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September 20, 2017 (amended November 28, 2017)

Rob Grose  
Township Manager  
Saginaw Charter Township  
4980 Shattuck Road  
Saginaw, MI 48603-2963

Dear Mr. Grose,

We have concluded our study of the Township's MERS pension and retiree healthcare (OPEB) funding options. This summary report presents our findings and a recommended strategy to address the challenges faced by Saginaw Township in paying for these underfunded employee benefits.

### **Background**

Saginaw Township provides a defined benefit pension benefit to its sworn police officers. The pension is managed by the Municipal Employees Retirement System (MERS). Annually, the Township contributes 15% of qualifying employee base pay to the pension system. Employee contributions are determined by the Annual Required Contribution (ARC), less the employer contribution. At present, employees contribute over 19% of their pay to the pension. Since 1994, the Township contribution has remained fixed at 15% of payroll, while employee contributions have ranged from 0% to nearly 20%.

Despite the significant contributions from both the Township and employees, the pension fund remains underfunded. According to the latest MERS actuarial valuation report, the pension was only 66% funded on 12/31/16. This is a slight decrease in funding from the prior year, when funding was at 68%. The 2014 valuation reported the plan was 71% funded. The table below summarizes some key metrics in the two most recent actuarial valuation reports.

	<b>12/31/15 MERS Valuation</b>	<b>12/31/16 MERS Valuation</b>
Funded Ratio	68%	66%
Unfunded Accrued Actuarial Liability (UAAL)	\$6.21 million	\$6.78 million
Discount Rate	7.75%	7.75%
Smoothed Actuarial Rate of Return	5.21%	5.14%
Actuarial Value of Assets as % of Market Value of Assets	113%	108%

The challenges faced by Saginaw Township are not unique. Many local government pension plans are underfunded, and there is increasing pressure from employees, elected officials, legislators and financial regulators to reign in the growing imbalance in public pensions. In Michigan, the Governor's Task Force on Responsible Retirement Reform for Local Government recently identified a number of issues with funding for municipal retiree benefits. The task force concluded the minimum threshold for pension funding should be 60%, before the State intervenes in a local unit's financial affairs. Saginaw Township is

currently above this target minimum, but the trend in the funded ratio suggests the Township could fall below 60% within a few years.

Similar to pensions, many retiree healthcare benefit plans, often referred to as Other Post Employment Benefits (OPEB), are also facing underfunding. Unlike pensions, there is no obligation to pre-fund OPEB. This has led to a far greater funding gap for retiree healthcare than for pensions. According to the most recent actuarial report, dated April 1, 2015, Saginaw Township's OPEB benefit plan is only 25% funded. The UAAL for OPEB is approximately \$7.5 million. The current funded ratio of 25% is a significant improvement over prior years. Historically, OPEB was funded at only 5.7% in 2009, 11.3% in 2011, and 9.8% in 2012.

According to the Governor's Task Force, the minimum OPEB funding ratio should be 40%. To achieve this level of funding would require an additional contribution of approximately \$1.5 million. Of this amount, about 50%, or \$750,000, is associated with police retiree benefits. The balance of unfunded liabilities can be allocated about 30% to non-union and 20% to DPS. To fully fund the police portion of OPEB UAAL would require a contribution of nearly \$3.75 million. At present, there is no obligation to fund OPEB at any particular level. However, if the State Legislature acts on the recommendations of the task force, it is possible there could be a minimum funding requirement by the end of 2017.

The Township Board and management would like to find a sustainable solution to the funding challenges for pension and OPEB, not only to avoid State intervention, but to ensure benefits promised to employees will be available to all retirees. Achieving greater funding will also be an indication of greater financial stability to bond rating agencies and to the community.

### **Resolution**

The Township is interested in understanding how it can achieve 100% pension funding, while also reducing the obligation of employees to contribute such a large percentage of their paycheck to pension costs. The downward trend of total pension funding suggests the Township should act as soon as possible to stabilize the pension. Waiting longer will likely require an even greater commitment on behalf of the Township and employees to achieve full funding.

