CITY OF FORT LAUDERDALE

OFFICE OF THE CITY AUDITOR

ADDRESSING THE PENSION DILEMMA:

A Review of Retirement Plan Options

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EXECUTIVE SUMMARY

As a result of tax reduction mandates and the severe housing slump, the City of Fort Lauderdale is experiencing financial challenges in providing the level of services that residents expect while dealing with salary increases and skyrocketing costs for healthcare, fuel and other operating needs. One of the fastest growing costs that we face is for the employee pension systems.

There is significant benefit to the City in providing a viable, attractive and affordable retirement option for its employees. Not having a retirement plan would put the City at a competitive disadvantage in recruiting for the best available employee. Good benefits lead to a higher level of employee morale that should translate into increased productivity and improved customer service to our residents.

A key factor in ensuring that retirement plans remain viable is maintaining public support. Across the country, governments are dealing with calls from angry taxpayers who are seeing themselves faced with disappearing pensions in their own private-sector jobs at the same time they are paying significantly more in taxes to provide government workers with generous pension benefits. There is a growing expectation that Americans should be responsible for their own wellbeing in retirement. To overcome "pension-envy", public pension plans must exhibit high levels of financial competence, ethical behavior, and public stewardship. To survive, plans must be proactive, embrace change and create flexible funding mechanisms that keep the demands on general fund revenues as low as possible.

It is clear that simply maintaining the status quo ignores changing demographics, fiscal reality, and developing trends in the private sector. The City is not immune to calls to "run government like a business". Failure to adapt to change and consider creative and innovative financial solutions is a risk we cannot take.

STATEMENT OF INTENT

This paper is not intended to advocate for a particular choice among retirement options. Its purpose is to discuss the various plan types and advantages/disadvantages of each type. The choice of what retirement options the City of Fort Lauderdale chooses to offer its employees is both a policy decision for our elected officials and a collective bargaining issue. This paper is designed to provide the reader with factual information for decision-making.

BACKGOUND

Pensions are the means by which employers provide for the long-term financial needs of their employees in retirement. They are part of the total package of salary, retirement, healthcare and other benefits used to attract, retain, motivate and reward employees. As such they are an inducement offered to maximize current and future service, not a reward for past service.

There are two general types of pension plans-Defined Benefit Plans and Defined Contribution Plans. In general, defined benefit plans provide a specific benefit at retirement for each eligible employee, while defined contribution plans specify the amount of contributions to be made by the employer toward an employee's retirement account. In a defined contribution plan, the actual amount of retirement benefits provided to an employee depends on the amount of the contributions as well as the gains or losses of the account.

Over the past several years, the City of Fort Lauderdale has found its pension plans to be an increasingly expensive proposition to maintain. The City's contribution rate to the General Employees Retirement System is currently 23.62% of covered salaries and 49.82% of covered salaries to the Police and Fire Retirement System.

The increases in contribution rates result generally from the following:

1. significant improvements to the retirement benefits offered

2. poor investment returns during fiscal years 2001, 2002 and 2004
3. improving life expectancies of retirees

With further tax reform on the horizon and other demands for available resources growing, it is prudent to consider what alternatives are available to policy makers to balance the needs of employees with the fiscal constraints the City faces.

Defined Benefit Plans:

The traditional model of providing retirement benefits has been the defined benefit plan, covering 90% of all governmental employees. The two primary features of a defined benefit plan are that the investment risk is borne by the employer and that the income stream to the retiree cannot be outlived. The defined benefit plan is characterized by a contribution rate that varies significantly over time depending on a variety of factors, including:

- assumptions by the pension board about future investment returns
- actual investment returns achieved
- changes in inflation
- changes in the size and composition of the workforce
- increases in benefits

The City of Fort Lauderdale currently has two defined benefit plans in place, the General Employees Retirement System (GERS) and the Police and Fire Retirement System (PFRS).

For the GERS, the City establishes the minimum level of benefits to be offered to employees through the collective bargaining process.

For the PFRS, the Florida Legislature declared that it is a proper and legitimate state purpose to provide a uniform retirement system for the benefit of firefighters and police officers. The Municipal Police Officers' and Firefighters' Retirement Trust Funds Office is the state entity responsible for the administrative oversight of local police and fire

pension funds in the State of Florida which participate under Chapters 175 and 185, Florida Statutes. Chapter 175 refers to firefighters' plans and Chapter 185 refers to the police officers' plans. These statutes regulate the minimum pension benefits provided to local police officers and firefighters under these defined benefit retirement plans.

Participating plans are eligible to receive annual distributions of state premium tax collections on property and casualty insurance policies written within the city/district limits or boundaries of the participating plan. The amount of premium taxes collected under Chapter 175 is equal to 1.85% of all property insurance written within the city limits or boundaries (in the case of fire districts) of the participating plan. Chapter 185 levies a 0.85% tax on all casualty insurance premiums written within the city limits of the participating plan. These funds are then available for distribution to the participating pension plans on an annual basis. Further funding for these plans is provided by employee contributions, other revenue sources and employer contributions. The City contributions are required to be adequate to meet any funding deficiencies as calculated by the plan's actuary, after all other revenue sources have been considered.

