

EXHIBIT NO. 1

22
6-24-03

City of Alexandria, Virginia

MEMORANDUM

DATE: JUNE 20, 2003
TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL
FROM: PHILIP SUNDERLAND, CITY MANAGER *PS*
SUBJECT: CONSIDERATION OF A PROPOSED DEFINED BENEFIT PENSION PLAN FOR FIREFIGHTERS AND POLICE OFFICERS

ISSUE: Consideration of a proposed defined benefit pension plan for firefighters and police officers to replace their current defined contribution pension plan.

RECOMMENDATION: That City Council adopt the proposed defined benefit pension plan in concept, and authorize the City Manager to proceed over the summer with the development of a detailed plan and conversion process, to obtain before the fall final decisions from firefighters and police officers whether they wish to convert to the proposed defined benefit plan, to report to Council in the fall on these decisions and whether they impact the feasibility of establishing the proposed defined benefit plan, and, if appropriate, present the proposed plan to Council for final adoption.

BACKGROUND: Prior to 1979, the City offered sworn police officers and firefighters a defined benefit (DB) pension program. Under a DB pension program, an employee is entitled to a specific monthly income starting at retirement. The amount is based on a formula, often a percentage of final average salary multiplied by the employee's years of service. For example, if an employee's final average salary is \$50,000 and he/she has worked for 25 years, then under a DB plan with 2.5 percent "multiplier" for each year of service, the employee's initial annual retirement benefit would be \$31,250 (\$50,000 x 25 years x 2.5% multiplier).

In 1979, the City switched to a defined contribution (DC) pension plan for firefighters and sworn police officers. Under this DC pension plan, which remains in effect today, the City deposits a specific amount of money into an individual account (i.e., 20% of pay). The money in the account is then invested by the employee to provide income for retirement. Today, there are 16

available investment options available to the employee in which account funds may be invested. When the employee retires, the employee's retirement income is determined by the amount of money in the account.¹

DISCUSSION: Approximately 12 months ago, police and fire employees asked the City to consider returning to a DB plan. The reduced value of the employees' DC account in the late 1990s and early 2000s largely drove this request. Also, the employees recognized that under a DC plan, it is they that incur all investment risks, and hence receive all the benefit or all the loss resulting from changes in the equity and bond markets, and from resulting changes in account values. Under a DB plan, of course, it is the employer that incurs all investment risks.

Late last Fall, a joint employee/staff committee (Study Group) was formed to study the feasibility of changing from a DC plan to a DB plan. The Study Group consisting of three employee representatives from the Police Department, two representatives from the Fire Department, representatives from the City Manager's Office, Personnel Services Department and the Finance Department. The Segal Company, a national pension consulting firm, was hired to provide the Study Group with technical assistance on the principles and procedures associated with the conversion of a pension plan from one form to another and to address the financial impact (and, therefore, the feasibility) of such a proposal. The basic ground rule set by the City at the outset of this study was that the City's contribution under any DB plan would not exceed the "20% of salary" contribution that is made under the current DC plan.

The Study: After 18 meetings conducted over the last eight months, the study revealed that the conversion to a proposed DB plan, which is defined below and in Attachment 1, would be financially feasible: (a) if the City continued to contribute 20% of employee salaries; (b) if all employees (from the effective date of the new plan) contributed 8% of their salaries; and (c) if all firefighters and police officers elected to join the new DB plan and transferred their existing DC account balances into the new plan.

The DB plan that is proposed has the following chief characteristics:

Eligibility: Full time employees, who are classified as firefighters or police officers and are currently participating in the DC plan, will be participants in the plan. New firefighters and police officers hired after the DB plan goes into effect will automatically become participants in the plan. Existing firefighters and police officers will automatically become participants in the plan only with respect to future service, and will have the ability to elect either (i) to transfer their DC account balance to the DB plan in exchange for service credit under the DB plan for all their prior service as a firefighter or police officer, or (ii) not to transfer their DC account balance to the DB plan and, instead, retain those funds, as is now the case, in a City administered account and continue to

¹ Almost all City employees other than firefighters and police officers are covered by the Virginia Retirement System (VRS) and the City's Supplemental Retirement plans. These are DB, not DC, plans.

invest them over time, and not receive any credit under the DB plan for their City service prior to the establishment of the DB plan.

