Pension Transition Committee Report

Presented to Mayor Brown on August 8, 2011

Introduction

It is with a strong sense of urgency that we report to the mayor our findings and recommendations regarding the City of Jacksonville's defined benefit pension system. The combination of pension fund deficits (unfunded actuarial accrued liabilities, or UAAL) for the total of all city plans was last reported to be over $1.6 billion. It is expected that Jacksonville's pension costs could skyrocket by more than 50% in the next 5 years if the current pension structure remains in place.

State law requires an actuarial study for each pension plan on a three year rolling basis. The last accepted actuarial studies were completed in September of 2008, prior to a large decline in the stock markets. Since that time, our pension funds may have underperformed the 8.4% to 8.5% expected rates of return, which could increase the pension deficit from the current $1.6 billion estimation. It is expected that the new actuarial studies will require an increase in pension funding ranging from 10%-50% more (ie: $132 million to $180 million) for the 2012-2013 city budget, which is to be completed in 12 months.

This large range of expected increase is based upon the results of the actuarial assumptions which, in the last 10 years, have been quite inaccurate. This has resulted in the 22 year performance of the PFPF (8.26% per year) having lagged the expected return (8.5% per year), as an example. If we, responsibly, adjust the assumptions to more accurately represent the current economic and investment environment, we risk increasing costs by over 50% for the next city budget. With all factors being considered, it is a reasonable expectation that current pension cost projections for the 2012-13 Budget are far less than the actual costs will be upon completion of the new actuarial study.

A new state statute (SB 1128) requires that all municipal defined benefit pension plans provide additional actuarial reports which use the Florida Retirement System (FRS) assumed rate of return of 7.75%. If a defined benefit pension plans already uses the 7.75% assumed rate of return, or lower, no additional report is necessary. Currently, our plans use the aggressive assumption of an 8.4% expected average return for the General Employees Pension Plan (GEPP) and an 8.5% expected average return for the Police and Fire Pension Fund (PFPF). Using the rate established by FRS could increase the aforementioned pension costs by more than 10%.

Jacksonville faces both a short term and a long term crisis as the escalating costs of pensions are projected to increase with significant volume and velocity over the next 20 years. The bear market has affected the FRS and local pension funds across the state. At present, Jacksonville's pension plans (primarily PFPF) are less funded than others across Florida. Our PFPF is 48.8% funded while comparable Police and Fire Pension Plans in the state of Florida are 83% funded on average, according to data provided by our Police and Fire Pension Plan. The next least well funded Police and Fire Pension Plan is in Miami (62% Funded), which is moving to a defined contribution plan.

According to Jim Linn of Lewis, Longman & Walker, P.A., "Public pension plans in Florida are in better shape than those in many other states because Florida law requires that public pension plans be funded on a 'sound actuarial basis'....in 2009, average annual pension costs for Florida cities accounted for 8.6% of total expenditures." Unfortunately, in Jacksonville these

facts do not hold true. Our pension plans are weaker than the national average and our costs are, for the 2011-12 fiscal year, 12% of total expenditures and are projected to rise to over 18% of revenue for the 2015-16 fiscal year (under current assumptions and projections which might be more conservative than the November 2011 report), if left unchecked. This could mean our pension costs would grow from $118 million this fiscal year to more than $180 million by 2016.

Without a substantial increase in city revenues (greater than 35% in the next four years), which is not possible without significant change in the current economic environment, the City of Jacksonville could be forced to reduce all other city services by 10% to 25% to compensate for the growing pension obligation problem.

Inaccurate actuarial assumptions and the granting of retroactive benefits are among reasons that have contributed to Jacksonville's pension problem. A debate also exists as to whether the city has taken "pension holidays". This committee does not attribute funding issues to any so-called pension holidays. The PFPF enjoys an independent structure which makes it responsible for projecting its pension costs (actuarial assumptions), managing its investments and billing the city exactly what it believe will cover its costs. The city has paid this "bill" at 100% or more for every year over the last 32 years. In fact, in the last 20 years the PFPF was near 100% funding. The "pension holiday" issue relates to the city not paying more than the PFPF requested, which is an illogical reason to be so far under-funded. The PFPF has a responsibility to apply accurate assumptions to its plan in order to properly fund it.

