REPORT TO THE BOARD OF SUPERVISORS
FAIRFAX COUNTY, VIRGINIA

REPORT ON:
FAIRFAX COUNTY'S
SUPPLEMENTAL RETIREMENT SYSTEM
POLICE OFFICERS RETIREMENT SYSTEM
UNIFORMED RETIREMENT SYSTEM

RETIREMENT SYSTEMS: EXCELLENT FINANCIAL CONDITION; COUNTY CONTRIBUTION RATES APPROPRIATE; AND FISCAL YEAR 1999 CONTRIBUTIONS PROJECTED TO BE SIGNIFICANTLY LOWER

COUNTY OF FAIRFAX
1742
VIRGINIA

OFFICE OF FINANCIAL AND PROGRAMS AUDITOR

FEB 2 7 1998

TABLE OF CONTENTS

APPENDIXES

TABLES

CHARTS

EXECUTIVE SUMMARY

Fairfax County contributes to five retirement systems for County and school employees. We reviewed the operation of three of these retirement systems, overseen by three Boards of Trustees and by Fairfax County's Retirement Administration Agency. Specifically, we reviewed the Supplemental, Police Officers, and Uniformed Retirement Systems to determine their financial condition, and whether Fairfax County was contributing an appropriate amount to each of the three systems. This is the first in a series of reports to be issued on the County's retirement systems.

The three retirement systems were created to provide retirement benefits to Fairfax County employees. The benefits are funded by employee contributions, County contributions, and earnings from investment of the contributions. The contribution rates of County employees for each system are fixed by ordinance. The contribution rates of the County for each system vary from year to year, and are determined by an actuary, in conjunction with the three Boards of Trustees. We found that both the contribution rates and the procedures used to determine them were appropriate.

We found that all three retirement systems are in excellent financial condition. The market value of the retirement systems' assets increased from June 30, 1990 to June 30, 1997, by an average of more than 15% a year reaching a total of $2.31 billion. The total unfunded liability for the three systems declined from more than $200 million in Fiscal Year 1991 to less than $40 million in Fiscal Year 1997. The systems were between 96.4% and 99.2% fully funded at the end of Fiscal Year 1997, up from 88.3% and 97.7% the previous year. This compares favorably with the 87.4% average funding ratio for 261 public employee retirement systems reported in The 1997 Survey of State and Local Government Employee Retirement Systems.

The dramatic growth in asset values in recent years has enabled the Boards of Trustees for the retirement systems to propose significant reductions in the County's Fiscal Year 1999 contribution rates. These proposed reductions are projected to result in an estimated $9.5 million decrease, from $57.9 million to $48.4 million, in the County's contribution to the retirement systems in Fiscal Year 1999. This $9.5 million projected reduction affects the following County budgets: the General Fund, the Public Schools, and other funds, primarily Special Revenue Funds and the Integrated Sewer System Fund. Further, $5.9 million of this projected reduction has already been integrated into the General Fund Advertised Budget and almost $1.9 million into the School Board's Proposed Budget for Fiscal Year 1999. Discussions with the County's Office of Management and Budget has confirmed a savings for other funds of $1.7 million which will be realized in actual expenditures during Fiscal Year 1999.

Whether or not the Boards of Trustees will propose County contribution rates at the new, lower levels for Fiscal Year 2000 depends heavily on the financial markets and the systems' investment performance during the current fiscal year. Over a long period of time, if the other actuarial assumptions are met, the general rule is that the County's contribution rates for the three systems will increase if assets earn less than the actuarially assumed rate, which is presently 7 ½%. Conversely, the County would pay less if the assets earn more than 7 ½%.

However, the recent bull markets, and an actuarial smoothing technique which recognizes only a portion of asset gains or losses in each year, has given the County a "cushion" of stored asset gains. That cushion would have to be used up before the County would see any adverse impact on its contribution rates. According to the systems' actuary, in order to use up the entire cushion in one year, the systems' assets would have to show *negative* returns of around 5%.

Returns that fall between *negative* 5% and positive 7 ½% would use up a portion of the stored gains but would still result in the County's contribution rates remaining at the lower levels, or being reduced further.

Returns in excess of 7 ½% would, because of the smoothing technique employed, go partly to increase the cushion against the possibility of future market downturns, and partly to further reduce the County's contribution rates.

While we will not know the final results of Fiscal Year 1998 operations for the three retirement systems for several months, we know that the market value of the assets for the three systems as of December 31, 1997, the mid point of Fiscal Year 1998, was $2.51 billion. This was an increase, since the end of Fiscal Year 1997, of 8.7% which, if sustained through the end of Fiscal Year 1998, would result in a further reduction in County contribution rates for Fiscal Year 2000.

In their response to our report (which is included in its entirety in Appendix VI), the Boards of Trustees of the Supplemental, Police Officers, and the Uniformed Retirement Systems stated that they concurred with our report. They also stated they have worked and will continue to work diligently to manage the retirement systems to meet the benefit obligations of the plans in an efficient and fiscally responsible manner. The Boards of Trustees added that they have the fiduciary responsibility to recommend annually the employer contribution rate to the Board of Supervisors which is based, in part, on the investment performance of the independent retirement systems. They pointed out that the rates of return achieved by the Boards have been achieved by using prudent investment standards to meet the funding requirements of each system.

We believe that the successful performance of the three retirement systems, as mentioned in this report, is due to the County consistently making its required contributions to each retirement system and the prudent investment decisions and diligent work of the Boards of Trustees. Because we found the systems to be in excellent financial condition and the process used for determining County contribution rates to be appropriate, we are making no recommendations for corrective action in this report.

INTRODUCTION

Fairfax County provides funding for employees in five separate public employee retirement systems. Three of the systems, the Supplemental, Police Officers, and Uniformed Retirement Systems, are overseen by three Boards of Trustees and the County's Retirement Administration Agency (RAA), and are the subject of this review. The County also contributes to the Virginia Retirement System (VRS) and the Educational Employees Supplemental Retirement System of Fairfax County, which is a component of the Public Schools. These two systems were not included in our review.

Supplemental, Police Officers, and Uniformed Retirement Systems

The Supplemental System was established on July 1, 1955, for full time and certain part time Fairfax County and Fairfax Public Schools employees who are not covered by one of the other three systems or the VRS. The Supplemental System got its name from the fact that it was created to "supplement" Social Security benefits established for general County employees. There were 11,669 active members and 3,162 retirees participating in the system as of June 30, 1997.

The Police Officers Retirement System was created on March 29, 1944, for sworn, full-time, law enforcement officers of the Fairfax County Police Department. It is a legally separate pension plan established under the Code of Virginia. The plan covers County police officers who are not covered by other plans of the County, or the VRS, and former Park Police officers who elected to transfer to the Police Officers Retirement System effective January 22, 1983. There were 1,052 active members and 488 retirees participating in the system as of June 30, 1997.

The Uniformed Retirement System was established on July 1, 1974, for uniformed or sworn employees of the Fire and Rescue Department, the Sheriff's Department, the Animal Wardens and Game Wardens of the Department of Animal Control, Helicopter Pilots, and certain Park Police officers who are not covered by other County pension plans or the VRS. There were 1,519 active members and 468 retirees participating in the system as of June 30, 1997.

Benefit Provisions and Payments,

Benefit provisions for the three pension systems are established and may be amended by County ordinances. All benefits vest at five years of service. To be eligible for normal retirement, employees generally must reach a certain combination of age and years of service. The normal retirement benefit is calculated using average final compensation and years of service at the date of termination. Annual cost-of-living adjustments are provided to retirees and beneficiaries equal to the lesser of 4 percent or the percentage increase in the Consumer Price Index for the Washington Metropolitan Area.