Benefit Formula: The DB provision, which has the largest economic effect, is the plan's multiplier. Under DB plans, the multiplier is a percentage that is applied to an employee's average final compensation to arrive at a figure which is multiplied by the employee's years of service to arrive at the annual pension. The multiplier under the proposed DB plan would be 2.5% for an employee's first 20 years of service, and 3.2% for the next 10 years of service. Years of service over 30 would have, in effect, a 0% multiplier. Thus, the maximum pension benefit under the proposed DB plan would be 82% of an employee's average final compensation, and would be reached after his/her 30th year of service.

Credited Service: Full time employees are credited for each month of active service, military leave, authorized leave and while disabled under the Plan. Credited Service is calculated to the nearest month. Participants who choose not to transfer DC account balances to the DB plan will receive no credit for years of service spent under the DC plan. Credited Service for those participants will accrue only from the date the new DB plan begins.

Current Plan: If the City switches to the new DB plan, it will cease contributions to the current DC plan. All then active fire and sworn police employees will be enrolled in the new plan. The employees will not be given the option to remain in the old plan. The assets in an employee's DC account plan that are not transferred to the new DB plan will remain in a pension-type of investment until the employee retires or leaves City employment.

Normal Retirement: An employee in the plan will be first eligible for unreduced normal retirement when he/she reaches age 55 with five years of Credited Service, or with 25 or more years of Credited Service regardless of age.

Early Retirement: An employee in the plan will be first eligible for early retirement with reduced benefits when he/she reaches age 50 with at least 20 years of Credited Service.

An analysis of the employee's age, years of service, and DC account balances, undertaken during the study, determined that the cost of providing the proposed DB plan would require not only the City's contribution of 20%, but the employees' contribution of 8% in order to fund the pension plan. The analysis also showed that the total assets in the current DC plan do not meet the accumulated cost of the accrued DB benefits earned to date by the participants. A traditional DB plan recognizes liability for the service worked by the employee prior to the establishment of the plan as prior service cost. Accounting standards permit government to amortize the prior service cost over an extended period of time.

The main financial assumptions made during the study are the following:

- The unfunded past service cost will be amortized over the next 25 years. At the inception of a plan, credit will be given for services rendered before the creation of the plan to those employees who transfer their DC account balances to the DB plan. Since those DC balances are insufficient to cover this past service cost, the excess cost or liability will be amortized over the next 25 years.
- The plan assumes that over time the plan's assets will earn an average of 7.5% annually.

Employee Survey: With this initial determination of feasibility, during the last weeks of May, a non-binding survey of all firefighters and police officers was undertaken to determine actual employee interest in the proposed DB plan and to get a rough sense of the number of firefighters and police officers who were willing to transfer their account balances to the DB plan. The survey document asked employees to indicate whether they would be willing to transfer their existing retirement account balance to the proposed DB plan in exchange for credit for their service under the DC plan. As of June 10, 2002, 92% of firefighters and 96% of police officers responded to the survey. Of the firefighters who submitted a response to the survey, 80% indicated they would transfer their DC account balance to the DB plan; of the responding police officers, 87% indicated they would make this transfer. Only 16% of responding firefighters and 12% of responding police officers directly stated that they would not transfer their DC account balance.

Based on the information from this non-binding survey, Segal was asked to prepare another analysis of the feasibility of converting to a DB plan. This new analysis considered the feasibility of the conversion by including in the new plan only those current employees who indicated in response to the survey that they would transfer their DC account balances to the proposed DB plan. Segal's analysis revealed that the proposed DB plan would cost 27.97% of the payroll. This is basically the same cost as the DB plan described in Attachment 1 in which the City would pay 20% of payroll (the same percentage as it now pays under the DC plan) and employees would pay 8% of their salaries.

It should be noted that some employees have asked that the City maintain two plans: (a) a new DB plan for employees who wish to convert their DC account balances to this new plan; and (b) a DC plan for employees who do not wish to make such a conversion and, instead, wish to remain in the current DC plan. Unfortunately, for a DB plan of the nature that has been proposed to be financially feasible, all employees must move to the new plan if it is established. The finances of the DB plan leave no room for employees to remain, in the future, in the DC plan. The reasons for this all-or-nothing requirement are the following:

1. The proposed DB plan would not be fiscally feasible if the plan's normal cost and past service cost are not distributed as a percentage of the entire payroll. If individuals were able to opt out entirely from the DB plan and not make the

employee contribution, the DB plan's annual cost would need to increase to a level that would render the plan unaffordable. The proposed DB plan works because everyone shares the cost.