Since 1999, the Legislature has added EMTs and paramedics to the special risk class, along with probation and youth custody officers and 24 types of forensic or correction employees. Every year additional benefit and disability enhancements are considered by the Legislature. Cities have little control over these unfunded mandates.

Defined Contribution Plans:

An alternative, and increasingly popular model is the defined contribution plan. A 401(a) Money Purchase Plan is a retirement savings plan that allows the employee to set aside money for retirement. A 401 (a) plan may be structured to allow contributions to be made by the employer, employee, or both. Employee contributions may be made on either a mandatory or a voluntary basis. The employer decides on the method of participant contribution, as well as whether participant contributions will be made on a pre-tax or an after-tax basis.

The most common method used is direct employer contributions with mandatory participant contributions made on a pre-tax basis. The plan may also allow for voluntary contributions on an after-tax basis. These voluntary after-tax contributions are limited to 25% of compensation. Employer contributions to the 401 plan may be made under one of the following methods:

1. The employer may contribute a fixed dollar or percentage amount, either with or without a required employee contribution.
2. The employer may match a fixed percentage of employee contributions.
3. The employer may match the participant contribution within a given range (i.e. a variable employee match).

The primary advantage to employers of a defined contribution plan is the fixed contribution rate. There are no unexpected financial surprises related to a failure to achieve the actuarial assumptions or a change in benefits. A defined contribution plan differs from a defined benefit plan in several other important ways:

- the employee chooses the investments in the account
- the account is portable and can be taken by the employee when he leaves
- the amount of money available at retirement will vary based on the investment choices the employee makes
- there is complete control over the distribution schedule in retirement, enhancing flexibility in estate planning

<u>Other Plans:</u>

The other employer-sponsored retirement savings plan available to governmental employees is the 457 Deferred Compensation Plan. A 457 plan is a voluntary supplemental retirement savings program that allows for contributions on a pre-tax basis. Federal income taxes are deferred until the assets are withdrawn, usually during retirement when the employee may be in a lower tax bracket.

TRENDS/CONCERNS

Because of the growth and volatility in costs to employers, the number of private sector pension plans has dropped from 75,000 a decade ago to 28,000 today. The burden of pension and retiree healthcare costs has impacted the competitiveness of the American manufacturing sector in recent years and has contributed to the loss of market share in major industries to foreign companies. The result is that significant numbers of large corporations have frozen their defined benefit plans to new participants, created new tiers of benefit levels, done cash balance conversions or substituted defined contribution plans. The percentage of private sector employees with a defined benefit plan has dropped to around 20%.

A cash balance plan is a hybrid type of defined benefit plan that defines the benefit in terms that are more characteristic of a defined contribution plan. In other words, a cash balance plan defines the promised benefit in terms of a stated account balance. In a typical cash balance plan, a participant's account is credited each year with a pay credit (such as 5 percent of compensation from his or her employer) and an interest credit (either a fixed rate or a variable rate that is linked to an index such as the one-year Treasury bill rate). Increases and decreases in the value of the plan's investments do not directly affect the benefit amounts promised to participants. Thus, the investment risks and rewards on plan assets are borne solely by the employer.

When a participant becomes entitled to receive benefits under a cash balance plan, the benefits that are received are defined in terms of an account balance. For example, assume that a participant has an account balance of $100,000 when she reaches age 65. If the participant decides to retire at that time, she would have the right to an annuity. Such an annuity might be approximately $10,000 per year for life. In many cash balance plans, however, the participant could instead choose (with consent from their spouse) to take a lump sum benefit equal to the $100,000 account balance.

Cash balance conversions have been very controversial. In 2005 the Government Accountability Office (GAO) released a report analyzing the effects of cash balance

conversions on worker benefits. They found that in a typical conversion the cash balance plan would provide lower benefits for most workers than if the defined benefit plan had remained unchanged and the worker had stayed in their job until retirement age. This decline in benefits tends to be largest for older workers. This is because in a traditional plan, where benefits are based on final average pay, the value of the benefits accrues much faster for older workers than for younger workers.

Mobility

Another issue is that increasing mobility in the modern workforce has created significant demand by employees for portability. Many young employees see the portability of defined contribution plans, where depending on plan design they can keep up to 100% of the accumulated plan assets when they change jobs, as particularly attractive. Younger workers also tend to favor defined contribution plans because they are provided full control over their money and, if they successfully invest their pension assets, the potential to reap greater financial rewards.

In contrast, the earlier defined benefit pension system, where payouts are tied to the number of years of service rather than job performance, was a better match for the lifetime employment expectations of the previous generation.

