City of Alexandria, Virginia

MEMORANDUM

DATE: APRIL 1, 2009

TO: THE HONORABLE MAYOR AND MEMBERS OF CITY COUNCIL

FROM: JAMES K. HARTMANN, CITY MANAGER

SUBJECT: BUDGET MEMO # 66 : EFFECTS THAT A PAY FREEZE HAS ON EMPLOYEES' VIRGINIA RETIREMENT SYSTEM (VRS) PENSION

This memo is in response to a request from Councilman Wilson that the City Council be provided information on what effects a freeze on employee pay could have on employees' pensions within the Virginia Retirement System (VRS). Additionally, staff was asked if a one-time bonus given to employees could be directed in a way to benefit employees' VRS pensions, as opposed to a direct cash payout.

The VRS pension is based on employees' years of service and salary averaged over the highest consecutive 36 months of pay (narrowly defined to exclude overtime, shift differentials, etc). The VRS pension for those who are retirement eligible is 1.8% of that average salary per month time the years of service. So generally speaking, each 1% increase in average salary yields a 1% gain in pension benefits for those employees who work a full year at the higher salary level before retiring. With regard to years of service, to the extent that an employee continues working and accrues more service, their accrued pension increases.

For salaries, if they were to remain flat for a year, the average salary for employees who are not at the top of their pay grade may still increase because each new month of work replaces a salary from three years earlier that likely was lower. On the other hand, employees who have been at the top of their pay grade for the last 36 months will see no increase in their three year salary average. The reason for this is because employees at the top of their pay grade will continue to be paid at their current step, and no market-rate adjustment would have been provided to City employees since July 1, 2007 (this assumes no market-rate adjustment in FY 2010). The following example demonstrates this point:

A	B	C	D	E
	Salary Increase Included	**No Salary Increase Included**	**Prior Year**	**Employees at the Top of their Pay Grade**
FY 2010	$51,000	$48,000		$51,000
FY 2009	$48,000	$48,000	$48,000	$51,000
FY 2008	$45,000	$45,000	$45,000	$51,000
FY 2007			$42,000	
3 Year Average	**$48,000**	**$47,000**	**$45,000**	**$51,000**

From an employee's perspective, ideally there would be a salary increase in FY 2010 and this would increase their average salary and pension. In the example above, a salary increase would increase the average salary to $48,000 (see Column B). However, even without a FY 2010 salary increase, the average salary for employees who are not at the top of their pay grade would increase to $47,000 (see Column C). This amount would still be larger than the average salary earned through FY 2009 which is $45,000 (see Column D). The three year average would remain unchanged at $51,000 however for employees at the top of their pay grade (see Column E).

A freeze on pay has the potential to impact the pensions of employees who are about to retire more greatly than those who remain employed with the City. This is because the average salary during the final compensation period for an employee who is nearing retirement will be lower due to the pay freeze. Employees who remain working could potentially see the negative impact to their pension corrected if after the current fiscal crisis salaries are increased, to approximate inflation, in order to make up for the lag in wages that was experienced. If salaries do not return to prior inflation adjusted levels, then the impacts of the pay freeze on pensions would be experienced by all employees.

A one-time pension bonus given to employees could help deflect some of the negative impacts on pensions resulting from a freeze in salaries. This type of bonus, which would be directed specifically towards an employees' pension, would differ from prior one-time direct payouts or one-time increases to salaries. It would be easier to direct a one-time pension bonus through the Supplemental Retirement Plan because we have the ability to amend the plan. Options we could consider would be to change how we define average salary or the benefits multiplier. Any changes to the supplemental plan would be subject to a plan amendment and review and approval by City Council.

With regard to VRS, it is not possible to use a one-time bonus to offset the negative impacts on pensions resulting from a pay freeze. When calculating an employees' three year average for salary VRS uses an employees' stated monthly salary. Permanent increases to salary, such as step/merit increases or market rate adjustments, are included in the calculation of the three year average. One-time bonuses are not. Monthly salaries are actively reviewed by VRS and when an employees' pay rises above their normal monthly salary, the City is notified. A one-time salary increase would certainly trigger a review by VRS. If we cannot justify the increase as a permanent increase to salary, VRS will reject the increase.