McLean Citizens Association

MCA

The Voice of McLean for Over 100 Years

STRESS TEST & SENSITIVITY REPORTS TO REDUCE COUNTY PENSION PLAN UNFUNDED LIABILITIES
March 6, 2024

EXECUTIVE SUMMARY

The stated funding objective of the County's pension plans is to have level employer contribution rates over time. That objective has not been realized despite rapidly increasing annual County cash contributions to these pension plans. Instead, pension plan unfunded liabilities have continued to increase, which have necessitated ever-higher employer contribution rates.

All three County pension plans failed to meet their investment return assumptions in 8 of the last 10 years, which resulted in consistent underestimation of liabilities and consistent increases in plan unfunded liabilities. This pattern cannot continue without adversely affecting the County's financial position, its ability to fund other programs, and its standing in the bond markets.

The County's three pension plans are scheduled to conduct 5-year experience studies during 2026, which will compare assumptions to actual results for FY 2020 through FY 2025, in addition to annual Actuarial Valuations and financial statements. However, unlike the Stress Test and Sensitivity Reports to the General Assembly about the Virginia Retirement System (VRS), the regular reports on ERS, PORS and URS do not focus on adverse scenarios and explain in plain English the potential ramifications of each adverse scenario, and they do not discuss the pros and cons of different strategies to reduce rapidly unfunded liabilities.

This resolution urges the Board of Supervisors to commission independent, in-depth Stress Test and Sensitivity Reports on ERS, PORS and URS that use the same or similar analyses and approaches as the VRS Stress Test and Sensitivity Reports to the General Assembly.

BACKGROUND

Whereas:

1. Fairfax County (County) employees participate in one of three defined benefit pension plans: Employee Retirement System (ERS); Police Officers Retirement System (PORS); and Uniformed Retirement System (URS).[1]

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[1] In addition, eighty percent (80%) of Fairfax County Public School (FCPS) employees participate in two defined benefit pension plans, the Virginia Retirement System-Teachers (VRS) plus the Educational Employees'

2. ERS, PORS and URS each have their own trustees, benefit provisions and investment policies, but they share an Executive Director, hire the same accounting and actuarial firms, and share selected other staff.

3. Every year, each pension plan has an Actuarial Valuation and an audited financial statement.
    a. The annual Actuarial Valuation uses assumptions adopted by each plan's trustees to estimate the present value of each pension plan's accrued benefits, then subtracts the value of the plan's assets to determine the plan's unfunded liabilities.[2]
    b. The annual Audited Comprehensive Financial Report (ACFR) incorporates findings from the Actuarial Valuation, in addition to disclosing information about the plan's structure and investments.

4. Each pension plan commissions periodic actuarial experience studies that compare the plan's assumptions to actual experience, and the next set of experience studies for ERS, PORS and URS will be done in 2026 and cover FY 2020 to FY 2025.

5. Each County plan's trustees adopt an "amortization" schedule intended to eliminate unfunded liabilities, based in part on the most recent experience study.

6. A growing number of states require stress tests in addition to actuarial valuations and audited financial statements, to "gauge the effects of hypothetical adverse market conditions on their retirement systems" and to "improve the planning and decision-making of pension plan fiduciaries, policymakers and budget officials."[3]

7. In 2017, Virginia's General Assembly mandated stress tests of the Virginia Retirement System (VRS) to "project benefit levels, pension costs, liabilities, and debt reduction under various economic and investment scenarios," to disclose gross and net investment returns by asset class and external manager, and to "regularly report" external manager fees, carried interest fees and investment department expenses for private equity and other asset classes. [4]

8. VRS Stress Test & Sensitivity Reports to the General Assembly focus on negative scenarios that "provide the most challenges to plan sponsors," and explain the effects of negative scenarios in plain English:

Supplementary Retirement System of Fairfax County (ERFC). The remaining 20% of FCPS employees participate in the County's ERS. This resolution focuses on ERS, PORS and URS, but similar analyses should be done for ERFC, which assumes a more aggressive investment return (7.0%) than VRS, ERS, PORS and URS (6.75%).