There is less pressure to fully fund the OPEB liability, but the Township should consider how it can achieve at least 40% funding as soon as possible. This level of funding may be achieved with a contribution from DPS-affiliated departments/funds of \$310,000, a contribution of \$435,000 for non-union employees, and \$750,000 from police.

After considerable review of the pension obligation, available resources within the Township, possible outside funding (pension bonds), and the long-term financial outlook of the Police Fund, the following strategy was developed:

1. Fully fund the pension UAAL of \$6.78 million, using a combination of available Police Fund reserves (\$2.68M), and internally borrowing from other Township funds (\$4.1M) with sufficient cash reserves.

2. Fund OPEB at a minimum of 40% accrued actuarial liability. This can be done using available cash in the funds associated with the different employee groups (DPS, non-union, police). The contribution from the Police Fund would be \$750,000.
3. Repay the internal funds borrowed over 10 years, at 1% interest. Use Police Fund operating revenues to pay the annual debt service.
4. Continue to pay the normal costs of the pension from the Police Fund operating budget.
5. Pay AT LEAST the ARC on the OPEB. Overfunding the ARC could be possible, if additional resources are available to do so.
6. Township continues to contribute a fixed 15% of payroll to the pension fund.
7. Employees contribute a fixed 10% of their pay to fund the pension.
8. Increase the funding ratio of the pension to at least 125%, to minimize the potential negative impact of market fluctuates or changes to actuarial assumptions. (Depending on market rates of return, attaining 125% funding ratio may require 7-10 years.)
9. After the pension is at least 125% funded, the Township could use “excess” employer and employee contributions to pay the debt service on the borrowed funds.
10. Any savings on debt service payments could be used to increase funding for retiree healthcare.

The suggested approach results in:

- Full funding of the pension obligation
- A minimum of 40% funding of the OPEB liability
- Lower and predictable employee contributions
- No increase in the Township (employer) contribution rate
- Elimination of a long-standing (and increasing) unfunded liability in the pension system
- Greater resilience to maintain a strong funding position even if market returns or actuarial assumptions sour
- Sufficient time to adjust funding, if the funded ratio greatly exceeds or falls below the target of 125%
- A better return on cash in other Township funds loaning money to the Police Fund
- No outside borrowing and associated borrowing costs

Admittedly, this strategy requires the Township expend \$7.75 million from its Police Fund over 10 years to ensure 100% pension funding and 40% OPEB funding. This level of expenditure is possible due to 1) property tax revenues are exceeding initial assumptions used to calculate the Police millage, 2) the Police Department has not expanded staffing, and has managed to operate below estimated expenditure levels, and 3) the low cost of internal borrowing, and the availability of reserves in other funds, makes it possible to fully fund the total pension UAAL in the current year and spread the impact on the Police Fund over 10 years.

In recognition of the value of guaranteeing pension funding and stabilizing employee contributions, the Township should be in a strong negotiating position with the affected Police bargaining units. This

position may allow the Township to negotiate an additional employee contribution for retiree healthcare, lower wage rates, or other concessions that help improve Police Fund fiscal stability.

### **Police Fund Analysis under Alternate Scenarios**

In this section, four different scenarios are presented in graph form, to illustrate the impact of different options the Township has for utilizing Police Fund resources to address pension and OPEB unfunded liabilities. Estimated future revenues and expenditures are based on a number of assumptions, including:

- Property Tax Growth Rate ..... 1.0%
- CPI Inflation Rate ..... 1.0%
- Wage Rate Increase ..... 1.5%
- Public Utilities Rate Increase ..... 5.0%
- Healthcare Inflation ..... 6.0%
- Retiree Healthcare Inflation..... 5.1%
- Township Retirement Contribution ..... 15.0%
- Gasoline & Oil Increase ..... 5.0%

The model assumes one new officer will be hired in FYs 2021, 2025 and 2029. The current Police millage is set to expire in FY 2029.

