City of Richmond, Virginia

RICHMOND RETIREMENT SYSTEM

January 1, 2013

Dear RRS Members,

Given today's economic environment, many RRS members and their families are concerned about their financial futures and the ability of the RRS to meet its financial obligations.

In truth, the RRS has $485 million dollars in assets and fewer than 10,000 members, and while it does have an unfunded actuarial liability, there is a plan in place to fund the system so that RRS members will receive what is owed to them, and this will happen provided that your employer is able and willing to make its required contributions each year.

In the past, employers have always made their annual required contributions, and in fiscal years 2006 and 2012 City Council approved additional contributions totaling $1.5 million dollars to the RRS to "pay down" the unfunded actuarial liability more quickly.

For retirees and employees interested in what an *unfunded actuarial liability* is, we have created a document to explain this in more detail. Likewise, we publish a *Comprehensive Annual Financial Report* each year with detailed information about our funded status and reports from independent auditors, RRS investment consultants, and actuaries.

I urge you to begin 2013 with a resolution to plan and save for retirement, as most employees will look to the RRS, Social Security, and their own personal savings for income in retirement.

Sincerely,

Natasha Neagu

Natasha Neagu
Interim Executive Director
Richmond Retirement System

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Richmond Retirement System

RRS

Building your financial future.

THE RICHMOND RETIREMENT SYSTEM

Unfunded Liabilities Report

CREATED WITH DATA AS OF 06/30/2012

To learn more, visit us online:
www.richmondgov.com/retirement

EXECUTIVE SUMMARY

According to the National Association of State Budget Officers, pension funds derive the majority of their income through investment returns, and recent market volatility has increased the unfunded actuarial liability of most public pension plans, including the RRS. The purpose of this document is to help RRS members, participating employers, City Council members and their staff better understand what an *unfunded actuarial liability* is and what it means for the RRS:

- The RRS has an unfunded actuarial liability. Most well managed systems have an unfunded actuarial liability. This is often just called the "unfunded liability."

- There is nothing wrong with having an unfunded liability, but to remain financially healthy, systems with an unfunded liability need participating employers to make minimum required contributions.

- No RRS participating employer has failed to make minimum required contributions. In 2006 and 2012 City Council made payments of $1M and $0.5M above the minimum required contribution, and this worked to reduce the RRS's unfunded liability.

- As long as participating employers meet the funding needs of the RRS over the long term, the unfunded liability will not negatively impact the ability of the RRS to pay benefits to its members.

- The fact that a retirement system has an unfunded liability does not mean that the plan is *underfunded*, and most retirement systems, including the RRS, have a plan to pay off the unfunded actuarial liability in 20-30 years.

- Market volatility will impact the unfunded liability of the system. This means that the unfunded liability of the system increased when markets performed poorly in 2008 and 2009 and decreased when markets performed well in 2010 and 2011.

- The health of the RRS is not determined by the unfunded liability. The health of the RRS is determined by the City of Richmond and Richmond Behavioral Health Authority's ability and willingness to make the minimum required contribution.

STEPS THE RRS HAS ALREADY TAKEN

The RRS is structured to reduce the risk and effects of market volatility, and both the RRS and City Council have been proactive in reducing the costs of employee retirement benefits while ensuring that the RRS is able to meet its current obligations owed to RRS members:

- In 2006 the City of Richmond closed its defined benefit plan to new general employees, and introduced a defined contribution plan. This plan shifts the risk of market volatility from the employer to the employee, similar to many 401(k) plans offered by private sector employers.

  In the short term this change makes the RRS more susceptible to market volatility, as during times of economic uncertainty, pension funds with open plans are able to use contributions by employees who are still working to reduce their unfunded liability.[1]

  In the long term, a shift from a defined benefit plan to a defined contribution plan makes it easier for participating employers to budget for the costs of these benefits.

