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Testimony of the Boston Municipal Research Bureau

Before the

City Council's Committee on Ways and Means

April 23, 2012

Regarding: Docket #0318. Order for a hearing regarding the cost of living adjustment for retirees and raising the base amount.

Mr. Chairman, my name is Sam Tyler, President of the Boston Municipal Research Bureau and I am here today to provide a financial context which I believe the City Council should consider as it contemplates what action it would take if the State-Boston Retirement Board were to submit a proposal to increase the base amount used in the calculation of a cost of living adjustment (COLA) for retirees. At the outset, let me state that the Research Bureau is concerned about the City's sizeable long-term unfunded liabilities and the implications for city operations. For that reason, we believe that the City should take no policy action on spending that would increase its pension liability.

Since the Retirement Board has not submitted a proposal to change the COLA payment to the City Council at this time, it would seem that this hearing is intended to provide an opportunity to discuss the issues that should be considered when an actual order is filed. To that end, the Research Bureau presents the following financial facts for consideration.

Spending Growth

Pension and health insurance expenditures have increased at a faster pace than any other budget categories. In the seven years from fiscal 2005 to fiscal 2012, the City's total spending for operations has increased by 26.3% but spending for pensions has increased by 80.7% and health insurance has increased by 61.1%. The increase in benefit spending at a time of limited revenue growth has resulted in slower departmental growth with salaries increasing by 17.9% during this same time.

Pension Liability

Boston's pension liability was $1.37 billion and its funded ratio or assets to liability was 69.9% as of the latest actuarial valuation as of January 1, 2010. The City's fiscal 2012 pension appropriation is $126.5 million. The current funding schedule is calculated to reduce the unfunded pension liability to zero by 2025. However, the Retirement System's pension valuations assume an annual investment rate of return of 8.0%. While that rate has been exceeded slightly on average since 1985, the expectation that the rate can be maintained over the next decade is being questioned by investment experts around the country. A reduction in the return rate even by 0.25% would significantly increase the pension liability.

Other Post Employment Benefits (OPEB) Liability

The City of Boston provides OPEB benefits such as health care and life insurance to participating retirees and their beneficiaries. Boston's unfunded OPEB liability was $3.06 billion as of June 30, 2011. At this point, the OPEB funded ratio is 3.5% compared with the pension funded ratio of 69.9%. The City funds its annual health insurance costs on a pay-as-you-go basis and the total appropriation in fiscal 2012 is $307.4 million. In addition, since 2008 the City has been appropriating annually between $20 million and $35 million into what is now an OPEB Trust Fund to help prefund the retiree liability. The City's total health insurance cost for retirees in fiscal 2012 including the $35 million allocated to the Trust Fund was $153.7 million. If Boston had adopted a formal funding schedule to address its unfunded OPEB liability over a period of 30 years, its Annual Required Contribution (ARC) would be $194 million in fiscal 2012 and that gap will grow significantly in fiscal 2013. The value of creating a Trust Fund is that because it is irrevocable, a higher investment return rate can be applied to its projected investment yields to support funding the liability. While establishing the Trust Fund and making annual appropriations are important steps, the City will not be able to fully address the OPEB liability until it adopts a formal funding schedule and eventually funds the ARC annually.

Long-Term Funding Plan

The City of Boston has adopted a pension funding schedule in which the State-Boston Retirement System (SBRS) will reach full funding by 2025 utilizing annual appropriations and investment returns. By contrast, the City is now practicing a partial payment system for its much larger OPEB liability, funding most of its annual expenses on a pay-as-you-go basis with limited appropriations into the OPEB Trust Fund. A logical funding solution for the two long-term liabilities involves a sequencing of steps continuing the funding of both liabilities but with a greater emphasis on reaching full funding of the pension liability in 2025. The annual pension payment consists of two parts, the normal costs and the amortized liability costs. The normal costs represent the annual expenses required to fund the future benefits currently being earned by active employees. Amortized costs represent the system's unfunded liability that must be paid over a period of several years. The amortization payments generally make up 75% of the City's contribution to the SBRS. Therefore, if the City can maintain its current pension schedule and reach full funding by 2025, at that time 75% of its pension costs will be eliminated and those funds can be applied to the annual OBEB liability allowing the City to adopt a full funding schedule. This plan creates an urgency for the City to adhere to its current pension schedule and take no steps that would increase its pension liability.

COLA Impact On Pension Liability

Any increase in the pension base to which the cost of living adjustment applies will increase the City's pension liability. The current COLA practice by the SBRB has been to annually approve the COLA for retirees and beneficiaries based on 3% of the first $12,000 of the pension. The pension reform act approved in 2011 (Ch. 176, Acts of 2011) authorizes Retirement Boards to increase the pension base in increments of $1,000 to which the 3% would apply.

The City requested its professional actuarial firm, The Segal Company, to prepare an analysis of the financial impact of increasing the Cost of Living Adjustment (COLA) base of $12,000 effective July 1, 2012 in increments of $1,000 to $13,000 through $16,000. The table below shows that the unfunded liability increases from $21.4 million to $83.2 million by increasing the base.

Added Pension Liability from Increasing the COLA Base

Non-Teachers as of July 1, 2012

$ in Millions

COLA Base	$13,000	$14,000	$15,000	$16,000
Added Liability	$21.4	$42.4	$63.0	$83.2
Percent Increase	1.6%	3.2%	4.8%	6.4%

Source: The Segal Company

Conclusion

Recent legislative changes enacting pension reform (Ch. 176, Acts of 2011) and municipal health insurance reform (Ch. 69, Acts of 2011) and the Administration's April 2011 "coalition bargaining" agreement with its public unions will have long-term benefits in reducing the current pension and OPEB liability estimates. Even so the long-term unfunded liability will still be a serious matter that will require a strong commitment to not deviate from reaching full-funding of the pension liability by 2025. Several of the reforms of municipal health insurance have been factored into the most recent valuation estimate and Boston's OPEB liability is still over $3.0 billion.

There is no disagreement that older retirees are living on smaller pensions and that the COLA increase is important to them. What is also important is for the City to solidifying its funding for the retiree health and life insurance costs so that this generous benefit continues to be available to the retirees and their beneficiaries in the future as it is now. The best solution to achieve this goal is to pay off the amortized pension liability as quickly as possible and use those resources to fund the OPEB ARC. If no increase in the COLA base is approved, the Retirement Board will continue to approve COLAs based on the first $12,000 of each retiree's pension.

An important step in addressing the long-term unfunded benefit liability problem is to not adopt policies that will increase the City's pension liability. For that reason, the Research Bureau will recommend that the City Council not approve an increase in the COLA base if such a proposal is submitted to it by the State-Boston Retirement Board.

I would be happy to answer any questions the Committee may have.