July 13, 2023

To: Mayor and Members of City Council

From: Cincinnati Retirement System Board of Trustees

Copy: Sheryl Long, City Manager

Subject: Cincinnati Retirement System CY2022 Annual Report

This report is from the Cincinnati Retirement System (CRS) Board of Trustees (Board) and provides the City Council with the state of the CRS Pension Trust and Healthcare Trust. This summary report, together with the CRS Financial Report, is intended to provide a comprehensive summary of the status of the Cincinnati Retirement System, in compliance with the CRS Board's reporting requirements as set out in the City's Administrative Code and Board Rules. The report is as of December 31, 2022. For additional information, please see the City's Annual Comprehensive Financial Report, Actuarial Valuations, and Investment Results on the CRS website.

The CRS is governed by the Collaborative Settlement Agreement (CSA). Under the CSA, the CRS Pension Trust is to be 100% funded by 2045. Under the CSA, the Healthcare Trust is to be 100% funded through 2045.

Given the current and projected funding positions of the Pension Trust, we recommend that the City Council continue to take action to increase the funding of the Pension Trust. In addition, we recommend that the City Manager continue to work with class counsel to finalize a funding policy for the Healthcare Trust. The City's municipal code requires that the City obtain input and recommendations from the CRS Board for the funding policy.

Background

The purposes of the CRS Pension Trust and Healthcare Trust are to provide promised retirement benefits and healthcare benefits to eligible retired city employees. CRS is a defined benefit plan that was established in 1931. The Collaborative Settlement Agreement (CSA) was approved in 2015 to settle litigation and provide a comprehensive strategy to stabilize CRS while securing sustainable and competitive retirement benefits for both current and future retirees.

As of December 31, 2022, there were 2,875 full-time active members (which includes 157 members in the DROP plan who are still working), 4,148 pensioners receiving pension payments, and 4,762 pensioners and spouses receiving healthcare benefits. The CRS Board serves as an independent fiduciary on behalf of active and retired members of the retirement system. The Board retains Marquette Associates, an independent investment consulting firm, and Cheiron, a pension and healthcare actuarial consulting firm, both of which specialize in public sector retirement plans. Marquette and the Board have developed and follow a disciplined investment policy that can be found on the CRS website. Cheiron calculates the actuarial value of assets and liabilities and projects the funded status of the Trusts in future years based on professional actuarial standards and practices.

The assumed investment rate of return and discount rate for calculating liabilities is 7.5% per year as prescribed in the CSA. The annualized capital market rates of return for the past 5 and 10 years as of December 31, 2022, were 5.43% and 7.32%, respectively. CRS investment performance is at or above the median of peer public defined benefit retirement plans.

The table below highlights the actuarial value of assets, liabilities, and funded ratios as of 12/31/22:

	Assets	Liabilities	Funded Ratio
Pension			
Actuarial Value	$ 1,811,291,262	$ 2,614,702,553	69.3%
Market Value	$ 1,703,876,000	$ 2,614,702,553	65.2%
Health			
Actuarial Value	$ 532,169,108	$ 363,450,123	146.4%
Market Value	$ 500,041,000	$ 363,450,123	137.6%

Pension Trust

A goal of the CSA is to establish a projected 100% funding ratio in 30 years (i.e., by 12/31/2045). The assumptions used in finalizing the CSA projected that the Pension Trust would be fully funded in 30 years if all of the assumptions played out exactly. The status of the annual contributions and distributions is described below:

- The active employees contribute 9% of covered payroll to the Pension Trust as required by the CSA.
- The City contributes the minimum rate per the CSA of 16.25% of full-time covered payroll to the Pension Trust. (The General Fund represents 35% of covered payroll and other non-general funds represent 65% of covered payroll.).
- In CY2022, the City contributed a payment of $2.76 million as result of the continued payments toward the cost of the 2020 Early Retirement Incentive Plan (ERIP). There are now 13 annual payments remaining. Cheiron estimates that payment at 1.33% of payroll for this additional benefit, bringing the City's contribution rate for CY2022 to 17.58%.
- In CY2022, the City also contributed a lump sum payment of $2.0 million dollars from the General Fund fiscal year-end surplus. Cheiron estimates that payment at 0.96% of payroll for this additional benefit, bringing the City's contribution rate for CY2022 to 18.54%.
- The Actuarially Determined Contribution (ADC) for the Pension Trust, as calculated by the actuary, is the annual employer contribution amount required to bring the Pension to a fully funded status in 30 years. **The ADC for FY2022 was 33.46% of covered payroll (as set by the CY2021 actuarial valuation). The actual contribution of 18.54% means the City contributed 55.4% of the actuarial recommendation.**
- Benefit payments and expenses have significantly exceeded employer and employee contributions for over a decade placing CRS in the bottom quartile among other public pension funds with negative cashflows. This means that CRS continues to liquidate a relatively large amount of assets to pay for benefits and expenses. This also means that CRS is much more dependent on investment returns than most public pension plans.