- In 2006, the City of Richmond chose to amortize its unfunded liability over a period of 20 years, while current Government Accounting Standards Board requirements permit this to be amortized over a period of up to 30 years.

  Choosing an amortization period of less than 30 years is a conservative approach and will "pay down" a system's unfunded liability more quickly and increase annual costs for participating employers. Conversely, choosing a period of 30 years will "pay down" a system's unfunded liability more slowly and decrease annual costs for participating employers.

  Most retirement systems, like the RRS, select an amortization period that balances the need to "pay down" the system's unfunded liability quickly with the ability of participating employers to afford minimum required contribution rates.

- In 2012, the RRS reduced its rate of return assumption from 8% to 7.5%. This change was made because the RRS expects to see additional market uncertainty, reducing the rate of return from year to year.

  Decreasing the rate of return assumption increased the RRS's unfunded liability. It also increased the minimum contribution rates for participating employers

  If the RRS reduced its rate of return assumption again, the RRS's unfunded liability would increase and minimum contribution rates would also increase for the City of Richmond and Richmond Behavioral Health Authority.

[1] Pension funds rely on employee contributions, employer contributions and investment income to pay benefits to members in retirement. Closing a plan makes a pension fund rely more heavily on employer contributions and investment income, as employee contributions will decrease over time as those members stop working and retire.

UNFUNDED ACTUARIAL LIBAILITIES EXPLAINED

"Having an unfunded liability does not mean in itself that a retirement system is unhealthy. The state of the economy and an employer's ability and willingness to pay actuarially determined contributions are equally as important."

-*William M. Dowd, Managing Principal, SageView Consulting Group*

Unfunded, Underfunded, and "Pay as you Go"

When speaking about the health of a pension plan, there is a big difference between the terms *unfunded*, *underfunded* and *pay as you go*. Likewise, there is a difference between these three terms and the term *unfunded actuarial liability*. However, many newspaper articles and television news reports fail to make a distinction.

If the RRS was *unfunded*, it would mean that the City Council would need to use current tax revenues to pay benefits to RRS retirees. If the RRS was *underfunded*, it would mean that City Council had not approved to pay the RRS's minimum required contributions. If the RRS was funded *pay as you go*, today's *employee contributions + employer contributions + investment income* would be used immediately to pay retired RRS members. This is why plans that operate *pay as you go* are criticized for unfairly transferring today's costs to the next generation.

The RRS is *prefunded* with each generation saving for its own retirement.

There have been a lot of recent media reports about *underfunded* systems. This occurs when a plan sponsor does not approve funding to pay present and future liabilities as promised. These are sometimes referred to as "contribution holidays" and examples include public pension funds in Illinois, New Jersey and California. In this sense, the RRS has never been *underfunded*.

In Richmond, City Council has always made contributions equal to or greater than the RRS's minimum required contribution. This *minimum required contribution* is also called the *annual required contribution (ARC)*.

Plan Funding

Funding for local retirement plans is based on a simple formula, referred to as the *Basic Retirement Funding Equation*:

$$C+I = B+E$$

C+I are contributions and investment income and **B+E** are benefits and expenses. So, on the left side of the equation we have *employee contributions + employer contributions + investment income*. This is how the RRS makes money. On the right side of the equation we have *benefits payable to employees when they retire + administrative expenses.* This is how the RRS spends money. **C+I** represent *assets* and **B+E** represent *liabilities*. Over time, money put in must equal money taken out.

When B Increases

B will increases when benefits are enhanced, a pay raise is approved, or a cost of living adjustment is made (also known as a COLA increase). When this happens, the **B+E** side of the retirement funding equation gets bigger. When the **B+E** side of the retirement funding equation gets bigger, the **C+I** must also get bigger. If **I** remains constant, contributions must increase.

When I Decreases

I will decrease whenever investment income declines. This is often due to market conditions beyond the control of RRS, and when investments perform poorly, **I** decreases. When this happens, **C+I** must still equal **B+E**, so contributions must increase.

