Section 18 – Retirement Plans

Overview

Retirement plan benefits are deferred compensation for services and form an important component of recruiting and retention within a compensation and benefits policy. Furthermore, they are significant financial commitments requiring the serious attention of government employers' financial staff.

Types of Plans

Public sector employers offer several retirement options for their employees. Retirement plans fall into three general categories: (1) defined benefit plans, (2) defined contribution plans, and (3) hybrid plans. The defined benefit plan retirement option historically has been the primary retirement plan offered to employees. In an effort to control costs, some government agencies are now offering a defined contribution plan as an alternative to the defined benefit plan. Other governmental entities have adopted a hybrid plan which combines the features from a defined benefit plan with a defined contribution.

Many public sector employers have implemented deferred retirement option plans as a feature in their defined benefit plans to achieve a variety of financial and human resource management objectives.

Defined Benefit Plan

A defined benefit (DB) plan provides employees with a predictable retirement benefit for life. DB plans are based upon an established formula and defined by a legal plan document. DB plans promise a monthly pension for life (with survivorship options).

The amount of the monthly pension is determined by a formula, usually multiplying a benefit accrual rate (as a percentage) <u>times</u> a final average monthly pay <u>times</u> years of service with the government. Some plans may include a Cost-of-Living-Adjustment (COLA) which increases the pension benefit over time to account for inflation. The monthly benefit to the employee is reasonably predictable, based on the formula. The monthly pension usually begins after leaving employment and upon satisfying certain age and service eligibility conditions. DB pensions usually provide disability pensions and death benefits to surviving beneficiaries as well.

A DB pension fund is professionally managed and builds up over time to systematically and actuarially finance the benefits promised. A reasonable goal is to work toward maintaining a 100% funded status; that is, a pension fund with assets equal to the liability attributed to past years of service. Typically, employees in a DB plan pay a fixed rate of payroll contributions into the pension fund to help finance their future monthly pension benefits. However, the employer is responsible for contributing the balance of what is actuarially required each year based on the actuarial valuation prepared by the plan's actuary.

Under conventional DB plans, the employer bears all the risks of a given plan, including investment and longevity risks. Since the employer pays the balance of the actuarially determined contributions, any shortfalls in investments and any other adverse actuarial experience must be made up by the employer over time. Conversely, if the plan's actuarial experience is better than expected, the employer reaps the reward of lower contribution requirements. The employer's contribution rates will fluctuate based upon the actuarial experience of the plan and if there are changes to the benefits offered under the plan.

Defined Contribution Plan

Defined contribution (DC) plans are the opposite of defined benefits plans in several ways. Contributions to DC plans may be made by the employee and/or the employer. The employer contributions are fixed and defined by the contribution formula, while the employee/retiree bears all the investment risks. Account balances are maintained in the name of each employee, with the ultimate benefit being unpredictable because it depends on the performance of the account's investment. DC plans provide funds for retirement based solely on the contributions made to the plan and the gains and losses on the assets available in an employee's individual account. Typically, the employee decides what investments are appropriate from a predetermined list, and all investment-related risk is borne by the employee.

The account balance is paid out to the employee according to the options outlined in the plan documents. This may include a lump sum payment upon termination or retirement, which would allow for the purchase of an annuity, or withdrawals may be made over the lifetime of the employee that are in compliance with required minimum distribution rules promulgated by the Internal Revenue Service. DC plans can be offered as the primary retirement plan or as a supplemental retirement plan to a DB plan, or they can be part of a Combination DB-DC pension plan.

Hybrid Plans

Other plan designs incorporate features of both DB and DC plans into a single plan. Hybrid plans can be offered as a primary, optional, or supplemental plan. There are a growing number of hybrid plans that express future retirement benefits as account balances. The key difference between DC plans and hybrid plans is that DC plans establish an actual funded account for each participant, which contains employer and employee contributions and investment gains and losses, while hybrid plans establish "accounting" or notational accounts for each participant. The participant's balance in a hybrid plan continues to grow throughout employment, and the benefit is defined by the current value of the account.

- **Cash Balance Plans** – Cash balance plans maintain notional account balances in the name of each employee, crediting their accounts with pay credits and interest credits, and pay lump sums upon termination or retirement like DC plans. However, the interest credits come from a professionally managed pooled fund. The ultimate benefit to the employee may or may not be predictable depending on the interest crediting method; and the employer contributions are not predictable either. The employer bears much or all the investment risk and reward.