Retirement benefits and refunds of contributions made to those who left the systems, paid during the Fiscal Year ended June 30, 1997, totaled $70.5 million. About $45.8 million was paid from the Supplemental, $13.5 million from the Police Officers and $11.2 million from the Uniformed System.

Member and Employer Contributions

The contribution requirements for employees who are members of the three retirement systems are established, and may be amended by County ordinances. The three systems require different percentage rates of contributions depending on the system the member belongs to, and the plan chosen within that system. When the plan has been chosen, the rate of contribution remains fixed at that level by ordinance. Employee contributions to the three systems for the year ended June 30, 1997, totaled $28.2 million, consisting of $17.2 million from Supplemental members, $6 million from Police Officer members, and $5 million from Uniformed members.

The contribution requirements for Fairfax County are set from year to year at an actuarially determined rate. Fairfax County's pension costs for the three systems for the Fiscal Year ended June 30, 1997, totaled $57.9 million, consisting of $29.9 million for the Supplemental, $11.9 million for the Police Officer, and $16.1 million for the Uniformed Retirement Systems.

Investment Income

Contributions by members of the three retirement systems and by Fairfax County are invested by Boards of Trustees who determine the types of investments to be made, select and contract with investment managers, and monitor the returns earned with the assistance of the RAA. The investment of the contributions is an issue of immense consequence to system participants, the County, and taxpayers. If the assets invested by a retirement system earn low rates of return, the County must contribute additional funds to pay retirement benefits that have been promised to system members. Conversely, if the assets earn high rates of return, the County's contributions could be reduced.

Investment income for the three systems for the year ended June 30, 1997, totaled $379.4 million, with $231.6 million earned by the Supplemental, $79.3 million earned by the Police Officers, and $68.5 million earned by the Uniformed System's investments. Investment income includes interest, dividends, realized and unrealized gains and is net of investment expenses.

Assets and Liabilities of the Retirement Systems

The assets of the three retirement systems consist primarily of financial investments. As of June 30, 1997, the three systems had accumulated assets with a market value of $2.31 billion. Since market value is such a volatile measure, it is a common and generally accepted practice to calculate an actuarially determined value of accumulated assets, which smoothes the volatility of the financial markets and keeps employer contributions at a relatively level rate. The actuarially determined value of assets for the three funds at June 30, 1997 was $2.06 billion.

At the same date, the actuarial liability for the three systems, which is the present value of all future retirement system benefits that will not be paid by future employer and member contributions, was $2.1 billion. Since the actuarial liability for each of the three systems was greater than the actuarially determined value of accumulated assets, the three systems had unfunded liabilities totaling $39.2 million, consisting of $10.4 million for the Supplemental, $14.7 million for the Police Officer, and $14.1 million for the Uniformed System. An unfunded liability is the difference between the actuarial value of accumulated assets and the actuarial liability, and may be either positive or negative. A negative value for an unfunded liability would be a surplus.

ROLES OF THE RETIREMENT ADMINISTRATION AGENCY, BOARDS OF TRUSTEES AND ACTUARY

The RAA processes benefit payments to eligible Fairfax County retirees and their survivors from the three retirement systems and refunds of retirement contributions to terminated County employees. The RAA management counsels and provides active and retired County employees with complete information pertaining to their benefits. In addition, the RAA oversees the management and investment of retirement trust funds. The RAA is responsible for maintaining internal accounting controls to provide reasonable assurance that transactions are properly authorized and recorded. The RAA prepares an annual budget for the three retirement systems for approval by the Boards of Trustees and the County's Board of Supervisors.

Each of the three retirement systems has a Board of Trustees. The Boards of Trustees are accountable to the Fairfax County Board of Supervisors. The Members of each of the three Boards of Trustees are listed in Appendixes I, II and III.

The Supplemental Board has 10 trustees. Three of them, the Fairfax County Director of Finance, who serves as the Treasurer of the Board, the Director of the County Office of Personnel, and the Fairfax County Public Schools Personnel Officer, are ex officio members of the Board. Four of the trustees are appointed by the Board of Supervisors, two are elected by the County employees who are members of the retirement system (one is elected by School Board employees and one is elected by general County employees), and one is a retired member elected by the retired members of the system.

The Police Officers Retirement Board of Trustees consists of five trustees. Two trustees are appointed by the Board of Supervisors, two trustees are elected by the members of the retirement system, and one trustee is the County's Director of Finance, who is an ex officio member of the Board.

The Uniformed Retirement Board of Trustees has eight trustees. Three trustees are appointed by the Board of Supervisors; two trustees are elected by the uniformed employees of the Fire and Rescue Department; one trustee is elected by the uniformed employees of the Sheriff's Department and the Department of Animal Control and Park Police and Helicopter Pilot members of the system; and the other two trustees are ex officio members, the Director of Finance and the Director of the Office of Personnel for Fairfax County.

All of the members of the Boards of Trustees, except the ex officio members, have four-year terms of office, and may be re-appointed.

Functions of the Three Boards

The three Boards of Trustees have similar functions. They each establish rules and regulations for the administration of their respective retirement systems and for the transaction of their business.

They each are required to keep in convenient form such data as shall be necessary for an annual, actuarial valuation of their systems and for checking the experience of the system.

The Boards are the trustees of the systems' funds and have full power to invest and re-invest them. Such investments are to be conducted with discretion and in accordance with the laws of the Commonwealth of Virginia as may apply to fiduciaries investing such funds. They are permitted to employ investment counsel to assist them in their investment efforts.

The Boards have Investment Objectives and Policies that establish investment goals, guidelines, constraints and performance standards the trustees use when exercising their fiduciary duties to manage the investment assets of the retirement systems. The Boards operate in conformity with the standard of care required in making investments as stated in the Code of Virginia.

The Boards of Trustees are required by County Ordinance to have actuarial evaluations made of the systems. The firm of Milliman & Robertson, Inc., has been retained to provide actuarial services for all three systems.

The Role of the Actuary

The actuary provides annual reviews of the three retirement systems and submits reports which include, among other things, an analysis of funding, a determination of plan cost, participant and financial data, funding method, factors and assumptions used in determining cost estimates and other factors deemed appropriate. Reports containing this information are submitted to each of the three Boards of Trustees. The actuary meets with the respective Boards of Trustees for comments and discussions before and after completion of the studies and submission of each report.

In addition, the actuary appears before the Board of Supervisors as requested; provides cost estimates for proposed plan changes; meets with the various Boards of Trustees as requested concerning suggested plan changes, administration of the plan, and any other pertinent questions posed by the trustees; and apprises and reminds the trustees of changes in the law which may affect the plans and assesses the impact of these changes on the plans.

The actuary also is required to provide an actuarial experience study which includes studies of the systems' experience with respect to both economic and demographic assumptions and recommended actions. The last such study covered the period from July 1, 1990, through July 1, 1995. Future studies are to be done every five years thereafter.

Actuarial Assumptions

The actuary uses certain assumptions in determining the retirement systems' assets, liabilities, and funding requirements. These assumptions are recommended by the actuary and adopted by the Boards of Trustees based on periodic analysis of the Systems' experiences. The current actuarial assumptions, first used in the actuarial valuation as of June 30, 1996, are as follows:

a. A rate of return on investments of 7 ½ % compounded annually;

b. Projected salary increases of 4% compounded annually, attributable to inflation;

c. Additional projected salary increases ranging from 0.09% to 4% per year, (rates vary among the three systems) attributable to merit and seniority;

d. Post retirement benefit increases of 3% compounded annually;

e. Rates of mortality, termination of service, disablement, and retirement based on actual experience; and

f. A 4% annual increase in the aggregate active member payroll.

