REPORT OF THE CITY OF ALEXANDRIA AD HOC RETIREMENT BENEFIT ADVISORY GROUP TO THE CITY COUNCIL AND CITY MANAGER

Pursuant To City Council Resolution 2432 (January 25, 2011)

November 9, 2011

Excerpts: Sections XIII and XIV

XIII. Findings & Observations

Based on the Advisory Group's proceedings as well as our collective knowledge and experience, we offer the following observations.

1. Introduction: The City of Alexandria participates in the VRS and sponsors the FPOPP and the SRP to provide its employees with a sound and decent retirement income after years of service to the Alexandria community. A pension is not a gift. Rather, a pension is deferred compensation earned by an employee for the labor he or she provided to the City over a period of years. The City's "employer contributions" to the pension plans are really substitute salary. If the City did not make these contributions, all or at least some portion of this money would have been paid to the employees as salary.

   Recognizing the importance of retirement savings to individuals, as well as to the public at large, Federal and State tax laws provide valuable incentives for the creation and maintenance of employee pension plans. Employer contributions to plans are not treated as taxable income for the employee for purposes of income and payroll taxes. Taxable employers are entitled to immediately deduct the contributions from their taxable income. The investment income of the plans is not subject to taxation. Pension benefits are taxable to a retiree as income when paid in the future, but presumably at lower tax rates.

   Pension plan coverage is a part of the total compensation package (which includes salary and benefits) that the City offers to current and prospective employees. Through various ways, the City tries to maintain a total compensation package that is competitive so as to attract and retain qualified employees. The City, through its Human Resources office, biennially compares salary and benefits to the Market (the City's comparator jurisdictions). These comparisons can be used to adjust salaries, City pay scales and possibly benefit contributions and benefit plan design. In the past three years, these changes have not been funded by City Council.

   In 2008, the City commissioned a comprehensive Benefits Comparison Study through the Towers Watson consulting firm. The study looked at the health, dental, security, and pension programs of the City's comparator jurisdictions. The study found that some groups of City employees' pay and benefits were below the Market and some were at or above the Market. The report on this study was submitted to City Council in March 2009. As a result of the report, City Council approved additional annual leave for all employees.

   The City also uses Benchmark studies to evaluate how City employees' compensation compares to its Market, and adjustments to pay scales and/or benefits are recommended based on the studies' results. This is done to maintain a competitive posture with the Market in the region. Cuts in pensions or other benefits would require the City to explore ways to compensate employees in order to achieve a competitive total compensation package for City employees.

On the other hand, sustained increases in pension costs could force the City to reduce other components of the compensation package or otherwise reduce labor costs (salary freezes and reductions, reductions in other benefits, reductions in force through attrition or layoffs, etc.).

In short, although not explicitly stated in the charge to the Advisory Group by the City Council, the members are mindful of the balance that must be struck between the need for a comprehensive and responsive compensation and benefits program for employees and the demand on taxpayers to pay for such a program. One should never be at the sacrifice of the other and when this report and recommendations are read in their entirety, the Advisory Group believes that the employees and taxpayers of the City and the City Council will find that a balance has been struck.

2. Overview of funding: Since the historic investment markets crash of 2008 and the onset of the economic downturn, news media and professional publications have carried a steady stream of articles about public employee pension plan funding troubles and the related political and labor relations battles. Some articles have been thoughtful and constructive, while many others have been overblown and designed to advance political agendas. It is no surprise that the public is confused and worried, that public employees feel scapegoated, and that some public officials are choosing to simply follow current trends.

No doubt, there are a significant number of public employee pension plans that are seriously under-funded. Many pension plans and retirement savings programs, public and private, suffered deep investment losses in 2008, and it will take time for investment portfolios to recover, particularly with the return of highly volatile markets. A lingering recessionary economy and battered housing market have reduced the revenues of most jurisdictions. Unexpected pension plan obligations have been blamed for cutbacks in public services, tax increases, layoffs, hiring freezes, wage and benefit cuts, and similar unpleasant actions.

But, for many public employee pension plans, the causes of under-funding go beyond the investment markets and revenue declines. Some State and municipal governments irresponsibly failed to make appropriate contributions to their employees' pension plans over the years in the hope that investment performance would cover the shortfall or that later administrations or legislatures would find extra money to fill in the hole. Some public pension plan sponsors deliberately used unreasonable actuarial assumptions to reduce funding obligations, or gambled on risky investments. And, some governmental pension plans have provided overly generous benefits or have been subject to manipulations and mal-administration that drove up costs.

The City of Alexandria government and its employees have made a number of significant policy decisions and contributions to ensure that Alexandria is not one of those jurisdictions whose employee benefit plans are in jeopardy. Among those actions are the following:

(a) The City has consistently made all of the required annual contributions to the Virginia Retirement System.

(b) The City has consistently made all contributions to Firefighters and Police Officers Pension Plan and Supplemental Retirement Plan recommended by the actuary for those plans.

