance the costs of upgrading or replacing an existing transfer station and procuring and installing a single stream recyclables processing system at the Baltimore County Resource Recovery Facility in Cockeysville. This action by the Trustees followed the November 7, 2011 approval by the Council for the County's issuance of up to $25 million in Certificates of Participation (COPs) for the same project. The Administration decided to seek an alternative to the COPs because the County's bond counsel advised that the County would face a higher mixed, private-purpose interest rate on the bonds in light of the fact that the project would generate a profit, some of which would go to a business entity (Maryland Environmental Service).

The Administration previously advised that the loan is a sound investment for the System because it provides a guaranteed rate of return of 7.875%, a level in excess of the System's current 10-year average of 6.4%, without any risk. The Administration further advised that the loan was fiscally prudent for the County because the System's failure to achieve the assumed rate of return is already a budget obligation of the General Fund. In addition, it was expected that revenues and operating savings from the upgraded transfer station and the single stream recycling facility would more than offset the debt service on the loan. However, it is important to note that the return on the loan is a General Fund obligation of the County and is in no way dependent on the profit generated by the project.

On December 20, 2012 the County borrowed $21,508,651 from the Employees' Retirement System for a term of 12 years at an interest rate of 7.875%. Payments are scheduled to begin in FY 2014 at approximately $1.5 million. In subsequent years the payment is estimated to total approximately $3.1 million. Total payment to the Employees' Retirement System is estimated to be $32.6 million, or approximately $10.1 million more than the borrowed amount. The new recycling center and transfer station are expected to open in October 2013.

The Office should be prepared to discuss whether it plans to finance any other County project with loans from the System.

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7. Accounting and Record-Keeping System Replacement

The County is currently replacing its current pension administration and record-keeping application, Pension Gold. This software was purchased 17 years ago and has been customized to meet the County's unique plan provisions. The Office advised that a new system is necessary because of various issues with data retention, rate calculation, and manual intervention with the current system. The new system, CPAS, is expected to increase productivity and efficiency and improve customer service while replacing manual calculations and an unsupported software. Additionally, the new web-based design will enable members to view and change their account information (e.g., contact information) online and independently.

The estimated project cost totals $5.4 million, including $3.4 million funded through the Retirement System and $2.0 million for both equipment purchased through the Enhanced Productivity Thru Technology capital project and OIT internal hours. The Office advised that the equipment purchased using capital funds will be used for other purposes in addition to supporting the new pension software, which is why the Retirement System is not funding the entire cost of the software upgrade. To date, $3,485,096 has been expended on the new system. The Office advised that the project is currently in the development and testing phase and the estimated implementation date for the new system is July 1, 2013. The Office's annual maintenance costs will total $100,500 for the first two years with a 5% increase in each subsequent year. The maintenance and support fee will begin one year after implementation.

The Office should be prepared to discuss:

- ***The errors that have occurred as a result of the manual processes and interventions necessary with the existing software;***
- ***The present status of the project;***
- ***Any issues that have arisen thus far or are anticipated in the transition to a new software product; and***
- ***How and when employees will be educated regarding access to and use of the new system in light of the anticipated July 1, 2013 implementation date.***

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8. 0% COLA for Retirees on July 1, 2013 **(*For informational purposes only.*)**

The County's current pension law (Baltimore County Code, Section 5-1-235) provides that after 60 months of retirement, retirees are entitled to a cost-of-living-allowance (COLA) increase to their pension checks each July 1 based on the annual increase in the Consumer Price Index—United States City Average (CPI-U) as of the previous December 31 (up to a maximum 3%) if sufficient funds are available in the Post Retirement Increase Fund (PRIF). The PRIF is funded by excess investment earnings (i.e., the amount by which actual investment earnings exceed expected investment earnings on an actuarial basis over the prior 10-year period). If the funds are insufficient to provide at least a 1% increase, then no increase is granted. This coming fiscal year is only the fifth time retirees have been denied COLAs due to insufficient funds in the PRIF. The four other times were for fiscal years beginning July 1, 2004, 2006, 2011, and 2012.

The increase in the CPI-U from December 2011 to December 2012 was equal to 1.7%. The estimated cost of a 1.7% COLA effective July 1, 2013 totals $23.3 million. The PRIF balance of $10.5 million as of December 31, 2012 is insufficient to fund a 1.7% COLA. The estimated cost of a 1% increase in retirement allowances effective July 1, 2013 is $13.7 million. The PRIF balance as of December 31, 2012 is also insufficient to cover this estimated cost. Therefore, no increase will be granted on July 1, 2013. The following graph illustrates the historical PRIF account balances and COLA costs.

