CITY OF URBANA, ILLINOIS
FINANCE DEPARTMENT

M E M O R A N D U M

TO: Mayor Diane Wolfe Marlin and City Council Members

FROM: Elizabeth Hannan, Finance Director

DATE: May 24, 2018

SUBJECT: **Funding for Police and Fire Pensions**

Introduction: The purpose of this memo is to discuss a recommendation for addressing funding for Police and Fire pensions. Todd Schroeder, an actuary with Lauterbach & Amen, will be present to discuss the recommended funding plan and transition.

Discussion:

Components of a Pension Funding Policy: There are several basic components of a pension funding policy.

1. Actuarial Cost Method: The technique used to allocate the total present value of future benefits over an employee's working career.
2. Amortization Policy: The length of time and structure selected for increasing or decreasing contributions to systematically eliminate any unfunded liability or surplus.
3. Asset Smoothing: The technique used to recognized gains or losses in assets over a period of time to reduce the effects of market volatility and stabilize contributions.

Government Finance Officers Association (GFOA) Best Practices: The GFOA recommends the following –

1. Amortization Policy: Local governments should target 100% funding over a closed period of not more than 20 years.
2. Actuarial Cost Method: GFOA recommends using an actuarial cost method designed to fully fund the long-term cost of promised benefits, consistent with the objective of keeping contributions relatively stable and equitably allocating costs of the employee's period of active service. One method that meets this requirement is the "entry age normal – level percent of pay" method.
3. Asset Smoothing: Asset smoothing should be unbiased relative to the market and provide for smoothing to occur over fixed periods of five years or less.

City's Pension Funding History: Historically, the City has funded Police and Fire pensions based on the State law in effect prior to 2010, which required 100% amortization of unfunded pension liability by 2033. The funding amounts were calculated based on an entry age normal, level dollar formula, which is more aggressive than the level percent of pay formula. (At that time, the law did permit municipalities to use the level percent of pay calculation.) The City has always employed asset smoothing, consistent with best practices, so that issue is not explicitly discussed below.

Beginning in 2014, funding was reduced in two steps. First, when taxes were levied in 2014, the City Council approved a tax levy based on a level percent of pay formula, while still maintaining the 100% amortization by 2033. For the 2014 tax levy, this reduced the City's contributions by about $568,000 relative to the funding requirement under the previous method. This change was consistent with the best practices described above.

2014 Levy	100% by 2033, Level Dollar Amount (Used Prior to 2014)	100% by 2033, Level Percent of Pay (Used for 2014 Levy)	Difference
Police	$2,039,106	$1,619,190	($419,916)
Fire	$1,265,542	$1,117,736	($147,806)
Total	**$3,304,648**	**$2,736,926**	**($567,722)**

When taxes were levied in 2015, the City Council approved a tax levy based on the minimum amount required by State law, which is amortization of 90% of the unfunded liability by 2040. The State's calculation also uses the projected unit credit method, which tends to understate unfunded liability in earlier years, resulting in lower payments in early years and rapid increases in unfunded liability and contributions in later years. This resulted in an additional reduction in funding, reducing the City's contributions by about $1.28 million compared to the method used in 2014. This change was not consistent with the best practices described above.

2015 Levy	100% by 2033, Level Percent of Pay (Used for 2014 Levy)	90% by 2040, Projected Unit Credit (Used for 2015 Levy)	Difference
Police	$2,203,886	$1,209,795	($994,091)
Fire	$1,253,825	$970,292	($283,533)
Total	**$3,457,711**	**$2,180,087**	**($1,277,624)**

In total, over this two-year period, pension contributions were reduced by well over $1 million. While this allowed the City to balance its budget and pay for wage increases without significant reductions in service levels, the long-term implications of the new approach to pension funding implemented in 2015 are concerning. Pension costs can be expected to increase over time, with increases rapidly accelerating as we move closer to 2040. This funding strategy was also employed for tax levies in 2016 and 2017. When the FY2018 budget was proposed, the Mayor identified this a significant financial issue that would need to be addressed.

