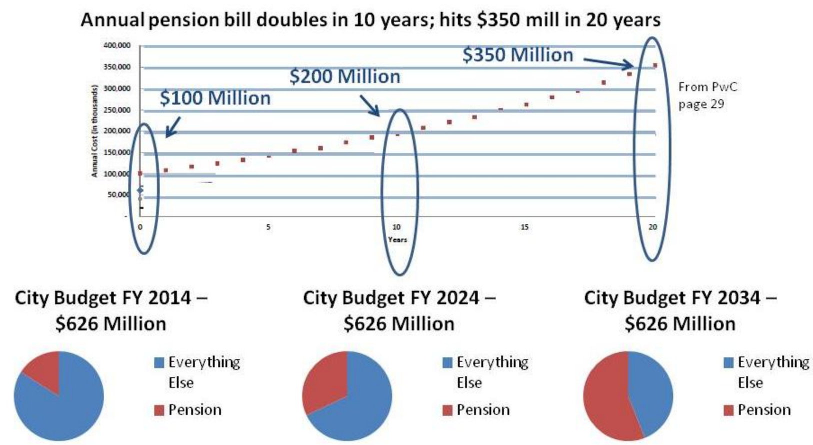
An Open Letter from Mayor A C Wharton to the Citizens of Memphis about Pension Reform and the City's Financial Health

I have a sincere and deep appreciation for the dedicated, hardworking men and women who comprise City government's workforce. And I know I speak for our entire community in recognizing and valuing especially those who put their lives on the line for our safety every day. Compensation, including retirement benefits, is one of the important ways we show that appreciation and I am committed to making sure our government employees have both wages and retirement benefits that are comparable to fellow citizens and taxpayers in other sectors of our community.



At the same time, my overriding responsibility to the citizens of Memphis is to make sure their government is solvent and sustainable. It is that responsibility that has caused me deep concern about our employee pension system, whose costs are spiraling out of control.

Meanwhile, State of Tennessee officials have warned that they will solve this problem their way if City government doesn't set a new course.

We guaranteed a Cadillac and have been paying for a Chevy. Many years ago, with good intentions, our government put a Cadillac retirement plan in place that guaranteed employees a generous lifetime annual payment based on assumptions that the pension assets would generate healthy market returns which would mostly cover the annual pension bills. *But it was a plan built on the mistaken assumption that market growth would remain consistently strong which we all now know is not realistic -- the most recent example being the Great Recession where Memphis taxpayers saw their pension bill jump by $50 million in a single year between 2008-2009.*

Today, we have a new normal. Pension costs have skyrocketed, abetted by an aging workforce and the fact that people are living much longer, and our taxpayers simply can no longer afford the pension plan as it is now. In fact, because the costs are high and our community's other needs are great and serious, and because our current retirement system allows it, our government has these past years "kicked the can" of payment responsibility down the road, very much like a credit card holder making minimum payments on a

Our Annual Pension Bill

Plan Year	Annual Required Contribution (ARC)	ARC as % of Payroll	City's Contribution	City Contribution Rate
July 1, 2008	$21,208,000	7.5%	$16,172,000	5.0%
July 1, 2009	$71,447,000	24.1%	$17,419,000	5.0%
July 1, 2010	$80,021,000	25.9%	$20,132,000	6.0%
July 1, 2011	$89,006,000	28.1%	$21,108,000	6.0%
July 1, 2012	$90,363,000	30.3%	$18,968,000	6.0%
July 1, 2013	$95,606,000	32.4%	$19,530,000	6.0%
July 1, 2014	$101,325,000	30.3%	$20,089,000	6.0%

What we paid toward our annual pension bill credit card all the while racking up an increasingly overwhelming balance due. In our case Memphis taxpayers' "balance due" (unfunded liability) is now a staggering $700+ million. Bottom line: we've guaranteed a Cadillac plan and have been paying for a Chevy. It's that reality that puts the financial future of our government and our community at stake.