(c) The City uses reasonable actuarial assumptions as approved by the plans' actuaries, including the assumption that the plans will earn an average annual investment return of 7.5% over the long term.

(d) The City has developed a professionally managed investment program with prudent investment policies that reflect the long-term objectives of the pension plans and produce market returns.

(e) The City has adopted pension plans whose benefits are not overly generous and that minimize the risk of costly manipulation, such as excluding non-basic salary amounts from the benefit formula.

(f) Firefighters and police officers are contributing 8% of their salaries to their pension plan.

(g) New City employees, except for firefighters and police offices covered by the FPOPP, are placed in the lower tier VRS-2.

(h) New City employees are required to contribute a percentage of their salaries towards their pension coverage.

(i) The City and employees are working to implement various administrative efficiencies that will reduce costs of plan administration.

(j) The Pension Administration Division of the City's Finance Department is fully staffed by experienced benefits professionals who carefully monitor the City's employee benefit plans.

3. Solvency of Plans: The City's pension obligations have been increasing as a percentage of pay, in dollars, and as a percentage of the City's overall budget. They are not, at the moment, out of control. But, there is cause to be concerned about the future, primarily because those obligations are heavily affected by investment performance; lower than expected investment returns eventually translate into higher contribution obligations. Even prudent investment programs are necessarily hostage to the vicissitudes of the investment markets. The recent return of turmoil in the investment markets and stall in our Nation's economic recovery has heightened uncertainty about the future.

   The City has no control over the VRS' investment performance. VRS investments are overseen by a Board of Trustees appointed by the Governor. The City's contribution obligations to VRS will continue to be determined in large measure by the Board's investment program, and the City cannot mitigate that effect other than by reducing the number of VRS covered employees or controlling creditable salaries.

   The City does control the investment program of the SRP and the City's Firefighters and Police Officers Pension Plan Retirement Board oversees the FPOPP's investment program. The plans are long-term investments that need not be overly concerned by short-term fluctuations, and there are actuarial tools for mitigating the impact of such fluctuations on contribution obligations (*e.g.* "smoothing" of asset values). However, there is no denying that the City's contribution obligations will be greatly affected by the investment markets.

4. "Sustainability": The Resolution appears to request the Advisory Group's opinion on the "sustainability" of the City's pension obligations. Implicit in the concept of "sustainability" are political judgments that we are not in a position to make; that is the province of the City's elected leaders. To assess whether the City can sustain its current or projected obligations, one must take into consideration a myriad of factors and choices such as the City's revenues prospects, its other obligations, the types and levels of public services to be provided, the levels of employment, salaries and other employee benefits, etc.

5. Defined Benefit vs. Defined Contribution: Some State and municipal governments have abandoned or are considering abandoning pooled defined benefit pension plans and substituting individual account, defined contribution retirement savings plans, as a way of capping their pension contribution obligations.

   Under a defined contribution plan ("DC"), the employer simply makes a pre-determined annual contribution to each employee's account. The employee self-directs the investment of his or her account, usually from among a platform of investment funds provided by a third-party administrator. At retirement, the employee gets only what is in his or her account, which may or may not last for the rest of the retiree's life. In other words, the employee takes all of the risks: the investment risk (that the account will lose money or otherwise underperform under his or her direction); the early withdrawal risk (that loans or hardship withdrawals will reduce the account's assets before retirement); the longevity and inflation risks (that the account will be exhausted before death); and the expense risk (the loss of assets due to investment fees and other expenses charged to the account directly or netted from investment returns). The impact of these risks on employees has been sadly demonstrated by the 2008 investment crash that slashed defined contribution account values, and by stories of retirees who are returning to any job they can find before they run out of money.

An advantage of DC plans is that they provide ready portability if an employee changes employers. Typically, the employee can take a distribution of his or her account or roll the account over tax-free into another qualified retirement savings vehicle.

In contrast, under a defined benefit plan ("DB"), the plan promises each employee a monthly retirement income that he or she cannot outlive. The amount of that income is determined by the plan's formula (average salary, years of credited service, accrual rate or multiplier, etc.). The employer periodically contributes to the plan (along with employee contributions, if required) an amount calculated by the plan actuary--on the basis of various assumptions, including investment return, turnover, and longevity–to fund over a period of years each employee's pension. In other words, the employer takes the risk that it will be required to contribute more (or less) than expected due to investment performance and plan experience.

Further, a DB can provide a decent, life-long disability pension to employees who become unable to work. An employee who becomes disabled before retirement under a DC plan is entitled to no more than the amount in his or her account.

Similarly, a post-retirement cost-of-living increase in monthly pension benefits has been a common feature of DBs, although a DC could offer an insurance company variable annuity.

Finally, the question of a DB versus a DC is not a matter of "good or bad," but fundamentally a question of how the two plans impact the participant. There is certainly the expectation that a DB, which is typically directed by trustees who retain professional investment advisors, should perform well over time while limiting risk. By the same token, a DC can be professionally managed and enjoy market returns, as well. However, research suggests that individual investors, when investing directly, may not always make the best strategic decisions for their long-term investment needs, especially in the volatile economic and market climate of recent years. But each type of plan comes with certain "trade-offs."

