BALTIMORE COUNTY
FISCAL YEAR 2015 RECOMMENDED BUDGET

RETIREMENT AND SOCIAL SECURITY (041)

BUDGET SUMMARY

$ in Thousands

PROPOSED CHANGE	GENERAL	SPECIAL	TOTAL	% Change Prior Year
FY 2014 - 2015 Change	$ 19,983.1	-	$ 19,983.1	22.7%
Recommended Reduction	**TBD**	-	**TBD**	
BUDGET TRENDS				
FY 2013 Actual	$ 81,910.7	$ -	$ 81,910.7	
FY 2014 Approp.	88,172.5	-	88,172.5	7.6%
FY 2015 Request	108,155.6	-	108,155.6	22.7%
Recommended	**$ 108,155.6**	**-**	**$ 108,155.6**	**22.7%**

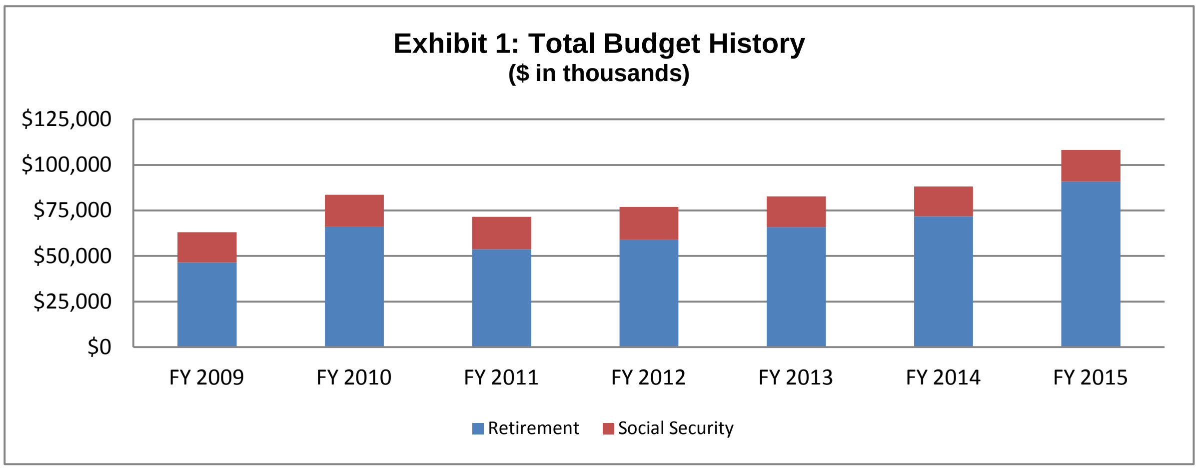
PERSONNEL

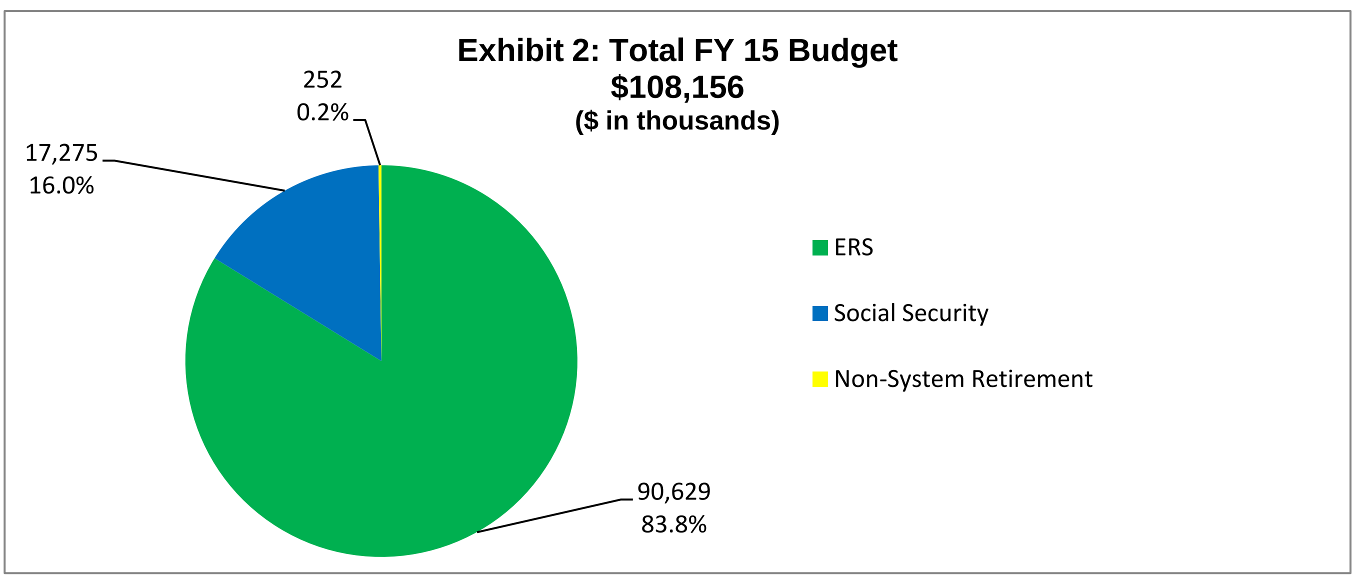
No personnel are funded in the Retirement and Social Security program budgets; rather, Retirement System personnel are paid out of the pension fund.