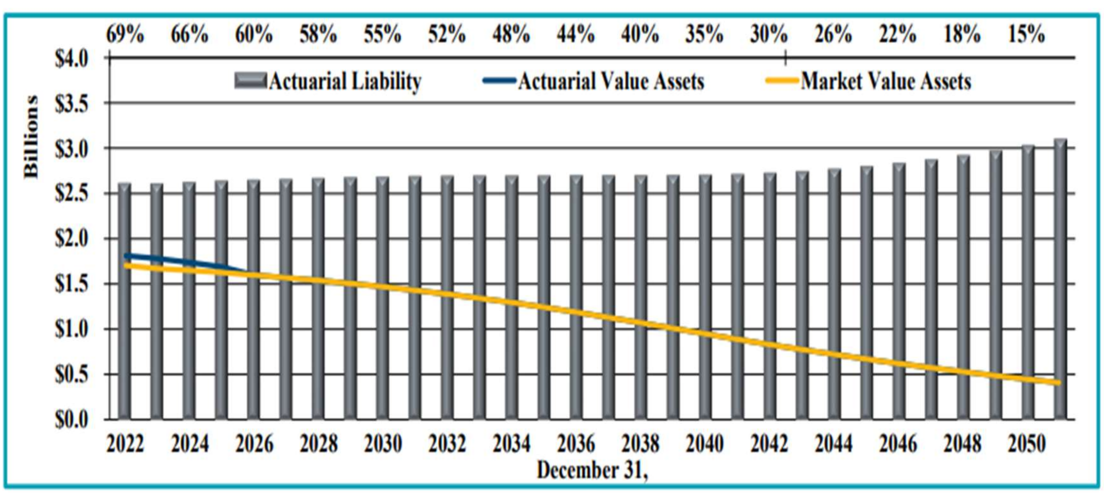
The following events occurred after the CSA was finalized:

- Ordinance 336, which reflects changes made in finalizing the CSA that increased liabilities, was approved by City Council in 2016.
- Revisions to actuarial assumptions (e.g., longer life span of retirees) occurred as recommended by the actuary and approved by the CRS Board.
- Annualized 5-year investment returns (2018 – 2022) were 5.43% as of December 31, 2022 vs. the assumed 7.5%. However, CRS is especially sensitive to the timing of capital market swings because it continues to liquidate assets to pay benefits when the capital market drops. This requires more time and a significantly higher rate of return for the remaining assets to recover from capital market volatility.
- The City offered the ERIP in 2020 that provided two (2) additional years of service to eligible participants resulting in earlier retirements, additional benefits, and an increase in liabilities.
- The Deferred Retirement Option Plan (DROP) established in the CSA is required to be cost neutral.

The actuary's latest revised funding progress for the Pension Trust, which includes the impact of the DROP and the ERIP, projects the funded ratio on an Actuarial Value of Assets basis is projected to decrease over the next 30 years and will not reach 100% by 2045 in accordance with the CSA.

The graph below reflects the City's minimum required contributions of 16.25% of covered payroll for 30 years. It also includes the recommended budget's $2.7 million contribution per year for the next 15 years to pay for the ERIP liabilities and assumes the CSA benchmark return of 7.5% investment return for all future years. The funding ratio declines precipitously over 30 years to near-insolvency.