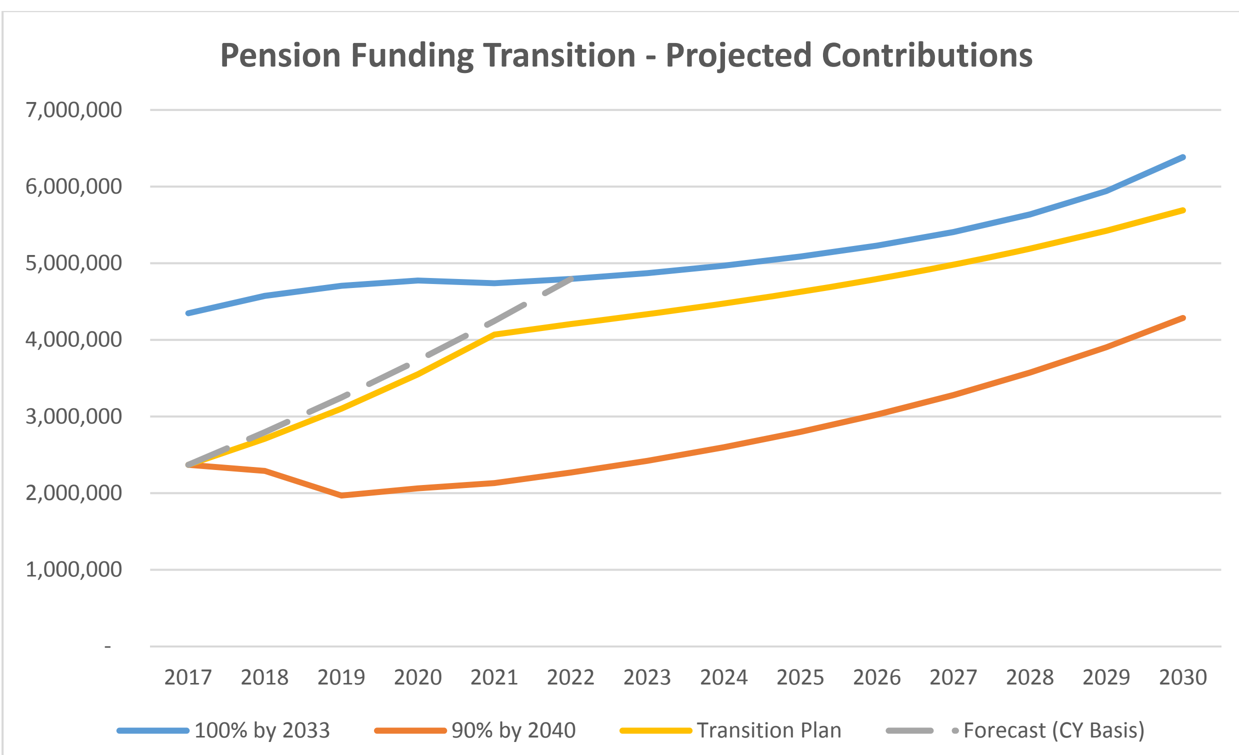
Impact of Funding Decisions on Unfunded Liability: The City's unfunded pension liability has increased from $15.4 million to $19.1 million for the Police Pension Fund and from $5.5 million to $9.6 million for the Fire Pension Fund, since 2014. This is a total increase of $7.8 million in the City's unfunded pension liability, over a relatively short period.

Funding Recommendation: The Finance Director has worked with the City's actuary to review various funding strategies in the context of the City's financial situation. Based on a balance between City's financial situation, consideration of the long term impact of various funding strategies, and best practices, the following strategy is proposed –

1. Amortization Policy: Amortize 100% of the unfunded liability over a 20 year period, with a five year transition, beginning with the 2018 tax levy
2. Actuarial Cost Method: Use an entry age normal, level percent of pay method.
3. Asset Smoothing: Continue the current practice of smoothing assets over a five-year period.
4. Review of Funding Policy: Because contributions will become more volatile as we move closer to being fully funded, the City should review the funding policy before taxes are levied in 2028, which is half way through the 20-year period for amortization of unfunded liability.