A DB provides the participant with the potential for a predictable, lifetime income, while giving up control of the asset for estate planning purposes. However, if the participant lives well beyond a projected life expectancy and if the stock market went through a prolonged decline, the income does not stop. With a DC, the participant has the potential for significant growth of the asset, the ability of the account to generate income, and to have any residual value be part of the participant's estate upon his or her death; but if the account declines in value or excessive amounts of income are withdrawn, there is no guarantee (or guarantor) of a lifetime income. Ultimately, for most people, the predictability and reliability of lifetime income will outweigh the potential for significant appreciation, and that will be reflected in the recommendations to follow.

The City Council has visited this issue of defined benefit versus defined contribution before; indeed, as recently as 2004 when it deliberately chose to replace the Retirement Income Plan for Firefighters and Police Officers (a defined contribution plan) with the Firefighters and Police Officers Pension Plan (a defined benefit plan). The City came out definitively in favor of defined benefit pension coverage, as noted in City Manager Sunderland's February 6, 2004 memorandum:

> *"Conclusion: As a long-term policy, we believe that, instead of having the public safety employees bear 100% of the investment risk for their entire pension, it is more appropriate for the City to assume the risk. The City is far better able to handle fluctuations in the equity and bond markets and in earnings over time than individual employees. An employee near retirement is especially less able to handle such fluctuations. Moreover, the City now takes this same type of risk under the retirement programs that cover most other City employees (through VRS and other pension programs). It is reasonable for the City to take a similar risk for sworn police officers and fire fighters.*
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> *"The proposed DB program ensures that a definite retirement income not-affected-by-investment-returns will be available throughout the retirement years of a firefighter and police officer. For some, this might be less than they would have been able to receive under the DC plan. For others, this will be more than what the DC plan would have delivered. But for all there will be no investment risk. We believe it is desirable that public safety employees receive similar retirement benefits for similar service to the City, regardless of their investment acumen or the state of the economy, particularly in their later years of service.*

> *"Fiscal Impact: The City has been and is currently paying 20% of payroll into the firefighters and police officers DC plan. This percentage does not change over the years as the investment market changes. If the City adopts a DB pension plan, initially the cost to the City will be 20% of payroll. However, the City's 20% cost could increase if the market value of the pension plan assets and investment earnings decrease or if plan retirement cost experience is higher than projected. Conversely, the City's 20% cost could decrease if the market value of the pension plan assets and investment earnings increase beyond projected returns or if plan retirement costs are lower than projected."*

It cannot be said that the City was naive about the investment markets in 2004. During 2000-2003, the nation had experienced what was then considered the worst investment market in 50 or more years: three consecutive years of negative returns.

The City's employees have expressed strong opposition to replacing the defined benefit plans with a defined contribution model. As noted during our proceedings, and borne out by national experience, many employees feel less capable to properly direct and monitor the investment of their pension accounts. The market crash of 2008 devastated many self-directed 401(k) plan accounts, and that experience has further soured employee groups on defined contribution plans.

Note also that if the City did decide to "freeze" the FPOPP and SRP and substitute defined contribution plans, the City would still be required to continue contributing to the frozen plans, for many years in the future, to fund the already-earned benefits under those plans. The City has some experience with such dual contribution obligations; it is still continuing to fund the "Old, Old" Firefighters and Police Officers defined benefit plan that was closed in 1979 when the Firefighters and Police Officers Retirement Income Plan was established as a substitute. In other words, the City would be required to continue contributing to the frozen defined benefit plans as well as to the new defined contribution plans.

6. <u>City and Employee Contributions:</u> Notwithstanding the broad language used by City Manager Sunderland, it is unreasonable to expect the City to absorb limitless investment risk and other risks and expenses for the VRS, FPOPP, and SRP, just as it would be unfair for employees to bear the investment risk. Neither the City Manager's memoranda nor the City Council's action thereon constitute a legally binding commitment never to increase employee contributions, reduce future benefits, or terminate the plans, even though they obviously created expectations among employees. Raising taxes or reducing services to cover unexpected pension costs may not be possible, and pressures

would inevitably rise to reduce labor costs to the detriment of the employees. Some accommodation must be reached to protect the City and its workforce against long-term investment under-performance. As shown earlier in this report, contribution costs for the City have been rising as a percentage of the City's total budget over the last ten years and the Standard & Poors' 500 (an index of the prices of 500 large capitalization stocks that is viewed as a leading indicator of the market) has yielded a return well below the 7 to 7 ½ percent investment return assumed by the plans. Resulting changes in actuarial assumptions also have a significant impact on contribution rates. Our recommendations at the end of this report suggest such an accommodation.

Some State and local governments have imposed or increased employee contribution requirements in response to pension funding challenges. The City of Alexandria has taken steps in this direction. Firefighters and police officers have been contributing 8% of their salaries to the FPOPP since its inception in 2004. Newly hired General Schedule employees are required to contribute 2% of their salaries to the SRP in addition to 4% of their salaries to VRS-2. New deputy sheriffs, medics, and fire marshals covered by VRS-2 are required to contribute 4% of their salaries too, although they have been exempted from the 2% contribution to the SRP.

