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9/19/2011

report.

VIII. Costs: Pension Plans & Retirement Income Programs

The costs and projected costs of maintaining the above-described pension plans and retirement income programs for the City and its employees are described in this section.

A. Overall Costs To City

A-1. The City's contribution costs for the following pension programs: VRS, Firefighters and Police Officers Pension Plan; City Supplemental Retirement Plan, and the "Old, Old" Fire & Police Plan

Fiscal Year	Contribution Total	Total City Budget	Pension as % of Budget
2012*	$39.7m*	$699m	5.6%*
2011	$37.0m	$660m	5.6%
2010	$34.8m	$642m	5.4%
2009	$35.2m	$658m	5.3%
2008	$31.5m	$630m	5.0%
2007	$31.7m	$616m	5.1%
2006	$24.2m	$563m	4.3%
2005	$21.3m	$520m	4.1%
2004	$18.6m	$478m	3.9%
2003	$17.3m	$437m	4.0%

* Projected.

These figures do not include: (a) employee contributions actually made by employees (as opposed to "employee contributions" made by the City); (b) Social Security / Medicare payroll taxes paid by the City; or (c) the cost of any other post-retirement benefits provided by the City.

IF SOCIAL SECURITY IS INCLUDED THEN THE CITY'S CONTRIBUTION COSTS ARE: [SAME TABLE INCLUDING SOCIAL SEC.]

A-2. The City's contribution obligations to VRS, the City's employee pension plans, and Social Security are affected by the number of employees and the amount of the employees' basic salaries. So, as the City adds employees or increases salaries, it is to be expected that the City's pension costs will increase.

MY THOUGHT: (CITY SHOULD GET CREDIT FOR ITS SOCIAL SECURITY PARTICIPATION PARTICULARLY AS OTHER JURISDICTIONS DON'T PARTICIPATE. THE COST OF THAT PARTICIPATION SHOULD BE REFLECTED IN A CONTRIBUTION CHART.]

B. Costs By Employee Group

B-1. City Contributions To Current Firefighters & Police Officers Pension Plan

Fiscal Year	City's Contribution: $	and % of Salary	Total "Pensionable" Salary
FY2012*	$9.5m*	28.22%*	$34m

(g) has adopted the lower tier VRS-2 for new City employees;

(h) has imposed employee contribution requirements on new City employees;

(i) is implementing various administrative efficiencies that will reduce costs of plan administration; and

(j) carefully monitors the City employees' pension plans through the Finance Department and its Pension Administration Division.

3. 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 have 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 investors 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. 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. THESE PLANS ALSO PROVIDE READY PORTABILITY SHOULD THE EMPLOYEE CHANGE EMPLOYERS.

   Under a defined contribution plan, 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.

In contrast, under a defined benefit plan, 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 defined benefit plan can provide a decent, life-long disability pension to employees who become unable to work at a relatively young age. An employee who becomes disabled before retirement under a defined contribution plan is entitled to no more than the amount in his or her account.

[SEE PROPOSED INSERT PARAGRAPH ON FOLLOWING PAGE]

Similarly, a post-retirement cost-of-living increase in monthly pension benefits is possible only under a defined benefit plan.[9]

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 Firefighters and Police Officers Retirement Income Plan (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 memoranda:

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[9] As a further response to the Resolution's specific request for information regarding the advantages and disadvantages of defined benefit versus defined contribution plans, see Addendum ___ to this report.

(DELETE? I BELIEVE THAT - WITH THE PROPOSED ADDITIONS ON PAGES 53, 54 & 56 - THE DESCRIPTION OF THE DB AND DC PLANS WILL SATISFY THE COUNCIL'S REQUEST THAT THE GROUP CONSIDER THE ADVANTAGES AND DISADVANTAGES OF THE TWO TYPES OF PLANS)

Possible insert on page 54

Finally, defined benefit plans generally produce higher returns than defined contribution plans. They are usually directed by trustees who hire professional advisors who are better able to make prudent investment decisions than individuals managing their own defined contribution accounts, usually have a wider range of investment options available to them and generally have higher allocations to long-term equities.

incompetent 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.