RETIREMENT AND SOCIAL SECURITY (041)

BUDGET SUMMARY:

The proposed FY 2015 budget for Retirement and Social Security totals $108.2 million, an increase of $20.0 million, or 22.7%, over the FY 2014 budget. The Retirement portion of the budget increases by $19.1 million, or 26.6%, primarily due to a change in demographic and salary scale assumptions resulting from a recent experience study as well as the decrease in the interest rate assumption. The Social Security portion of the budget increases by $908 thousand, or 5.5%, primarily due to increments, longevities, and the employee bonus. **See Exhibits 1 through 3 for additional detail.**





RETIREMENT AND SOCIAL SECURITY (041)

Exhibit 3
FY 2015 Proposed Budget ($ in 000's)

How Much it Grows:	Retirement[1]	Social Security	Total
2014 Appropriation	$ 71,805	$ 16,367	$ 88,172
2015 Request	90,881	17,275	108,156
$ Increase	$ 19,076	$ 908	$ 19,984
% Increase	26.6%	5.5%	22.7%

(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:		
Change in demographic and salary scale assumptions	$9,058	
Decrease in interest rate assumption from 7.25% to 7.0%	7,204	
Increase in Unfunded Accrued Liabilities, experience losses, etc.	4,051	
Asset experience	2,618	
Change in appropriation payroll	(13)	
Total – All Funds	22,918	
Less increase attributable to Component Units & Metro. District	(3,862)	
General Government, General Fund Portion of Contribution Increase		$19,056
Non-System Plans (Judges', Sheriffs', and Volunteer Fire Widows') Benefit Payments		20
Total Retirement		19,076
Social Security		908
Total:		$19,984

(1) Agency 041 includes the retirement contribution for General Government. The proposed budgets for Baltimore County Public Schools, the Community College of Baltimore County, and Baltimore County Public Library each include their respective funding for retirement contributions.

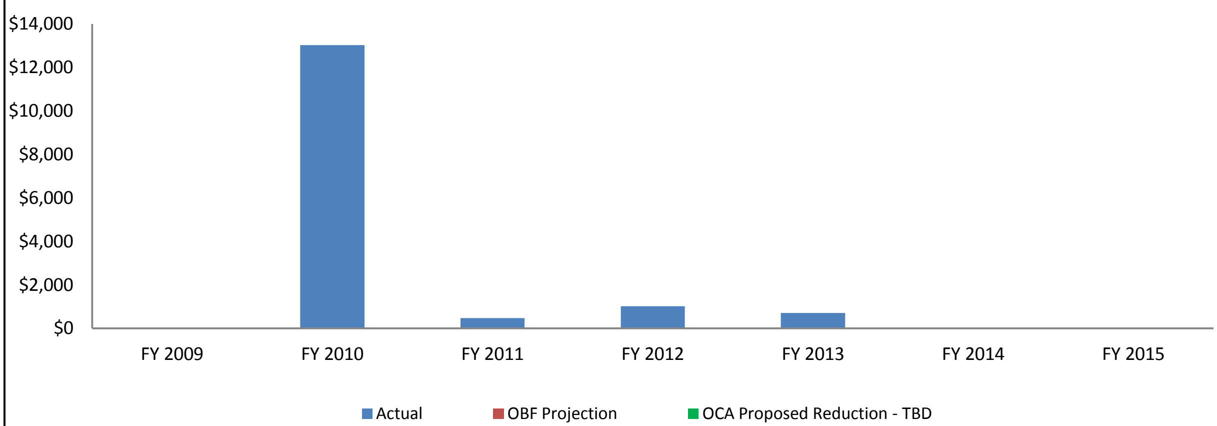
RETIREMENT AND SOCIAL SECURITY (041)

BUDGET RECOMMENDATIONS:

<u>Budget Reductions</u> <u>TBD</u>

With the exception of the reversion of a planned one-time extra contribution of $13 million to the Employees' Retirement System in FY 2010, the Retirement and Social Security budget has seen minimal reversions since FY 2009. In FY 2014 the Office of Budget and Finance estimates that the Social Security program is under-budgeted and will require an additional $150,000.