Salary rate, currently and prospectively, is the most attractive component of a compensation package. Imposing or increasing employee contribution requirements is the equivalent of a salary reduction for employees. Their current income is reduced to help fund pensions that will not be payable until, for most employees, many years later. Even a 1% or 2% cut in take-home pay can have a significant adverse impact on an employee, yet an employee's pension contribution at that rate would be insignificant to the funding needs of the pension plan.

The proceeding paragraphs of this Section demonstrate that the City's contributions to the various pension plans may be considered to be substitute salary in whole or in part. That is, the City is contributing to its employees' pension plans money that might otherwise have been paid to its employees as salaries.

7. <u>Employee Expectations</u>: Further, there is the matter of the City employees' expectations based on earlier actions by City Council. Whether one accepts or does not accept the validity of these expectations, in whole or in part, the fact of these expectations needs to be taken into account in considering any changes to the employees' pension coverage. We are advised that the following beliefs are held by General Schedule employees:

> "In 1982, City Council passed a resolution that provided that beginning in

FY 1983, it would not require City employees who participated in VRS to pay the 5% employee VRS member contribution (Resolution 868, dated June 8, 1982). Instead, the City would make this contribution on behalf of these employees. In exchange, the City employees in VRS did not receive the 5% in-step increase that would have been provided pursuant to the pay scale that was in effect at that time. Uniformed City employees who participated in the Police/Fire Pension and not VRS received a 5% in-step increase as provided by the pay scale in effect in FY 1983.

“The State government made a similar pay decision for its employees in the early 1980s. When the State decided to re-impose the 5% VRS employee share this year, they coupled this with a 5% salary increase for State employees. This salary increase was intended to address the in-step increase not received in FY 1983 and to help address the current budget impact on employees who had to pay the 5% employee share of VRS.

“We understand that a large number of the City employees who are members of VRS (General Scale employees, deputy sheriffs, medics, and fire marshals) believe that the City’s agreement to pay the City employee contribution in FY 1983 was a promise to continue this practice in the future. If State law changes, and the City is permitted to change its decision and require City employees in VRS to contribute the 5% employee share of VRS, affected City employees expect to be compensated for the 5% reduction in take-home pay like their counterparts in State government. Because an adjustment in compensation would result in other costs to both employees and the City, such as increased payroll taxes, employees expect no net reduction in take home pay as a result of such an increase. In addition, employees expect that an increase in compensation related to VRS contributions be considered independently from other salary adjustments, such as performance-based merit pay raises and market rate adjustments.

“Maintaining a defined benefit plan as the foundation for retirement security is very important to General Scale employees. When the City was considering re-establishing the defined benefit retirement program for firefighters and police officers almost eight years ago, a related discussion occurred. In a February 6, 2004 memorandum, former City Manager Phil Sunderland concluded: ‘As a long-term policy, we believe that, instead of having the public safety employees bear 100% of the investment risk for their entire pension, it is more appropriate for the City to assume the risk…An employee near retirement is especially less able to handle such fluctuations. Moreover, the City now takes this same type of risk under the retirement programs that cover most other City employees (through VRS and other pension programs). It is reasonable for the City to take a similar risk for sworn police and fire employees.'"

We are advised that the following beliefs are held by the Police and Firefighters:

> "At the behest of the City of Alexandria, the City of Alexandria Firefighters and Police Officers Pension Plan ("FPOPP") Pension Board was founded for the expressed purpose of implementing a defined benefit plan that incorporated 'a cost containment plan in advance of a crisis as a prudent measure for protecting the City from out-of-control costs and the employees from arbitrary and surprising benefits and/or contribution changes.' The Board is comprised of employee representatives and City staff, and is overseen by City Council.
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> "In 2004, the FPOPP Pension Board and the City of Alexandria mutually established the FPOPP. This plan was enacted and members voluntarily paid the highest percentage of salary than that of any other participant in a City of Alexandria recognized pension plan. Since its inception, there was the expressed agreement and understanding of the FPOPP Board and its members that we would share the responsibility of managing costs relating to our pension with the City of Alexandria. Additionally, as a result of a failed Defined Contribution plan, it was understood that now the City of Alexandria would assume the market rate fluctuations as the City was in a better position to cope with these market variations rather than an individual employee.
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> "It should be noted that the pension plan's rates were carefully crafted and negotiated with the City of Alexandria. At the onset of the plan, the employee contribution amount was determined based on an offset of oscillating future social security benefits as well as the variability of the stock market. In spite of increasing healthcare costs and loss of COLA increases, plan participants have remained steadfast in contributions because the FPOPP plan was designed with adjustment rate mechanisms in place to create a solid long term investment despite a fluctuating economy. Other pension plans that operate in the City contribute far less than the members of the FPOPP, thus placing a greater financial burden on the taxpayers of the City of Alexandria."
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> "Per its pact, the FPOPP Pension Board remained well educated with regard to this pension plan and continued to make recommendations on an as needed basis. The expectation of the FPOPP Board is that the City of Alexandria would also abide by our agreement and discuss any pension changes with the FPOPP Board prior to implementation.
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> "Additionally, the FPOPP Board recognized that the City of Alexandria has