It is important to note that more than 1,000 city employees were excluded from the city's defined benefit pension and enrolled into the Social Security system over a long period of time. The employees have since been enrolled into the City's defined benefit pension plan, at a cost which will be added to the previous projections. The potential cost is estimated to be as high as $50,000,000.

The options which can reduce the current crisis of cost include:

- Reducing benefits for new and current employees
- Increasing employee contributions
- Terminating, freezing or closing current pension plans and setting up lower cost plans

Even if the City alters benefits for new employees, that step may not provide all of the savings required to fund this immediate and fast growing gap in costs without increasing taxes substantially. The City may need to consider the proper level of employee contributions or benefits for current employees.

Executive Summary

- This report serves to provide an outline of the City of Jacksonville's pension plan challenges and a comprehensive list of options to address the pension deficits for Mayor Alvin Brown and the incoming administration to consider.
- The Milliman Pension Funding Index, which consists of the 100 largest corporate pension plans, rose to an overall funding ratio of 87% in June, 2011. The UBS Global Asset Management U.S. Pension Fund Fitness Tracker reports an 85% funding ratio for corporate plans at the end of the second quarter of 2011. It is expected that the PFPF will fall into the 35% to 45% range of funding after the actuarial study in November of 2011, and the GEPP will fall into the 65% to 75% range.
- According to a 2010 analysis of comparable PFPFs in the state of Florida, Jacksonville's PFPF is currently funded at a ratio of roughly 48.8% as compared to an average funded rate of 83% for other comparable cities in Florida. A study of best practices among other pension plans in the state is recommended.
- The vast majority of city's employees are not enrolled in Social Security through the city.
- A review of the governance policies of the pension plans could serve to improve strategic decision making, cost structure and reduce conflicts of interest which jeopardize the quality of fiduciary oversight.
- The city has benefited from using inaccurate actuarial assumptions in the GEPP because it can lower immediate and "projected" pension costs at the risk of future city budgets footing the bill. In the case of the PFPF, inaccurate assumptions can fail to capture the true cost of additional benefits.
- Maintaining the current review and advisory capacity of the Pension Transition Committee or a similar group of advisors is recommended. The committee would help to provide checks and balances, facilitate taxpayer and participant outreach, encourage transparent and conservative practices, and solicit input from objective resources.
- A review of potential options to fund or reduce the pension deficits can be categorized into two sub-sets. The first sub-set of options include strategies that reduce the cost burden to tax-payers and the city, while the second sub-set includes options that increase the cost burden to tax-payers and the city.
- A Defined Contribution system could serve to reduce costs to tax-payers and employees, align employee interests and benefits with the private sector, avoid budget crises as a result of the correlation between city revenues and pension deficits, and could reduce the potential for political influence to create massive budgetary issues related to employee benefits.
- Multiple national resources estimate that between 80% and 90% of private sector employers offer only defined contribution plans. The United States Bureau of Labor Statistics reports the average wage for private sector workers in the Southeast is $20.76 in comparison to an average wage for public sector workers of $32.14. This differential should be considered as defined benefit pensions have proven, in Jacksonville, to cost (on average since 1979) over 50% more than a defined contribution plan.
- People are working longer and living longer, so city benefits should reflect this in order to align public sector employee pensions with tax-payer benefits.

Potential Solutions to the UAAL Pension Deficits

This section is structured to include three primary areas, as recommended by our subject matter experts and our committee, which could serve to reduce or eliminate the funding gap (UAAL Pension Deficits) in our collective pension system. These areas include Governance, Revenue Saving Strategies and Revenue Intensive Strategies.

Governance:

When a pension system has significant funding challenges, a review of the policies, structure and leadership is vital. For example, PFPF employs an independent actuary to provide actuarial assumptions, which will reflect the projected costs of funding. The PFPF makes independent assumptions about retirement age of participants, participant mortality, expected investment returns (8.5%), participant payroll cost and more. The PFPF then uses these assumptions to arrive at the annual cost to the city for their fund. The city has funded this cost at or over 100% every year for at least the last 34 years. Yet, the PFPF is 48.8% funded compared to 75% for the GEPP as the actuarial assumptions for the PFPF have been different from those used in the General Employee Pension Plan (GEPP). It should be noted that the city has not provided additional funding to the GEPP to cause this difference.