These assumptions were based on (1) studies of the Systems' experiences for the period July 1, 1990, through July 1, 1995, and (2) expected future experiences of the Systems. These studies encompassed both economic assumptions, such as investment returns and wage increases, and demographic assumptions, such as retirement and turnover. Assumptions are also set to be in compliance with the parameters of the Governmental Accounting Standards Board Statement No. 25. This statement establishes financial reporting standards for defined benefit pension plans of state and local governments.

HOW COUNTY CONTRIBUTIONS ARE DETERMINED BY THE ACTUARY AND THE BOARDS OF TRUSTEES

Annually, the actuary computes the County's contribution rates (expressed as a percentage of payroll) for each of the three retirement systems and presents these rates for approval at meetings with the Boards of Trustees for each of the systems. After the Boards and the actuary agree on the contribution rates, they are submitted through the County's budget process. In June, the Board of Supervisors approves these rates for use in the next fiscal year.

The County's contribution rate for each retirement system is composed of (1) normal cost contribution, (2) administrative expenses contribution, and (3) unfunded actuarial liability contribution. The normal cost contribution is the percentage, when multiplied by the payroll for the system members, that will cover the portion of the County's projected liabilities resulting from the service of system members during the following fiscal year. (The County's normal cost contribution plus the employees' contribution is designed to pay for each member's projected benefits at retirement.) The administrative expenses contribution is the percentage, when multiplied by the payroll for the system members, that will cover the costs associated with administering each retirement system. Both the normal cost and administrative expenses contribution rates for each system remain fairly stable and are only adjusted, if necessary, for a change of assumptions or a significant plan change.

Unlike the first two rates, the unfunded actuarial liability contribution rates are determined annually. In July and/or August, the actuary requests specific financial data from the prior fiscal year from RAA. This data includes specific information on each member of each retirement system. The actuary uses this data to prepare the annual valuation report of each system, which is a snapshot as of July 1, immediately following the end of the County's fiscal year.

As part of the annual valuation, the actuary mathematically determines the actuarial value of the assets of each retirement system. This calculation usually results in a value that is more or less than the market value of each of the retirement systems' assets. This is due to the use of commonly-accepted techniques for pension plan valuations, which smooth the fluctuations in the financial markets.

The actuary also determines the actuarial liability of each retirement system. The actuarial liability is the portion of the present value of projected benefits that will not be covered by future employer and employee contributions.

The difference between the actuarial value of each retirement system's assets and its actuarial liability results in an unfunded actuarial liability (if the liability is greater than the value of assets) or a surplus (if the value of assets is greater than the liability). The unfunded liability or surplus is compared to the expected unfunded liability or surplus which was being amortized in prior years' valuations. The difference resulting from this comparison represents the annual "correction" that the actuary calculates in order to bring the retirement systems back into balance. These adjustments may be necessary because of increased benefits, such as the 3% increase provided in 1995. Other reasons for making adjustments are to compensate for deviations from the investment return assumptions or for the effect of other system assumptions not being met (actuarial gains or losses).

The actuary then computes the additional layer of unfunded liability contribution percentage for each retirement system which, when applied to each year's payroll, is sufficient to amortize the change in the July 1 unfunded actuarial liability in 15 years. If there is a surplus, this computation would result in a negative percentage which would lower the rate from the previous year's level.

In November of each year, the actuary makes a presentation to each Board of Trustees on the financial condition of the retirement system and recommends a County contribution rate for the following fiscal year for approval of the Boards. After deliberations, the Boards approve the rates for submission to the County's Office of Management and Budget where they are reviewed and used for estimating the amount of the County's contribution to each system for inclusion in the following year's advertised budget. Historically, the Boards' proposed rates have passed through the County's budget review and approval process unchanged, with the exception of proposed additional cost-of-living increases for retirees, beyond the normal cost-of-living increases.

One of the goals of both the actuary and the Boards of Trustees is to attempt to maintain relatively level County contribution rates from year to year. The table below shows that the Boards of Trustees have been successful in keeping the County's contribution rates relatively stable.

Table 1 Fairfax County's Contribution Rates
To
Supplemental, Police Officers, and Uniformed Retirement Systems

Fiscal Year	Supplemental	Police Officers	Uniformed
1990	8.28%	17.22%	20.77%
1991	7.99%	20.36%	21.35%
1992	8.38%	20.75%	21.25%
1993	8.89%	21.13%	21.43%
1994	7.79%	22.20%	21.63%
1995	7.72%	21.89%	20.76%
1996	7.89%	22.24%	21.09%
1997	8.19%	23.64%	22.39%
1998	8.12%	21.79%	22.18%
1999 (Proposed)	**6.04%**	**19.40%**	**19.90%**

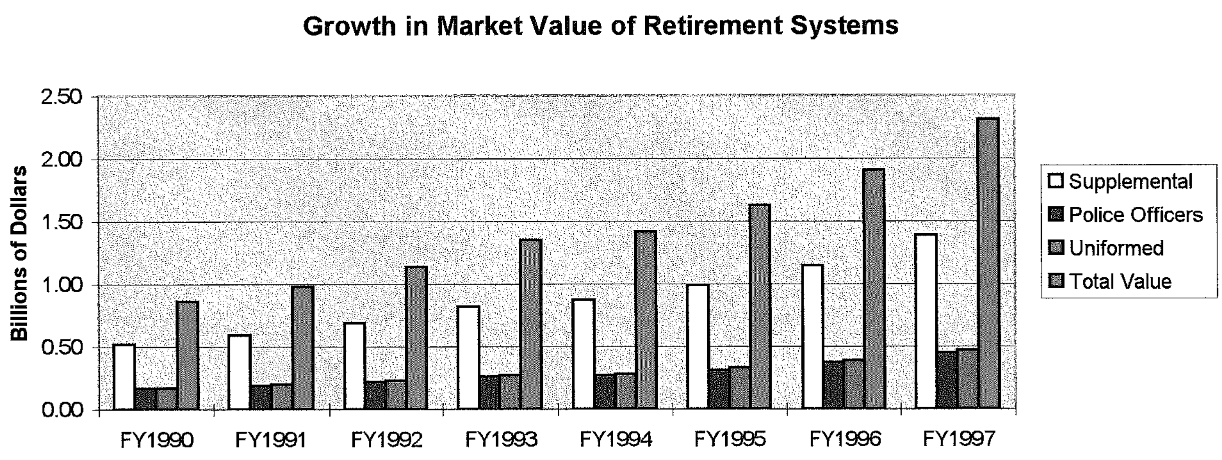
SUCCESSFUL INVESTING HAS REDUCED THE UNFUNDED ACTUARIAL LIABILITY FOR THE THREE SYSTEMS

The County has consistently made its required contributions to each retirement system and the Boards of Trustees have done an excellent job of investing their funds. As a result, the market value of the retirement systems' assets increased from June 30, 1990, to June 30, 1997, by an average of more than 15% a year. Due partly to the Boards' investment policies and partly to the bull market, the actuarial unfunded liability has been on a downward trend. And, with continued strong investment performance, this trend could continue to the point where the retirement systems could be in a surplus position.

Each Board of Trustees has established its own investment policy which sets forth investment strategies. Inherent in each of these policies is the objective to ensure, over the long-term life of the system, that adequate assets are available to provide benefits to the retirement system members and their beneficiaries when they are payable. To accomplish that objective, the Boards of Trustees have selected investment managers who specialize in different security classes so that the portfolios are diversified and yield an expected return on investment, in accordance with investment strategies.

The Boards' efforts have yielded dramatic results since 1990. As shown in the chart below, the market value of the assets in all three systems has grown from $.86 billion in 1990 to $2.31 billion at June 30, 1997.