already shifted the employee costs of the pension office and its required worker related disability payments into the total pension costs thus placing an artificial burden on FPOPP members. This shift allowed for the appearance of higher pension costs to the City of Alexandria tax payers. It is the expectation of the FPOPP Board that again prior to the enactment of any change to the FPOPP Pension Plan, these fabricated costs will be considered by the FPOPP, taxpayers, and City Council.

"Furthermore, we are confident that the City of Alexandria will recognize the inequity amongst multiple pension plan contributions and only discuss plan increases with retirement systems that have failed to prepare for an unpredictable economy and encumber City of Alexandria tax payers.

"The FPOPP Board is unwavering in our commitment to work with the City of Alexandria. It is the FPOPP Board's position that the City of Alexandria will continue their commitment to fund minor market fluctuations and furthermore confer with the FPOPP Board on all matters that affect the FPOPP membership.

"The FPOPP Board pledges to continually evaluate the pension plan; however, there is no need for modification of The City of Alexandria Firefighters and Police Officers Pension Plan at this time."

We are advised that the following beliefs are held by the Medics and Fire Marshals:

"The total cost for providing retirement benefits to the Medics has not shown a significant increase since 1992 because the Medics (and the Fire Marshals since they were added in 2005) have had a reduction in total benefits and a break from parity with PD and Fire. Specifically, the cost in 1992 was 23.0% of base salary and the projected cost for 2012 shown in the March 9, 2011 budget memo #3 was 23.59%. This represents a 2.57% increase in twenty years.

"The reason this increase was minor even in light of the significant increase in VRS costs is that the city had an automatically adjusting mechanism. The city would contribute 22.35% - 23.0% of base salary to retirement. From this the required cost to VRS and the required costs to the City Supplemental plan would be subtracted and any additional funds remaining would be deposited into the defined contribution account. For example, in 2004 VRS cost 5.75% and the Supplemental cost 3.5%; thus, the DC account received 13.1%.

"As can be seen from this example, over the years as VRS costs have increased, the Medics, FMs and Deputy Sheriffs' benefit has decreased since they received less or no contribution in their DC account. This account was viewed as a "bridge" to allow some offset of the significant VRS penalty associated with retirement at 25 years of service. It bears emphasizing that the Medics, FMs, and DSs have been sharing in the cost of rising retirement by accepting less benefits.

"We realize it is very difficult to compare a 30 year plan to a 25 year plan since they have significant cost implications and we caution Council to remember this when comparing contribution rates. This is one reason Medics and FMs have asked for the cost of a 25 year plan. Not only would it allow for an informed decision by the employees as to whether they would like to self-fund the benefit but it would also allow the Pension Subcommittee and Council to better compare plans.

"Delaying retirement for medics and FMs will increase the disability costs due to an increase in injuries and will reduce retention when other jurisdictions have 25 year retirements. We have already seen retention issues for Medics. There have been six medic classes hired in the past ten years (excluding the 2010 hiring since they are still on probation). Out of the 45 hired, only 21 remain. This 46.7% retention rate carries a significant impact on our service delivery and training costs to the city.

"Retirement contribution rates have recently been decided not as a result of sophisticated analysis related to long term sustainability but more as a reaction to nationwide trends, incomplete comparisons to the private sector and short term budget shortfalls or perceived shortfalls. Additionally, it has been done without apparent regard for the increased disparity with comparator jurisdictions. This is the reason we agree to an adjustment mechanism being considered. However, we strongly believe it should be determined by the Pension Subcommittee and the to be developed SRP Board but not be instituted for any group of employees unless a recent comprehensive total pay and compensation study shows that that employee group is at or above the average of comparators."

8. <u>New Employees:</u> Another commonly used approach among public employee plan sponsors is to create a new plan or a new plan tier with lower benefits or higher employee contribution requirements for new employees only. The rationale for this approach is that the employer has no pre-existing obligations or commitments to new employees, and a new employee who accepts employment on these inferior pension terms cannot legitimately complain. Furthermore, the employer can improve the pension coverage in the future, prospectively or retroactively.

The City has used this approach by covering new employees hired on or after July 1, 2010 under VRS-2 and requiring them to contribute 4% of their salaries to VRS, whereas earlier hires are covered by VRS-1 and are not required to contribute. Even if the employees were not required to contribute, the City's contribution obligations would be less for these employees than for VRS-1 employees because of the lesser benefit package under VRS-2. In addition, new General Schedule employees (hired on or after July 1, 2009) are required to contribute 2% of salary to the SRP, whereas earlier hires are not required to contribute. Newly hired firefighters and police officers contribute 8% of their salaries.