The employer sets aside a percentage of an employee's salary each period, and the balance set aside earns interest at a set rate. In other words, the employer promises to make a contribution to an account, usually with a specified percentage of pay (also referred to as a credit to the employee's account), and to credit the account with interest, usually a specified rate of return or a rate based on the yield of a particular benchmark. The employer invests the funds, retaining all investment income and bearing all the risks. The plans generally provide participants the option of receiving their vested account balances as an annuity or as a lump sum.

Cash balance plans have become common in the private sector and have seen some growth in the public sector.

- **Variable Benefit Plans** – The benefit factors and formulas in traditional DB plans are usually fixed and change up or down only through amendment by the governing body. However, a variable benefit plan is a DB plan with a multiplier or other factor that automatically varies up or down depending on the investment performance of the fund or on the contribution budget, so as to *share* the risk between the employer and the member. While these are rare in the public sector, they have a long history (although in the minority) in the private sector.

<u>Plans with Hybrid Features</u>

- **Defined Benefit Plans (DB) with Defined Contribution (DC) Features –** Public sector plans have options under section 401(a) of the Internal Revenue Code (IRC) to add a DC feature to a DB plan. There are several variations of DB plans with DC features. These include floor offset plans and pension equity plans. Another common approach is to simply offer a DB plan and a separate voluntary DC plan such as a 457, 403(b) or 401(k) plan.

- **Defined Contribution Plan (DC) with Defined Benefit (DB) Features –** Defined contribution plans may seek ways to allow members to manage the risk of outliving their money. This could include the purchase of an annuity contract, or allowing a transfer out of the DC plan into an appropriate DB plan where the employee can annuitize this transferring DC balance.

Deferred Retirement Option Plans (DROP)

Although DROP plan features can vary significantly, the plans usually result in a lump sum payout that supplements an employee's pension. DROP plans allow employees who would otherwise retire in a DB plan to continue working. However, rather than continuing to accrue credit for service and compensation, the monthly pension payment is credited to a separate account under the government's retirement plan. The account increases in value from the monthly payments which may include an agreed-upon interest amount, or may increase or decrease in accordance with the investment return of the account, until the end of the DROP period.

A significant concern about the use of DROP plans is that costs have been substantially higher than anticipated in some jurisdictions. In these cases, unexpected cost increases have been attributed to factors such as unfavorable plan design and guaranteeing an interest rate that equals or exceeds an overly optimistic return assumption.

Essential Elements of a Retirement Plan

- Defines employee groups that are eligible to participate in the retirement plan.
- Indicates vesting requirements for members of the plan.
- Defines the benefits provided by the plan, including the components of the formula to determine those benefits (e.g., benefit accrual rate in percentage, years of service, and final average compensation).
- Defines other benefit options, such as early and disability retirement, joint and survivor options, and lump sum withdrawals.
- Defines eligible service, including an employee's ability to purchase past service, such as prior military or other government service.

Essential Elements of a Plan Design

- Determine the adequacy of the retirement plan in meeting the needs of employees.
- Conduct a full actuarial analysis based on workforce demographics and the desired level of replacement income to determine the related cost of providing the benefit.
- Provide a tax deferral to the employee through the use of mandatory employee contributions (employer pick-ups).
- Design a plan that is financially sustainable for the employer.

Financial Statement Accounting and Footnotes

Governmental Accounting Standards Board (GASB) issued Statement No. 67, *Financial Reporting for Pension Plans—an amendment of GASB Statement No. 25* and Statement No. 68, *Accounting and Financial Reporting for Pensions—an amendment of GASB Statement No. 27,* which now comprise the primary accounting standards for reporting pension information in governmental financial reports. Other subsequent standards issues supplement these.

There are many different rules governing pension reporting and disclosure for accounting purpose, depending on the type of plan and the governmental entity's makeup. Pension plans can be classified in several different ways such as a single-employer DB plan, agent multiple-employer DB plan, cost-sharing multiple-employer DB plan, DC plan, or insured DB plan.

A pension plan and trust sometimes issues its own separate financial statement in compliance with GASB Statement No. 67, but if such a separate financial statement is *not* issued, then the financial reporting entity is required to provide all disclosures ordinarily required by GASB Statement No. 67 of stand-alone pension plan reports in addition to the accounting and financial reporting requirements of GASB Statement No. 68. On DB plans, these disclosures include significant information typically contained in actuarial valuations. The GASB Statement also requires historical 10-year data to be reported as Required Supplementary Information.