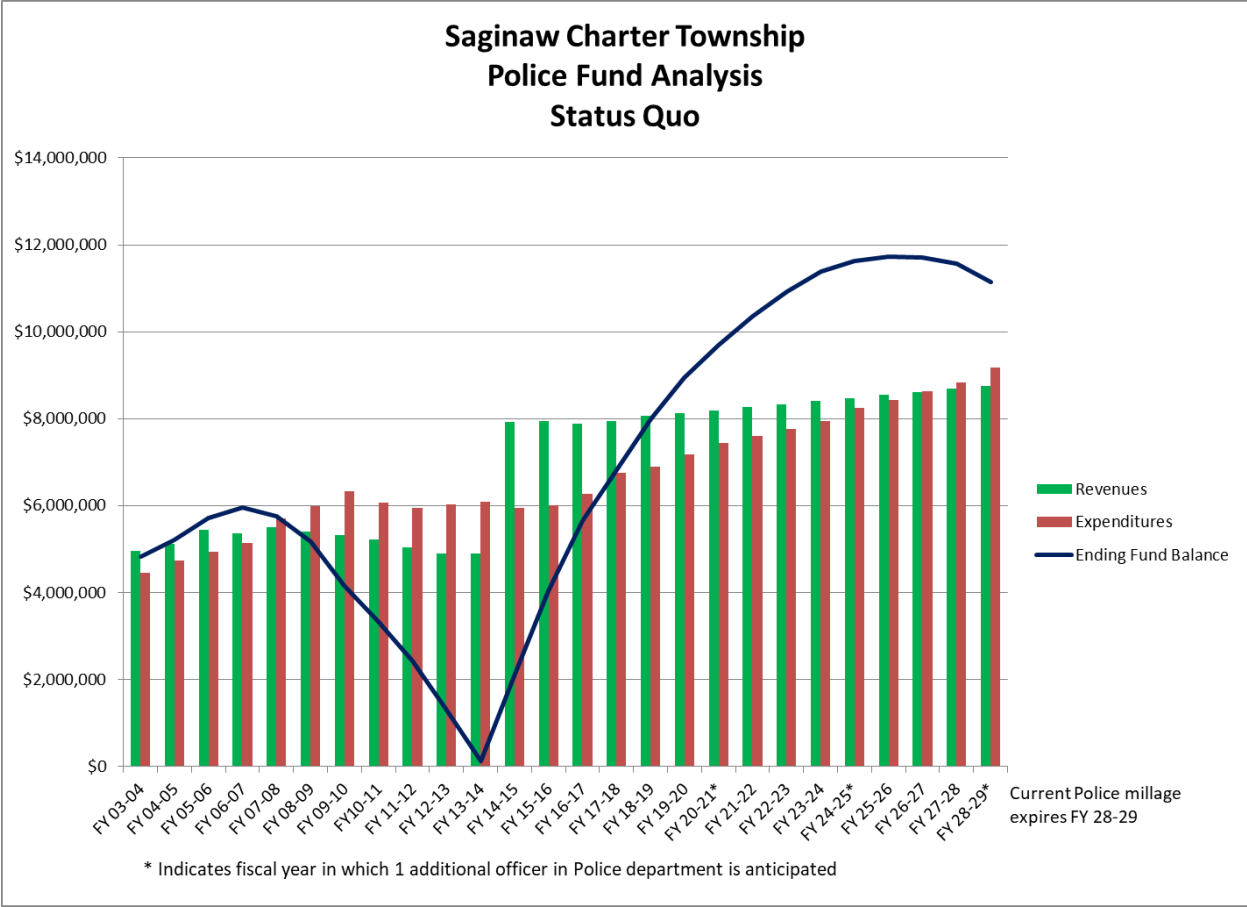
#### **Scenario 1: Status Quo (no change to current funding strategies for pension and OPEB)**

In this base scenario, we have assumed the Township will continue its current approach to funding the pension ARC, which requires a contribution of 15% of eligible payroll and over 19% from participating employees. The OPEB funding strategy is assumed to cover the ARC, through a combination of pay-as-you-go premium payments for current retirees and a supplemental contribution to the OPEB trust.