Disadvantages of a two-tier approach include the following:

(a) It does not provide cost relief in the near term, but only as more senior employees leave and new employees are hired. Eventually all employees will be covered under the less costly plan, but that transition can take many years.

(b) Inequities can create resentment among employees and human resources problems. These risks can be particularly acute where one employee hired just before the cutoff date works with an employee hired just after the cutoff.

(c) Multiple tiers of benefit programs can make administration difficult and more costly.

The Advisory Group appreciates that the City has left intact the basic defined benefit pension program for new hires rather than switch to a defined contribution plan.

9. <u>2010 New Employee Contribution Rate Decision</u>: From the record available to the Advisory Group, it appears that City Council decided at a June 2010 public meeting to require new employees not covered by the FPOPP to contribute 4% of their salaries to VRS-2 without any supporting analysis. Notably, the City Manager had recommended that the new employees not be required to contribute to VRS-2 at that time but that the matter is deferred until a more thorough review could be undertaken.

10. <u>Comparability With Other Jurisdictions:</u> Comparing the City's pension coverage to that provided by other jurisdictions, including Alexandria's "comparator jurisdictions," is a difficult exercise because there are many variations in plan terms and conditions from jurisdiction to jurisdiction and some favorable provisions in one plan may be offset by some unfavorable provisions in the same

plan. Some plans might require employee contributions, and others not. Some plans might allow salary enhancements in determining benefit levels, and others not. Some plans might have a relatively lower normal retirement age but a less favorable benefit formula. And, in any event, there is a moving target problem; most jurisdictions are reviewing their employee pension plans and considering adjustments based on their specific circumstances. In short, a true "apples to apples" comparison is difficult to achieve and should be tied in with a total compensation package approach.

What can be said is that the City's pension coverage is about the same on the whole as local jurisdictions. The City states that it is currently able to attract highly qualified employees in all job categories. The City also states that "exit interviews" do not indicate that dissatisfaction with the City's retirement plans is a cause for leaving employment with the City. However, there are some specific outlying issues (such as the higher retirement age for Alexandria's deputy sheriffs, medics, and fire marshals) and some anecdotal evidence that some employees have left City employment for jurisdictions with more generous retirement terms. It may also be said that the attractiveness of one City pension plan's terms (FPOPP) relative to other pension coverage (VRS & SRP) may affect decisions by City employees to transfer positions within City employment.

A more useful assessment of the relative value of Alexandria's pension coverage requires a professional study of the entire employee compensation package, including pensions, like that performed for the City by the Towers Watson consulting group in 2008-2009.

11. <u>Social Security:</u> In discussing the pension coverage provided to City employees, Social Security benefits are often overlooked and they should not be. As a governmental entity, the City is not required to participate in, or contribute to, Social Security on behalf of its employees. Nonetheless, unlike some other local jurisdictions, the City contributes to Social Security in an amount equal to 6.2% of its employees' salaries (up to a maximum salary level of $106,800 in 2011). All employees are required to contribute to Social Security as well; normally 6.2% of salary, but temporarily reduced by law to 4.2% in 2011. Even though full Social Security retirement benefits are not available until age 66 or 67 (with reduced early retirement benefits available at age 62), these benefits will add to a retiree's monthly income from the VRS, SRP or FPOPP.

Projected outcomes for a variety of retirement scenarios under the City's retirement plans – including Social Security – are attached to this report as Addendum C.

12. <u>Legacy Plan's Lingering Costs:</u> A significant part of the City's annual pension contribution costs relates to the legacy firefighters and police officers defined

benefit plan that was closed to new participation in 1979 (the "Old, Old Plan"); about $1.7 million per year for the next 2 to 3 years, but projected to continue at about $1.2 million per year for some years thereafter until the survivors pass on. These contributions fund benefits that were earned by retired employees many years ago. They are legacy costs for which current employees should not be held accountable.

13. State Employees Under City Plan: The City has been providing coverage under the SRP to State employees who work in the Health Department located in Alexandria but are not employed by the City. Pension coverage of these 87 employees costs the City about $340,000 per year. There are other State employees for whom the City contributes to the SRP.

Deputy City Manager Michele R. Evans provided the Advisory Group with a memorandum dated October 17, 2011 regarding the "City Supplemental Pension And Employees Of The Alexandria Health Department." This memorandum, which relates the history of this coverage, is attached to this report as Addendum I.

14. GASB: The Resolution requested that the Advisory Group consider the effects on the City's pension costs of the Government Accounting Standards Board's (GASB) proceedings to set new accounting standards for the reporting of public pension plan liabilities. The Advisory Group received briefings on GASB's proposals and their effect on the City from Steve McElhaney of Cheiron and Laura Triggs. And, in July 2011, GASB issued an Exposure Draft of its proposed new standards.