For those local governments that participate in the Florida Retirement System (FRS), the FRS provides the pro rata data required for accounting and financial reporting.

Benefits Policy Considerations

Adequacy and Competitiveness

The level of retirement benefit promised should be part of the employer's overall considerations as to benefits policy. How much in retirement income is considered "adequate" for a career employee? How much should be provided for retirement benefits in order to offer a competitive compensation package?

These are among the key questions to address as part of the employer's discussions of its benefits policy.

Affordability and Sustainability

Adequacy and competitiveness sometimes are competing objectives to affordability and sustainability. Affordability is an assessment of whether the employer can afford the cost of the retirement benefit for a given year, while sustainability is an assessment of the affordability over a long period of time. Both of these assessments are, of course, measured against other claims on limited revenue.

Sacrificing adequacy and competitiveness, in the name of affordability, can result in a lower standard of essential services by staff and a decline in public perception. On the other hand, sacrificing affordability and sustainability, in the name of adequacy and competitiveness, can result in higher taxes and reduction or elimination of other worthy programs.

Defined Benefit Plan Management

Pension Board

Typically, a pension board is created and comprised of appointed and elected trustees. The board and its trustees have fiduciary responsibilities to operate the plan prudently, as adopted by the elected officials, and not to act in their own self-interests or in other interests that are not aligned with the current pension interests of plan members. A pension board will need to engage the services of independent professionals to advise it, including an attorney, an actuary, and an investment consultant.

Funding Policy

A written funding policy sets forth the principles to determine when and how much the employer is to contribute to the pension fund in order to ensure the plan is well-funded, giving the employees and retirees a high level of benefit security. A funding policy strikes a balance among several policy objectives:

- A pension fund with actuarially sufficient assets to pay benefits when due.
- A reasonable annual matching of the cost to the employer and the service rendered by members earning benefits (in other words, inter-generational equity or not kicking the can down the road).
- Manage contribution volatility (not contribution affordability).
- Transparency and accountability.
- Governance integrity (avoiding agency risk and the employer's commitment to fund the program).

A good resource for establishing a funding policy is found in *Actuarial Funding Policies and Practices for Public Pension Plans* issued in 2014 by the Conference of Consulting Actuaries:
https://www.ccactuaries.org/docs/default-source/papers/cca-ppc_actuarial-funding-policies-and-practices-for-public-pension-plans.pdf?sfvrsn=6397cc76_6

Investment Policy and Risk/Reward

The pension board is typically given the responsibility to invest the pension fund. The board should adopt an investment policy to guide its investment duties.

The most important aspect of setting an investment policy is the decision about the risk profile of the fund. That decision should be made in cooperation with the employer's assessment of its own risk appetite and its natural desire for lower contributions which competes with actuarial benefit security.

A pension fund portfolio with a higher risk profile will usually result in volatile levels of investment returns and, thus, volatile employer contribution requirements. But a higher risk profile usually carries with it higher "expected" returns which lowers the contribution requirements. Conversely, a pension fund portfolio with a lower risk profile will usually result in more stable levels of investment returns and, thus, more stable employer contribution requirements. But a lower risk profile usually carries with it lower "expected" returns which raises the contribution requirements.

Since the employer is bearing all the investment risk in conventional DB plans, the employer should have significant input to the pension board on the risk profile of the pension fund and the resultant level of employer contributions required. The pension board should not set the risk profile of the fund in a vacuum.

The board's actuary and investment consultant should jointly advise the parties concerning the risk/volatility levels of different asset allocation policies.Section 112.662, F.S., requires that investment decisions be based solely on pecuniary factors as defined in Section 112.662(1), F.S., and requires periodic filing of a comprehensive report detailing and reviewing governance policies concerning investment decisions regarding retirement systems or plans. Additionally, Section 215.4755, F.S., provides certification and disclosure requirements by investment advisors and managers.

Actuarial Assumptions

DB plans make promises to public employees that can easily stretch over a period of several decades. Demographic actuarial models of the projected workforce and retired population are employed to estimate the number and timing of disabilities, terminations, retirements, and deaths among covered plan members and their beneficiaries. Economic actuarial models are integrated with the demographic models to estimate future salary increases, inflation, and investment performance. The combined models help the actuary to determine the future cash flow expectations, present values, annual contribution requirements, funded status, and pension liability and risk assessments.