2. There would be high administrative costs for maintaining two types of pension plans for the same employee group. The City would be required to maintain two types of investment monitoring systems, two types of employee pension files and reporting requirements, and two separate annual actuarial calculations and financial reports covering the same employee group.

Reasons for Recommendation:

Unlike the DC plan, the City, not the employees, will assume, under the DB plan, the risk of the return on investments. We believe this is appropriate (it is the case with practically all other employees' pensions plans). The City's pension cost will increase if the return on investment is less than the 7.5% assumed rate of return in the feasibility study. On the other hand, the City's contribution might decrease in the event that investment returns exceed the 7.5% assumption. However, in the long run, we expect that the City would be roughly in the same shape financially under the proposed DB plan as it would have been if the DC plan had continued.

As noted, we believe it is proper for the City to assume this risk. As a long-term policy, instead of having the employee bear 100% of the investment risk for his/her entire pension, it is more appropriate for the City to assume the risk. In addition, the current devaluation of the participants' accounts as a result of the wide fluctuations in stock market valuation has confirmed that, over the long term, the City is far better equipped to shoulder this risk. The City is simply better able to handle fluctuations in the equity and bond markets and in earnings over time than individual employees. 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.

The proposed DB program ensures that a definite, not-affected-by-investment-return set of benefits that will be available throughout the retirement of for 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. However, these differences relate not to the length or quality of their service to the City, but to their investment decisions. More importantly, the difference relates to the nature of the economy during the years those investment decisions were made. We believe it is befitting 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).

Where We Go From Here: If Council approves the concept of establishing the proposed new DB plan, staff will take the following actions:

- Over the summer, outside pension legal counsel will develop plan documents that meet the requirements of federal pension law.
- Before City Council takes any other action on the pension plan, staff will obtain the final binding vote of employees who wish to convert and who agree to transfer their DC account balances into the new DB plan. In conjunction with the employee unions, we will provide resources to assist employees in making this decision. Once we have the final list of planned participants, we will conduct one more feasibility study to be sure that the proposed DB plan will be financially feasible with contribution rates no larger than the now proposed 20% and 8% rates.
- As mandated by the current DC plan, employees will be given 60 days to comment on any changes to the existing plan including commenting on new plan documents.
- After the 60-day notice, final binding votes from employees and final feasibility study, Council will be provided with the necessary documents required to adopt the new DB plan. If all works as contemplated and the plan remains feasible, Council would be requested to take the necessary actions to adopt the new plan this fall.
- The plan documents will likely have the new plan go into effect approximately 30-60 days after approval by City Council.

FISCAL IMPACT: The City 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 when the market value of the pension plan assets and investment earnings decrease. Conversely, the City's 20% cost would decrease when the market value of the pension plan assets and investment earnings increase.

ATTACHMENT: Proposed Defined Benefit Pension Plan Summary

STAFF:

Daniel A. Neckel, Director of Finance
 Michele Evans, Assistant City Manager
 Mark Jinks, Assistant City Manager
 Caterina Tarver, Pension Administrator

