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June 20, 2013

The Honorable Alvin Brown
Mayor
City of Jacksonville
City Hall at St. James Building
117 W. Duval Street, Suite 400
Jacksonville, FL 32202

The Honorable Bill Gulliford
President-Elect, Jacksonville City Council
City of Jacksonville
City Hall at St. James Building
117 W. Duval Street
Jacksonville, FL 32202

Re: City Police and Fire Pension Proposal – Response of the Jacksonville Civic Council

Dear Mayor Brown and President-Elect Gulliford,

I am writing on behalf of the Jacksonville Civic Council, a group of 59 civic leaders deeply engaged in and committed to the future of Jacksonville. You asked our counsel with regard to the Mayor's proposal for reform of the Police and Fire Pension Plan (PFPP). We commend you both for your attention to this issue. Nothing has a greater long-term impact on the health of our City.

We have rigorously applied ourselves to your request. For approximately two years, a small task force has been studying pension issues and more recently it also has studied the Mayor's current proposal. We consulted with other experts and drew upon resources of our members. This letter is not intended to be an exhaustive recitation of all of our findings and conclusions. Rather, it is a summary of how we see the issues, how we evaluate the Mayor's proposal and what we recommend the City do.

To state the conclusion at the outset, we believe the Mayor's proposal makes very substantial progress, and we commend his work. But it isn't enough. We need to fully solve the problem, which means paying the liability we have accrued and not make the problem worse in the future. Now is the time to develop a comprehensive, fair solution for the benefit of our city and our valuable police and fire forces. Accordingly and with much careful thought, we encourage the City Council to not approve the mediated settlement as proposed. The remainder of this letter further explains our thoughts.

1. Background and Context

Jacksonville, like most states and municipalities, long has provided a defined benefit pension plan for its employees, specifically the police and fire employees. As with all benefits, the City is required to fund these future obligations on a current basis. Such funding is a significant part of the City's annual operating budget. The City's cash contributions to the Police and Fire Pension Plan for the period 2002– 2010, averaged \$36 million per year. In the current year, the City will contribute \$122 million – 13% of the operating budget.

For a variety of reasons, including benefit design, regulatory funding methodologies and lower than expected investment returns, the City has failed to keep pace with required contributions to the PFPP. The total accrued pension liability now stands at approximately \$2.4 - \$2.8 billion depending upon what investment return assumption is deployed. With approximately \$1.1 billion in assets in the pension fund, there is a \$1.3 billion to \$1.7 billion unfunded obligation that already has accrued. Moreover, even before counting additional accruals incurred upon new service, this obligation will grow each year at approximately 7 percent.

This problem isn't unique to Jacksonville. A majority of municipal pension funds in the U.S. are underfunded. But Jacksonville's is among the worst-funded public plans in Florida. The average funding level of municipal plans in the U.S. is approximately 70% - alarmingly low. Jacksonville's PFPP plan is approximately 38% funded. This is an extraordinarily serious problem. Left unattended, future annual City contributions will continue to rise, reaching over \$400 million in FY36. Clearly this isn't sustainable and if allowed to happen, would result in extraordinary and unacceptable cuts to other City services. The problem must be solved and the time to solve it is now.

2. How Do We Best Solve the Problem? - Guiding Principles

The details of pension accounting are complex, but the core of the problem is not. There are no easy solutions. The City must either put in more money (which comes from taxpayers), reduce expenses (which comes from pension beneficiaries) or both. Those who seek a painless solution do so in vain. We believe four principles should guide the development of a solution:

- a) **Affordable.** The solution must be one the City can responsibly afford.
- b) **Long-term.** The solution must be strategic and long-term. This isn't a time to kick the can down the road.
- c) **Shared sacrifice.** We – taxpayers, the City and pension participants and beneficiaries – got into this problem together. We must get out of it the same way. This means additional revenue and some changes to the plan for existing employees should be considered.

- d) **Competitive and Fair.** The police and fire employees perform indispensable services for our City and do it very well. Any solution must provide competitive compensation so the City can attract and retain talented women and men to the police and fire forces and must be fair to current retirees and employees. We think a plan where employers and employees contribute in roughly equal proportion is a good place to start a conversation around what is fair. That is how Social Security and many private sector plans work.

3. Evaluation of Mayor Brown's Proposal

Mayor Brown developed and has submitted to the City Council a comprehensive reform proposal for the PFPP. It makes several important and salutary changes that lower long-term costs, gradually increases employee contributions, lowers assumed rates of return and improve governance.

All of these changes are good. They move the pension benefit and the employees' contribution to their retirement support closer to more contemporary standards. But in our considered view, the proposed plan has four primary shortcomings.

First, plan assumptions, which are markedly more conservative than the current plan, still present too much risk for the City. This is particularly true of the assumed rate of return of 7.25%. While this is well within the range of other public pension plans, it still presents more risk than is prudent to the City. We don't think comparing to other public pension plans is an especially good barometer; most suffer from the same kinds of problems that Jacksonville faces and Jacksonville is in worse condition than almost all other plans.

Second, the burden of changes is borne almost entirely by future employees. As a result, the savings are very much back-loaded and less certain. That isn't a fair or an adequate solution.

Third, the term of the agreement is 17 years. That is a very long duration. When considering the guarantees inherent in a defined benefit plan, it imposes too much risk on the City.

Fourth and most importantly, the plan doesn't go far enough. Absent reform, the City's pension contributions, over the next 30 years, discounted at 7.25%, have a present value of \$2.5 billion. Nearly \$1.5 billion of this amount represents existing liabilities for retired and vested benefits that already have been earned. The remaining balance of about \$1 billion is the prospective pension costs that can be addressed through pension reform. The Mayor's plan impressively reduces these expected costs by about 65% but because these reforms primarily affect new employees, the present value of the plan savings is only about \$350 million. The length of this agreement (17 years) makes it especially important to fully solve the problem. This plan doesn't get there. We need to do more.