Workers' median tenure—the midpoint of wage and salary workers' length of employment in their present job—was virtually unchanged from 1983 to 2004: 4.9 years in 2004, compared with 5.0 years in 1983. Among older male workers (ages 55–64), who experienced the largest change in their median tenure, the median tenure fell from 14.7 years in 1963 (not considered a full career) to a roughly comparable but clearly lower level of 10.0 years in 2004. The median tenure for the oldest working males (ages 55–64) declined steadily from a peak of 15.3 years in 1983 to 10.0 years in 2004. ***The 25–34-year-old male tenure line was virtually flat, at three years.***

These tenure results indicate that, historically, most workers have repeatedly changed jobs during their working careers, and all evidence suggests that workers will continue to

do so in the future. Since the median length of employment for all wage and salary workers is currently just 4.9 years, and has not changed appreciably since 1983, a minority of American workers are likely to receive a significant benefit from a defined benefit pension, as was the case in the past.

One study comparing traditional pensions to defined contribution plans found that two-thirds of plan participants, mainly those who changed jobs often, would receive a larger benefit with a defined contribution plan than with a traditional defined benefit pension. This is because defined benefit payments are a function of years of service and final salary. Thus a much larger percentage of the total pension benefit is accumulated in the final years of employment. This significantly lowers the benefits of employees who change jobs in mid-career. This is not the case with defined contribution plans since the annual contribution is a straight percentage of salary.

Plan Costs

Investment and administrative costs tend to be higher for defined contribution plans. A review of 12 of the largest governmental defined benefit plans in the country indicated the average annual expense ratio was .25%, which includes both investment and administrative costs. In general, for benefit of dollar paid, it is less expensive to provide benefits through a defined benefit plan than a defined contribution plan.

This is due in part to the mutual fund management expenses for the investments held in the defined contribution plans. Defined benefit plans have the ability to directly own debt and equity instruments in their portfolios, avoiding the asset management fees that are part of the mutual fund's costs.

It is important to note that the plan costs are borne by the City in the defined benefit plan and by the employee in the defined contribution plan. This is because the City is ultimately responsible for ensuring that there are sufficient funds to pay retirement benefits, regardless of the amount of expenses and investment gains and losses. The

amount available to the employee in the defined contribution plan is after all the expenses, investment gain and losses, and withdrawals are factored in.

Risk Transfer

Another benefit of a defined contribution plan to employers is investment risk transfer. In a defined benefit plan, the pension board is responsible for managing the assets of the plan in such a manner as to achieve the investment rate of return assumed in the actuarial calculation. In the event that rate of return is not achieved, the employer alone is responsible for making up the funding shortfall. This leaves the employer exposed to significant risk, both for poor investment decisions made by the pension board and unfavorable market conditions.

On the other hand, the defined contribution plan transfers that risk to the employee. The employer's obligation is to fund the defined contribution plan at the predetermined rate. The benefit of excess investment returns or impacts of poor returns falls squarely on the employee. This increases the level of personal responsibility the employee is asked to assume for their retirement. To assist employees in successfully navigating the defined contribution environment, significant effort and attention must be paid to educating them about making smart investment choices. That education can be done either in-house or through the services of third-party advisors and can explain the different investment options that can assist the participant in maximizing their portfolio's return.

Investment Diversification

While defined benefit plans can participate in investment options not available to defined contribution plans, such as private real estate, private equities, commodities, and venture capital, today's defined contribution plan mutual fund offerings are able to provide the participant with sufficient diversification in their portfolio. Additionally, recent studies suggest that the inclusion of these asset categories may not add appreciably towards reducing the portfolio's volatility since they have tended to move more in tandem than had been the case historically.

Major investment firms have begun creating a more robust range of mutual fund products to offer to defined contribution plans. New products like life-cycle funds take much of the burden off of employees to understand the complexities of asset allocation, market timing and investment horizon. These funds are becoming a popular investment choice for defined contribution participants and are increasingly the default investment option offered.

Another recent example of innovation in the mutual fund industry is three new funds being offered by The Vanguard Group. They are designed to give retirees regular monthly payments while preserving their assets and allowing them to remain fully invested. The funds will utilize market-neutral strategies to create portfolios that can create positive returns through most economic conditions by combining investments with relatively low or negative correlations.

One significant advantage offered by traditional defined benefit plans can be described as the "going concern" perspective. Because a pension has no end date, it can invest its assets in a portfolio more weighted towards growth than would be prudent for an individual investor. Because the individual needs to begin withdrawals at a specific date, the investment choices must begin to shift towards less volatile ones as the retirement date approaches. The result is a lower rate of return than a portfolio with a higher percentage of equity holdings.

Other Options

To ensure that retirement benefits remain available to employees, they must be made more affordable. There are multiple options available to manage the costs that are worth evaluating:

- switch to a defined contribution plan for new employees
- move into the Florida Retirement System
- switch to a cash balance plan for new employees
- combine a reduced defined benefit with an employer contribution to a defined contribution plan

- postpone the normal retirement date
- increase vesting periods
- eliminate COLAs
- increase the employee contribution
- reduce the salary multiplier
- avoid early retirement incentives

While some of the choices listed may be less feasible than others, all are worthy of consideration, either alone or in combination. Further research into what other Florida cities and counties are doing can also be valuable. All of the these options have been implemented in some form elsewhere and a review of their success or failure can help guide the City of Fort Lauderdale in exploring its options.