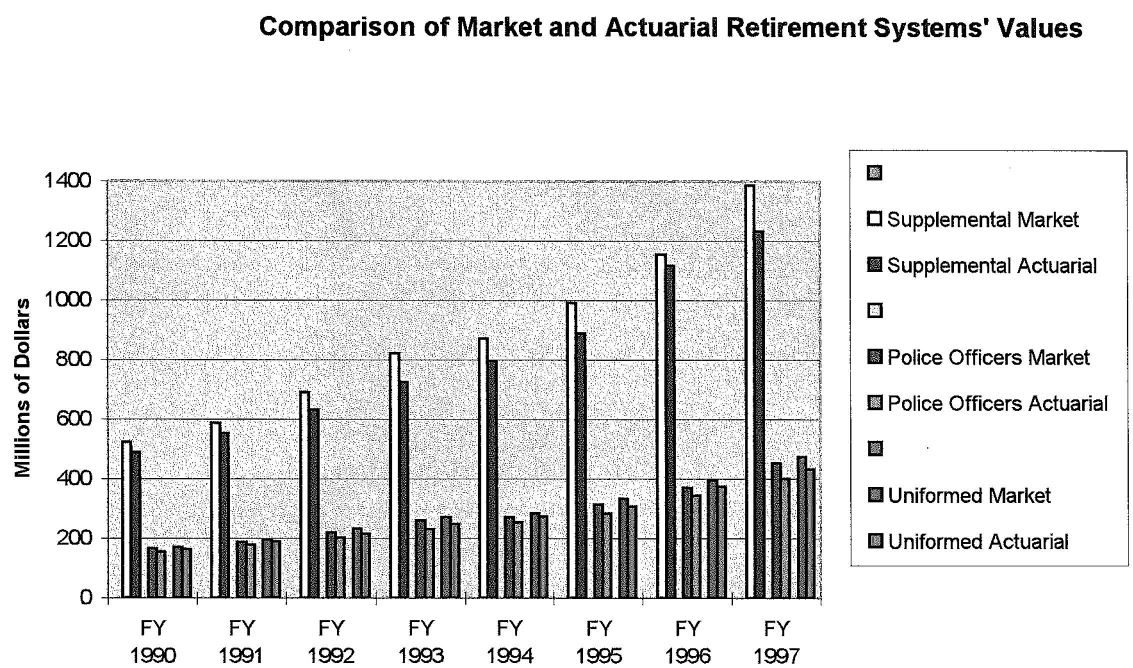
Chart 1



Further, the retirement systems continue to experience dramatic growth. As of the end of December 1997, the market values of the Supplemental, Police Officers, and Uniformed Retirement Systems were $1.50 billion, $.50 billion, and $.51 billion, respectively. The total market value of these retirement systems as of December 31, 1997, was $2.51 billion, an increase of $200 million or 8.7 % in six months.

As can be seen on Chart 2 below, the actuarial value of the assets of each system historically has been less than the market value, leaving a sizable cushion to absorb a sudden downturn in the financial market. This cushion is due to substantial earnings and the actuary's smoothing the market value of the assets. This technique, which is widely accepted for pension planning and supported by the Governmental Accounting Standards Board, acknowledges that the market is volatile and therefore recognizes in one year only a portion of the gains or losses in the market value of system assets.

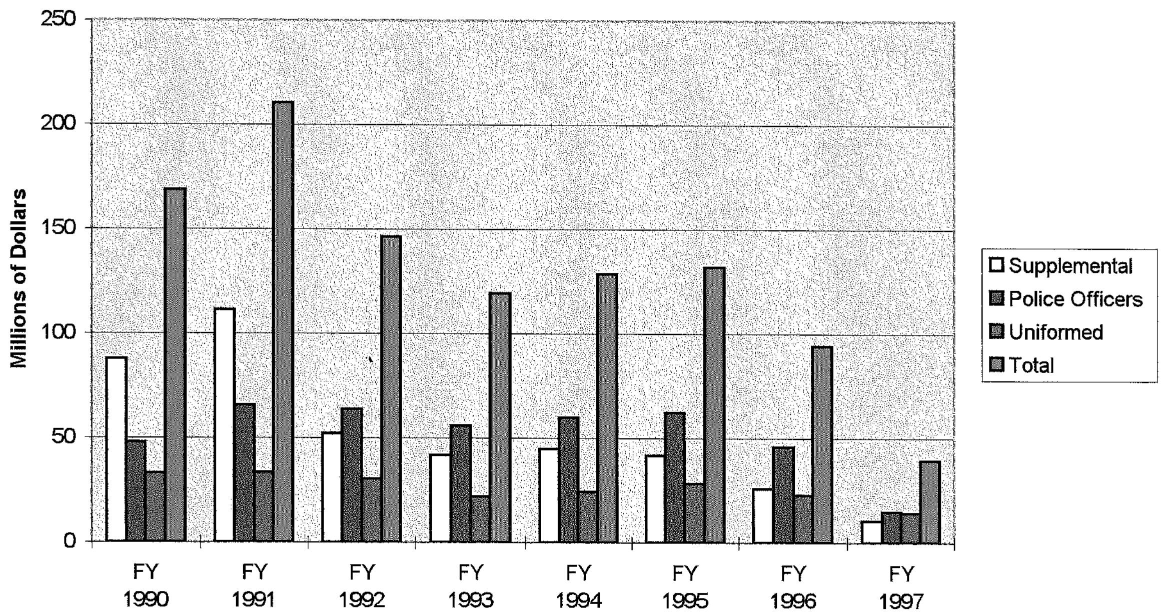
Chart 2



This tremendous growth in assets since 1990 has resulted in a corresponding decrease in the unfunded liability of each system during this period. In fact, as the chart below shows, each system has come close to eliminating its unfunded liability. At its highest, in Fiscal Year 1991, the unfunded liabilities for the three systems totaled more than $200 million, but had declined to $39.2 million at the end of Fiscal Year 1997.

Chart 3

Retirement Systems' Unfunded Liabilities Since 1990



At the end of Fiscal Year 1997, the Supplemental, Police Officers, and Uniformed Systems had achieved funding levels of 99.2%, 96.4%, and 96.8%, respectively, up from 97.7%, 88.3%, and 94.3% at the end of Fiscal Year 1996. This compares favorably with data in The 1997 Survey of State and Local Government Employee Retirement Systems, which reports that the average funding ratio for 261 public employee retirement systems was 87.4% in 1996. Those 261 systems represent 81% of the 13.6 million active system members.

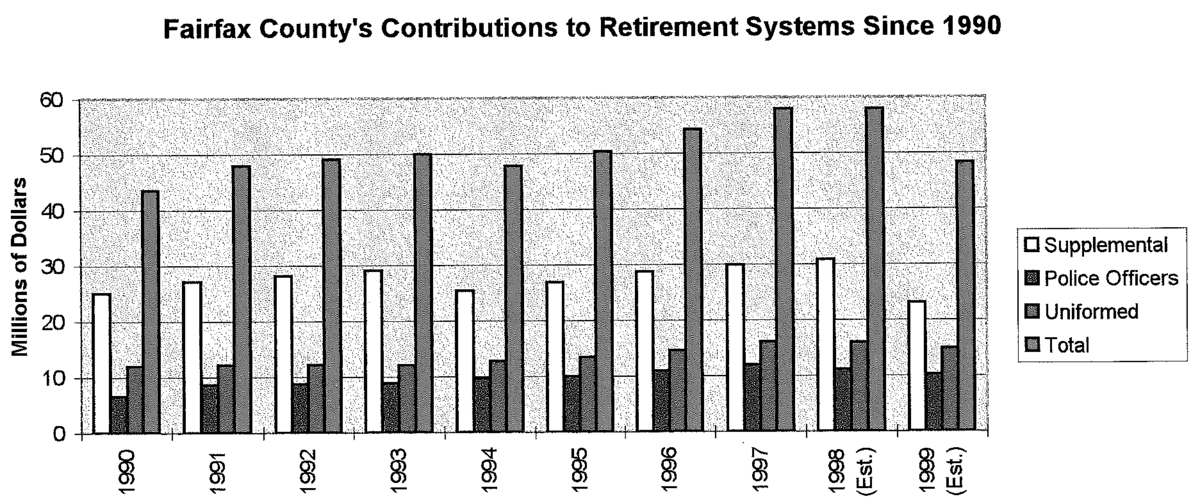
If the three retirement systems continue to experience similar growth in their assets, these systems could be in a surplus condition in the near future. Being in a surplus condition, however, does not mean that the County will not need to contribute to the systems. But surpluses, when amortized over 15 years, reduce the contribution rate for each retirement system. The actuarially determined normal cost rate and administrative expense rate total 5.80%, 12.59%, and 16.61% for the Supplemental, Police Officers, and Uniformed Retirement Systems, respectively. Since these rates are used to calculate the County's contribution to each system, surpluses realized during the year can be used to reduce the County's contribution.