4. Ideas for Improvement

We believe several additional steps should be considered that are consistent with the guiding principles set forth above. The details of these suggestions are best developed collaboratively, and we look forward to participating in the effort. Directionally, the City should consider the following.

- a) **Make the right investment assumption.** One of the biggest drivers in not understanding the true cost of our pension commitments is using an overly optimistic expectation as to how easily those commitments can be funded. The fundamental question is what rate the City is willing to guarantee on retirement savings. It is important to be realistic – now – about our pension liabilities and not reduce scheduled contributions on the expectation of more generous returns. We think an assumed rate of return of 7.0% or lower, starting immediately, is prudent. We estimate doing so will increase the projected annual cost of the new pension benefit from the 10.79% last estimated by the actuary for the current proposal to approximately 12.0% of payroll.
- b) **Further reduce plan costs.** The Mayor's proposal considerably reduces that plan cost but the cost is still very high – higher than what we think is standard in the marketplace and higher than the City can afford. We think a target of approximately 10.0% of payroll is a good starting point. To help achieve this cost reduction, the City should reduce or eliminate COLA adjustments and there should be no reexamination of benefits until the unfunded liability is retired. The City should also eliminate the DROP and Back DROP programs for future employees.
- c) **Establish a 50/50 cost sharing with employees.** The PFPP is a generous plan, much superior to Social Security, much superior to a defined contribution plan and superior to most other reformed defined benefit plans. It is fair to ask employees to pay more and it is fair for the City to match employee contributions. New employees should bear a contribution cost equal to half the total cost. Further, existing employees whose existing higher pension benefits will largely remain intact, should also contribute 10% of salary. City employees do not pay into Social Security, which normally is 6.2% for employees. We note that state employees now pay 3% plus Social Security for a total of 9.2%. Existing employees will more equitably share in a final solution and will bear a contribution cost equivalent to that of new employees while retaining existing higher benefits.
- d) **Stay current – establish discipline in funding.** Lowering the investment return assumption will increase annual funding requirements, but annual contributions also need to better address the unfunded obligation. It is crucial the City not fall further behind. City contributions should have a minimum floor until the unfunded liability is fully or at least substantially retired. The City should *not* take advantage of "pension holidays" or other similar techniques to lower annual

contributions. An accelerated contribution through a debt offering should also be considered. Debt offerings are complicated and not without risk but the historically low interest rate environment would seem to create opportunity with less risk than in prior periods. The subject requires more analysis.

- e) **Re-evaluate the term of the agreement.** The Mayor proposes a term of 17 years. On the surface, it is attractive to have stability around the pension debate. But a long-term agreement imposes a great deal of risk on the City, which ultimately is guaranteeing pension obligations. The longer the term of the agreement, the more conservative the City must be in its underlying assumptions. That said we cannot overstate the need to not kick the can down the road. Now is the time to craft a sustainable solution.
- f) **Strongly consider moving to a defined contribution plan.** The City should carefully evaluate freezing the current defined benefit plan and replacing it with a defined contribution plan or perhaps a hybrid plan on a go-forward basis. It represents a much more secure long-term solution to the pension issue, reflects what the private sector overwhelmingly has done over nearly the past 20 years and inherently causes plan funding to stay current with plan liabilities. To be sure, there are significant issues in making a conversion to a defined contribution plan. But other public entities have navigated that path, as have many or most private sector companies. It is tough but can be done.
- g) **Consider new revenues.** The concept of shared sacrifice necessarily includes all Duval citizens. For years, taxpayers have received a bargain, in the sense of not fully paying for promises made for pension obligations. This is one of the reasons, together with generally sound management and the inherent efficiencies of consolidated government, Duval taxpayers enjoy the lowest millage rates of any major city in Florida. But we can't continue to ignore a billion dollar plus liability and push the problem to our children. Even taking all of the recommendations set forth above won't fully solve the problem. We need to pay our bills, and we should have a responsible conversation about increasing revenue support for our City, to do so. The Mayor commendably proposes a "lazy asset" study to see if there are underutilized assets that can be applied to the issue. That can help, but the conversation should be enlarged to consider all sources of revenue.

Implementing the steps above, in addition to those proposed by Mayor Brown, will both save annual pension costs incurred for new service and will more aggressively tackle the underfunding. Sacrifices are borne more equitably among the City, the taxpayers, current employees and future pension beneficiaries. The ideas are tough but fair. *No current retiree is affected and no vested current benefit for current employees, other than COLA, is abridged.* More work needs to be done to develop details but we think these are the right ideas and the right direction.

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5. Conclusion

We conclude this letter the way we started; we commend the Mayor and City Council for forthrightly tackling perhaps the toughest issue facing the City in a generation. We commend the preparatory work of prior administrations and we commend the pension funds for willingness to negotiate these tough issues.

We are acutely aware of the consequences of these recommendations. They will put real stress on the City budget. They will not be popular. There may be some legal issues to confront, although we believe every recommendation is legally permissible. They introduce additional revenues as a part of the conversation. They will require the City to return to the bargaining table with the unions and pension funds. There is further work to be done to refine these thoughts and that work is complex.

But we can't dig out of a \$1.7 billion problem without hard work, sacrifice and a shared commitment to the long-term health and prosperity of the great City we call home. The Jacksonville Civic Council stands ready to work with all stakeholders to find the right set of solutions that advances the well-being of our community.

Respectfully,



Steven T. Halverson

On behalf of the Jacksonville Civic Council