The costs of pension and investment management as a percentage of fund assets are about twice as much for the PFPF as compared to the GEPP. The PFPF notes that its employees have responsibilities and duties that exceed those of GEPP staff, and that the costs of the GEPP staff do not reflect the involvement of the City's CFO, Treasurer, Controller and other finance staff which are provided for elsewhere in the budget. It should also be noted that the PFPF could share administrative resources with the GEPP and city finance department to save costs. The PFPF receives an $8.1 million line item from the city's General Fund Budget. Of the $8.1 million, $5.85 million is used for investment expenses which could be reduced as a result of sharing resources with the GEPP. The remaining $2.25 million goes to expenses which include PFPF salaries ($804,960 as of FY 2012), a miscellaneous line item, funds for travel, and office equipment and other duplicative costs.

One area that deserves additional examination is the history of PFPF leadership negotiating and authoring city ordinance stipulating increases in retroactive and future benefits for PFPF participants. This could pose a conflict of interest as the legal responsibility of the PFPF is to act as a fiduciary. As a fiduciary, the PFPF must decide upon actuarial assumptions and investment strategies that will provide successful (100%) funding for the PFPF participants. If the PFPF deviates from its legal obligation as fiduciary in order to be a negotiator on behalf of participant benefit increases, it could participate in aggressive practices with long-term fiscal consequences.

The city's unfunded liability was primarily caused by three major contributors: 1) The use of inaccurate actuarial assumptions; 2) The addition of retroactive benefits; 3) The Bear Market.

The market downturn negatively impacted all pension plans. However, Jacksonville remains significantly more under-funded than comparable Florida Public safety plans. In 2010, the Jacksonville PFPF was 58% below average with a mere 48.8% funding while comparable cities managed to average 83% funding status. The PFPF maintains that this disparity in funding is a result of the low PFPF funding level prior to the 2008 bear market. This is indicative of a longer history of poor funding practices by the PFPF than just the recent market.

For private sector comparison, the Milliman Pension Funding Index, which consists of the 100 largest corporate pension plans, rose to an overall funding ratio of 87% in June, 2011. The UBS

Global Asset Management U.S. Pension Fund Fitness Tracker reports an 85% funding ratio for corporate plans at the end of the second quarter of 2011. It is expected that the PFPF will fall into the 35% to 45% range of funding after a new actuarial study in November of 2011, and the GEPP will fall into the 65% to 75% range.

Possibly the most crucial element to the fiduciary duty of our pension fund leadership is an expertise in and careful management of the actuarial assumptions. The current state mandated process requires that the pension funds present their assumptions to the city and the state for approval. The state has a range of assumptions which it will allow. Our pension plans have consistently submitted assumptions that were on the "high end of reasonable". It should be understood by the reader of this report that with less accurate actuarial assumptions (8.5% expected rate of return for PFPF vs. 8.4% for GEPP, 1994 Mortality Tables for PFPF vs. 2000 Mortality Tables for GEPP) the projected costs are muted in the short term, but magnified over time. So, both the city and the pension funds have a conflict of interest as it relates to the actuarial assumptions. The city benefits from inaccurate assumptions because it can save current costs at the risk of future city budgets. The pension funds benefit from inaccurate assumptions because they can make the case that additional benefits could be added at lower projected costs. In fact, retroactive benefits have been added a number of times (i.e.: a participant with 10 years of service who has been accruing a pension at 2% per year has earned a 20% of salary pension calculation. If the pension fund were to add a retroactive benefit accrual of 3% per year of service, they would then automatically have earned 30% of pay without a single dollar being added to the plan to fund it).