THE COUNTY'S CONTRIBUTION IS PROJECTED TO BE $9.5 MILLION LESS IN FISCAL YEAR 1999

Fiscal Year 1999 should be a banner year for the County from the standpoint of the amount contributed to the Supplemental, Police Officers, and Uniformed Retirement Systems. Given the impressive performance of the investments and the corresponding reduction in unfunded liabilities, two of the three Boards of Trustees have approved and submitted into the County's Fiscal Year 1999 budget process for consideration by the Board of Supervisors the lowest contribution rates since 1990. (It should be pointed out that the Board of Trustees for the Police Officers Retirement System did have a lower rate in Fiscal Year 1990, but that was the only year that was lower than the Fiscal Year 1999 rate.) These Fiscal Year 1999 contribution rates, when applied to the expected Fiscal Year 1999 payrolls for County employees belonging to the three retirement systems, is projected to result in a $9.5 million reduction from the amount the County is expected to contribute in Fiscal Year 1998.

The chart below shows the amounts that the County contributed to each retirement system and in total since 1990 and what the expected contributions are for Fiscal Years 1998 and 1999. The County's total contribution to the three retirement systems has risen from $43.6 million in Fiscal Year 1990 to an estimated $57.9 million in Fiscal Year 1998, and is expected to drop $9.5 million in Fiscal Year 1999 to $48.4 million. (See Appendix V for calculation of $9.5 million reduction.)

Chart 4



This $9.5 million projected reduction affects the following County budgets: the General Fund, the Public Schools, and other funds, primarily Special Revenue Funds and the Integrated Sewer System Fund. Further, $5.9 million of this projected reduction has already been integrated into the General Fund Advertised Budget and almost $1.9 million into the School Board's Proposed Budget for Fiscal Year 1999. Discussions with the County's Office of Management and Budget has confirmed a savings for other funds of $1.7 million which will be realized in actual expenditures during Fiscal Year 1999.

WILL COUNTY CONTRIBUTIONS FOR FISCAL YEAR 2000 REMAIN AT LOWER RATES?

As discussed above, the County's contribution rates to the Supplemental, Police Officers, and Uniformed Retirement Systems are the lowest they have been since the early 1990s. Consequently, the County's Fiscal Year 1999 monetary contribution is projected to be $9.5 million lower than Fiscal Year 1998.

Given the dramatic growth in the value of the assets in the retirement systems and the corresponding decrease in the systems' unfunded liabilities, a logical question for County officials making budget decisions is: Is this a one-time reduction or will the contribution amounts remain at this lower level for Fiscal Year 2000?

The answer to this depends, in large part, on the performance of the financial markets. In general, if the other actuarial assumptions listed on page 8 are met, the County's contribution rates to the three systems will increase if assets earn less than the actuarially assumed return of 7 ½% and the County will pay less if the assets earn more than 7 ½%. Due to the smoothing techniques used to produce the actuarial value of assets, this is only strictly true if assets earn consistently more (or less) than the 7 ½% target rate over a long period of time.

In determining the contribution rate for Fiscal Year 2000, the actuary and the Boards of Trustees will be dealing with the fact that the smoothing method, in conjunction with recent bull markets, has built up a "cushion" of asset gains which would have to be used up before the County would see any adverse impact on it's contribution rates. This cushion can be measured in each system by comparing the actuarial and market values of the systems, which is shown in Chart 2 on page 12 of this report. In order to use up the entire cushion in one year, the systems would have to show *negative* returns of around 5% before the contribution rates would begin to increase to their prior levels. Any returns that fall between *negative* 5% and positive 7 ½% would use up a portion of the stored gains but would still result in the County's contribution rates remaining at these lower levels or even less.

Any returns in excess of 7 ½% would go partly to increase the cushion, against future market downturns, and partly to reduce the County's contribution rates even further. As mentioned earlier in this report, the market value of the systems' assets has already grown by 8.7% during the first half of Fiscal Year 1998, ending December 31, 1997. If this rate of growth continues through Fiscal Year 1998, the County's contribution rates for Fiscal Year 2000 would decline further.

CONCLUSIONS

All three retirement systems are in excellent financial condition. The market value of the retirement systems' assets increased from June 30, 1990 to June 30, 1997, by an average of more than 15% a year reaching a total of $2.31 billion. The total unfunded liability for the three systems has fallen from more than $200 million in Fiscal Year 1991 to less than $40 million in Fiscal Year 1997. The systems are between 96% and 99% fully funded.

The dramatic growth in asset values has enabled the Boards of Trustees for the retirement systems to propose significant reductions in the County's Fiscal Year 1999 contribution rates. These proposed reductions are projected to result in an estimated $9.5 million reduction in the County's Fiscal Year 1999 contribution to the retirement systems. Based on our analysis, we concluded that both the contribution rates and the procedures used by the Boards of Trustees and the consulting actuary in determining them were appropriate.

Whether or not the Boards of Trustees will propose County contribution rates at the new, lower levels for Fiscal Year 2000 depends heavily on the financial markets and the systems' investment performance during the current fiscal year. Over a long period of time, if the other actuarial assumptions are met, the general rule is that the County's contribution rates for the three systems will increase if assets earn less than the actuarially assumed rate, which is presently 7 ½%. Conversely, the County would pay less if the assets earn more than 7 ½%.

However, the recent bull markets, and an actuarial smoothing technique which recognizes only a portion of asset gains or losses in each year, has given the County a "cushion" of stored asset gains, which is evidenced in the chart on page 12 of this report. That cushion would have to be used up before the County would see any adverse impact on its contribution rates. According to the three systems' actuary, in order to use up the entire cushion in one year, the systems' assets would have to show *negative* returns of around 5%.

Returns that fall between *negative* 5% and positive 7 ½% would use up a portion of the stored gains but would still result in the County's contribution rates remaining at the lower levels, or being reduced further.

Returns in excess of 7 ½% would, because of the smoothing technique employed, go partly to increase the cushion against the possibility of future market downturns, and partly to further reduce the County's contribution rates.

While we will not know the final results of Fiscal Year 1998 operations for the three retirement systems for several months, we know that the market value of the assets for the three systems as of December 31, 1997, the mid point of Fiscal Year 1998, was $2.51 billion. This represents an increase since the end of fiscal Year 1997 of 8.7% which, if sustained through the end of Fiscal Year 1998, would result in a further reduction in County contribution rates for Fiscal Year 2000.