As illustrated in the chart below, this scenario is expected to result in a significant fund balance at the end of the current millage term. The balance in FY 2029 could be as high as \$11.1 million.

It is impossible to accurately predict the funded ratio of the pension plan 12 years from now, but without an increase in contributions, the pension fund will not be able to sustain even the current ratio of 66%. According to MERS, if employee contributions are held at current levels, and the employer contribution was increased to 19.6%, the pension system would be only 75% funded in 2029.

The OPEB funding ratio is even more difficult to forecast, but if the Township fully funded the ARC each year, it is likely the unfunded liabilities would decrease. However, this would require a significant and sustained increase in Township annual contributions, reaching \$586,750 in 2029. This level of funding is 67% higher than the amount budgeted for 2016-17.

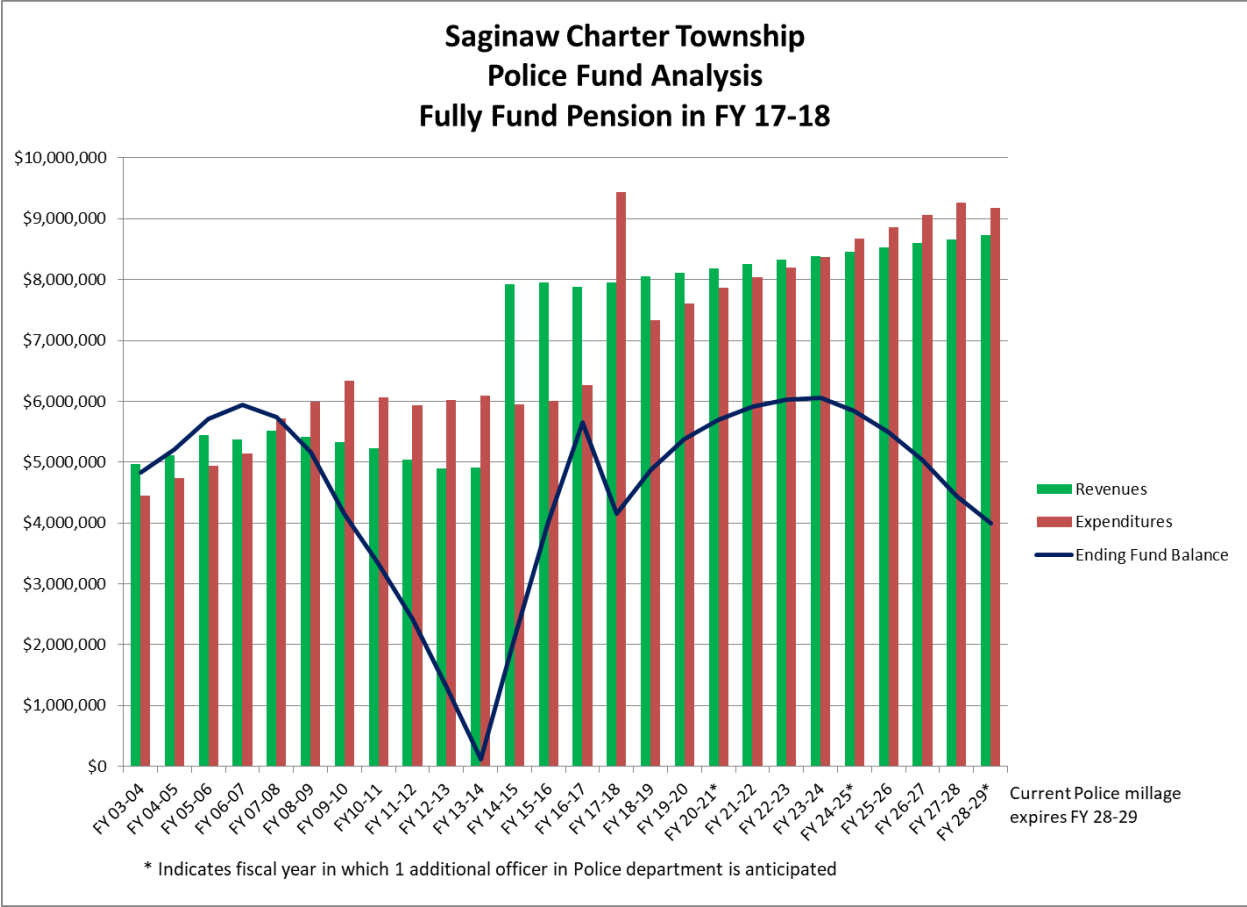


**Scenario 2: Fully Fund the Pension in the Current Fiscal Year; No Change in OPEB Funding Strategy**

Since the focus of retirement benefit underfunding is pensions, this scenario considers the impact of only addressing this issue. In this scenario, we assume the funding strategy discussed above: use \$2.68 million of Police Fund reserves, and borrow a total of \$4.1 million from other Township funds, to fully fund the UAAL, based on the 12/31/16 actuarial valuation. The borrowed funds would be repaid to the other funds over 10 years at 1.0% interest. The Township contribution to the pension plan would remain unchanged at 15% of qualifying payroll, and employee contributions would be reduced to 10% of payroll.

The Township and employee contributions would exceed the ARC (normal costs), but these contributions would continue to be made to the pension plan, until the funded ratio reaches at least 125%. Any excess contributions could be used to pay the debt service on the borrowed funds. The forecast model conservatively assumes 125% will not be attained by the end of the current millage. Therefore, the debt service is assumed to be paid entirely from the Police Fund operating budget.

The chart below shows this strategy could be viable. If all assumptions are fulfilled, the estimated fund balance at 2029 under this scenario would be \$3.99 million.