[2] See, e.g., ERS FY 2023 ACFR, p. 73. Actuarial Standard of Practice No. 51 (adopted Sept. 2017) imposed more risk analyses and disclosures for Actuarial Valuations. http://www.actuarialstandardsboard.org/asops/assessment-disclosure-risk-associated-measuring-pension-obligations-determining-pension-plan-contributions-3/ The risk analysis in the VRS Stress Test & Sensitivity Report to the General Assembly "complements and enhances the risk measures shown in VRS' annual funding actuarial reports." https://employers.varetire.org/media/shared/pdf/vrs-stress-test-and-sensitivity-analysis-2022.pdf

[3] https://www.ncsl.org/fiscal/public-pension-stress-testing-in-the-states

[4] VA Code Section 51.1-124.30:1. https://employers.varetire.org/publications/?category=stress

a. The 2018 VRS Stress Test & Sensitivity Report advised state legislators that "the consensus view is that a lower return environment may persist" and explained the consequences of 5% investment returns for 5 and 10 years; and
b. The 2022 VRS Stress Test & Sensitivity Report to the General Assembly (Oct. 2023) stated that "future investment performance in the near term may be materially lower than both historic norms as well as projected returns over longer timeframes" and that "if protracted unfavorable economic experience were to occur, it is likely that plan design changes would be considered to maintain the long-term health of the funds."

9. VRS Stress Test & Sensitivity Reports also recommend strategies to reduce unfunded liabilities more rapidly, given that "unfunded liabilities have the potential to create additional volatility in contribution rates" and "pay[ing] down unfunded liabilities on a more accelerated basis may help to cushion any potential uncertainty that could occur with future market downturns":
    a. The 2018 Report recommended "accelerating the payback of the legacy unfunded liabilities" to "provide significant long-term savings and better position the statewide plans to weather future volatility in investment returns."[5]
    b. The 2022 Report commended the Governor and General Assembly for contributing an extra $750 million in June 2022 and $275 million in June 2023, and recommended the use of "level dollar" instead of increasing amortization payments. [6]

10. The County's three pension plans and VRS have significantly different net investment returns, even though all four plans currently assume net investment returns of 6.75%:
    i. VRS – 6.1% in FY 2023, 8.2% over 10 years, 7.9% over 20 years, and 6.8% over 25 years[7];
    ii. ERS – -2.5% in FY 2023, 5.6% over 10 years, 7.2% over 20 years;
    iii. PORS – -3.9% in FY 2023, 6.2% over 10 years, 6.8% over 20 years; and
    iv. URS – 8.1% in FY 2023, 5.9% over 10 years, 6.6% over 20 years.

11. The County's three pension plans, like most public pension plans in the United States, are increasing the percentage of their assets invested in illiquid private funds (including private equity), which tend to have higher and more complex fees than public funds.[8]

12. A pension fund that passively invested 60% of its assets in equity and 40% in bonds would have had higher net investment returns than ERS, PORS and URS in FY 2023, and over the past 5 years, 10 years and 20 years.[9]

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[5] https://employers.varetire.org/media/shared/pdf/vrs-stress-test-and-sensitivity-analysis-2018.pdf
[6] https://employers.varetire.org/media/shared/pdf/vrs-stress-test-and-sensitivity-analysis-2022.pdf
[7] https://www.varetire.org/pdf/publications/2023-investment-highlights.pdf
[8] https://reason.org/commentary/why-public-pension-systems-invest-in-private-equity-even-when-they-shouldnt/; https://www.ai-cio.com/news/what-is-the-future-of-the-60-40-portfolio/; https://www.pewtrusts.org/-/media/assets/2022/05/pensionschartbook_final.pdf. The complexity of private funds also has made it more challenging to ensure that pension trustees have the background needed to fulfill their fiduciary obligations.
[9] See FY 2025 Fairfax County Budget Question and Answer C-3. https://www.fairfaxcounty.gov/budget/sites/budget/files/Assets/documents/fy2025/qa/FY_2025_QA.pdf

13. To determine a plan's recommended annual cash contribution, actuaries add unfunded liability amortization payments, the estimated cost of newly-accrued pension benefits and administrative expenses.

14. ERS, PORS and URS repeatedly changed assumptions and policies with the goal of gradually eliminating unfunded liabilities,[10] but their unfunded liabilities nonetheless increased due largely to the plans not achieving their assumed net investment returns:[11]
    a. ERS unfunded liabilities rose from $1,042 million in FY 2014 to $2,302 million in FY 2023;
    b. PORS unfunded liabilities rose from $192 million in FY 2014 to $544 million in FY 2023; and
    c. URS unfunded liabilities rose from $264 million in FY 2014 to $707 million in FY 2023.