While a lot can affect the **C+I = B+E** retirement funding equation, one thing is always true:

MONEY IN = MONEY OUT

Predicting C+I = B+E

The difficulty with the retirement funding equation is that in order to know exactly how much employers need to contribute for each employee's retirement benefits to be prefunded, you have to know B and I over time. Of course, when the City of Richmond or Richmond Behavioral Health Authority hires a new employee, it does not know how long that employee will live or how well investments will perform from year to year. To best estimate this cost over time, City Council and the RRS rely on a team of actuaries.

Actuaries analyze the financial consequences of risk, and then estimate the true cost of retirement benefits over time, making assumptions about what B and I may be, to determine the systematic contributions that employers need to make to ensure that the RRS has the resources it needs to pay out the benefits the City of Richmond and Richmond Behavioral Health Authority promised their employees.

"RRS plans are prefunded. This means that the RRS predicts what benefits may be owed to an employee in retirement, and then determines what mix of employee contributions, employer contributions, and investment income is needed now – while an employee is still working – to pay for these future benefits."

-Natasha Neagu, Interim Executive Director, Richmond Retirement System

Actuarial Assets and Actuarial Liabilities

Actuaries use statistics – like mortality tables and input from investment advisors – to quantify many unknowns and make actuarial assumptions. Actuaries then use these assumptions and information about the plan and its participants to determine the amount a plan would need to pay its members' benefits, and this is called the *actuarial liability*. Once this is done, actuaries compare this cost to the plan's *actuarial assets*:

If costs are equal to assets, the plan is deemed to be fully funded, and plan sponsors will only need to pay the "normal cost" of the plan.

If costs are greater than assets, the plan is deemed to have an unfunded actuarial liability, and plan sponsors will need to pay the "normal cost" of the plan plus a portion of the unfunded actuarial liability.

An unfunded actuarial liability does not mean that a plan cannot meet its current obligations, but it does mean that plan sponsors will need to “pay down” the difference between actuarial costs and assets. RRS participating employers plan to do this over a 20 year period, like a mortgage.

Recognizing that a plan’s liabilities and assets are a snapshot of a plan’s finances on any given day, actuaries take measures to account for steep fluctuations in gains or losses. In short, the value of actuarial liabilities and actuarial assets changes daily.

For this reason annual valuations are scheduled, and each year, if past actuarial assumptions are not met – because, for example, actual investment returns differ from estimated returns – the amount of a plan’s unfunded actuarial liability will change. For a plan sponsor paying down an unfunded actuarial liability, this looks like a series of mini-mortgages. Every year one will be paid off and another will be added to ensure that the plan can meet its future obligations.

Each year, this information is published in the organization’s *Comprehensive Annual Financial Report*.

“Relative to peer group comparison [the RRS’s investment returns over fiscal years 2009-20012] ranked the RRS in the 8th percentile, outpacing 92% of other public funds within the universe.”

Kevin Leonard, Partner, NEPC LLC
Source: InverstorForce Public Fund Universe

Conclusions

Current economic conditions and longer life spans mean that most public pension plans have large unfunded actuarial liabilities, making retirement benefits more expensive for employers, but having unfunded actuarial liabilities does not mean that a plan is *underfunded*.

The RRS’s ability to pay its financial obligations to its retirees and its future retirees is not determined by its unfunded actuarial liability, but with the city’s ability and willingness to make the minimum required contributions.

In the past, the city has always made its annual contribution, and in 2006 and 2012 the city made additional contributions totaling $1.5 million dollars to the RRS to “pay down” the unfunded actuarial liability more quickly.

“As long as participating employers are able and willing to meet the funding needs of the system over the long term, this unfunded actuarial liability will not negatively impact the RRS’s ability to pay its retirees.”

-*William M. Dowd, Managing Principal, SageView Consulting Group*