Importantly, the proposed new standards distinguish between pension plan funding and accounting by employer for pension plan obligations. The standards, once finalized, are not expected to have any significant effect on the City's pension contribution obligations so long as the City continues its longstanding policy of contributing 100% of actuary's annual recommended contribution, although the shorter amortization period bears watching. Further, the FPOPP and SRP should be able to continue using 7.5% as their long-term investment return assumption, according to Cheiron. Acting City Manager Bruce Johnson informed the Advisory Group that "the new standard has proven to be significantly less onerous than anticipated and the final outcome, at this time, may be fiscally and administratively workable for the City."

But, the new standards, once they become effective, will affect City's accounting for its pension obligations: unfunded actuarial liability will go on the City's balance sheet rather than merely be disclosed in the notes. This change in reporting may create a false impression of the City's pension obligations to the general public, but it should not affect the more expert opinions of the City's creditors and rating agencies.

15. VRS: VRS contribution requirements are a major driver of the City's cost increases because of the relatively large number of City employees that are covered by the VRS. The VRS contribution costs are largely beyond the City's control, as discussed above. The City can affect its contribution obligations through the number of employees it hires and retains in VRS-covered positions and the salaries they are paid. The City may also be able to exercise some influence over VRS decisions through the normal political process inasmuch as the VRS is a creature of State government.

    The State's Joint Legislative Audit and Review Commission is currently conducting a formal study ("Follow-up Review of Retirement Programs for State and Local Employees") to update its 2008 report. The results of this study are due by the end of 2011, and JLARC may make recommendations for reducing VRS costs that impact the City's future contribution obligations.

16. Federal Legislation: The Resolution also asks the Advisory Group to assess the prospects for Federal legislation that would impose additional pension costs on the City.

    The proposed "Public Pension Transparency Act" (HR 567 / S. 347) was re-introduced in the current Congress by its Republican sponsors. Generally the bill would require sponsors of State and local government employee pension plans to annually report specific financial information to the Federal Government (Department of Treasury). Governments failing to report this information would lose their ability to issue tax exempt bonds until they comply with the reporting requirements. However, the legislation also states that it does not alter the existing funding standards for State and local governments or require Federal funding standards for such plans.

    The bill has generated controversy among public officials, and has been referred to committees in the House of Representatives and Senate, but no further action has been taken on it in either chamber and none is expected in the foreseeable future.

17. Retirement Boards: The FPOPP has a Firefighters and Police Officers Pension Plan Retirement Board that plays a significant role in the governance of that plan. As described earlier in this report, the Board consists of 8 members appointed by the City Council: 4 representatives of the City, 2 nominees of the Firefighters, and 2 nominees of the Police.

    Currently, there is no comparable joint board for the SRP which covers the vast majority of City employees, including Deputy Sheriffs, Medics, Fire Marshals, and

General Schedule employees.

Ongoing involvement of employee representatives in pension plan oversight would advance employee understanding and appreciation of the plans. Moreover, such boards serve as a valuable forum for resolving controversies, addressing employee concerns, and discussing future changes in the City's pension coverage. There will be more developments affecting the City's pension obligations (*e.g.* when JLARC reports on VRS at the end of 2011), and pension boards provide a permanent structure for discussion between partners–City government and its employees.

18. Employee Education: There is a need for more education of City employees about the retirement income and post-retirement benefits provided by the City. This is particularly true with regard to the retiree health policy and the retiree life insurance program for which there is no descriptive document for employees, or at least none that was brought to the Advisory Group's attention. Some members of the Advisory Group who are City employees commented that they learned a lot about the City's retirement programs through our proceedings.

    The Acting City Manager informed the Advisory Group that the City plans to develop a summary plan description regarding retiree health insurance and life insurance, and to post it on the City's website and on AlexNet.

19. Stability: Stability in the operation of pension plans is valuable to the City and employees alike. Frequent tinkering in the funding, benefits or other aspects of pension plans is unnecessarily disruptive. If and when changes to City employees' pension plans are necessary or advisable, the changes should be made only after a deliberative, fact-based process.

20. Part-time Employee Benefits: There are approximately 325 City employees who work on a permanent part-time basis and who have limited access to future pension benefits. These employees are enrolled in the City's SRP only and have no opportunity to participate in VRS. Based on the average part-time employee salary of $21,723 provided in the City's FY2012 Approved Budget, a part-time employee retiring with full benefits could expect a total pension of $425 monthly. Further, while part-time employees retiring from the City may continue to purchase health insurance through the City's group plans, they do not have access to the City's monthly $260 health insurance stipend that has been offered to full-time City employees at retirement.

XIV. Recommendations

Mindful of the foregoing findings and observations, the Advisory Group unanimously makes the following sixteen recommendations for the Mayor's and City Council's consideration. The first five are our major recommendations. The subsequent eleven recommendations are of comparable importance; the order of their listing is not intended to suggest any order of priority.

1. We recommend that the City continue its defined benefit pension plans, and do not recommend that the City create a new defined contribution plan.

2. We recommend that the City Council establish, as soon as possible, a joint management-employee retirement board for the SRP comparable to the Firefighters and Police Officers Pension Plan Retirement Board. We further recommend that the activities of the two boards be coordinated as appropriate to minimize duplication and maximize efficiency.