Exhibit 4: General Fund Unexpended Balance
($ in Thousands)



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

<u>Explanation:</u>

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.

RETIREMENT AND SOCIAL SECURITY (041)

SIGNIFICANT PROGRAM/POLICY INITIATIVES AND/OR CHANGES

2. New Rate of Return on Investments and Pension Obligation Bonds $7.2 million

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. The Office advised that while the Administration felt that the rate should be lower than 7.25%, this rate was reasonable at that time. The Office further advised that the County has since decided to lower the rate even further, and on April 8, 2014 the Trustees voted to reduce the assumed rate of return to 7.0% as of June 30, 2013. The Administration believes that this reduction establishes a realistic rate of return for the next 30 years. As part of both of these decisions to reduce the rate of return, the Trustees kept the 7.875% rate as the mechanism for funding the Post Retirement Increase Fund (see related Issue #3).

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 Office previously advised that the annual County contribution to the System plus debt service on the POBs was 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. The Office advised that estimated savings for FY 2015 are not available. The actuary calculated that further lowering the interest rate assumption to 7.0% increased the accrued liability of the System by an estimated $92.3 million (present value). The Office advised that this additional liability will be met through increased County contributions to the System. The

County's FY 2015 contribution to the System includes an increase of $7.2 million attributable to the reduction of the interest rate assumption to 7.0%.

The System experienced a 10.7%, gross-of-fee return on investments for FY 2013, which ranked in the 72nd percentile of the InvestorForce (IF) Public Funds Universe. The market value of the System's combined assets increased from $2.00 billion on June 30, 2012 to $2.33 billion on June 30, 2013. This increase was driven primarily by investment gains.

The System's 10.7%, gross-of-fee return on investments, when taken with the losses and gains over the last 10 years, is only 5.526%, which is still significantly less than the new actuarial assumed rate of return of 7.0%. 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, though often higher, 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, as of their most recent actuarial valuations. The State uses an actuarial assumed rate of return of 7.70%.

The Office should be prepared to discuss:

- ***Any plans for another issuance of POBs; and***
- ***Any changes to the System's investment strategy that occurred during FY 2014 or which are planned for FY 2015.***