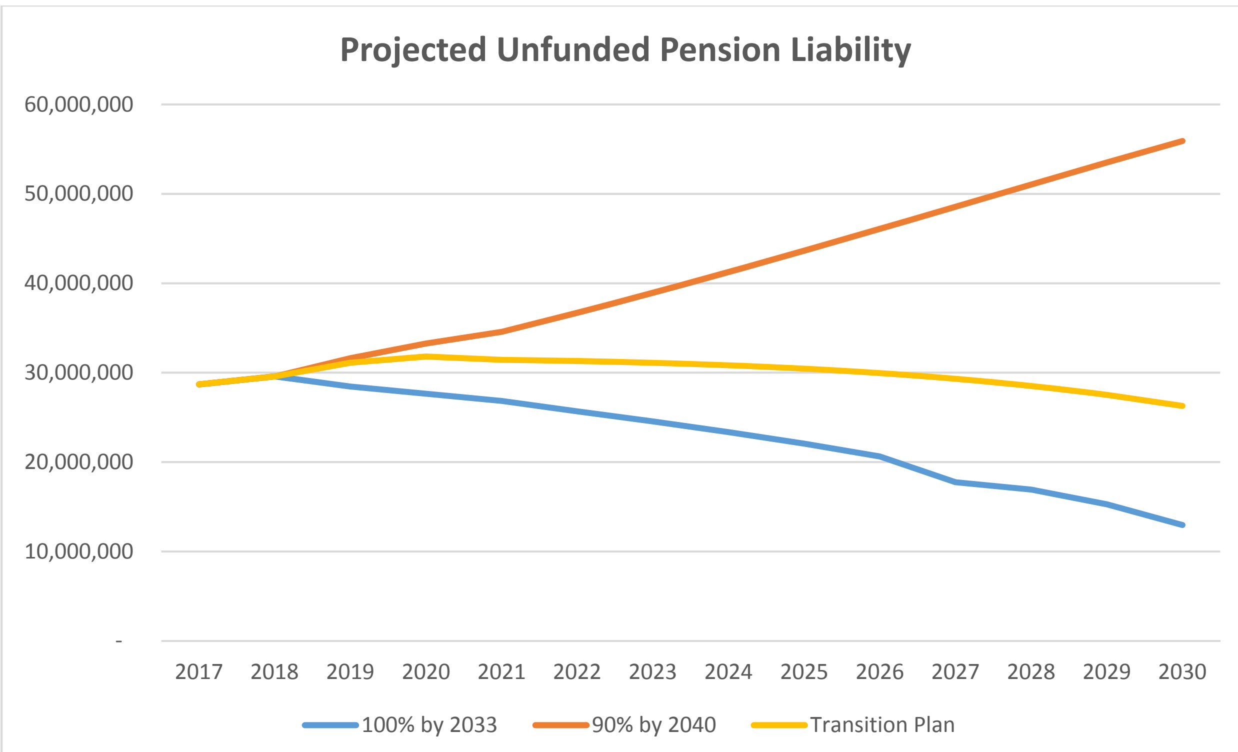
The Finance Director reviewed this recommendation with the Mayor, and then with the Police and Fire Pension Boards on April 27. Both boards passed motions supporting this funding policy and indicated that they view it as significant progress towards adequately funding the City's pension obligations. They expressed thanks for the City's willingness to address this issue, particularly given the City's current financial situation.

The following chart illustrates the pension funding requirements (for both funds combined) under the old 100% by 2033 funding plan, the current 90% by 2040 plan, and the transition scenario. The gray, dashed line represents the pension funding that was incorporated into the 2018 Financial Forecast.



The transition plan shows contributions increasing rapidly over four years, and then reverting to a more steady level of growth. During the five-year transition period, the increases closely track with the Financial Forecast. Contributions under the 90% funded by 2040 scenario are beginning to grow more rapidly, but are still lower because in this scenario the obligations will never be 100% funded. The transition funding plan contributions remain less than the 100% by 2033 scenario because the time frame for funding the unfunded liabilities is extended.

The following chart illustrates the impact of the various funding scenarios on the unfunded pension liability, again for both funds combined.



As you can see, in the transition plan scenario, unfunded liabilities level off and then begin to decrease, although not as quickly as in the 100% funded by 2033 scenario. However, in the 90% by 2040 scenario, unfunded liabilities rapidly increase, reaching nearly $66 million by 2030. By 2030, unfunded liabilities are $13 million in the 100% by 2033 scenario, and $26.3 million in the transition plan scenario. Adopting the proposed approach results in an unfunded liability in 2030 that is $29.6 million less than it would be if we continue with the current approach.