Pension Negotiation and Law - The City of Jacksonville has enacted the following pension ordinances, agreements or memoranda of understanding from 1991 through 2006: Ordinance 91-1017 and Signed Agreement; Ordinance 93-1983-1407; Ordinance 93-1983-1407; Ordinance 97-1103-E; Ordinance 2000-1164-E and Signed Agreement; Ordinance 2003-303-E and Unsigned Agreement; Ordinance 2003-1338-E and Unsigned Agreement; Ordinance 2006-508-E and Unsigned Agreement. The Committee is concerned that these previous ordinances and agreements may not be in the best interest of the taxpayers and deserve an intensive review from both a policy and legal perspective to determine their validity.

Reconstitute the GEPP Trustees – The current Trustees of the GEPP consist, primarily, of GEPP participants receiving defined benefit pensions. This potential conflict of interest could be reduced by the appointment of private sector citizens with pension expertise.

Merging the PFPF and GEPP according to State Statutes 175 & 185 – The negotiations over the last few years to reform the PFPF deficits with changes to current employees benefits have been unsuccessful. Should the city refuse the premium taxes (from Duval County residents property and casualty insurance premiums), which currently amount to about $10,000,000 per year, the PFPF could be eliminated. The duplicative costs of the PFPF would also be eliminated and the administration and management would be assumed by the GEPP personnel. However, the City would need to reduce participant benefits by an additional cost of $10,000,000 per year as the premium taxes would no longer be available to fund the PFPF.

Transfer Defined Benefit Plans to the Supervision of the Florida Retirement System – A secondary option to the current structure of our pension management systems would be a transfer of authority and management to the State of Florida's "Florida Retirement System". The FRS has been much more successful in managing investments, adopting realistic actuarial assumptions and managing the comprehensive costs as they are spread over a much larger base of assets. Our City pension systems cost more to manage and have been largely unsuccessful in developing realistic actuarial assumptions. Although the objective would be to reduce costs, the pension deficits would still be required to be funded.

Benefit and Funding Management Options for Consideration

A review of the remaining potential options to reduce the pension deficits can be categorized into two sub-sets. In order to provide some clarity to these solutions, sub-set one will be referred to as "Cost Saving Strategies," while sub-set two will be referred to as "Revenue Intensive Strategies." The cost saving strategies are aimed at reducing pension costs, while the revenue intensive strategies would be aimed at enhancing revenue.

Cost Saving Strategies:

Freeze Defined Benefit Pension Plan(s) in favor of Defined Contribution Plan(s) – Since 1979 the costs to the city for the GEPP have averaged over 17.5% of payroll and have ranged from 0% to 22.5%. The costs for the PFPF have averaged more than 14% over the same time period, and ranged from 3.5% to 50% of payroll. This volatility in cost is due, primarily to the use of inaccurate actuarial assumptions (i.e.: 8.5% expected rate of return, using out of date mortality tables, etc.) and has lead to more aggressive investments in the pension funds and greater risk of a crisis in cost.

In order to transition to a defined contribution plan, the city must enroll employees into Social Security, which costs 6.2% of payroll. If the city were to provide every employee with a 6% of payroll contribution benefit, the cost to the city for a defined contribution plan would be 12.2% of payroll. This would change the cost to the city from a variable cost to a fixed cost. The liability to the city would be contained to the fixed cost and fluctuations in investment markets would cease to jeopardize other city resources during times of economic and financial hardship for tax-payers. Employees would not feel obligated to remain in a position out of concern of losing pension benefits. Employees could retire or transition more freely. As 80% to 90% of private sector companies do not provide a defined benefit pension, this would create more equal footing between public and private sector benefits.

A defined benefit pension plan is able to spread costs over the entire projected lifespan of its participants. By freezing the defined benefit pension plans, the timeline of costs to fully fund the pension plan is reduced and the number of active workers contributing to the plan slowly decreases. The short term costs to the city could be significant, while the long term costs are significantly reduced. According the United States Bureau of Labor Statistics, the average wage for private sector workers in the Southeast is $20.76 in comparison to an average wage for public sector workers of $32.14. This should be considered as defined benefit pensions have proven to cost (on average since 1979) 50% more than a defined contribution plan.

Hybrid Defined Benefit/Defined Contribution "Share Plan" – This would entail a reduction of defined benefits (as listed in the proceeding section) to a level which the city budget could afford, even in difficult economic periods, with a specified contribution being made to a Defined Contribution plan for employees. For example: using the premium taxes provided under Chapter 175 and Chapter 185, Florida Statutes for Fire and Police participants to fund defined contribution accounts while still providing a minimum defined benefit.