Pension Trust

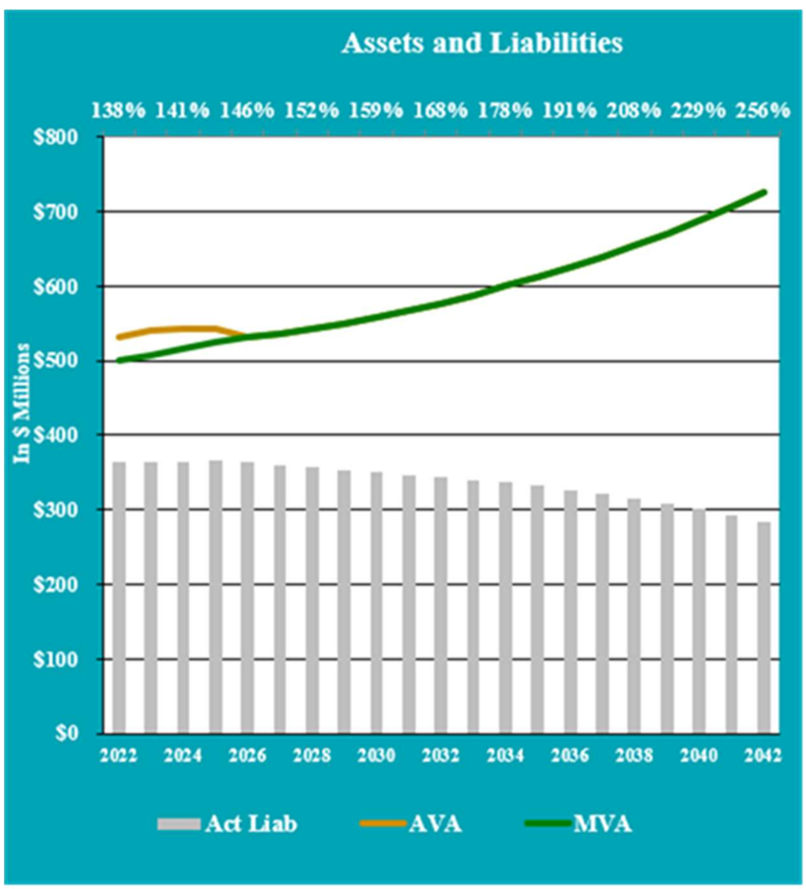


Healthcare Trust

At the time of the CSA signing, the Healthcare Trust was fully funded, and the City was required per the CSA to develop and present a proper funding policy to fully fund the healthcare trust at actuarially appropriate levels. The funding policy would keep the Trust fully funded over the lifetimes of current and future retirees and their beneficiaries covered by the CSA. Implementation of a full funding policy will ensure that the Healthcare Trust remains fully funded to provide promised benefits. The Healthcare Trust is irrevocable, and its assets must be used exclusively for healthcare benefits for CRS retirees and their beneficiaries. The City has yet to adopt a Healthcare Trust funding policy as required by the CSA and there have been no City contributions to the Trust since the CSA was signed.

In the graph below, the bars represent liabilities, and the lines represent the actuarial value of assets (AVA) and the market value of assets (MVA) assets. The graph shows that the Healthcare Trust is fully funded in 2022 and beyond. This is based on current assumptions being fully met. A funding policy would safeguard the trust for retirees and their beneficiaries in the future should the assumptions not be achieved.

Healthcare Trust



Investment Performance

While the simple conclusion may be to achieve higher returns or "invest our way out of this," CRS' investment performance has been solid relative to what the capital markets have provided. The 7.5% annualized return assumption remains a high hurdle as well as optimistic given persistent capital market volatility and the outlook of many investment consultants. The median investment return assumption of U.S. public retirement systems has steadily decreased over the past several years and is currently 7.0%. CRS will be challenged to achieve the 7.5% rate of return with an acceptable level of risk going forward, especially given the high negative cash flow.

The following chart reflects the annual rates of return and 10-year compound return. CRS has achieved the 7.5% CSA assumption. The poor capital market performance in 2022 has resulted in a five-year compound return that is less than the 7.5% CSA assumption.