15. Employer contributions[12] to ERS, PORS and URS[13] have increased substantially:
    a. ERS employer contributions were $31.1 million (6.12% of payroll) in FY 2002[14] and will equal $252.8 million[15] (32.58% of payroll)[16] in FY 2025;
    b. PORS employer contributions were $15.1 million (21.79% of payroll) in FY 2002[17] and will equal $84.1 million[18] (57.57% of payroll[19]) in FY 2025; and
    c. URS employer contributions were $18.8 million (18.93% of payroll) in FY 2002[20] and will equal $113.3 million[21] (52.58% of payroll[22]) in FY 2025.

16. The portion of FY 2025 ERS, PORS and URS employer contributions attributable to the amortization of unfunded liabilities substantially exceeds employer contributions for newly-accruing benefits[23]:
    a. 22.65% of the 32.58% ERS contribution rate is to amortize unfunded liabilities;
    b. 36.77% of the 57.57% PORS contribution rate is to amortize unfunded liabilities; and
    c. 34.36% of the 52.58% URS contribution rate is to amortize unfunded liabilities.. .

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[10] For example, the County plans gradually reduced assumed net investment returns from 8.5% in 1996 to 6.75%, changed from an open to a 15-year fixed period to amortize unfunded liabilities, and increased the targeted funded ratio from 90% to 100%. Supervisors agreed not to reduce a plan's employer contribution rates until a pension plan was fully funded. In 2018, Supervisors reduced pension benefits for new County employees.

[11] See ERS FY 2023 ACFR pp. 47 and 80; PORS FY 2023 ACFR pp. 48 and 80; URS FY 2023 ACFR, pp. 47 and 85. See also Attachment A.

[12] Consistent with County ordinances approved by the Board of Supervisors, employee contribution rates are fixed, so 100% of pension contribution increases are borne by the County, as the employer.

[13] Contributions from FCPS to ERFC and to VRS have also increased but are not addressed in this resolution.

[14] ERS FY 2011 CAFR, p. 55.

[15] FY 2025 Fairfax County Advertised Budget Plan (Vol. 2), p. 407.

[16] ERS FY 2017 CAFR, p. 38. ERS Actuarial Valuation as of June 30, 2023, p. 1.

[17] PORS FY 2011 CAFR, p. 55.

[18] FY 2025 Fairfax County Advertised Budget Plan (Vol. 2), p. 409.

[19] PORS Actuarial Valuation as of June 30, 2023, p. 1.

[20] URS FY 2011 CAFR, p. 55.

[21] FY 2025 Fairfax County Advertised Budget Plan (Vol. 2), p. 408.

[22] URS Actuarial Valuation as of June 30, 2023, p. 1.

[23] See ERS FY 2023 Actuarial Valuation, p. 31; PORS FY 2023 Actuarial Valuation, p. 31, URS FY 2023 Actuarial Valuation, p. 30. See also Attachment B.

17. All three County plans have increased their projected maximum future employer contribution rates, as their unfunded liabilities continued to increase:[24]
    a. ERS' Actuarial Valuation as of June 30, 2017 projected the employer contribution rate would never exceed 29% but it is now expected to increase to 37%;
    b. PORS' Actuarial Valuation as of June 30, 2017 projected the employer contribution rate would never exceed 42% but it is now expected to increase to 66%;
    c. URS' Actuarial Valuation as of June 30, 2017 projected the employer contribution rate would never exceed 39% but it is now expected to increase to 57%.

18. ERS, PORS and URS Actuarial Valuation reports have repeatedly pushed back the year when each plan was projected to be fully funded, despite rising employer pension contributions:
    a. ERS was projected to be fully funded by 2033 as of FY 2017, but by FY 2023 it was not projected to be fully funded until 2036;[25]
    b. PORS was projected to be fully funded by 2032 as of FY 2017, but by FY 2023 it was not projected to be fully funded until 2037;[26] and
    c. URS was projected to be fully funded by 2031 as of FY 2017, but by FY 2023 it was not projected to be fully funded until 2037.[27]

19. None of the County's plans have realized their common funding objective, which is to "establish contribution rates that will remain level as a percentage of payroll over time."[28]

20. Allowing pension unfunded liabilities (and related employer pension plan contributions) to continue rising will require Supervisors to further increase local taxes, cut or limit expansions of competing County-funded programs, and/or risk the County's valuable credit rating.