BOARDS OF TRUSTEES' COMMENTS AND OUR EVALUATION

In their response to our report (which is included in its entirety in Appendix VI), the Boards of Trustees of the Supplemental, Police Officers, and the Uniformed Retirement Systems stated that they concurred with our report. They also stated they have worked and will continue to work diligently to manage the retirement systems to meet the benefit obligations of the plans in an efficient and fiscally responsible manner. The Boards of Trustees added that they have the fiduciary responsibility to recommend annually the employer contribution rate to the Board of Supervisors which is based, in part, on the investment performance of the independent retirement systems. They pointed out that the rates of return achieved by the Boards have been achieved by using prudent investment standards to meet the funding requirements of each system.

We believe that the successful performance of the three retirement systems, as mentioned in this report, is due to the County consistently making its required contributions to each retirement system and the prudent investment decisions and diligent work of the Boards of Trustees. Because we found the systems to be in excellent financial condition and the process used for determining County contribution rates to be appropriate, we are making no recommendations for corrective action in this report.

APPENDIX I

INFORMATION ON

FAIRFAX COUNTY

SUPPLEMENTAL RETIREMENT SYSTEM

APPENDIX I

Fairfax County Supplemental Retirement System

BOARD OF TRUSTEES

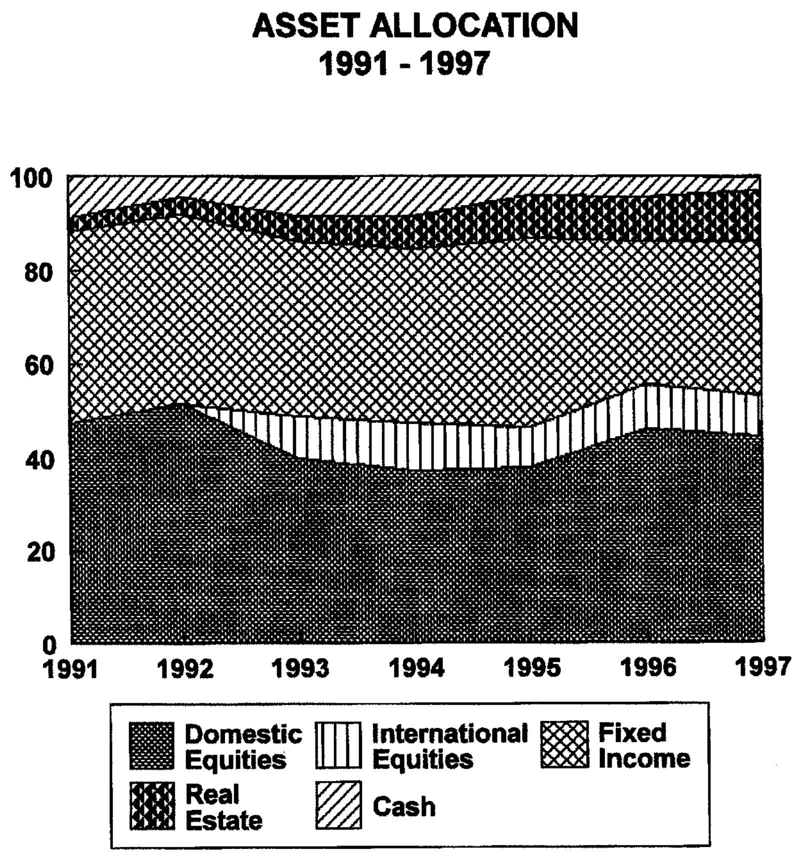
Fairfax County Supplemental Retirement System

LIST OF LARGEST ASSETS HELD
(June 30, 1997)

Fifteen Largest Equity Holdings	Shares	Market Value
IBM	128,400	$11,588,100
Student Loan Marketing Association	79,200	10,058,400
Philip Morris Companies Inc.	217,200	9,611,100
Eli Lilly & Co.	86,800	9,488,325
Citicorp	66,200	7,981,238
Vornado Realty Trust	104,400	7,529,850
Lockheed Martin Corp.	72,100	7,466,856
Electronic Data Systems Corp. New	180,500	7,434,344
Kimberly Clark Corp.	145,628	7,244,993
Johnson & Johnson	110,100	7,087,688
Rouse Co.	235,900	6,959,050
Mellon Bank Corp.	150,700	6,800,338
Crescent Real Estate Equities	207,700	6,594,475
Public Storage Inc.	208,800	6,107,400
Spieker Properties Inc.	171,100	6,020,581

Fifteen Largest Fixed Income Holdings	Interest Rate	Maturity Date	Par Value	Market Value
United States Treasury Notes	4.750%	Aug. 1998	14,870,00	$14,679,515
United States Treasury Notes	6.250%	Feb. 2003	13,705,00	13,597,964
United States Treasury Notes	5.000%	Jan. 1998	10,750,00	10,711,408
United States Treasury Notes	6.875%	May 2006	8,500,000	8,676,630
United States Treasury Notes	6.750%	Jun. 1999	8,155,000	8,254,409
United States Treasury Notes	6.125%	Dec. 2001	8,000,000	7,921,280
United States Treasury Notes	11.750%	Nov. 2005	7,500,000	7,175,400
MBNA Master Credit Card Trust II	.990%	Nov. 2004	7,000,000	6,986,840
Federal National Mortgage Assn.	6.350%	Nov. 2001	7,000,000	6,912,500
Tennessee Valley Authority	6.375%	Jun. 2005	7,000,000	6,844,670
General Electric Capital Corp.	8.700%	Feb. 2003	6,000,000	6,538,020
Citicorp Medium Term Notes	6.650%	May 2000	6,500,000	6,514,040
IBM	6.375%	Jun. 2000	6,500,000	6,478,875
Federal Home Loan Mortgage PC	6.000%	Apr. 2006	6,000,000	5,923,080
General Motors Corp.	9.125%	Jul. 2001	5,400,000	5,837,184

Fairfax County Supplemental Retirement System



APPENDIX II

INFORMATION ON
FAIRFAX COUNTY
POLICE OFFICERS RETIREMENT SYSTEM

Fairfax County Police Officers Retirement System

BOARD OF TRUSTEES

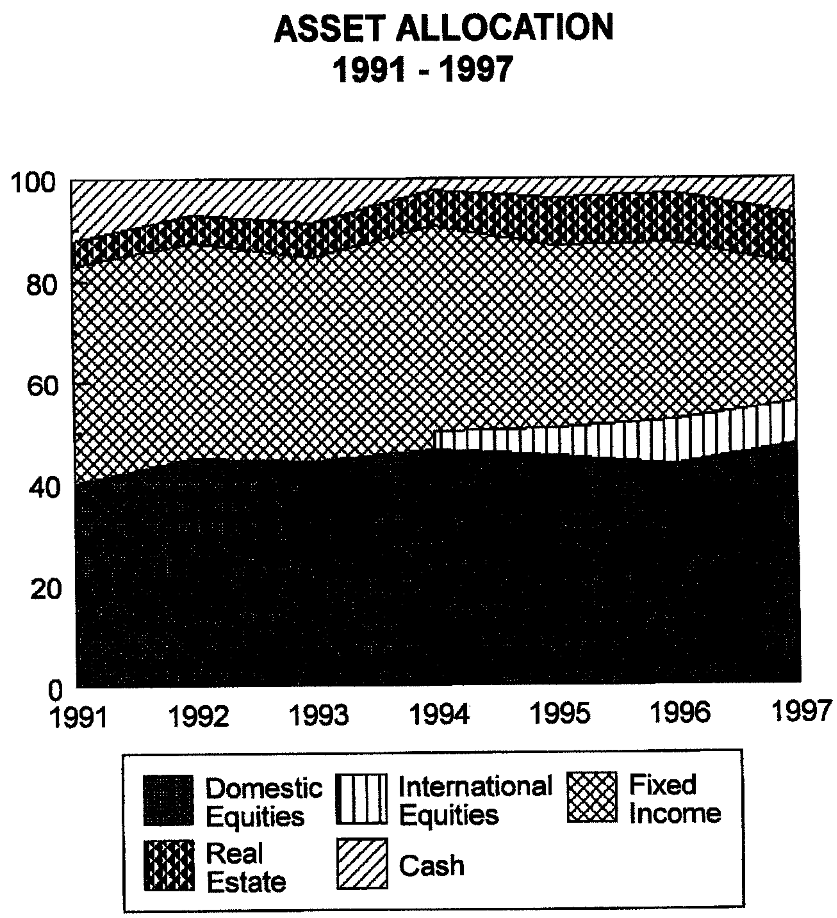
Fairfax County Police Officers Retirement System