Many ask: 'Is this problem for real?' The numbers referenced above come directly from our financial advisors and actuaries from the well-respected firm Price Waterhouse Coopers (PwC). While our police and fire unions have retained their own actuaries and question some of the PwC numbers, even their numbers point to a serious problem, although based on their math, it's not as bad as PwC says. On the other side of the coin, the current thinking of many experts – including that of Moody's and the Government Accounting Standards Board (GASB) -- suggests the PwC assumptions have been significantly underestimated, that our problem is two to three times the size we've been told by PwC, and that this is largely due to PwC's overly "optimistic" estimates of market return rates. So at best, the PwC numbers fall in the middle of the two extremes.

If we don't fix our problems, the state will dictate our solution. Both the State of Tennessee Treasurer and state Comptroller have issued warnings to the City that we must address our pension problem or risk the state stepping in to dictate our solution. In an October 7, 2013 letter to me, Comptroller Wilson said "…we understand the City is in the process of…reforming its pension plan to address the significant unfunded obligations*. I would impress upon the City that it is imperative that it pursue those efforts with dispatch*." And our state Treasurer is working with legislators across the state to require governments to pay their pension bill at 100% - something we certainly must begin doing. However, I will be negotiating with Nashville for a five-year ramp up period so that we can get to our $100 million annual payment over five years, each year increasing our payment by approximately $15 million, rather than having to go from $20 million to $100 million immediately in FY 2015 which would be crippling for our government.

EVERYONE loses if we fail to change. First of all, while it may seem that status quo is good for our retirees and vested employees, the truth is that their futures are seriously at risk without change. They're counting on payments for which not enough money has been set aside (today we're $700+ million short) all while our pension obligations and funding gap continues to expand exponentially. There are plenty of recent cautionary examples of governments which, suffering under the weight of unfunded pension liabilities, have defaulted on obligations to retirees, and many state and local governments are on the brink. The recent ruling in the Detroit case which lifted pension protections should be a clear wake-up call that retirees are left vulnerable in the event of government financial duress.

Our neighborhoods, businesses and families are also at great risk. As pension payments consume an increasingly larger share of our total budget, core government services like policing, trash collection, parks, roads maintenance, community centers, youth programs and libraries get squeezed out. After services are cut to the bone to pay pension bills – making Memphis less attractive for citizens and businesses – property values will plummet bringing tax revenues down with them. Then there will be no way to honor pension obligations other than raising property taxes, which will further drive people and businesses from our city and which could trigger a cycle comparable to Detroit's.

This is not hyperbole. It is a very real possibility if we don't make changes to our pension plan. Thankfully there is still time to change our trajectory, and we must take steps immediately to do so.

A win-win solution, in two steps. That's why, with the City Council's help, we must take action now and I am recommending a two-step solution.

STEP ONE: **Stop the problem from getting worse.** With City Council's help, we will establish a new retirement system – called a Defined Contribution system – for all new employees and active employees with less than 10 years of employment. This change will NOT apply to retirees or "vested" employees (those on the job for 10 or more years) as changes to their benefits are currently not allowed by state law.

It is important to note, however, that the new plan won't start substantially reducing our TOTAL pension costs downward until about 10 years from now because our retirees and vested employees (3,707 people / 60% of recipients) are still receiving benefits under the original, very costly plan. This will continue for the next half century or so until the last wave of recipients has passed away.

That said, the change to a Defined Contribution pension plan will have significant medium and long-term positive impacts on our pension costs, and thus, it is a win for taxpayers and retirees dependent on the financial health of the city. The reasons I support the Defined Contribution plan above all others are these:

- First, a defined contribution plan is the only plan type that does not put taxpayers in the position of guaranteeing market returns like our current plan and all of the other alternative plans do. That means our retirement plan costs will finally become controllable and predictable, and under that model we will never again be vulnerable to recessions or bad years for the stock / bond markets.
- Second, a defined contribution plan is the only plan type that does not allow government to "kick the can" down the road on paying pension bills when they are due. EVEN if we begin paying our full "Annual Required Contribution" which we must and will do with City Council's help, our current plan and all of the other plans have built-in formulas that back-end load pension costs to years down the road – they are "IOU" models. Instead, the defined contribution model requires us to pay today's bills today – meaning we would be structurally protected against unfunded liabilities. And frankly government could use more of that discipline.
- Third, changing to a defined contribution plan will help reassure our rating agencies and state government officials that we are moving to more sound financial footing as a government, which then gives us more negotiating room when we have to set a schedule for beginning to pay 100% of our Annual Required Contribution (See Step Two).