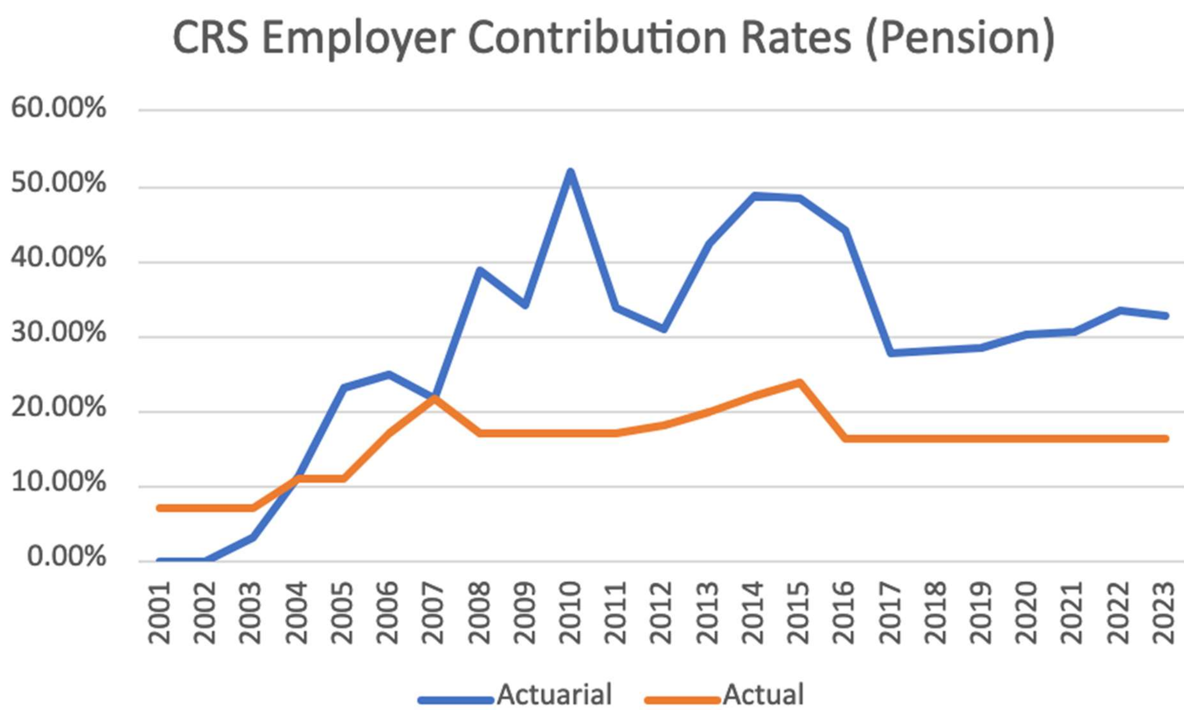
Annual CRS Rates of Investment Return		
Plan Year	Investment Return Assumption	Market Return
2013	7.50%	16.99%
2014	7.50%	6.46%
2015	7.50%	-0.11%
2016	7.50%	9.24%
2017	7.50%	14.51%
2018	7.50%	-3.93%
2019	7.50%	16.40%
2020	7.50%	8.03%
2021	7.50%	18.06%
2022	7.50%	-8.68%
10-Year compound Average		**7.32%**
5-Year Compound Average		**5.43%**

The Board's Investment Policy provides for a well-diversified portfolio across asset class, sector, investment managers and securities. The chart below is designed to achieve the 7.5% return over time with an acceptable level of risk.

CRS Asset Allocation	
Fixed Income	25.5%
Domestic Equity	28.5%
Non-US Equity	18.0%
Real Estate	7.5%
Infrastructure	10.0%
Volatility Risk Prem	2.5%
Private Equity	8.0%
Total	100.0%

Employer Contributions

In a defined benefit retirement plan such as CRS, the employer is responsible for providing benefits (as opposed to a defined contribution plan) and the employer generally accepts the financial risk. The Actuarially Determined Contribution (ADC) is the actuary recommended employer contribution to achieve full funding in 30 years. The chart below reflects the Pension Trust ADC and the City employer contribution for the last 20 years. By not contributing to the ADC the unfunded liability increases over time meaning that the actuarial liability exceeds the value of assets.



Conclusion

The CRS Pension Trust and Healthcare Trust are undoubtedly challenged in providing promised retirement benefits. When the Collaborative Settlement Agreement was implemented, the Pension Trust and Healthcare Trust were projected to be fully funded in 30 years by 2045. For the Pension Trust this is no longer the case.

At the close of 2022, the Pension Trust experienced major capital market losses. The Actuarial Value of Assets decreased $20.66 million from the prior year close, the annual investment return was a -8.68% and the funding ratio on an AVA bases dropped 2.3%. Funding vigilance therefore remains a priority for the Board. The future of the Health Care Trust is also uncertain due to the lack of a funding policy as required by the CSA.