LIST OF LARGEST ASSETS HELD
(June 30, 1997)

Fifteen Largest Equity Holdings	Shares	Market Value
Johnson & Johnson	75,900	$4,866,063
Student Loan Marketing Association	33,800	4,292,600
IBM	45,300	4,088,325
Citicorp	32,500	3,918,281
Guidant Corp.	37,900	3,221,500
Eli Lilly & Co.	28,900	3,159,131
Mellon Bank Corp.	69,200	3,122,650
Dover Corp.	50,000	3,081,250
Sherwin Williams Co.	99,600	3,075,150
Phillip Morris Companies Inc.	69,000	3,053,250
Illinois Tool Works Inc.	61,000	3,046,188
Gannett Inc.	30,700	3,031,625
Newell Co.	71,400	2,838,150
American Express Co.	38,000	2,831,000
General Motors Corp.	46,700	2,691,088

Fifteen Largest Fixed Income Holdings	Interest Rate	Maturity Date	Par Value	Market Value
United States Treasury Bonds	7.625%	Feb. 2025	4,020,000	$4,401,900
United States Treasury Notes	6.625%	Jun. 2001	3,050,000	3,078,579
United States Treasury Notes	6.125%	May 1998	3,000,000	3,008,910
Federal Home Loan PC	7.500%	Nov. 2008	2,828,249	2,878,451
Federal National Mortgage Assn. GTD	6.000%	Mar. 2008	3,000,000	2,867,790
Federal National Mortgage Assn. REMIC	6.250%	Mar. 2009	3,000,000	2,860,290
U.S. Department Veteran Affairs REMIC	6.750%	Feb. 2013	2,335,000	2,318,935
Federal National Mortgage Association Pool 7238	8.000%	Jun. 2008	2,243,724	2,314,715
United States Treasury Notes	5.875%	Nov. 2005	2,400,000	2,296,128
Government National Mortgage Association Pool 780337	7.250%	Feb. 2006	2,236,572	2,260,816
Federal National Mortgage Association Pool 50718	7.000%	Apr. 2008	2,191,895	2,199,413
Federal Home Loan Mortgage PC	7.000%	Jun. 2006	2,100,000	2,108,526
Sears Credit Account Master Trust II	6.200%	Feb. 2006	2,100,000	2,075,052
Federal Home Loan PC	6.500%	Oct. 2007	2,035,434	2,027,373
United States Treasury Notes	6.000%	Nov. 1997	2,000,000	2,003,440

Fairfax County Police Officers Retirement System



APPENDIX III

INFORMATION ON
FAIRFAX COUNTY
UNIFORMED RETIREMENT SYSTEM

APPENDIX III

Fairfax County Uniformed Retirement System

BOARD OF TRUSTEES

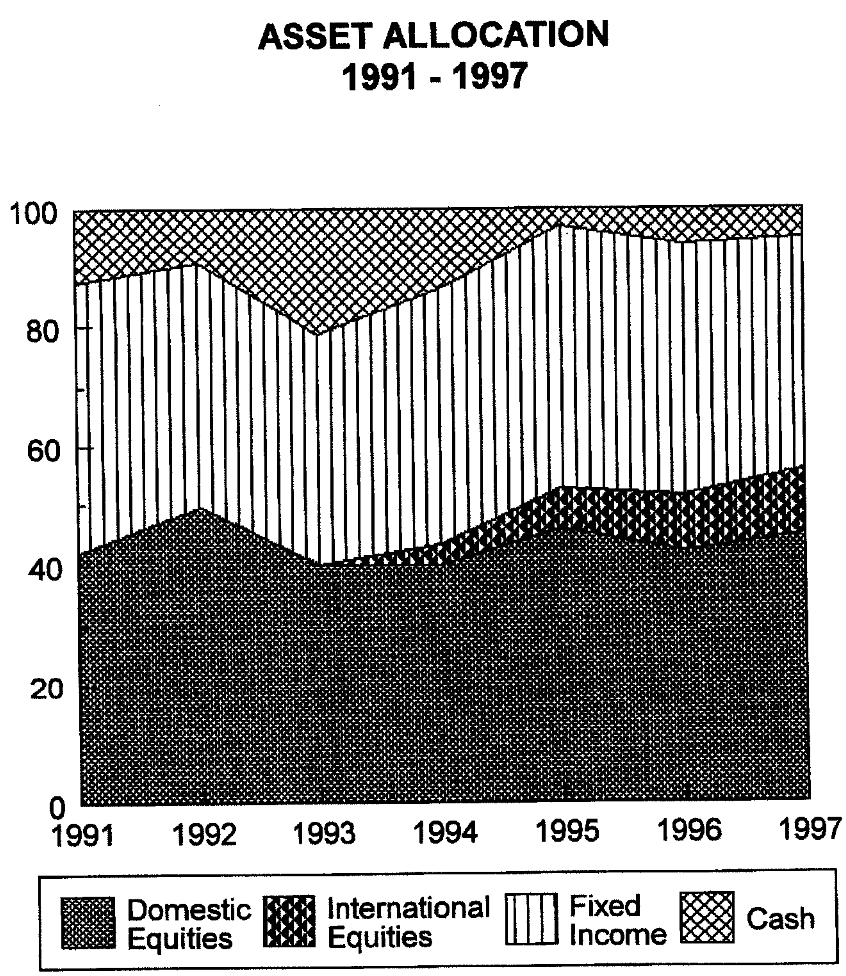
Fairfax County Uniformed Retirement System

LIST OF LARGEST ASSETS HELD
(June 30, 1997)

Fifteen Largest Equity Holdings	Shares	Market Value
Gannett Inc.	31,800	$3,140,250
Dover Corp.	36,300	2,236,988
Mobil Corp.	31,000	2,166,125
Illinois Tool Works Inc.	42,000	2,097,375
IBM	22,400	2,021,600
Sherman Williams Co.	65,000	2,006,875
Newell Co.	48,600	1,931,850
State Street Corporation	39,900	1,845,375
Johnson & Johnson	28,200	1,815,375
Chase Manhattan Corp. New	18,648	1,810,022
H.J. Heinz Co.	38,600	1,780,425
Philip Morris Companies Inc.	39,300	1,739,025
Compaq Computer Corp.	17,100	1,170,450
Clorox Co.	12,700	1,678,781
Bank of New York Inc.	37,600	1,640,300

Fifteen Largest Fixed Income Holdings	Interest Rate	Maturity Date	Par Value	Market Value
United States Treasury Bonds	8.125%	Aug. 2019	7,700,000	$8,784,006
Federal Home Loan PC	7.000%	Dec. 2026	7,975,273	7,825,736
United States Treasury Notes	7.000%	Jul. 2006	7,500,000	7,715,625
Government National Mortgage Association Pool 442138	8.000%	Nov. 2026	5,848,806	5,984,030
Federal Home Loan Mortgage Corp.	7.000%	Mar. 2022	4,064,649	4,065,909
Premier Auto Trust	6.575%	Oct. 2000	4,000,000	4,018,720
United States Treasury Bonds	6.250%	Aug. 2023	4,320,000	3,999,370
AT&T Capital Corp. Medium Term Note	6.100%	Aug. 1998	4,000,000	3,998,160
First National Bank Comm. New Orleans	6.500%	Jan. 2000	4,000,000	3,994,720
International Lease Financial Corp.	6.375%	Jan. 2000	4,000,000	3,982,920
First Bank Corporate Card Master	6.400%	Feb. 2003	4,000,000	3,950,000
Green Tree Financial Corp.	6.550%	Feb. 2024	4,000,000	3,900,000
United States Treasury Bonds	7.625%	Feb. 2025	3,330,000	3,646,350
Federal Home Loan Mortgage Corp. Gold TBA July 15	6.500%	Jan. 2099	3,650,000	3,579,263
Federal Home Loan PC G00718	7.000%	May 2027	3,459,713	3,431,585

Fairfax County Uniformed Retirement System



SCOPE OF OUR REVIEW

This review is part of the Board of Supervisor's work plan for our Office. The work plan was approved by the Audit Committee on July 8, 1997, and was presented to and approved by the Board of Supervisors on July 21, 1997.