PROPOSED DEFINED BENEFIT PENSION PLAN SUMMARY

Plan Provision	<p style="text-align: center;">City of Alexandria Firefighters and Police Officers Defined Benefit Pension Plan</p>
Eligibility	Full time employees who are classified as a firefighter or police officer and are currently participants in the Defined Contribution Retirement Income Plan. New firefighters and police officers will automatically become participants in the plan. Existing firefighters and police officers will automatically become participants in the plan with respect to future service and will have the opportunity to transfer their account balance under the Retirement Income Plan in exchange for prior service credit as a firefighter or police
Effective Date	To be determined.
Plan Year	July 1 through June 30
Type of Plan	Defined Benefit Plan
Current Plan	Defined Contribution Plan. There will be no further benefits accrued to the current defined contribution plan after the proposed defined benefit plan becomes effective.
Contributions by Employer and Employee	<p>The City will pay the employer required contribution which is expected to be 20%.</p> <p>Employees will pay a contribution of a specified percent of gross pay. Current proposed rate is 8%.</p> <p>All employee contributions are in pre-tax dollars. Payroll deductions for employee contributions are made with each pay period. City contributions are made monthly.</p>
Vesting	<p>Upon 5 years of Credited Service. See explanation of "Credited Service" on page 2.</p> <p>Upon separation from City service, all participants, whether or not vested, may withdraw their employee contributions and interest.</p>
Normal Retirement	Age 55 with 5 years of Credited Service, or 25 or more years of Credited Service regardless of age.
Early Retirement with Reduced Benefits	At age 50 with at least 20 years of Credited Service.
Average Final Compensation (AFC)	Highest average earnings received during any 36 consecutive months while actively employed by the City and covered by the plan. Overtime pay, holiday pay and other additional compensation are excluded.
Benefit Formula	<p>2.5% of Average Final Compensation (AFC) multiplied by years of Credited Service up to and including 20 years; and</p> <p>3.2% of Average Final Compensation multiplied by years of Credited Service in excess of 20 years.</p> <p>The maximum benefit of 82% of Average Final Compensation is reached with 30 years of Credited Service.</p> <p>Benefits are paid according to this formula until the employee is first eligible for unreduced Social Security benefits.</p>

Plan Provision	<p style="text-align: center;">City of Alexandria Firefighters and Police Officers Defined Benefit Pension Plan</p>	
Credited Service	<p>Full time employees are credited for each month of active service, military leave, authorized leave and while disabled under the Plan. Credited Service is calculated to the nearest month.</p> <p>Participants who choose not to transfer Retirement Income Plan balances to the Defined Benefit plan will receive no credit for service under the defined contribution plan. Credited Service for those participants will accrue from the date of participation in the new plan.</p>	
Cost of Living Adjustments	<p>Annual adjustment to pension benefit is based on the increase in the CPI. The annual increase cannot exceed 3% or never be more than double the original monthly pension benefit.</p>	
Social Security Adjustment	<p>When a retiree is first eligible for unreduced Social Security, the monthly pension benefit is recalculated, reducing the 2.5% and 3.2% multipliers by .25. The benefit will be 2.25% of Average Final Compensation up to and including 20 years of Credited Service and 2.95% up to and including the next 10 years of Credited Service.</p> <p>[If there is no Social Security Program, there will be no reduction.]</p>	
Separation Prior to Retirement	<p>An employee who leaves the employment of the City of Alexandria and who is vested will be entitled to receive benefits beginning at normal retirement age. Upon separating, an employee may make a full withdrawal of employee contributions, including interest. Separated employees who withdraw their employee contributions and interest will not receive any future retirement benefit.</p>	
Death/Survivor Benefits Before Retirement	<p>If an employee is married at the time of death, the surviving spouse receives 50% of the normal retirement benefit. The date of death is treated as if the participant reached his/her normal retirement age and is eligible for an unreduced benefit. The benefit is payable immediately and for the remainder of the spouse's life.</p> <p>If the participant is not married at the time of death, the beneficiary will receive a refund of the participant's contributions and interest.</p>	
Death/Survivor Benefits After Retirement	<p>The employee can elect survivor benefits upon retirement. Benefits may be paid in the form of a 50%, 66 2/3% and 100% joint and survivor annuity or 5-year, 10-year, and 15-year certain and life annuity option.</p>	
Investment of Plan Assets	<p>The City of Alexandria will be responsible for the direction of the investment of the plan assets and assume the investment performance risk. The Retirement Income Board will direct the investment management of the pension plan assets once it is established. There will be no individual participant accounts.</p>	
Payment of Benefits	<p>Benefits may commence as soon as administratively possible upon retirement, death, or termination of employment.</p>	
Prior Service Buy-Back	<p>Service buy-back is to be considered in the future.</p>	
Options	<p>Deferred Retirement Option Program (DROP), purchased sick leave, and other options designed to encourage employees to delay retirement are under consideration.</p>	
Plan Assumptions	Investment Return	7.5%
	Amortization of Unfunded Liability	25 Years