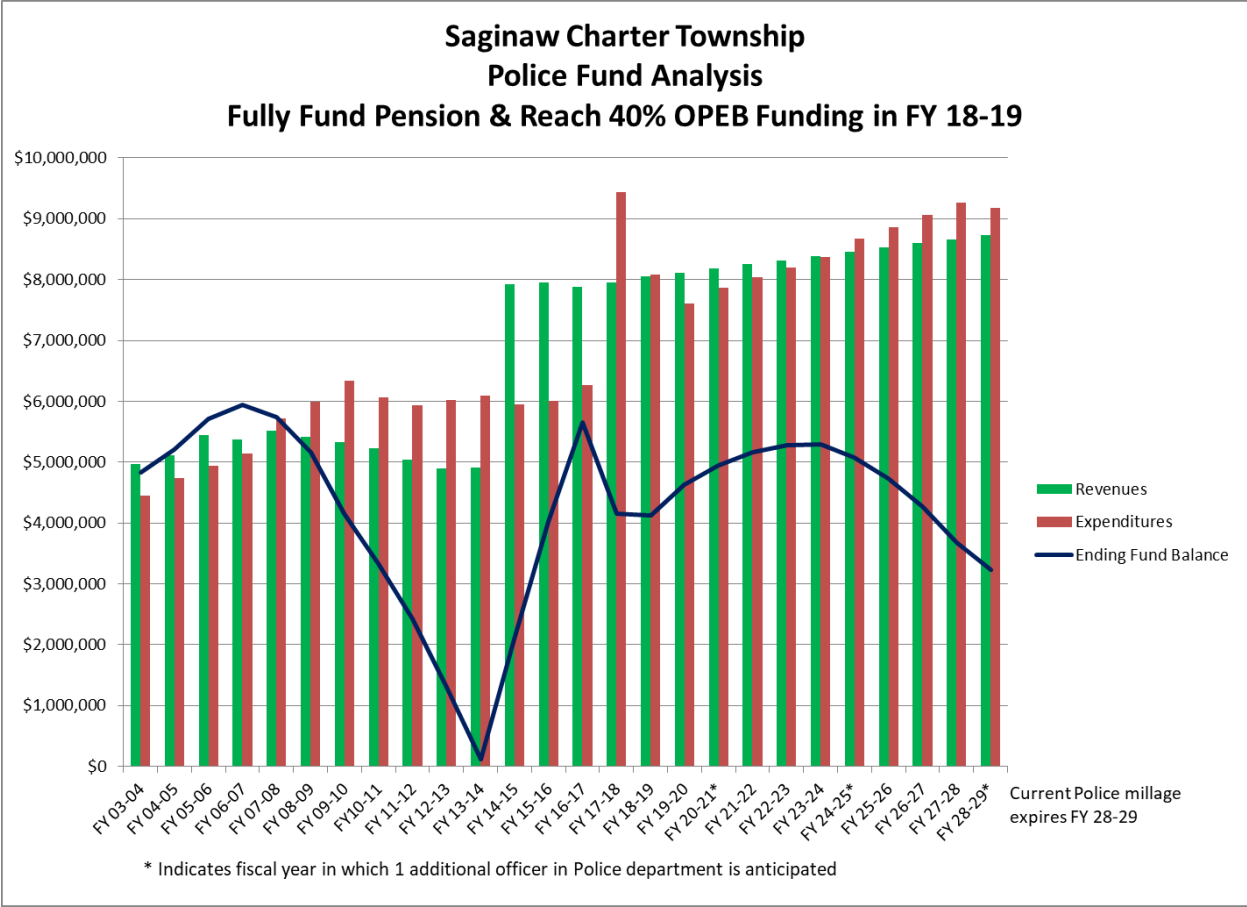


**Scenario 3: Fund Pension at 100% and OPEB at 40% in FY 2018-19**

This scenario is similar to the one above, with the exception of an additional \$750,000 contribution to the OPEB trust next fiscal year. This level of additional funding is estimated to be sufficient to achieve 40% OPEB funding of the Police actuarial accrued liability.

Outside of this additional contribution, the model continues to assume the OPEB contribution will grow at over 5% per year. The impact on funded ratio 12 years from now is unknown, but the Township can be certain it will be better than the current 25% under this scenario.

The graph below shows how the additional \$750,000 contribution next fiscal year could impact the Police Fund through FY 2029. The forecasted balance at that time is \$3.22 million