Alternatives:

1. Adopt a revised set of Financial Policies, which are consistent with the recommended strategy for funding Police and Fire pensions, and adopt the annual budget, which anticipates levying taxes in 2018 consistent with the recommended approach.
2. Do not adopt this recommendation and provide further direction to staff on developing an alternative funding policy.

Recommendation: Direct staff to proceed with Alterative 1. The City Council will be asked to approve a revised policy on pension funding on June 18, when the budget is adopted, and staff will prepare the 2018 property tax levy consistent with the revised policy.

Fiscal Impact: This recommendation is consistent with maintaining the City's long-term fiscal health. As discussed when Council reviewed the 2018 Financial Forecast, we anticipate that a total of $2.5 million in budget reductions or revenue increases will be required over a period of several years. That recommendation was driven, in part, by the need to address pension funding issues.

CITY OF URBANA, ILLINOIS
FINANCE DEPARTMENT

M E M O R A N D U M

TO: Mayor Diane Wolfe Marlin and City Council Members

FROM: Elizabeth Hannan, Finance Director

DATE: May 24, 2018

SUBJECT: **Updates to Financial Policies**

Introduction: The purpose of this memo is to discuss recommended changes to the City's Financial Policies.

Discussion:

Proposed Changes to Financial Policies: Two changes to the City's Financial Policies are proposed. These changes are included in the strikeout version of the policies, which is attached.

1. Pension Funding: As discussed in a separate memorandum regarding Police and fire pension funding, changes are recommended in Section V. A. "Property Taxes" consistent with that recommendation.

2. Balanced Budget: Section III. "Balanced Budget" would be revised to indicate that the City's budget is balanced if recurring expenditures do not exceed 98.5% of budgeted recurring revenues. This provides increased capacity to deal with revenue fluctuations, including any reduction in State shared revenues, without having to make immediate budget reductions. It also allows for a margin of error in budgeting for revenues. While recurring expenditures in the proposed budget for FY2019 are slightly higher than this level, this appears to be achievable for FY2020. This is consistent with one of the recommendations made at the time the City Council reviewed the Financial Forecast.

A strikeout version of the policies is attached.

Alternatives:

1. Adopt the revised Financial Policies as proposed.

2. Do not adopt the Financial Policies as proposed and provide further direction on desired changes.

Recommendation: Adopt the Financial Policies as proposed. The resolution (which is included on page 189 of the proposed budget document) would be presented for City Council approval with the budget on June 18.

Fiscal Impact: This recommendation is consistent with maintaining the City's long-term fiscal health.

FINANCIAL POLICIES

I. **Purpose:** Financial policies establish goals and targets for the City's financial operations. Formal policies provide for a consistent approach to planning and budgeting, and support the City's long-term financial stability.

II. **Long-term Planning:** Each year the City's Finance Department will prepare a five-year financial forecast for the City's General Operating Fund to assess the City's future fiscal condition. The purpose of the forecast is to give context to decisions that will be made in the budget process.

III. **Balanced Budget:** The City considers the budget to be balanced if budgeted, recurring expenditures in the General Operating Fund do not exceed 98.5% of budgeted, recurring revenues. In other City funds, unless specific reserve targets have been established, expenditures will not exceed the total of budgeted revenues and unassigned fund balance at the beginning of the year.

IV. **Reserves:** The city will maintain adequate reserves to establish a cushion of available cash during economic downturns, finance cash flow needs, provide stable tax rates, and provide for unanticipated needs or unexpected opportunities.

A. **General Fund:** The City will maintain reserves of approximately 15% of recurring expenditures in the General Operating Fund. This is in addition to any reserve that is established for a specific purpose. The reserve will be depleted below 10% only in the event of a catastrophic need. If the reserve dips below 15%, the Finance Director will recommend a strategy to replenish the reserve over a period of no more than three to five years.

