Village of Key Biscayne Pension Workshop

May 28, 2019

Two Basic Types of Retirement Plans

- **Defined Contribution Plans**
  - Individual accounts are maintained for each participant
  - Employee and Employer contributions are paid into these individual accounts
  - Account assets are invested at the direction of the employee but can be limited by employer
  - Benefit paid to employee upon retirement is whatever is in the account at the time of retirement
  - Risk is on the employee

- **Defined Benefit Plan**
  - Provides a guaranteed benefit at retirement, usually a monthly payment
  - Benefit is a formula, usually based upon age, length of service and salary of employee
  - Annual contributions to the plan can change based upon events
  - Benefits cannot be paid while still employed
  - Risk of Funding usually falls upon employer

Tax Considerations

- **Defined Contribution Plans**
  - Plans must be "Qualified Plans" under the Internal Revenue Code, otherwise the employers contributions are taxable to the employee and the employees contributions cannot be tax deferred
  - Plan assets are segregated and not available to creditors (In trust)
  - Generally not subject to ERISA requirements
  - Taxable to employees when withdrawn

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Deferred Retirement Option Plan-

DROP

- DROP provisions allow a participant to retire but continue working for the employer for up to 5 years
- The employee files for retirement and the retirement pay goes into a separate account that usually earns income
- The employee cannot have "constructive receipt" [1] of the money
- The employee forgoes any benefit increases they may have gotten had they not "retired" from the plan:
  - Future raises
  - Future multipliers
- When the employee leaves employment, their retirement checks start going directly to them and their DROP balance is paid out to them. The retirement plan is then just obligated to pay the monthly annuity.

Funding Considerations

- **Defined Contribution Plans**
  - Employer contributes a fixed amount
  - Employee contributes a fixed amount
  - Usually a function of salary or wages in a governmental plan
  - Investment earnings belong to employee
  - Employee only entitled to "vested amounts". If an employee leaves the employer and isn't vested, employer amounts and investment income on that amount return to employer
  - Employee is always entitled to a refund of their contributions

- **Defined Benefit Plan**
  - Employees pay a fixed percentage of the pensionable earnings
  - Employer usually makes up the actuarially required differences
  - Investment income on employee and employer contributions help fund the benefit
  - Employee is only entitled to a benefit that has vested. Can sometimes be less than 100% of an otherwise payable benefit.
  - Payments cease when employee or other entitled person dies.
  - Employee is always entitled to a refund of their contributions

Village of Key Biscayne Retirement Plans

- **Defined Contribution Plans**
  - IRC 401(a) Money Purchase Plan
  - Covers General Employees
  - Employer Pays 12%
  - Employee Pays 6%
  - Administered by Third Party
  - Employees Direct Investments from a pool of investments chosen by the plan sponsor (Village)
  - The Village also maintains a second plan for the Village Manager, with a 12% employer contribution and no required contributions by employee.
  - The Village also maintains a third plan that is closed, that covered police and fire sworn personnel. Some employees still have vested funds in that plan.
- **Defined Benefit Plan**
  - IRC Qualified governmental plan that also complies with Florida laws (§112,175, & 185); Single Employer Plan
  - Established by Village Ordinance
  - Covers Full-time Police and Fire Sworn Personnel
  - Established in 1997
  - 100% Vesting after 5 years of employment
  - **Village's contribution is capped at 20% of covered payroll. Unusual provision**
  - Employees must make up difference.
  - Funding ratio cannot be lower than 80%, otherwise employees must contribute more or reduce their benefits

Funding Requirements

- Florida’s Constitution requires that government defined benefit pension plans be funded on a actuarially sound basis and that future taxpayers are not stuck with current taxpayers bill
- The State exercises stringent oversight on these pension plans
- Consequently, they are generally well funded, but not always
- State can force local governments to put additional money into the pension plan to pay what should have been paid
- Annual actuarial valuations are conducted to determine plan funding status
- Assumptions are used in determining the funding levels
- **In Key Biscayne, the Village’s funding levels are fixed at no more than 20%. This is rare and is a good thing financially for the Village.**

Funding Requirements

- Cities receive money from taxes levied on commercial insurance policies written in the Village. These are referred to as “175” or “185” or “Chapter” money.
- The money comes with strings attached
  - Must be used to provide benefits that are greater than those generally given to other employees
  - Annual compliance must be demonstrated or funds will not be distributed to Village. This has happened in recent past.
  - The State could at any time change the laws and that revenue would have to be made up at the local level.
- The Village complies with the statutory requirements.

Key Assumptions Used In Funding Calculations

- Key Assumptions To Look At In Any Pension Plan:
  - Investment return rate. The rate of return the plan is assumed to achieve on its investments of plan assets. Currently, this rate is 7.7% but will be reduced to 7.5%. A smaller rate means greater required contributions. Funding is very sensitive to this assumption.
  - Pay Increase assumptions. How fast pay increases for participants. Higher rates of pay increases require greater funding. This compounding over time can have a noticeable impact to the plan.
  - Mortality. How long people live can affect how long payments will be made to them. As people live longer, additional funding will be required.