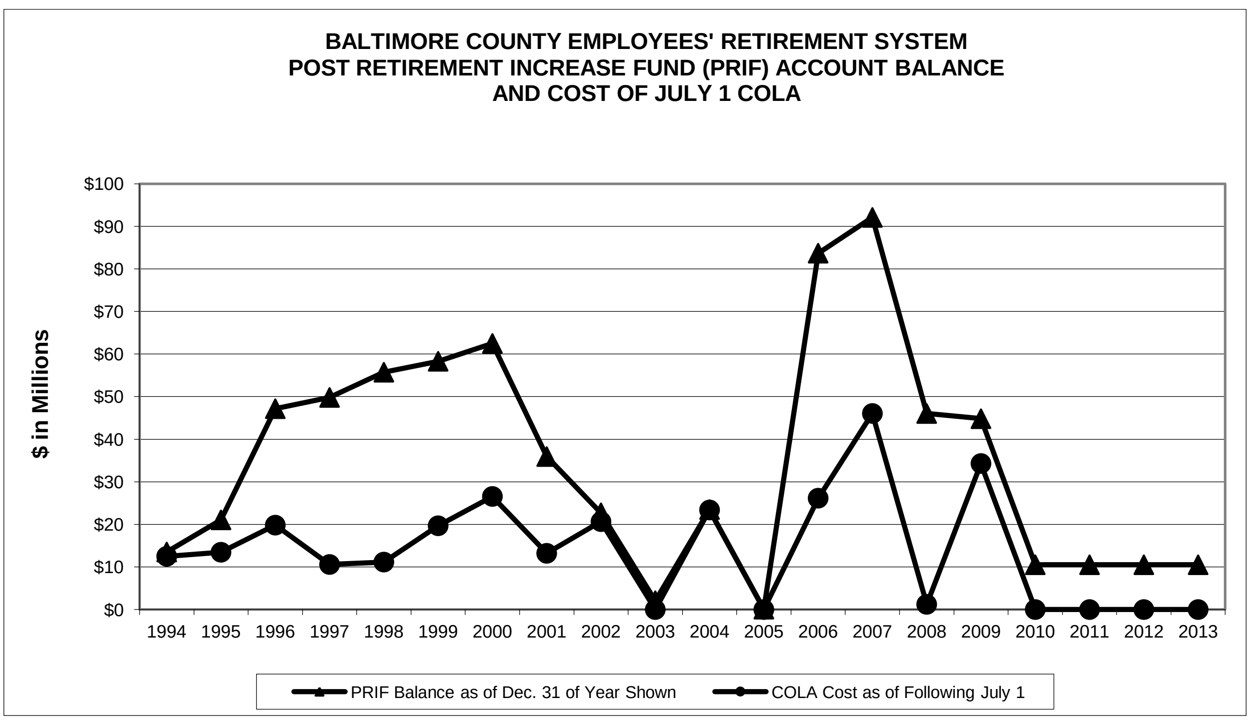
OTHER ISSUES

Retirement System

3. 0% COLA for Retirees on July 1, 2014

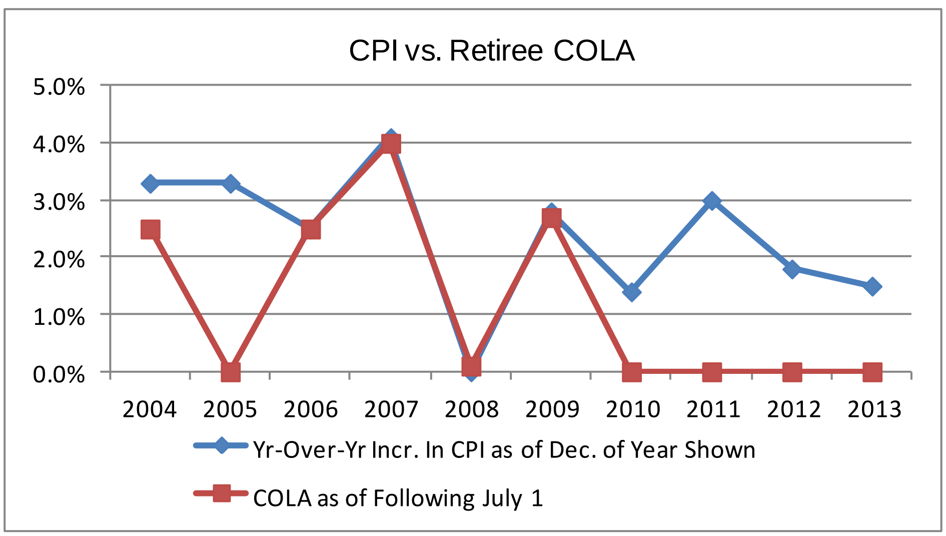
The County's current pension law (Baltimore County Code, Section 5-1-235) provides that after 60 months of retirement, retirees are entitled to a cost-of-living-allowance (COLA) increase to their pension checks each July 1 based on the annual increase in the Consumer Price Index—United States City Average (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). If the funds are insufficient to provide at least a 1% increase, then no increase is granted. This coming fiscal year is the fourth consecutive year, and the sixth year overall, that retirees have been denied COLAs due to insufficient funds in the PRIF. The five other times were for fiscal years beginning July 1, 2004, 2006, 2011, 2012, and 2013.

The increase in the CPI-U from December 2012 to December 2013 was equal to 1.5%. The estimated cost of a 1.5% COLA effective July 1, 2014 totals $20.7 million. The PRIF balance of $10.5 million as of December 31, 2013 is insufficient to fund a 1.5% COLA. The estimated cost of a 1% increase in retirement allowances effective July 1, 2014 is $13.8 million. The PRIF balance as of December 31, 2013 is also insufficient to cover this estimated cost. Therefore, no increase will be granted on July 1, 2014. The following graph illustrates the historical PRIF account balances and COLA costs.



The PRIF account balance has remained unchanged in recent years because the PRIF is funded through the System's excess investment earnings, meaning that funds are only transferred into the PRIF if the investment return on the System's 10-year smoothed actuarial value of assets for the previous calendar year exceeds 7.875%. Despite recent reductions in the System's assumed rate of return, the Trustees have decided to keep the 7.875% rate as the mechanism for funding the PRIF (see related Issue #2). The System experienced significant investment losses in CY 2008 resulting from the economic downturn, and because of the 10-year smoothing period, the System's investment return continues to be impacted by these losses. In CY 2013, the return on the System's 10-year smoothed actuarial value of assets was 6.1%, lower than both 7.875% and the new assumed rate of return of 7.0%.

The absence of COLAs in recent years has had an impact on retirees. For example, a retiree who received a pension of $10,000 in FY 2004 would be receiving a pension of $11,233 in FY 2015. However, if that same retiree had received COLAs equivalent to the year-over-year increase in the CPI-U from the previous December in each of the last 10 years, his or her pension would total $12,632 in FY 2015. This retiree's buying power has declined by $1,399 over the last 10 years. The following graph shows the increase in the CPI-U compared to the COLAs granted to retirees over the last 10 years.