This level of reserve is appropriate given-

- the City's reliance on cyclical revenue sources (e.g., sales tax)
- the reliance of other funds (e.g., Retained Risk and Capital Improvements) on the General Fund as a source of revenue
- the current backlog of unmet capital needs, which could result in an immediate demand for funds due to infrastructure failures
- the potential for unavoidable cost increases imposed by the State of Illinois
- concerns about the potential impact of the State's fiscal situation, including potential reductions in State-shared revenues

B. Vehicle & Equipment Replacement Fund: The City will maintain adequate reserves for planned replacement of capital equipment. Annual charges will be made to various operating budgets at 90% of calculated straight-line depreciation for each capital asset accounted for in this fund. The replacement schedule will be updated on an annual basis. A capital asset is defined as equipment with an initial purchase price of $5,000 or more and a useful life of 5 years or more.

Other funds, including the Landscape Recycling Center Fund and the Equipment Services Fund, may retain reserves for equipment replacement separate from the Vehicle and Equipment Replacement Fund. Adequate funds will be reserved in fund balance for planned equipment replacement.

C. Retained Risk: Retained Risk Fund reserves will be maintained to provide funding in the event of large workers compensation and liability claims. The reserve amount will be established based on a periodic actuarial review. Annual transfers will be made from operating budgets to support risk management activities such as insurance premiums and routine claims, as well as to replenish the reserve, when necessary. Reserves will be replenished over time to minimize impact on the operating budget.

V. Property Taxes: The City's goal is to maintain a property tax rate equal to that of the City of Champaign, and to work with overlapping taxing districts to create an overall tax rate equal to the City of Champaign.

A. Pension Funds: The City will levy property taxes to provide funding for ~~pensions consistent with State of Illinois law, which requires 90% funding by 2040.~~ a 20-year closed period amortization of 100% of unfunded liability, including a five-year transition to the higher funding level, beginning with the 2018 property tax levy. Contributions will be calculated using the entry age normal (level percent of pay) method. Asset smoothing will be used over a five-year period to reduce the effects of market volatility. 8.12% of the pension funding requirement will be allocated from personal property replacement tax, also consistent with State law.

Prior to levying taxes in 2028, staff will recommend to the City Council an appropriate strategy to minimize volatility as the funds move closer to the goal of being fully funded.

B. Library General Fund: The City levies property taxes for the Library to support operations, which are funded from the Library's General Fund. The City Council approves the Library's budget, including estimated property tax revenues necessary to support the expenditure budget. When the City Council approves the property tax levy, it will include a levy sufficient to support the approved Library General Fund budget. (The City also allocates a portion of the Ameren franchise fee to the Library, based on the Library's proportionate benefit from free gas therms provided by Ameren prior to the franchise agreement approved in 2015. This allocation will continue in the same proportion.)

C. Corporate Tax Levy: Remaining funds that can be raised within the City's target tax rate will be allocated to the General Operating Fund to pay for public safety services.

VI. Capital Improvements: Capital improvements are defined as a project or activity costing more than $10,000 resulting in construction, renovation, or acquisition of land, infrastructure, or buildings, with an expected life of at least 10 years.

A. Capital Improvement Fund: The Capital Improvement Fund is used to pay for capital improvements that do not have another source of funding, or for which other sources are insufficient. The City's goal is to increase funding for capital improvements each fiscal year by at least the amount of increase in the construction cost index for the prior calendar year. This funding is to be used only for the purpose of funding capital improvements.

As the budget allows, the City will consider additional one-time transfers to provide additional funding for infrastructure maintenance and improvements; or increasing the base level of the recurring transfer to provide a stable, ongoing source of funding.

B. Stormwater and Sewer Improvement Funds: These enterprise funds are established to provide ongoing funding for maintenance and improvements to the City's stormwater and sanitary sewer systems. Fees will be established to provide funding consistent with long-term plans for operation and maintenance of these systems.

C. State and Local Motor Fuel Tax Funds: These funds are reserved for transportation improvements.

VII. **Debt:** The City may use long-term borrowing for capital projects that cannot be funded from current resources, when the improvements have a useful life of 25 years or more. Debt maturities will not exceed the useful life of the improvement. Combined debt service payments will not exceed 10% of recurring General Operating Fund revenues, regardless of the source of repayment. The City will generally use bank qualified bonds because of the lower cost of borrowing and reduced administrative burden.