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June 23, 2009

Ms. Daisy Madison
Chief Financial Officer
City of Chattanooga
100 East 11th Street, Room 302
Chattanooga, TN 37402

Re: Funding Policy Options

Dear Daisy:

As requested, we are preparing this letter to address the implications of contributing amounts to the Chattanooga General Pension Plan Fund (the Fund) that are less than the actuarially determined amounts.

Any contribution strategy which involves contributing an amount not equal to the actuarially determined amount will create accounting issues. Specifically, contributing amounts lower than the Annual Required Contribution (ARC) will increase the City's Net Pension Obligation (NPO).

Funding Strategies

To ensure proper funding of the Plan and benefit security for its participants, the City should contribute annually to the Fund an amount based on the actuarially determined contribution rates. This rate was 6.31% of payroll as of January 1, 2008 (for 2009 contributions). As of January 1, 2009 (for 2010 contributions), the rate increased to 12.45%, implying a contribution of $7.4 million. This increase was due almost entirely to investment losses experienced by the Fund during 2008.

If the City is unable to make the contribution in any given year, there are options to move towards actuarial funding more gradually. Two of these options are explained below.

Apply Prior Year Rate

Applying the prior year contribution rate for 2010 contributions would entail a contribution of approximately $3.75 million to the Fund. There are no advantages to this approach for the Plan itself; however, the temporary advantage to the Plan sponsor is obvious.

There are several disadvantages to this approach, most notably the following:

1. The current underfunded position of the Plan will not improve. The ratio of Market Value of Assets to Actuarial Accrued Liability as of January 1, 2009 was 66%. By contributing the actuarially determined contribution, this ratio would gradually improve, but contributing significantly less will cause the ratio to decrease even in the absence of other actuarial losses.

2. The actuarially determined rates for years after 2010 will be higher than they would have been, most likely causing an eventual spike in contributions.

Limit the Annual Increase in Contribution Rate

Another possible contribution strategy is to increase the contribution rate, but to limit this increase to a certain percentage. For example, if the limit were 25% and the prior contribution rate were 10.0% of payroll, then the maximum new rate would be 12.5% of payroll.

If this approach is adopted, we recommend a maximum annual increase level of 20% or higher. While not as desirable as full actuarial funding, this approach does offer significant advantages over the “prior rate” approach describe above, aside from improved budgeting capabilities:

1. Funding will improve more rapidly, and the risk of more severe underfunding is lessened.

2. A sharp increase in the contribution rate in any given year is avoided.

3. A rate that is increased by 20% per year will generally “catch up” to the actuarially determined rate over a period of 4 – 10 years.

The following table shows the contribution rates and estimated amounts over the next five years according to this approach.

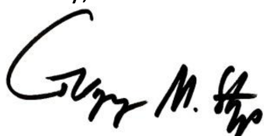
Year	Contribution Rate	Projected Contribution	Notes
2010	**7.57%**	**$ 4,500,000**	**Actuarially determined contribution rates would apply in any year that they are less than the rate shown in this schedule.**
2011	**9.08%**	**5,600,000**	
2012	**10.90%**	**6,900,000**	
2013	**13.08%**	**8,500,000**	
2014	**15.69%**	**10,500,000**	

Recommendations and Conclusion

Our primary recommendation for the contributions to the Fund for 2010 is that the contribution rate be increased. The first preference would be to increase the rate to the actuarially determined rate of 12.45% of payroll. A “second best” approach would be to increase the rate by 20% (from 6.31%) to 7.57% of payroll for 2010, then follow the schedule shown above, unless the actuarially determined rate in any given year is lower than what is shown in the schedule.

Please contact me with any questions or if you would like to further discuss.

Sincerely,



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