Separate Benefits Tracks among Different Divisions of City Government –The private competitors of JEA do not, largely, provide defined benefit plans. If JEA had the authority to increase employee incomes and decrease benefit costs, it might increase its competitiveness in the marketplace for intellectual and leadership capital. The same may not be true for certain segments of JEA's workforce or, for that matter, other divisions of city government. An objective review of benefits provided by competitors to each division of the city is recommended to

determine what constitutes a competitive hiring practice. An independent group should provide this objective analysis as current employees likely have a conflict of interest.

Prohibit Retroactive Benefit Increases – The practice of retroactive benefit increases should be completely abolished. The additional burdens, added at times when the funds were not fully funded have compounded our current crisis and have complicated reform in such a way that the previous City Council members spent two years attempting to repeal these added benefits for current employees without success.

Reduction of Payroll Costs – Through the reduction of salaries or total number of employees, the amount of the pension deficits can be reduced. This should be considered a secondary alternative in the event that the pension funds continue to be unwilling to reduce the retroactively added benefits that have contributed to the deficits.

Increase the Retirement Age for City Workers to Match Social Security Age – As people are living longer, the costs for pensions are escalating due to some employees collecting pension payments for a longer period of time than they were working. Some employees can retire in their early 40s in Jacksonville (after working 20 years) and collect a pension for 40 to 50 years more. General Employees can retire at 55 with 20 years of service and collect a pension for 25-30 years. Social Security can begin as early as 62 with a reduced payment and at 66 with full payment. This would match public sector benefits with private sector benefits. The shortened pension payment period would provide the city significant cost savings.

Reduce the Benefit Accrual Calculations – This means that workers will be required to work more years to achieve the same pension benefits. For example, Police Officers and Fire Fighters receive 3% of pay for each year of service (i.e.: 20 years of service x 3% = 60% pay). A reduction to 2.5% of pay per year of service would require Police and Fire Fighters to work 24 years to reach 60% of pay and 32 years to reach 80% of pay. General Employees receive 2.5% of pay per year of service. A reduction to 2% per year of service would require workers to complete 30 years of service to reach 60% of pay and 40 years of service to reach 80% of pay. This change also reflects the prevailing trends of longevity of life and career for Jacksonville citizens. The overall cost savings likely project to be significant. The city could benefit from employees working longer by maintaining intellectual capital and institutional memory among city workers.

Increase the Required Match from Salary – General Employees currently match 8% of salary to contribute to their pension plan. Police Officers and Fire Fighters currently match 7% of income into their pension plan. An increase to 10% of income to receive a pension could further defray costs to the city. This puts a greater emphasis on employee participation, similar to the private sector.

Eliminate or Reduce Automatic 75% Survivor Benefit – Significant savings can be derived from requiring pension participants to assume the actuarial costs of providing survivor benefits for their spouses. Presently, all city pension systems provide 75% of participant pensions to any spouse they have been married to for the 12 months prior to their death.

Eliminate or Reduce the Deferred Retirement Option Program (DROP) – During the last five years of a participant's career, they are eligible to participate in the DROP program. This is highlighted by a cost to the city, for that five year period, of paying the employee a full salary while also compensating them with a pension income that is deposited into a special "DROP" account. For Police and Fire participants, an 8.4% guaranteed rate of return is provided for up to 40 years, which is an additional cost to tax-payers during periods when the pension funds do not return 8.4%, such as the previous 10 years. One of many other options is to index the fund's

rate of return to the actual investment returns of the pension fund. There are a number of like municipalities using this practice.

Change the Final Average Pay Calculation – As a part of the formula for determining a participant's pension calculation, an average pay is used. The PFPF, for example, uses the highest two years pay. If the average last 10 years were used, for example, the pension may more accurately reflect the career of the participant.

Reduce, Eliminate, Index or delay the implementation of the 3% Cost of Living Adjustment (COLA) – The compounding 3% costs of the pensions due to the 3% COLA could have been reduced had the COLA been based upon the Consumer Price Index (CPI) or reduced to 2-2.5%. This should be analyzed by the actuary and pension trustees as a source of savings.