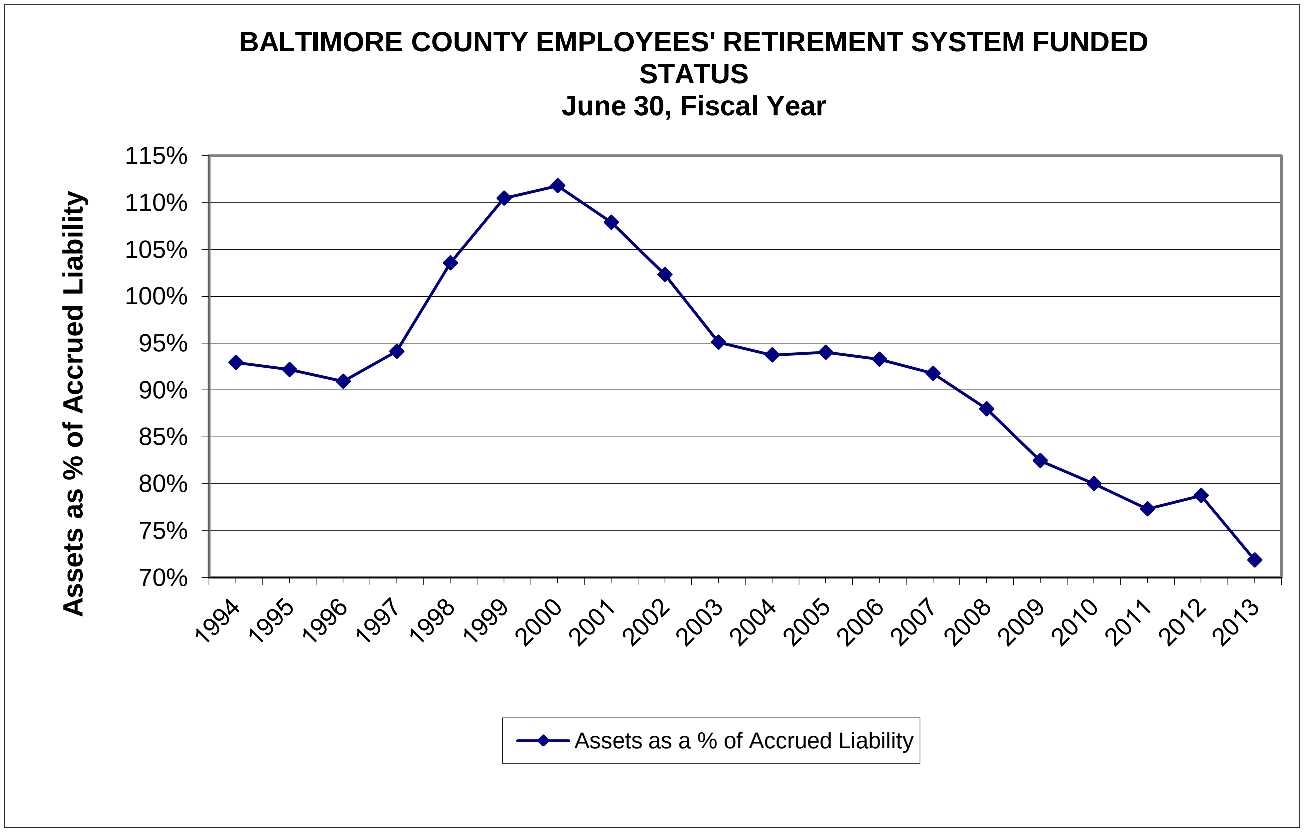


The Office should be prepared to discuss:

- ***The impact of maintaining the 7.875% rate as the mechanism for funding the PRIF on future COLAs for retirees, including future prospects for funds being transferred into the PRIF; and***
- ***How other jurisdictions and the State determine COLAs for retirees.***

RETIREMENT AND SOCIAL SECURITY (041)