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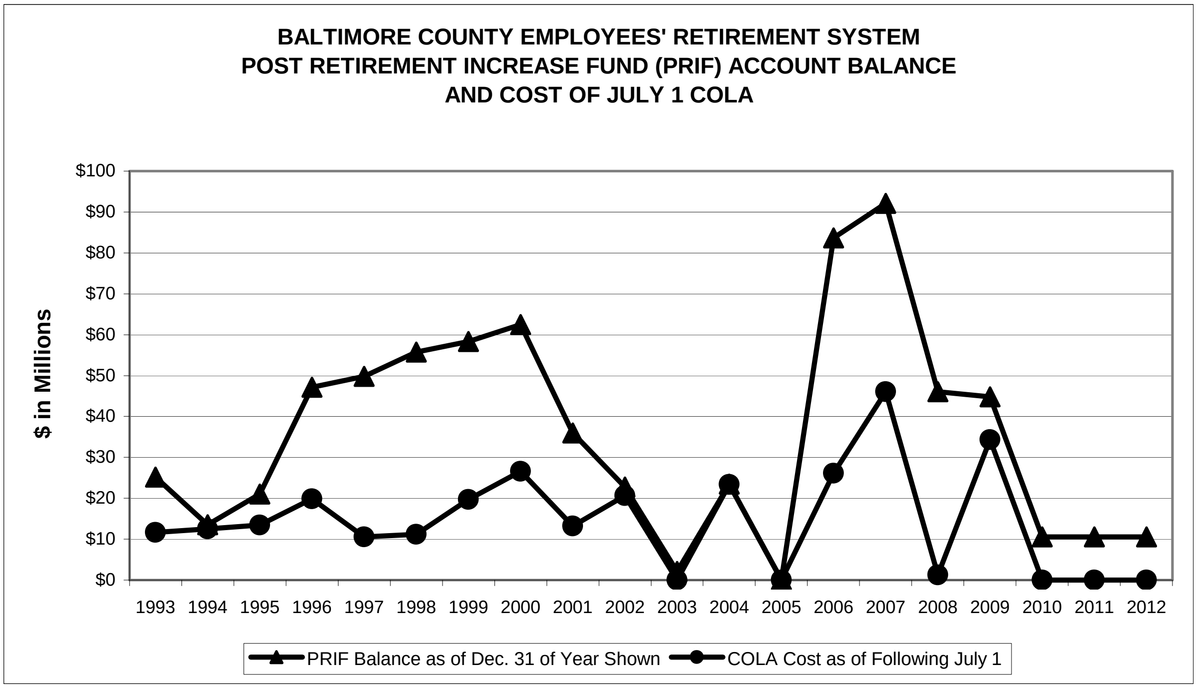

9. <u>Teacher Pension Costs</u> ***(For informational purposes only.)***

The proposed FY 2014 budget includes $20.0 million to fund the second year of the 4-year phase-in of the teacher pension cost shift, an increase of $4.2 million over the FY 2013 obligation. Although this cost is shown in the budgets of local boards of education, county governments are responsible for paying this expense through an increase in their Maintenance of Effort (MOE) requirement. A county that does not meet its MOE requirement is subject to an offset of its local income tax by the State with the amount owed directly diverted to the school system. By 2016 the transfer will be fully phased in, with Baltimore County's cost totaling $24.8 million. In order to partially offset the impact of this cost shift, in FY 2013 the State began providing counties with a Teachers Retirement Supplemental Grant. The County received $3 million from this grant in FY 2013, and the State's FY 2014 budget maintained that funding.

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10. State Retirement and Pension System's Board of Trustees ***(For informational purposes only.)***
During its 2013 legislative session, the Maryland General Assembly passed a bill that adds a member to the Board of Trustees of the State Retirement and Pension System (SRPS) to represent the interests of local governments. This additional member must have at least 10 years of experience in the financial management and oversight of county government budgets, be appointed by the Governor, and may be appointed from a list submitted by the Maryland Association of Counties (MACo). MACo requested this additional member in order to give local governments a voice in the management of the SRPS, now that local governments are responsible for paying a portion of teacher pension costs (see related Issue #9). The Teachers' Retirement System and the Teachers' Pension System are both part of the SRPS.

11. New GASB Pension Statements ***(For informational purposes only.)***
In June 2012, the Governmental Accounting Standards Board (GASB) approved a pair of related Statements that represent substantial changes to pension accounting and financial reporting by state and local governments and pension plans. Statement No. 67, Financial Reporting for Pension Plans, addresses financial reporting for state and local government pension plans. Statement No. 68, Accounting and Financial Reporting for Pensions, establishes new accounting and financial reporting requirements for governments that provide their employees with pensions. The Statements are intended to improve the decision-usefulness of reported pension information and to increase the transparency, consistency, and comparability of pension information across governments. The Statements do not address how governments fund their pension plans, but rather how pension costs and obligations are measured and reported in audited external financial reports, establishing a shift from the funding-based approach to an accounting-based approach. Statement No. 67 will take effect in FY 2014 and Statement No. 68 will take effect in FY 2015.

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<u>Social Security</u>

12. <u>Employee FICA Withholding</u> **(*For informational purposes only.)***
    The Federal Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 provided for a reduction in payroll taxes during CY 2011. Specifically, the Act reduced the employee-share of Social Security tax from 6.2% to 4.2%, or a two-point reduction. Under the Middle Class Tax Relief and Job Creation Act of 2012, this reduction was extended through December 2012. The reduction only applied to wages earned in CY 2012 up to $110,100, generating a maximum savings of $2,202 per employee. The employee share of Medicare Tax is unaffected, as are employer-withholding requirements. As of January 2013, the employee share of Social Security tax returned to 6.2%, and employees are being taxed on income up to $113,700.

BALTIMORE COUNTY
FISCAL YEAR 2014 RECOMMENDED BUDGET

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APPROPRIATION DETAIL

	FY 2012 ACTUAL	FY 2013 APPROP	FY 2014 REQUEST	NET CHANGE AMOUNT	NET CHANGE %
4102 Employees' Retirement Cont.	$ 58,786,927	$ 65,629,629	$ 71,573,858	$ 5,944,229	9.1%
4107 Social Security Contribution	16,903,461	16,771,176	16,367,159	(404,017)	-2.4%
4109 Non-System Retirement	222,049	218,000	231,450	13,450	6.2%
General Fund Total	$ 75,912,437	$ 82,618,805	$ 88,172,467	$ 5,553,662	6.7%

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PERSONNEL DETAIL

	FY 2012 ACTUAL		FY 2013 APPROP		FY 2014 REQUEST		NET CHANGE	
	FULL	PART	FULL	PART	FULL	PART	FULL	PART
Employees' Ret. System [(A)]	-	-	-	-	-	-	-	-

[(A)] No personnel are funded in the Retirement and Social Security program budgets; rather, Retirement System personnel are paid out of the pension fund.