Key Assumptions Used In Funding Calculations

- Other Actuarial Assumptions:
  - Rate of Retirement
  - Rate of Separation from Active Membership
  - Rates of Disability
  - Cost Methods
  - Other minor considerations

Important Funding Note Regarding Assumptions

- Assumptions and valuations that result from them DO NOT CHANGE WHAT WILL ULTIMATELY BE REQUIRED TO BE PAID TO PARTICIPANTS.
- At the end of the plan, all benefits owed to participants will be paid to participants.
- Valuations and assumptions only determine the fair timing of funding for the plan

Plan Stewardship

- The Pension Plan is set up as a separate trust fund, with oversight provided by a separately appointed board. The Board is comprised of 1 police officer, 1 firefighter, 2 council appointments, and a 5th member appointed by the other 4 appointments. The Board has the ability and duty to administer the plan as it is written and to enter into contracts and make decisions regarding the plan. They do this without interference from the Village Management or Elected Officials. The Board cannot change any benefits nor expend any funds in an attempt to study benefit changes. The plan benefits are at the sole discretion of the Village Council, but can be affected by union agreements. Changes to benefits must be collectively bargained, but not all plan members are covered by the union agreement.

Financial Considerations

- Pension Plans are extremely long-term obligations of the Village and its taxpayers. In many ways, they are more constricting than debt issued for projects in the Village. Project debt has a limited duration, but pension plan obligations can continue past the Village's existence.
- Because plan assets are invested in securities and investments that have volatility, contribution amounts can vary widely making financial planning sensitive.
- Employee groups will continue to want better benefits or reduced contributions.
- The Plan is very well funded. Overfunding a plan can lead to many complications. Employees and their representative may come back and ask the Council for additional benefits using the "overfunding" to pay for those benefits. When investments decline, the Village is left with the obligation but no longer has the same level of assets to pay for them.

Financial Considerations

- Employees and the public often misunderstand or mischaracterize what their benefits are or how the plan is funded. You will often hear employees refer to the plan as "their money". The plan provides "benefits" and the employees help fund those benefits, but so do the State and local taxpayers.
- The plan is a Trust between the Village and the plan participants. Both parties have a financial interest in the plan.
- A dollar spent on management or investment fees or any non-benefit payment from a public pension plan is usually a dollar that will need to be paid by the local government.

Financial Considerations

- The Village of Key Biscayne is fortunate that they have a young plan that provides generous benefits at a very reasonable cost compared to out South Florida local plans and provides for a cap on its own contributions.
- It is more important to control the benefits and the employer's contribution amounts than to worry about how much a plan is funded or underfunded. Underfunded plans will eventually have to become fully funded before all benefits are paid. As noted earlier, annual funding in Florida is about the timing of the ultimate payments and making the cost fair to current and future taxpayers. At the end of the plan's days, what is owed will be paid. Contribution rates usually are a very good proxy for the level of benefits being paid to participants. It is not unusual in South Florida to see a mature public safety pension plan have employer contribution rates of 40% to 60% of covered payroll or more.

Collective Bargaining (Union) Agreement Considerations

- Pension Boards are not supposed to propose changes to benefits. That is done between the Village and the Employee Unions through periodic contract negotiations.
- Issues arise during pension changes:
  - To understand the cost of proposals, an actuarial valuation must be performed. Sometimes both the union and the employer will hire actuaries. Sometimes, and perhaps inappropriately, a pension board may direct the study be done
  - Timing can be problematic. A CBA may be agreed to between the Village and the Union, but an "Actuarial Impact Study" will need to conducted and accepted by the Council and the Plan amended. If the Council (which may be different than the Council that approved the CBA) rejects the change, serious issues will arise.

GFOA Best Practices and Advisories

- Pension administrators and finance professionals consider key plan design elements, plan funding, plan governance, including roles and responsibility and risk management, and participant education.
- Under no circumstance should state and local government plan sponsors engage in pension contribution holidays or make insufficient contributions. Florida's laws prohibit this for local plans.
- Local governments that offer defined benefit pensions formally adopt a funding policy that provides reasonable assurance that the cost of those benefits will be funded in an equitable and sustainable manner. Florida's law require this.

GFOA Best Practices and Advisories

- Local government officials should ensure that the costs of DB pensions are properly measured and reported. Florida law and GASB require this.
- Local government retirement systems establish, within their overall investment policy, an asset allocation plan. Florida requires this and the plan has adopted one.
- It is recommended that retirement systems, especially those that use alternative investment strategies, adopt an investment management fee policy that will allow the retirement system to negotiate the lowest competitive fee possible while looking out for the system's long-term earning potential. It is not clear if the Board had done this.

Last Thoughts

- Not every state has the same rules that Florida has for the operation of defined benefit pension plan. One shouldn't assume a bad story in Illinois or California means that it applies here.
- Pensions are a major benefit to employees and they should be assured that what they've been promised will be paid.
- Understanding how these pension plans work and the risk they represent to local government finances is important not just to elected officials, but to the public and employees, too.
- Misunderstandings can result in ill-will and lawsuits.
- Florida has very good laws and oversight on local plans, particularly police and fire plans, to assure they are well-managed and properly funded and that current taxpayers pay their fair share without shifting the cost to future taxpayers.
- Most handwringing on Florida plans occurs after the cow has left the barn: the benefits were given to the employees and the bill came due and now the budget is constrained. Proceed with great caution when improving benefits.

Very Last Thoughts

- Pensions are not bad things.
- Pensions are valued benefits by employees and help attract and retain employees.
- While pensions can represent financial exposure to an employer, prudent stewardship can avoid catastrophe.
- Retirement plans work best when employees, retirees, and the employer work together to strike balance between benefit and cost.
- Proceed with caution, education, and financial understanding when considering benefit changes.