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

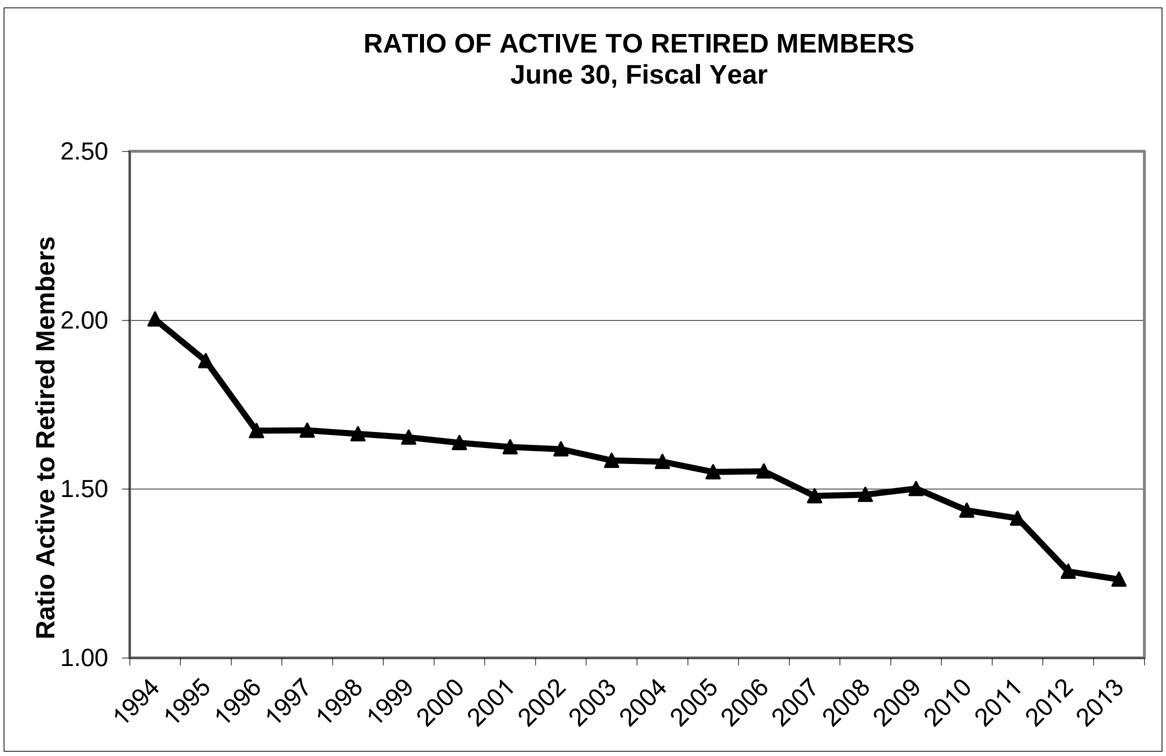


Expressing plan net assets as a percentage of the actuarial accrued liability provides one indication of the System's funded status. Analysis of this percentage over time indicates whether the System is becoming financially stronger or weaker. Generally, the greater this percentage, the stronger the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

The funded status of the System at the end of FY 2013 was 71.8%, down from 78.7% at the end of FY 2012 and considerably lower than the funded status at the end of FY 2000 when it reached a peak of 111.8%. The decline in funded status in FY 2013 is attributable to the lowering of the interest rate assumption from 7.25% to 7.0% as well as the changes in demographic assumptions adopted as a result of the recent experience study.

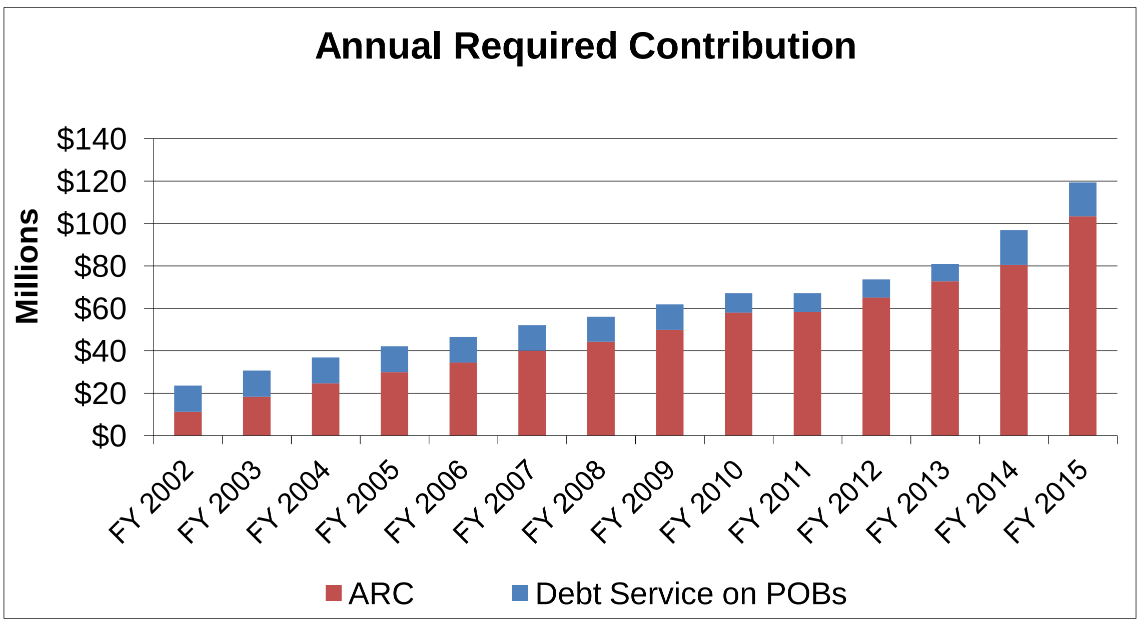
The funded statuses of other local jurisdictions' retirement systems vary considerably, with some better off than the County and others worse off. As of June 30, 2013, the retirement systems of Baltimore City and Anne Arundel, Howard, and Carroll counties had funded statuses of 68.1%, 73.3%, 89.3%, and 94.6%, respectively. The State's retirement system had a funded status of 65.5% as of the same date.

