City of Alexandria, Virginia

MEMORANDUM

DATE: APRIL 2, 2010

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER

SUBJECT: BUDGET MEMO # 44 : UPDATE ON RECENT CHANGES TO THE VIRGINIA RETIREMENT SYSTEM (VRS)

This memo is provided to update City Council on the recent changes made to VRS by the Virginia General Assembly, and to address Councilman Fannon's question regarding the savings that would result from a shift of one percent of VRS contribution rate from the employer to the employee. During the March 23, 2010 City Council meeting Bernie Caton, Legislative Director, and the City's State delegation summarized the relevant changes to VRS. (See Attachment 1 for specific details on these changes). In brief, those changes are: 1) raising the normal retirement age, 2) increasing the length of the average final compensation period, 3) permitting local jurisdictions to require future plan participants to contribute 1% - 5% of salary, and 4) adjusting the Cost of Living Adjustment provisions. All of these will diminish the value a future employee receives from the pension plan. The implications of these changes to the City workforce as well as the City budget are discussed below.

The VRS legislation is pending awaiting action by the Governor. He can sign the legislation (included in a bill and the state budget), suggest amendments, or veto it (very unlikely). If he recommends amendments, the General Assembly must accept or reject them at its veto/reconvened session on April 21. It is unlikely we will know what the Governor proposes until the week of April 12.

Deferred Budget Impact

Each biennium VRS provides the City with a required contribution rate for covered employees. Beginning in FY 2012 VRS will provide one rate composed of two parts: a rate for those becoming plan participants prior to July 1, 2010 and another for those hired on or after July 1, 2010. The second rate will lead to cost savings. However, the budget savings will not occur all at once but instead be phased in over a period of time.[1]

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[1] Reasons for this include: (1) New hires will be phased in over time and tend to have lower salaries than the average employees; (2) the recession will slow the rate at which new hires will replace pre July 1, 2010 employees; and (3) the July 1, 2012 VRS contribution rate will be set using June 30, 2011 data, further reducing the impact of the lower cost employees.

Deferred Impact on the Workforce
Ten or fifteen years from now changes to employee benefits for future plan participants will create a significant number of employees with lesser benefits than their coworkers. Because employees rarely give much consideration to retirement when they are first hired, this issue is not likely to be a major concern in the near term. As new employees near retirement though, future City Councils may be faced with requests to balance the differing benefit packages amongst employees. If future Council's elected to do so, there would be financial implications to future City budgets.

Shifting VRS Costs to Employees
Local employers who are members of VRS, including local governments and school boards, will have the authority to require employees hired after July 1, 2010, to pay from 1 to 5 percent of their salaries toward their retirement benefits. Language in the State budget also allows local governments and school boards, if they choose to do so, to require their current employees to pay between one and five percent of their salary toward their VRS benefits.[2] (Attachment 2 includes preliminary guidance from VRS regarding the implementation of this new policy).

Each one percent of the contribution rate that the City pays to the Virginia Retirement System is budgeted at approximately $1.16 million. The salary expenses for full time general government employees applicable to the VRS contribution rates are approximately $116 million.[3]

Demographic Impact
People generally retire for one of two reasons, 1) they are eligible, or 2) they can afford to. If benefits are reduced, deferred, or otherwise inaccessible then many employees will defer retirement. Also, changing the early retirement eligibility from age 50 to 60, creates still another reason employees will leave employment at a later date than current rules permit. A potential unintended consequence of the VRS cost savings may be to create a more aged workforce in the long run.

Impact Concentrated on New Employees
Other than VRS, several changes made to employee benefits in prior City budgets have reduced benefits for new hires. These include having new (post July 1, 2009) General Salary employees pay 2% into the City Supplemental Retirement Plan, grading benefits to retiree health insurance so that a full 25 years of service is required for full benefits, and reducing the City contribution for group life insurance to 1 times salary (down from 2 times salary). When taken as a group the combination of these cuts, when added to the VRS changes, is significant for new City employees.

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[2] Please note that changes to employee contribution rates must include all VRS covered employees, meaning no exemptions are permitted for Sheriff's Deputies, Fire Marshals or EMTs.

[3] Although the City's total All Funds personnel costs are $248 million, only a portion of this is subject to the VRS contribution rate. The rate is applied only to employee salaries, not any other personnel costs, such as benefits. The City currently has seven retirement plans, including the VRS plan, which covers the general government employees. Sworn Police and Fire employees are covered under a separate plan with separate contribution rates. Although every City employee working at least 20 hours per week is eligible for the supplemental retirement plan, only full time employees (40 hours per week) are eligible to participate in the VRS plan. As a result the cost of the plan cannot simply be calculated as one percent of total payroll.

Linkage to Social Security
The Normal Retirement Age for new employees is linked to the Normal Retirement Age of Social Security (66 or 67), which could change in the future.[4] It should be noted that several benefits – including the Supplemental Plan and retiree life insurance – are structured around a key age of 65. That age for VRS is now 66 or 67 and may change in the future without any City control, and eligibility for different retirement benefits may be triggered at different ages.