<u>RESOLVED</u>

NOW THEREFORE, be it resolved that the McLean Citizens Association urges the Board of Supervisors to commission an independent, in-depth study that will be presented to the Board of Supervisors, which is similar to the VRS Stress Test and Sensitivity Reports to the General Assembly, and that includes:

(1) an analysis of the costs and benefits of each strategy discussed in the VRS Stress Test and Sensitivity Reports that could accelerate the paydown of unfunded liabilities; and
(2) an analysis of the optimal governance structure, including trustee selection and training policies for the County's three pension plans.

Approved by the MCA Board of Directors
March 6, 2024

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[24] See ERS Actuarial Valuation as of June 30, 2017, p. 6; ERS Actuarial Valuation as of June 30, 2023, p. 6; PORS Actuarial Valuation as of June 30, 2017, p. 6; PORS Actuarial Valuation as of June 30, 2023, p. 6; URS Actuarial Valuation as of June 30, 2017, p. 6; URS Actuarial Valuation as of June 30, 2023, p. 6.
[25] See ERS Actuarial Valuation as of June 30, 2017, p. 6; ERS Actuarial Valuation as of June 30, 2023, p. 6.
[26] See PORS Actuarial Valuation as of June 30, 2017, p. 6; PORS Actuarial Valuation as of June 30, 2023, p. 6.
[27] See URS Actuarial Valuation as of June 30, 2023, p. 6; URS Actuarial Valuation as of June 30, 2023, p. 6.
[28] ERS FY 2023 ACFR, p. 73. PORS FY 2023 ACFR, p. 73. URS FY 2023 ACFR, p. 79.

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Copies to:
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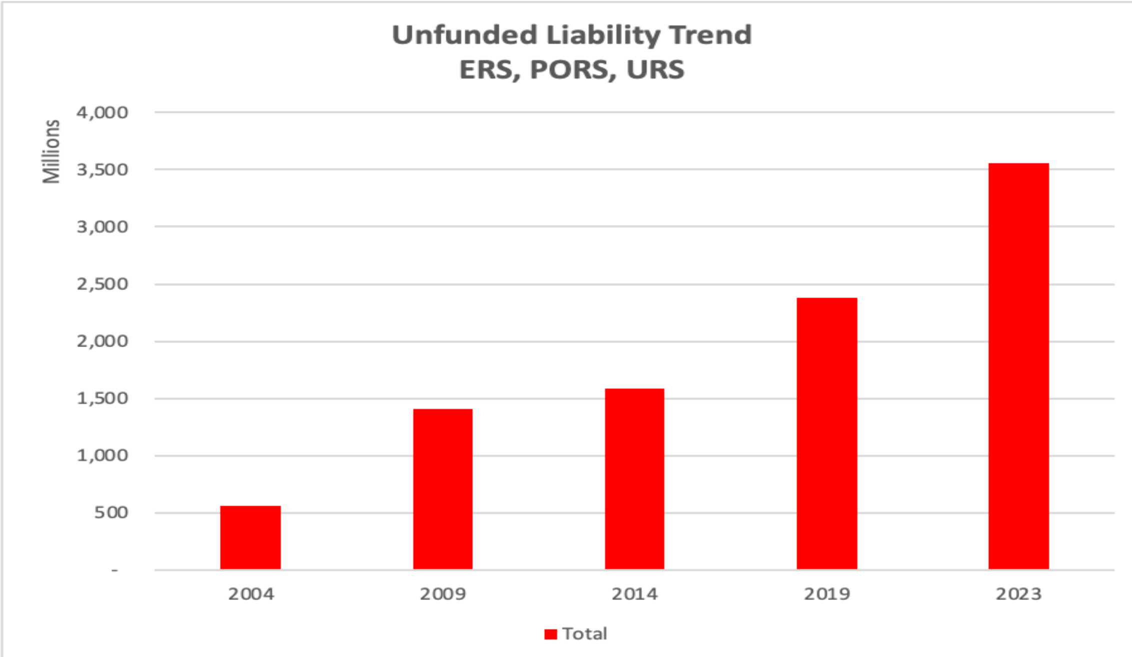
Attachment A



Attachment B: Amortization Costs for Unfunded Liabilities Overtake Normal Costs