5. Notwithstanding the broad language used by City Manager Sunderland, it is unreasonable to expect the City to absorb limitless investment risk 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. Our recommendations at the end of this report suggest such an accommodation. [SEE PROPOSED INSERT ON NEXT PAGE]

6. 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

Proposed insert on page 56

In this regard, it should be noted that the Standard & Poors 500 (an index of the prices of 500 large capitalization common stocks that is viewed as a leading indicator of the U.S. economy) has yielded close to a zero percent return over the past ten years.

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.] (DELETE. 1-2% CAN MAKE A SIGNIFICANT DIFFERENCE OVER 20 - 30 YEARS)

Moreover, as discussed earlier in this section, the City's contributions to the various pension plans are really substitute salary in whole or in part. That is, the City is contributing to the pension plans money that it would LIKELY have paid to the employees in salary but for the existence of the pension plans. In a real sense, the City's contributions are employee contributions.

Further, there is the matter of the City employees' expectations based on earlier actions by City Council. There is a strong belief among the City's employees that the City Council made deals not to impose an employee contribution requirement on current employees in exchange for groups of employees foregoing salary increases (step and market adjustments) for some periods or accepting other changes in terms and conditions of employment. In addition, the February 2004 memoranda from City Manager Sunderland discussed above reflect a view that City employees should not have to bear the cost investment losses in the FPOPP or SRP, if not the VRS.

7. Another commonly used approach among public employee plan sponsors is to create a new plan or a new plan tier with lower benefits or 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 under VRS-2 and requiring them to contribute 4% of their salaries to VRS. 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 are required to contribute 2% of salary to the SRP.

   Disadvantages of this new employee 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) It 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 DOES APPRECIATE, HOWEVER, THAT THE CITY HAS LEFT INTACT THE BASIC DEFINED BENEFIT PROGRAM FOR NEW HIRES RATHER THAN SWITCH TO A DEFINED CONTRIBUTION PLAN.

8. 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 higher 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.

[SEE NEXT PAGE FOR PROPOSED TWO SENTENCE INSERT]

What can be said is that the City's pension coverage is about the same on the whole as local jurisdictions. ~~although~~ 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 Watson Wyatt consulting group in 2008-2009.

9. In discussing the pension coverage provided to City employees, Social Security benefits are often overlooked. They should not be. Even though full retirement benefits are not available until age 66 or 67 (with reduced early retirement benefits available at age 62), these benefits will add significantly to a retiree's monthly income from VRS and SRP or from the FPOPP.

Notably, there is no offsetting of benefits under VRS, the FPOPP or the SRP by the amount of Social Security benefits received by the retiree. Some public plans do have offset provisions. The City contributes a substantial amount

Proposed insert on page 58

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 plan is a cause for leaving employment with the City.

towards its employees' Social Security benefits, and these benefits should be included in valuing the City's pension coverage. [illegible] OF PROJECTED OUTCOMES FOR A VARIETY OF RETIREMENT SCENARIOS UNDER THE CITY'S RETIREMENT PLANS (INCLUDING SOCIAL SECURITY) ARE INCLUDED IN APPENDIX —.

10. 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.

11. For reasons unknown to the Advisory Group, 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. Coverage of these 89 employees (annual salaries $5,350,297) is a significant cost to the City. It may be that the City receives something of value from the State for providing this coverage, but consideration should be given to whether this practice should be continued.

12. The Resolution requested that the Advisory Group consider the effects on the City's pension costs of the Government Accounting Standards Board's (GSAB) 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 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. Further, the FPOPP and SRP should be able to continue using 7.5% as their long-term investment return assumption, according to Cheiron.

    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 perceptions of the City's creditors and rating agencies.

13. As noted in the Resolution, VRS contribution requirements are a major driver of

the City's cost increases. 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 ("Followup 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. JLARC MAY ALSO PROVIDE BENCHMARKS THAT LOCAL GOVERNMENTS SHOULD SEEK TO MEET THROUGH THEIR RETIREMENT PLANS.

14. 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 a lot of controversy among public officials, and is viewed by many as more of a political stunt than a serious measure. While supporters claim that the legislation would improve financial transparency, the opponents argue that the legislation would impose costly, duplicative and misleading reporting requirements.

The bill 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.

15. All City employees have a big stake in the management of the City's pension plans, particularly in light of the employee contribution requirements. The City has recognized the value of employee input in pension matters in establishing and maintaining the FPOPP's Retirement Board.

Expansion of that joint City-employee Board, or creation of a new board, to include representatives of employees covered by the SRP and the DS, F & FM