Leapfrogging
"Old" employees get 100% inflation protection up to 3% inflation (as measured by the Consumer Price Index (CPI)) and then half that protection on the next 4% change in the CPI. Annual COLAS therefore are capped at 5%. "New" employees now get 100% inflation protection up to 2% and then half that protection on the next 8% points change in the CPI. New employees COLAS therefore are capped at 6%. In periods of low inflation "old" employees will fare better. On the other hand, in periods of high inflation "new" employees will do better. This creates an environment where pressure may develop to balance the benefits of old and new employees (for example, to raise the "old" employee's COLA cap to 6% and to raise the "new" employee's bend point from 2% to 3%). If efforts to balance benefits are successful the City ultimately would be forced to fund these changes.

Portability Discouraged
Defined benefit pension plans are sometimes referred to as "Golden Handcuffs." While they do have strong powers of retention, they discourage employees from moving outside VRS covered jurisdictions. The state currently encourages finding the best talent pool available by allowing members to retain benefits when they move from one covered position to another. As a result of the recent changes, lesser benefits will be provided under certain circumstances to employees who quit and then take another VRS covered position after July 1, 2010. This change may result in employees staying with the City in order to maximize their retirement benefits. Increased retention would provide more time for the City to recoup the investment it made to hire and train new employees. On the other hand, it will be more difficult to attract employees to the City from other "VRS" covered jurisdictions for the same reason.

Bond Ratings
The City of Alexandria has funded its City plans consistently and in good faith. Not-with-standing timing issues, we have funded all our major plans according to acceptable government pension practices. The reduction in VRS benefits for new employees and the permission to increase employee contributions will only relieve funding pressure and be a positive factor in the bond rating.

However, the state reductions to pension funding for teachers and other school district professionals is a different story. The reduced funding over the next two fiscal years will lead to increased funding requirements at a later date. The City is currently working with the Alexandria City Public Schools to address this issue and mitigate any concerns the rating agencies may have.

[4] The 1983 changes that deferred retirement dates may not be sufficient to sustain the Social Security Trust Fund. It is conceivable that future changes to Social Security may defer the plan's normal retirement date.

(A separate memo addressing the VRS changes impacting the Schools will be sent to City Council.)

Attachment 1: Detail on VRS Changes. Pulled from Docket Item 18 of the March 23, 2010 City Council Meeting, *Report on Legislation*, pages 2 & 3.

Attachment 2: Information on Preliminary VRS Guidance regarding Employee Retirement Cost Sharing.

<u>VRS Changes Enacted at the 2010 General Assembly Session</u>

Information pulled from Docket Item #18
Presented at the March 23, 2010 meeting of City Council

<u>VRS</u>. Major legislation was passed to restructure Virginia Retirement System Benefits for most state and local employees. Major components of the legislation include the following:

- State employees hired after July 1, 2010, will be required to contribute 5 percent of their salaries toward their retirement benefits. Local employers who are members of VRS, including local governments and school boards, will have the authority to require employees hired after July 1, 2010, to pay from 1 to 5 percent of their salaries toward their retirement benefits. Language in the State budget also allows local governments and school boards, if they choose to do so, to require their current employees to pay between one and five percent of their salary toward their VRS benefits.

- The normal retirement date for employees hired after July 1, 2010, will be the date for retirement under Social Security (this varies depending on one's birth date, but it will be between 66 and 67 years). Currently, the normal retirement date is 65.

- It allows those who are hired after July 1, 2010, to have early, unreduced retirement after the sum of the employee's age and years of service equals 90. Currently, the earliest one can retire with full benefits is at age 50, with 30 years of service. This change does not apply to public safety employees who are members of the LEOS/VRS retirement system benefits.

- Retirement compensation for all state and local employees hired after July 1, 2010, will be based on the average salary during the 60 highest consecutive months of service (the current system uses the highest 36 months of salary).

Preliminary Guidance on Employee Contributions to VRS
Information pulled from Virginia Municipal League (VML) Update
Dated April 2, 2010

VRS has provided preliminary verbal guidance regarding the new authority local employers who are VRS members would have requiring current and new employees to pay 1-5% of their salary toward their retirement benefits. The verbal guidance below was provided by VML:

- Local employers will have to take affirmative action through adoption of a resolution on the issue of payment of the 5 percent employee share. The resolution will need to be adopted before July 1.

- VRS has outlined these scenarios: Scenario 1: Local employees pay the full 5 percent employee share for current and new employees. Scenario 2: Local employers require current employees to pay any portion of the 5 percent employee share, which acts as a trigger to require that new employees hired after July 1, 2010 must pay the full 5 percent employee share. Scenario 3: Local employers continue to pay the 5 percent share for current employees and require all new employees to pay any whole portion of the 5 percent employee share.

- Local employers likely will be able to change the decision on requiring employees to pay any (or all) of the required 5 percent employee share. Still to be decided is how often that decision can be revisited. VRS has asked its benefits counsel to determine the timeline for that decision.