One 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 9,099 active members and 7,382 retirees (a ratio of 1.23 to 1) as of June 30, 2013. The 311 employees (including one Revenue Authority employee) who retired in FY 2012 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 (when the ratio was 1.26 to 1). 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 190.1% as of June 30, 2013, up from 133.8% as of June 30, 2012.

As the System has grown financially weaker, the total annual required contribution (ARC) has increased more than nine-fold since FY 2002 to $103.4 million in FY 2015. In addition, debt service payments on the County's pension obligation bonds (POBs) have increased significantly following the FY 2013 issuance of $255 million in POBs. In FY 2015, the ARC and the debt service payments on the County's POBs combine to total $119.4 million. The following chart shows the increase in both the ARC and the debt service on the County's POBs since FY 2002.

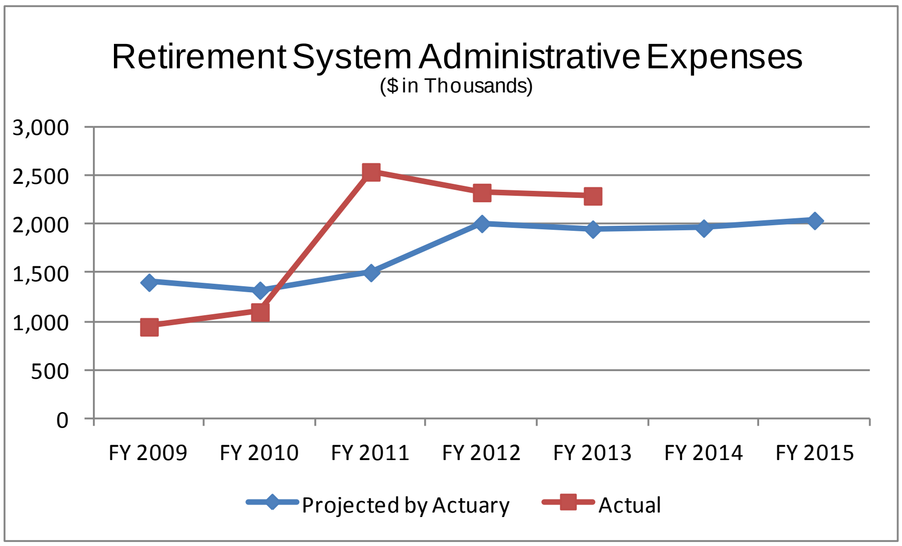


The Office should be prepared to discuss:

- ***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; and***
- ***The impact that the large number of public safety DROP retirements in FY 2014 is expected to have on the System and the contribution cost to the County over the next few years.***

5. <u>System Administrative Expenses</u>

Beginning in FY 2003, all administrative expenses of the Employees' Retirement System are paid from System assets. As a result, each year the actuary's recommended ARC includes projected administrative expenses as part of the normal (current year) cost. If the System's actual administrative expenses come in higher than the actuary's projection in a given year, then any expenses above the projection become a liability of the System. The following chart shows a history of the System's administrative expenses since FY 2009.



The Office advised that actual administrative expenses have exceeded projections in recent years due to costs related to the new pension administration software, which were funded with System assets and are being recognized in the County's General Fund (through the normal cost portion of the ARC) over a period of 5 years beginning in FY 2012.

The Office should be prepared to discuss:

- ***Why the General Fund costs related to the new pension administration software are being phased in over a 5-year period;***
- ***Any other reasons why actual administrative expenses have exceeded projections in recent years; and***
- ***In light of the fact that the software maintenance fee for the new pension administration software is being funded in the proposed Office of Information Technology FY 2015 budget, any other System administrative expenses that are not being paid from System assets.***

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 Central Acceptance Facility in Cockeysville.