The following are possible solutions:

1. Continued increases to City contributions to the Pension Trust above the minimum required amount of 16.25%, as provided for in the CSA. The Board has formally recommended an increase in rates by 1.5% each year until the actuarial projections reflect anticipated full funding by 2045. The Board also recommends that the City adopt the multi-year incremental increase funding methodology to achieve full funding by 2045, update the methodology annually, and budget accordingly. The Board acknowledges and appreciates the 0.75% increase in the contribution rate and the use of variable General Fund carryover to reduce unfunded pension obligations. Nonetheless, a more stable and predictable path to full funding is necessary. Failure to increase the City's annual contribution rate will result in the CRS Pension Funded Ratio steadily decreasing until it reaches 28.5% in 2045; alternatively, incremental increases in the rate are required to achieve 100% funding by 2045 based on the most recent projection:

Incremental Increase Plan

Schedule of Funded Ratios	Earnings Assumption = 7.5%			
	Flat E'r Rate of 17%		Increase E'r Rate by 1.5%	
	E'r Contr Rate	Funded Ratio	E'r Contr Rate	Funded Ratio
12/31/2022	16.25%	69.3%	16.25%	69.3%
12/31/2023	17.00%	68.2%	17.00%	68.2%
12/31/2024	17.00%	66.2%	17.00%	66.2%
12/31/2025	17.00%	64.1%	18.50%	64.2%
12/31/2026	17.00%	60.5%	20.00%	60.8%
12/31/2027	17.00%	59.3%	21.50%	60.0%
12/31/2028	17.00%	58.1%	23.00%	59.4%
12/31/2029	17.00%	56.8%	24.50%	58.9%
12/31/2030	17.00%	55.4%	26.00%	58.6%
12/31/2031	17.00%	54.0%	27.50%	58.5%
12/31/2032	17.00%	52.5%	29.00%	58.6%
12/31/2033	17.00%	50.9%	30.50%	59.0%
12/31/2034	17.00%	49.3%	32.00%	59.7%
12/31/2035	17.00%	47.6%	33.50%	60.8%
12/31/2036	17.00%	45.8%	35.00%	62.2%
12/31/2037	17.00%	43.8%	36.50%	64.1%
12/31/2038	17.00%	41.9%	38.00%	66.5%
12/31/2039	17.00%	39.9%	39.50%	69.5%
12/31/2040	17.00%	37.8%	41.00%	73.1%
12/31/2041	17.00%	35.8%	42.50%	77.4%
12/31/2042	17.00%	33.9%	44.00%	82.5%
12/31/2043	17.00%	32.0%	45.50%	88.5%
12/31/2044	17.00%	30.2%	47.00%	95.3%
12/31/2045	17.00%	28.5%	48.50%	103.0%
Cheiron Projection, May 2023				

2. Increase investment performance by increasing risk. There are several strategies affecting increased investment return. These include using different investment managers, making a riskier asset allocation, and attempting to lower fees. There is little we can do regarding these factors because we believe we have the appropriate managers, the appropriate asset allocation, and fees are already on the low end. Regarding asset allocation, the only way to increase expected returns in the future is to lower the fixed income allocation and add more to equities or other "riskier" assets. Investment performance has been solid over time and the risk level of the portfolio is already aggressive relative to our peers. The Board and the investment consultant believe that taking any more risk would be imprudent. Conversely, taking less risk would decrease our chances of achieving the 7.5% target.
3. Reduce benefits. While unpopular and considered the last resort, reducing benefits would require re-opening the CSA for a prolonged negotiation.
4. As the City has done before, explore issuing judgment bonds to reduce the unfunded actuarial liability. As of 12/31/2022, the unfunded actuarial liability for the Pension Trust was $803.4mm.

Recommendation

At this time, we recommend the following:

1. That City Council adopt a plan to continue increasing the Pension Trust employer contribution incrementally on an annual basis to o assure full funding in 2045 (see table, page 8)
2. That the Incremental Annual Increase Plan be updated every two years in anticipation of the City's fiscal year biennial budget.
3. That the City Council approve and appropriate the Pension Trust employer contribution in accordance with each updated Incremental Annual Increase Plan.
4. That the City Manager continue to negotiate the Health Funding Policy with class counsels, consider the input and recommendations from the CRS Board, and that the City Council approve the funding policy for the Healthcare Trust to ensure that the promises to CRS members will be met well into the future. The Healthcare Trust was well funded as of the December 31, 2022, valuation and does not now require an ADC amount but may in the future.
5. That the City comply with the CSA to assure that the DROP program is cost neutral to the CRS Pension Trust and does not negatively impact the CRS Funding Ratio.

Immediate action is requested. Further delays will result in higher contributions in future years.