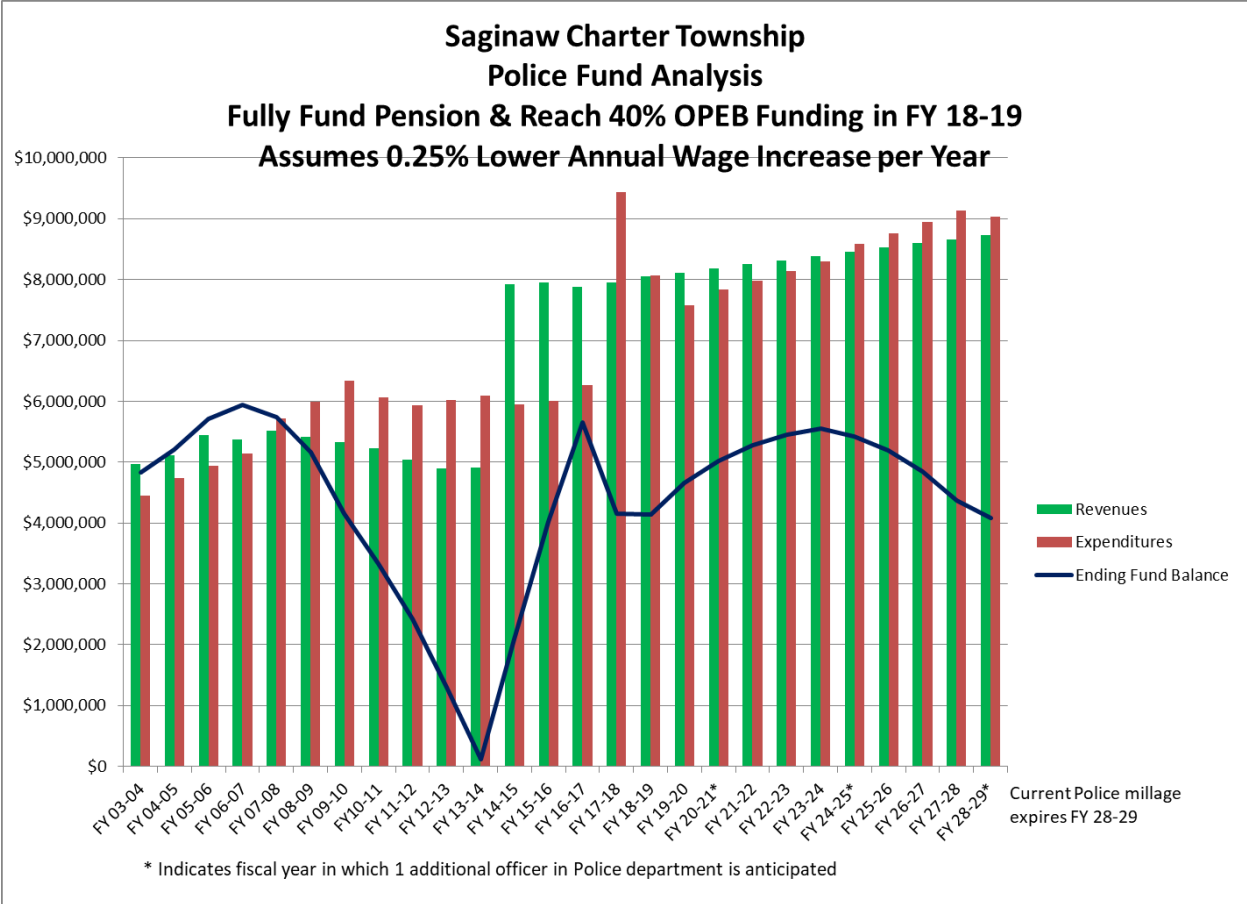


**Scenario 4: Same Assumptions as Scenario 3, with One Change in Assumptions**

In this scenario, we held all assumptions and funding strategies the same as the above scenario. In an effort to understand how difficult it might be to overcome the potential negative fund balance resulting from the increased OPEB contribution of \$750,000 in FY 18-19, we changed one assumption.

The impact of wage inflation is considerable in the Police Fund, as wages alone comprise over 50% of the budget. The chart below illustrates the impact of changing the wage increase assumption from 1.5% per year to 1.25% per year. This small change is sufficient to move the projected fund balance in 2029 from \$3.22 million to \$4.08 million. This one change could itself pay for the additional funding for OPEB.

As noted, by taking decisive action to fully fund the pension, implement a strategy to ensure long-term sustainable pension funding, reduce employee contributions, and substantially increase OPEB funding, the Township should be in a much stronger position to work with its Police unions to find a way to ensure the Police Fund itself remains stable and sustainable.



Estimated fund balance at end of FY 28-29: \$4.08 million

**Conclusion**

Saginaw Township has a unique opportunity at this time to address the unfunded liability in its MERS pension plan, as well as increase funding of its OPEB liabilities. These goals can be met, while also stabilizing employee retirement contributions, by using a combination of available reserves in the Police Fund and some internal borrowing from internal Township funds. Delaying the strategies presented in this report may result in increased unfunded liabilities, and an inability to achieve full funding without external borrowing.

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It has been a pleasure working with the Township on this study. If you have any questions, please do not hesitate to contact John Kaczor at 734-623-8033 or [johnk@municipalanalytics.com](mailto:johnk@municipalanalytics.com).

Very truly yours,

John Kaczor, Principal