3. We recommend that an “adjustment mechanism” triggered by economic developments be developed as a hedge against runaway contribution costs with regard to the FPOPP and SRP, and to ensure that future plan changes are not arbitrary nor a surprise. By “adjustment mechanism” we mean a plan rule under which the occurrence of an objectively determinable event will cause an automatic change in the future employee contribution rate, the future benefit accrual rate or eligibility, and a reversal of the action upon the occurrence of a countervailing objectively determinable event.

   The adjustment mechanism is intended to ensure that increases in pension cost will be shared to a certain extent by both the City and its employees. It is not intended as a device to shift all of the burdens to the employees. It is our intention that the mechanism be triggered only by significant events.

   The development of an adjustment mechanism will require working out various important details, including what objectively determinable event(s) will trigger the mechanism, what actions will be triggered (including the extent to which the affected employee groups will be given choices), and when the mechanism will go into effect. In other words, any adjustment mechanism must state explicitly and unambiguously (a) what it takes to initiate the change in contributions, benefits, or eligibility, (b) what it takes to return to the original level of contributions, benefits, or eligibility, and (c) what it would take to restore the foregone contributions, benefits, or eligibility.

   The Advisory Group did not have adequate time or technical expertise to consider these essential details. A fair, joint process for carrying on this important work and making recommendations to the City Council needs to be established. We make no recommendation as to the form of this process, but possibilities for the City Council to consider include: (a) assigning the task to the Firefighters and Police Officers Pension Plan Retirement Board and the SRP board that we recommend be created; (b) assigning the task to a special committee composed of the City and employee group representatives who served on the Advisory Group; (c) extending the term of the Advisory Group; (d) creating a new Advisory Group; or (e) some combination of these options.

4. We recommend that the City not impose additional employee contribution requirements outside of the adjustment mechanism referred to above.

5. We recommend that any change in the plan design of the FPOPP be considered by the FPOPP Board prior to action by City Council, and that any change in the SRP's design be considered by the SRP pension board, if created, prior to action by City Council.

6. We recommend that the City initiate a review of the disparities in employee contribution rates and benefits for new employees and more tenured employees under the VRS and SRP. While some disparity may be understandable in light of budget pressures, a disparity that is too wide can negatively impact recruitment and retention of qualified employees.

7. We recommend the City Council issue a request to the VRS for a calculation of projected City costs to provide full retirement benefits at age 50 with 25 years of service for Deputy Sheriffs, Medics, and Fire Marshals. This calculation would allow the City and its affected employees to engage in informed and meaningful discussions regarding whether and under what terms such an additional benefit might be provided.

   Acting City Manager Johnson has commented to us that an earlier VRS retirement for Deputy Sheriffs, Medics, and Fire Marshals would lead to earlier retirements under the SRP by these employees, and he urged that implementation of this recommendation be deferred until the City's new actuary completes the SRP's valuation and a SRP retirement board is created. Assuming that the City Council takes timely action to create a SRP pension board, we recommend that City Council accept Mr. Johnson's suggestion.

8. We recommend that the City investigate pension portability so that the benefits of employees who change jobs within City employment are not adversely affected. This task could be assigned to the pension boards or to an ad hoc committee.

9. We recommend that the City undertake a study of the fiscal impact of amending the SRP to add a post-retirement cost of living benefit increase (COLA) provision. The SRP is the only pension plan covering City employees that lacks a COLA provision.

10. We recommend that the City enhance employee education regarding their pension coverage and other employee benefits. Consideration should be given

to mandatory retirement education for all City employees, and to providing this education in stages at the beginning of City employment, in mid-career, and within five years of full retirement eligibility.

11. We recommend that the retiree health policy and retiree life insurance policy be described in a plainly written document and made readily available to all potentially eligible employees.

    As noted earlier in the report, Acting City Manager Johnson informed us that he will ask the City's Human Resources and Finance Departments to develop a summary plan description regarding these benefits and post it on the City's website and AlexNet. This is a positive step, and we urge that the City follow through on it.

12. We recommend that the City Council review the current retiree health plan premium subsidy policy and consider increasing the longstanding maximum limit of $260 per month as funding permits.

13. We recommend that the City strive to improve pension plan coverage and other employee benefits for part-time employees, including the retiree health plan premium subsidy. Currently, part-time employees have access only to the SRP which provides limited benefits.

14. We recommend that the City carefully review its contributions to the SRP for State employees to ensure that the historical reasons for maintaining this relationship continue to be appropriate and necessary.

15. We recommend that City Council consider delaying any formal changes to the current pension plans until the release of the upcoming report of the Virginia Joint Legislative Audit and Review Commission (JLARC). The finding of the report may present additional opportunities to the City to enhance local sustainability and cost control within the existing VRS system and may reduce the perceived need to additional changes to the SRP.

16. We recommend that City Council consider reconvening the Advisory Group following publication of the JLARC report on State pension benefits that is expected before the end of 2011. The Group is the best group to review the JLARC study and then assess whether it affects any of the Group's recommendations, and make a supplemental report to Council.