City of Alexandria, Virginia

MEMORANDUM

DATE: APRIL 12, 2010

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER

SUBJECT: BUDGET MEMO #: 53 BACKGROUND INFORMATION ON THE FUNDING OF THE CITY'S PENSION PLANS

The memo is being provided to City Council given the recent abundance of articles and media coverage on public pension plan funding. The memo outlines information about the City's policies and other measures that the City has put in place in order to keep our pension plans in good order. It also provides an update on the funding status of our plans and discusses potential issues the City faces in the future.

There are fundamental differences between public and private pension plans. Public pension plans are designed, funded, and reported along the assumption the plans will operate in perpetuity, while private plans are funded and reported, as if the sponsoring companies were to be shut down and companies were to enter bankruptcy. These realities drive different accounting standards and funding methods. While some private plans have never been closed, and some public plans are altered or closed, practices are designed around the larger benefit. The Government Accounting Standards Board (GASB) is considering accounting standards that would have far reaching effects on public plans. The ideas stem from the goal of creating greater similarity between public and private pension plans. While well intended, the standards GASB is considering do not reflect the significant differences between public and private pension plans. We will monitor GASB's proposals very closely. Attachment 1 provides a list of the City's pension plans.

Current City Pension Practices Are Working

(1) The City and its vendors (outside auditors and actuaries) comply with all acceptable accounting and actuarial standards applicable to funding public pension plans. The City's plans are administered by certified personnel, with continuing education requirements, and audits are performed annually by outside auditors. As a result of these practices and high professional standards the City has earned the certificate of merit from the Government Finance Officers Association for twenty years running. This honor is only awarded to local governments with the highest quality annual reports and accounting standards.

(2) The governance structure and oversight of the City's pension plans are aligned with prevailing government practices. Governance of the City plans fall into two types 1) There is an

oversight board for the Firefighters and Police Officers Pension Plan composed of four employee representatives and four management representatives; and 2) the City Manager or his designees have oversight for other plans. Oversight includes a review of portfolio performance and asset allocation amongst other things. The City uses Dahab Associates as its investment consultant. They are contractually obliged to attend four Police and Fire Pension Board meetings annually but typically attend more, and conversations occur more frequently. Other vendors also provide investment support. The City's Internal Auditor has performed some reviews of retirement issues, and the City Attorney's Office and an outside specialist are used for legal counsel. In 2008 a plan amendment to the Fire & Police Plan was enacted that changed the board member terms from three years to staggered four year terms. This will create greater continuity and experience on the board. Finally, members are encouraged to go to training through the International Foundation of Employee Benefit Plans.

(3) Key funding assumptions are conservative for government pensions. The press tends to focus on just the investment earnings assumptions when reporting on pension plans. Investment earnings are the most important indicator when making pension funding assumptions and can create the most trouble when not reasonably assumed. The City assumes an investment earning of 7 ½% for the two largest internally managed plans (Police and Firefighters and Supplemental Plan), which is the national average. The City also looks at economic measures, such as inflation and salary increases, in addition to demographic measures. As a result of this analysis the City's approach to pension funding assumptions is a rational, disciplined, and conservative one. This practice helps us avoid adjusting assumptions in order to meet budget pressures. Rather, the City's practice is to adjust the budget to meet pension funding needs.

(4) There is a circular nature in the relationship between bond ratings and pension funding. The City is proud of its AAA/Aaa bond rating and makes significant efforts to retain it. One way to retain a strong bond rating is regularly funding pension obligations. Conversely, a regularly funded pension plan will be financially healthy and have lower funding requirements than those plans funded erratically. This leads to stronger bond ratings as well as lower funding requirements. Also, this discipline to regularly pay contributions in full imposes a discipline that makes it hard to significantly increase benefits without providing appropriate funding service. The City of Alexandria has funded its City plans consistently and in good faith. Not-with-standing timing issues, the City has funded all of its major plans according to accepted government pension practices. This means amortizing any unfunded liabilities over an acceptable period of time (which is considered an acceptable practice).

(5) Diversification of portfolios has improved performance and decreased risk. The City's largest plans have diversified portfolios that include domestic and international stocks, bonds, real estate, and timber. The portfolios are diversified by value and growth, large, mid, and small capitalization, and private equity. In the time that diversification has taken place relative performance has improved significantly. For example, in the three year period ending December, 2006 the Fire & Police pension plans underperformed peers. After diversifying the portfolios relative performance has improved and risk has decreased. The table below shows the investment performance ranking of the Fire and Police pension before and after diversifying the portfolios.

Relative Investment Performance		
	2004-2006	2007 -2009
Pension	56	23
Disability	72	61

(Performance is rated 1 – 100, with 1 being the best)

(6) The City has begun a pension simplification effort to make administration of the plans more manageable. Currently staff is working to consolidate the City's pension plans and vendors in order to make the plans less burdensome to administer and improve services to both active and retired employee participants. This effort is focused solely on the administrative aspects of the plans and would not result in changes to benefits.

(7) Coordinated management of pension plans creates administrative efficiencies and ensures uniformed performance. Historically the City's largest pension plans operated in isolation. More recently though, management of the plans has become more coordinated which means work done for one plan is utilized for the others. For example, when a new investment category was added to the Fire and Police pension plan, the same was done for the Supplemental Retirement plan and the retiree medical and life insurance trust. Similar actions were taken in both the Supplemental Retirement Plan and the retiree medical and life insurance trust for private equity investments as well. The investment consultant for the largest plans is also the same, and through a recent RFP the Alexandria City Public Schools may also utilize the same investment consultant as the City for its Supplemental Pension Plan (the RFP has been initiated due to contract expiration, not performance). The coordination of our City pension plans helps to generate efficiencies from a management standpoint, and it also ensures that good investments made in our larger plans are also available to our smaller ones if appropriate.