   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 entered into an agreement to borrow an estimated $21,508,651 from the Employees' Retirement System for a term of 12 years at an interest rate of 7.875%. On August 15, 2013, the loan was transferred to the Police, Fire and Widows' Pension Fund. According to the Office, the estimated loan amount was reduced to $18,625,000, and the payment schedule was accelerated to 5 years to approximately match the life of that fund. The Office advised that this transfer was an administrative decision based on where the investment was deemed to be the most beneficial. Payments on the loan began in FY 2014, with debt service payments expected to total approximately $1.7 million. As of March 31, 2014, the County had made payments totaling $1,319,625. In FY 2015 and subsequent years, payments are estimated to total approximately $5.4 million annually. Total payment to the Police, Fire and Widows' Pension Fund is estimated to be $21.8 million, or approximately $3.2 million more than the borrowed amount.

   The new recycling center and transfer station opened in November 2013 and generated nearly

$750,000 in net operating revenue during its first 4 months of operation. The Office advised that estimated net operating revenue for all of FY 2014 totals $2.1 million, not including the accelerated debt service payments.

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

7. Accounting and Record-Keeping System Replacement

The County recently replaced its long-time pension administration and record-keeping application, Pension Gold. This software was purchased 17 years ago and had been customized to meet the County's unique plan provisions. The Office advised that a new system was necessary because of various issues with data retention, rate calculation, and manual intervention with the current system. The new system, CPAS, was implemented on August 1, 2013. It 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 total cost for the software replacement project was $3.9 million, including $3.6 million funded through the Retirement System and $0.3 million for equipment purchased through the Enhanced Productivity Thru Technology capital project. The Office previously 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. The original budget for this project was $5.4 million. The Office of Information Technology (OIT) advised that the project came in $1.5 million under budget because the original estimate was based on the use of a Microsoft platform, and the software was implemented on a Linux platform, which costs less. In addition, both the performance bond and the contingency included in the original estimate were not used. Annual maintenance costs for the new software will total $52,000 in each of the first two years, with a 5% increase in each subsequent year. OIT's FY 2015 budget includes $52,000 for the software maintenance fee.

OIT advised that as part of the roll-out of the CPAS system, there was an issue with the software not printing all of the 1099-R forms for TY 2013. OIT further advised that these forms were reprinted to ensure that all retirees received them, and that the only cost was the mailing of duplicate forms. In addition, OIT advised that necessary post-implementation activities, including data validation, software corrections, and additional training, are expected to cost an estimated $108,125.

The Office should be prepared to discuss:

- ***The errors that have occurred as a result of the manual processes and interventions necessary with the previous software as well as the cost of correcting these errors;***
- ***Why the annual maintenance costs for the new software are included in OIT's budget and not the System's administrative expenses;***
- ***How the post-implementation activities will be funded;***
- ***Any other issues that have arisen thus far or are anticipated in the transition to a new software product; and***
- ***How and when employees and retirees will be educated regarding access to and use of the new system.***

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

The proposed FY 2015 budget includes $21.1 million to fund the third year of the 4-year phase-in of the teacher pension cost shift, an increase of $1.1 million over the FY 2014 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 FY 2014, and the State's FY 2015 budget maintained that funding. In addition, beginning in FY 2015 the State will bill local school systems for the retirement costs of federally funded teachers. The federal government will reimburse school systems for this expense, which for Baltimore County Public Schools will total $4.5 million in FY 2015.

9. 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 takes effect in FY 2014 and will be reflected in the System's FY 2014 Comprehensive Annual Financial Report (CAFR) and Statement No. 68 will take effect in FY 2015 and will be reflected in the County's FY 2015 CAFR.

RETIREMENT & SOCIAL SECURITY (041)

APPROPRIATION DETAIL

	FY 2013 ACTUAL	FY 2014 APPROP	FY 2015 REQUEST	NET CHANGE AMOUNT	NET CHANGE %
4102 Employees' Retirement Cont.	$ 65,629,629	$ 71,573,858	$ 90,628,977	$ 19,055,119	26.6%
4107 Social Security Contribution	16,054,677	16,367,159	17,275,000	907,841	5.5%
4109 Non-System Retirement	226,418	231,450	251,600	20,150	8.7%
General Fund Total	$ 81,910,724	$ 88,172,467	$ 108,155,577	$ 19,983,110	22.7%

BALTIMORE COUNTY
FISCAL YEAR 2015 RECOMMENDED BUDGET

RETIREMENT & SOCIAL SECURITY (041)

PERSONNEL DETAIL

	FY 2013 ACTUAL		FY 2014 APPROP		FY 2015 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.