Revenue Intensive Strategies:

Pension Obligation Bonds – This city must utilize its municipal bond credit rating to borrow funds for a designated period of time and interest rate. With the proceeds from the debt offering, the pensions would invest into the pension investments. The objective is for the investment returns to exceed the borrowing interest rate in order to make a profit for the pension fund. The city can choose to pay the bond obligations at maturity with either pension funds or city funds. The hope is that the profit from the pension funds would fill some of the pension deficit gap. Over a long period of time, the pension investors would expect the pension investment rates of return to exceed the borrowing costs. This could jeopardize the city's credit rating and borrowing capacity, therefore, hindering its ability to borrow. The pension investors may fail to achieve investment returns in excess of the borrowing rate, thereby increasing the pension deficit (this would have been the case over the last 10 years).

Pension Stabilization Fund – The purpose is similar to a "rainy day" fund as it is intended to fill the deficit gap during periods of negative investment market returns. This strategy could negate the need to draw from city resources or reduce benefits as it can reduce pension deficits by transferring assets to the primary pension fund. This could be considered an additional cost to the tax-payer as it would be funded through a result of excess contributions from the city budget. Another part of the budget may suffer to fund this. Additional funds could be made available, in similar quantity, if the assumed rates of return were lowered, thereby increasing the chances for fund investments to provide excess capital.

Transfer City-owned Real Estate to the Pension Funds – By transferring real estate assets from the city to the pension funds, the city can provide needed stimulus to the funds. The pension funds could sell or lease the properties and use the profits to reduce the pension deficits. The city can dissolve itself of non-tax revenue generating properties and, potentially, find buyers that would be required to pay property taxes. If managed well, the proceeds from this could greatly reduce the pension deficits. Should the pension funds poorly manage the sale or lease of these properties, it would reduce the effectiveness of the deficit reduction as the city is still obligated to fund the gap. Additionally, the city may need the additional property for future municipal development or use. The city's recent transfer of property to the Police and Fire Pension Fund was followed with an additional revenue stream from the General Fund budget to assist the PFPF in the development and management of the properties. The cost to benefit ratio on this transaction may have been less than expected.

Increase the Millage Rate for Property Taxes – It is estimated that a millage increase of 1 mil could reduce over 90% of the pension deficit in a 10 to 20 year period. An increase in the millage rate would greatly offset the pension deficits and provide an additional revenue stream for future projects. As the vast majority of tax-payers do not receive a defined benefit pension, there would be public resentment in the institution of a 1 mil tax increase. Had the pension funds been managed more conservatively, pension benefits would be less and the pension deficits would not be so extreme. Mayor Brown has expressed his opposition to tax increases, and City Council may not see the efficacy of adding more tax-payer funds into a system that has not worked properly.

Decrease the Actuarial Assumed Rates of Return – By decreasing the assumed rate of return on the pension funds from 8.4%/8.5% to 7% or less, the pension funds would be in better position to achieve expected results and this would diminish the chances for future deficits. By lowering the bar for investment returns, the pension funds can invest more conservatively and have a lower probability of future deficits. The costs to the city would increase as the city contribution rate has a negative correlation to expected investment performance. The immediate result would mean in increase in projected costs to the city unless a reduction in benefits was made concurrently. In spite of the additional projected costs, this would be a responsible measure as it would reduce the volatility costs and risks of future deficits.

PFPF to Adopt the Most Current Mortality Tables – By the PFPF adopting the most recent mortality assumptions (year 2000) the fund would be able to more accurately predict the actual cost of the funds unfunded liability. This would aid in the effective management of the fund, while also increasing projected costs.

PFPF and GEPP Salaries – Adopt more realistic salary growth assumptions that more accurately reflect the growth and incomes of participants. This would increase projected cost in the short term, but could provide a more realistic projected cost for the long term.

Institute a Windfall Provision – Should the city receive financial windfalls or one-time revenues, it could use the funds to fund the pension plans. This could provide excess actuarial funding to the pension plans at the expense of other city services.