Funding Status Update

For information on pension plan assets and unfunded liabilities, please refer to columns B and C of Attachment 1.

Options to Address Future Challenges

Investment markets do periodically experience significant setbacks and when these inevitably occur the City may feel funding pressures. In the event of serious market turbulence, the City could employ some of the options and techniques listed below to help deter erratic swings in funding obligations.

(1) Flexibility to Address Potential Issues: The State generally takes the view benefits provided by the Virginia Retirement System (VRS) are fixed for life. Benefit formulas and eligibility requirements, amongst other things, may be reduced for future employees only. In fact, VRS benefits were recently reduced for new employees. The City has the legal right to modify the Supplemental Retirement Plan, post retirement medical and life insurance programs, and the Firefighters and Police Officers Pension Plan.

(2) Asset Smoothing: Asset smoothing is a technique commonly employed by pension plans to smooth out the vicissitudes of volatile investment markets. In up markets smoothing defers gains to future funding periods, while in down markets it defers losses. It makes for more level contribution rates and muted extremes in funding ratios. In cyclical markets it works well. The Fire and Police Pension Plan's losses in 2008 were muted as were the tremendous gains in 2009 because of smoothing over a four year window. In a long term (multi-year) bear market, however, asset smoothing will not significantly help the funding issues.

(3) Asset/Liability Offsets: Pension assets are accumulated to fund liabilities. Some of the factors that impair assets have an offsetting impact on liabilities. For example, recessions tend to dampen investment performance. However, recessions also tend to keep salary increases down and also retiree Cost of Living Adjustments (COLAs). To the extent these are partially offsetting the impact is not as severe as one might think when only viewing the asset side.

(4) Deferred Compensation: On the one hand deferred compensation (a.k.a. 457 plans or International City/County Management Association Retirement Corporation (ICMARC which is the local government version of a 401 K type plan) may be thought of as a tool for personal savings and thus separate from the City's funding issues. However, to the extent deferred compensation plans include employee education and pension projections, it helps develop reasonable expectations, and improved retirement planning by plan participants.

(5) Closed Plan: The old Pension Plan for Firefighters and Police officers was closed in 1979, and the last remaining active employee retired in 2007. We currently fund approximately $1.7 million annually to that plan. Recently funding has increased to cover plan contractual obligations. We expect that by 2014 these contractual requirements will be met, and we may be able to reduce funding for the closed plan and still meet all our obligations. There are 148 retirees covered by this plan.

Looking Forward

To maintain a pension program that is in good order now and remains so into the future there are several other issues and considerations the City should focus on.

With the number of retirements by baby-boomers increasing and the expansion of retirement education programs, the City will need to closely monitor operational risks to ensure they do not reach a point which could begin to negatively impact the investment performance of the City's pension plans. In the last few years much has been done to improve controls and daily operations within the Pension Administration Division in the Finance Department by reviewing and improving processes and procedures. In addition, efforts such as pension simplification will help us better manage the administration of the plans. More resources, however, may need to be considered in the future if and when the pension administration workload increases.

Also, continuing education of pension board members, City Council and plan participants on evolving issues relevant to pension funding will help us continue to make informed and rational decisions in the future. The City staff and pension board members administering these plans need to continue to receive dependable, expert advice and assistance. This will help them to understand historical stock and bond market performance and swings in performance of the financial markets generally and our pension investments specifically. This understanding will assist in the review of the asset allocation targets guiding pension investments.

Attachment

City of Alexandria Retirement Plans [2, 3]

A	B	C	D	E	F
Plan	**Assets In Millions (As of March 2010)**	**Unfunded Liabilities in Millions (As of June 2009)**	**Plan Type** [1/]	**Number of Participants**	**Primary Administrator**
Alexandria [2/] Part of Virginia Retirement System (VRS)	$258	$60	Defined Benefit	1,820 Actives 757 Retirees	Commonwealth of Virginia
Firefighter & Police Officer Pension Plan	$137	$62	Defined Benefit	446 Actives 152 Retired or Disabled	City of Alexandria
Fire & Police Disability Plan	$13	$6	Defined Benefit	446 Actives 78 Disabled	City of Alexandria
Supplemental Retirement Plan	$86	$54	Defined Benefit	2,068 Actives 259 Retirees	City of Alexandria
Pension Plan for Fire & Police (Old Plan)	$27	$17	Defined Benefit	148 Retirees	City of Alexandria
Retirement Income Plan Fire & Police	$19	$0	Defined Contribution	142 Actives, Disabled, Retirees	City of Alexandria
Retirement Income Plan Deputy Sheriffs, ERTs, Fire Marshals	$16	$0	Defined Contribution	250 Actives	City of Alexandria
Deferred Compensation	$96	$0	Voluntary Savings Program	2,727 Actives & Retirees	(ICMA-RC)

1/ Unfunded liabilities of these plans are periodically provided for each year over an extended amortization period of 16 to 20 years. This amortized payment is generally expressed as a percentage of each covered employee's salary and is added above the "normal" cost of paying for that individual's projected future retirement costs.

2/ Excludes Alexandria City Public School participation in VRS, its stand-alone supplemental retirement plan, its deferred compensation plan, and its post retirement health and life insurance plans (OPEB).

3/ Excludes City other post retirement health and life insurance plans (OPEB).