Make no mistake though, the new Defined Contribution Plan is generous, and it's comparable to a 401k plan that most people in the private sector have if they are fortunate enough to work for a company that provides retirement benefits. The aspects of a Defined Contribution plan which make it a generous retirement benefit include the following:

- First, existing employees (including any vested employees who choose to move to the new defined contribution plan) will receive an *increase* in contribution amount from the City. In today's current system, the city contributes 6% of worker pay annually toward the City's defined benefit plan system. My new plan will increase the city's contribution to 8%, and put it directly into each employee's 457b account. For an employee paid $50,000 per year, that 8% amounts to $4,000 annually which would be paid *directly to her account*.
- Second, it begins Year 1 of employment. The employee gets her contribution from the City (the 8% of earnings) beginning year 1 of employment. In the current pension plan, an employee must be employed 10 years to qualify for retirement benefits.
- Third, it's portable. The employee owns the account in full -- all the money from the City, from her own savings, and from the investment earnings generated. It's hers from the beginning and she can take it all with her if she goes elsewhere, for example if she chooses a new employer or moves out of town. (Most people today don't stay with the same employer for life, or even for 10 years.) In the current plan, the employee does not own an "account" and loses her benefits if she leaves before the 10 year vesting period.
- And finally, payments owed are paid in full each year to the employee account, as with a paycheck. In the current plan a retiree pension benefit is an "IOU" for payments down the road although there is serious risk to later payments if the government gets into financial trouble, which we're seeing in Detroit, California, Central Falls, RI, and Pritchard, AL, just to name a few places that are seeing how pension benefits can be sacrificed to bail out insolvent governments.

This represents a win-win for taxpayers and employees and is why I'm recommending that City Council support this first step of adopting a new Defined Contribution plan.

STEP TWO: Start Paying Our Bills. As a result of STEP ONE, our pension bills are going to start getting smaller over time. But we still have a problem in the short run that must be addressed by different solutions.

Remember that we've not been paying our pension bills – and in fact this year we've allocated only $20 million toward a $100 million pension bill – an $80 million gap. The main contributing factor for this gap is that the defined benefit plan is inherently flawed, causing our pension bill to jump by $50 million in one year (2008-2009), making it very difficult for government leaders to find the money. Additionally, it was expected around that time that the balance owed to the school system would be eliminated in a judicial ruling and that these funds could be used to pay the pension bill and other things. That did not happen, but the fact remains: like many governments around the nation, we have a pension problem primarily because of the inherent problems with defined benefit plans.

Also remember that while we're changing to a defined contribution plan for new employees and active employees who've worked less than 10 years, we are obligated for the next 50+ years to pay the bills on the original pension plans of our retirees and vested employees (those on the job for 10 or more years).

So, step two is a plan for how to pay those bills. Not only must we for our own sakes begin paying our bills in full, we must also do so because the state is planning to require it.

I am currently in discussions with key state officials about giving us a little extra time – hopefully allowing us to develop a five-year plan increasing payment by approximately $15 million each year -- to address this funding challenge rather than immediately next year being required to pay the additional $80 million annually that the City owes toward our yearly pension bill.

Based on my conversations with state officials, I know that they will look favorably on a change to a Defined Contribution retirement plan and will be willing to then negotiate a five-year timeframe for ramping-up to pay our full bill. After completing that negotiation, I will then recommend to City Council in early spring a five-year plan of how we close that $80 million annual gap without raising taxes.

Thanks to the great work conducted over the past year by my team on the Five-Year Strategic Fiscal Plan, of which a draft was provided to City Council this summer, we have identified approximately $120 million in potential cost savings. I am confident that there is plenty of opportunity to pay our current pension bills through cost savings versus raising taxes, and I look forward to that discussion with Council members and citizens.

I am confident that this two step plan of action will get our community on a sound financial path for the future, but it will be neither easy nor painless. I ask the City Council to join with me in taking these important steps, and I would appreciate your support as citizens as we make the necessary changes to protect the financial health and future of our great city.

A C Wharton
Mayor, City of Memphis

Monday, December 16, 2013