These models require a selection and adoption of assumptions about the future. These are called actuarial assumptions. The assumptions must be reasonable and constitute an honest, best estimate of the future events, without influence or bias in favor of any parties' self-interests or in other interests that are not aligned with the current pension interests of plan members. Two of the more significant actuarial assumptions are the mortality tables that estimate future longevity and the investment return assumption that estimate how much the pension fund will earn over time.

The investment return assumption should be developed through a robust process of estimating the future returns of the fund's own portfolio, taking into account: (a) the forward-looking capital market assumptions of multiple professional experts in the fields of forecasting inflation and investment returns, (b) the fund's own asset allocation, and (c) the plan's expected cash flow.

Sections 112.63 and 112.664, F.S., require local government pension plans to use the mortality tables used in either of the two most recently published actuarial valuation reports of the FRS, including the projection scale for mortality improvement, and appropriate risk and collar adjustments based on plan demographics. These tables are

to be used in preparing the local plans' actuarial valuations and actuarial disclosures. Copies of recent FRS actuarial valuations may be found on the FRS website on the Publications page at:
https://www.dms.myflorida.com/workforce_operations/retirement/publications/actuarial_valuations

The mortality methodology is described in Appendix A of the valuation.

The Bureau of Local Retirement Systems in the Department of Management Services' Division of Retirement is responsible for monitoring Florida's local government DB pension plans for compliance with Florida law and Florida Administrative Code provisions. These responsibilities are divided between the Local Retirement Section and the Municipal Police Officers and Firefighters' Retirement Trust Funds Section.

The Local Retirement Section pages provide information regarding the local government pension plans for compliance with Part VII of Chapter 112, F.S.

The Municipal Police and Fire Plans pages provide information regarding the local government pension plans established under the provisions of Chapters 175 and 185, F.S.

Defined Contribution Plan Management

Fiduciary Responsibility

DC plans have fiduciaries to select vendors and to monitor the investment performance of the pre-determined list of investments offered. These fiduciaries are often the employer's own finance department or other committee, or can be a board of trustees.

Bundled vs. Unbundled

DC plans require outside vendors to provide various services. These services can be grouped as follows:

- Recordkeeping **–** (a) prepare quarterly statements and IRS forms, (b) distribute funds as required, (c) develop and maintain a website, (d) maintain a platform for access to investment funds, and (e) execute investment trades.

- Education **–** assist plan members to make informed decisions concerning which investment funds they should select from the pre-determined list for their own account.

- Investment Management **–** manage the investment funds made available to plan members (usually mutual funds).

- Investment Consulting – (a) assemble the list of funds or investment managers, (b) monitor the performance of the funds and (c) recommend fund replacements within the list or the entire list when advisable.

The most *unbundled* arrangement involves engaging four independent vendors for the four categories of services, separately. Some might group categories 2 and 4 under one vendor. Decoupling the list of investment funds from the recordkeeping provides a better chance of maintaining optimal investment choices and optimal investment performance over time for the plan members' accounts. Unfortunately, there is not a broad range of choices for fully unbundled arrangements for small employers.

The most *bundled* arrangement involves engaging one vendor for all four categories. Most DC vendors' programs bundle categories 1 through 4(b), leaving the employer to decide whether to engage an independent advisor for category 4(c) or leave that to the single vendor as well. Many bundled vendors may not even permit an alternative version of the fund list, forcing the employer to terminate the entire relationship to rid the plan of less-then-desirable fund offerings. The most bundled arrangement relieves the plan fiduciaries of more day-to-day responsibilities. However, it leaves the most opportunity for conflicts of interest and is harder to unbundle later because the plan is locked in with all the services.

Small employers can consider a *bundled* vendor with a wide range of investment funds that also leaves latitude for employer participation in selection of the pre-determined list of funds and some flexibility in replacing them as needed. Under that arrangement, an independent investment consultant can assist the employer or board in the discharge of the fiduciary duties it has in the selection, monitoring and replacement of investment options made available to plan members.

References

Several Best Practices Regarding Retirement and Benefits:
http://www.gfoa.org/best-practices

Annual Conference and School of Government Finance Materials:
www.fgfoa.org

Florida Retirement System:
http://FRS.myflorida.com

Chapter 112, F.S.:
Public Officers and Employees: General Provisions

Chapter 175, F.S.:
Firefighter Pensions

Chapter 185, F.S.:
Municipal Police Pensions

Chapter 60T-1, F.A.C.Local Retirement Systems:https://www.flrules.org/gateway/ChapterHome.asp?Chapter=60T-1