Our review of Fairfax County's Supplemental, Police Officers, and Uniformed Retirement Systems has two objectives: (1) to review the financial condition of the systems, and determine whether the County was contributing an appropriate amount to each system and (2) to determine whether the retirement systems were being administered in an efficient, effective, and economical manner. We began our review by performing the work necessary to address the first objective because this issue has the most significant impact on the Fiscal Year 1999 budget. Thus, this report focuses on the appropriateness of the County's contribution rates and the procedures used to determine them. We did not review the level of benefits provided to retirees under each retirement system nor do we plan to during our work under the second objective. We plan to issue at least one more report on the retirement systems after we complete our work addressing the second objective.

To accomplish our first objective, we reviewed the Fairfax County Code, rules and regulations for the Boards of Trustees, and investment objectives and policies applicable to each of the three retirement systems. We also reviewed and analyzed the Comprehensive Annual Financial Reports for the three systems for the past two fiscal years, the only years for which such reports had been issued. In addition, we reviewed and analyzed financial information on the retirement systems contained in the Comprehensive Annual Financial Reports for Fairfax County as well as the most recent valuations and experience studies conducted by the actuary for the three systems. Further, we reviewed Governmental Accounting Standards Board pronouncements relevant to the operations of government pension funds.

We met with the actuary to question her regarding the actuarial assumptions used and the calculations she made that led to the development of the County's contribution rates for the three retirement systems. We also attended, as observers, the meetings of the Boards of Trustees of the Supplemental, Police Officers, and Uniformed Retirement Systems held in November 1997. It was at these meetings that the actuary and the Boards of Trustees of the Supplemental and Uniformed Retirement Systems came to agreement on the rates the County would be asked to contribute to the these systems in Fiscal Year 1999. The Board of Trustees for the Police Officers Retirement System agreed on the County contribution rate to its system at a meeting in December 1997, which we also attended.

We met with the Acting Director and the new Director of the RAA and with RAA's personnel to discuss operations relating to the three retirement systems. We also reviewed the reports previously issued on the retirement systems by the County's Internal Audit Office and the previous Auditor to the Board of Supervisors.

We did not review the adequacy of internal controls designed to ensure the accuracy of financial data produced by the accounting system for the three retirement systems. Instead, we relied on the work conducted by KPMG Peat Marwick LLP, which conducts the County's annual financial audit.

However, we plan to review other operational controls and possible additional economies, efficiencies, and effectiveness that might be achieved through changes in the operations of the RAA or the Boards of Trustees in work to be performed later, as we address the second objective.

We would like to express our appreciation to the Boards of Trustees, personnel of the RAA, and the actuary for their cooperation and assistance during this first phase of our review.

CALCULATION OF REDUCTION IN COUNTY'S CONTRIBUTION TO THE THREE RETIREMENT SYSTEMS IN FISCAL YEAR 1999

	SUPPLEMENTAL SYSTEM	POLICE OFFICERS SYSTEM	UNIFORMED SYSTEM
FY-98 Estimated Payroll 1/	$378,997,007	$51,187,022	$72,122,426
County Contribution Rate	8.12%	21.79%	22.18%
Estimated Amount To Be Contributed By:			
General Fund	$15,996,535	$11,153,652	$15,996,754
Other Funds 2/	6,986,993	--0--	--0--
Public Schools	7,791,029	--0--	--0--
Total	$30,774,557	$11,153,652	$15,996,754
TOTAL ESTIMATED COUNTY CONTRIBUTION FOR FY-98			**$57,924,963**
FY-99 Estimated Payroll 3/	$383,137,464	$52,723,020	$75,413,010
County Contribution Rate	6.04%	19.4%	19.9%
Estimated Amount To Be Contributed By:			
General Fund	$11,998,370	$10,228,266	$15,007,189
Other Funds 2/	5,240,668	--0--	--0--
Public Schools	5,902,465	--0--	--0--
Total	$23,141,503	$10,228,266	$15,007,189
TOTAL ESTIMATED COUNTY CONTRIBUTION FOR FY-99			**$48,376,958**
REDUCTION IN FISCAL YEAR 1999 CONTRIBUTION			**$ 9,548,005**

Footnotes:
1/ Computed by Office of Financial and Program Auditor based on known contribution rates, and estimated contributions obtained from the Fairfax County Fiscal Year 1998 Revised Budget.
2/ Other Funds primarily are Special Revenue Funds and the Integrated Sewer System Fund.
3/ Payroll estimate computed by Fairfax County's Office of Management and Budget.

FAIRFAX COUNTY, VIRGINIA

MEMORANDUM

TO: John J. Adair
Auditor to the Board of Supervisors

FROM: Lt. Arthur J. Hurlock, Jr., President
Board of Trustees
Police Officers Retirement System

Robert C. Carlson, Chairman
Board of Trustees
Supplemental Retirement System

Littell G. McClung, Chairman
Board of Trustees
Uniformed Retirement System

DATE: February 25, 1998

SUBJECT: Audit Report - Phase I

The purpose of this memorandum is to provide our comments on the draft report to the Fairfax County's Board of Supervisors on the first phase of your audit of the Fairfax County Police Officers, Supplemental and Uniformed Retirement Systems.

It is our understanding that your direction from the Board of Supervisors was to provide an analysis of the employer contribution rates which are approved by the Board of Supervisors and to determine whether these rates were determined using sound actuarial analysis and adequately funded the plans to meet the future benefit obligations of the three (3) retirement systems. The Boards are pleased with the professional approach taken by your office in conducting this review.

The Boards of Trustees have, and will continue, to work diligently to manage the retirement systems to meet the benefit obligations of the plans in an efficient, fiscally responsible nature. One of our major objectives has been to manage the financial liability of each System while maintaining a level employer contribution rate. The Boards of Trustees have the fiduciary responsibility to annually recommend the employer contribution rate to the Board of Supervisors which is determined based, in part, on the investment performance of the independent retirement system. The rates of return achieved by the Board have been achieved by using prudent investment standards to meet the funding requirements of each System.

We are pleased that the findings of your independent review have highlighted the excellent investment results we have worked hard to achieve. We are also pleased that you have confirmed the soundness of the actuarial process we employ to develop the employer contribution rates and to manage the funding requirements while avoiding large annual fluctuations.

The Boards of Trustees appreciate the opportunity to have been able to work with your office in conducting this study and concurs in the overall outcome of your report. On behalf of the Boards of Trustees and the Retirement Administration Agency, we thank you for the opportunity to participate in this informative study.

cc: Members, Boards of Trustees
Police Officers Retirement System
Supplemental Retirement System
Uniformed Retirement System