

Pension 101

Paul Shamoun



Retirement Plan Overview

- Types of Pension Plans
 - Defined Benefit
 - Defined Contribution
 - Deferred Compensation



Why Provide a Retirement Plan at all?

- Recruiting and Retention
- Reward for Long-term Service
- Security
- Tax Deferral



Questions to be answered

- What will it cost?
- Who will pay for it?



Retirement Income

Ultimately, there is one fundamental truth in saving for retirement

Contributions + Compounded Interest =
Retirement Benefits/Assets – Expenses

This is what an actuary tries to keep in balance



Defined Benefit Plans

- As the name implies, the benefit is defined in the ordinance or resolution.
- Defined benefit or “Traditional” retirement plans are a very complex mechanism.
- Promise a specific benefit to be paid to plan participants at a specific retirement date.
- The amount of the benefit is determined on the basis of a formula which is specified in the plan document.



Normal Retirement Benefit

Under this plan, employees are entitled to a normal retirement benefit (NRB) that is determined by a formula: years of service (A), times the benefit accrual percentage (B), times average salary (C).

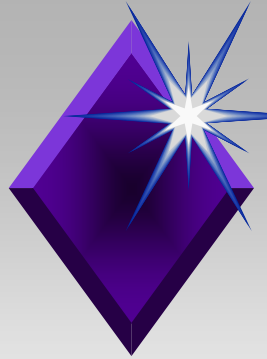
$$A \times B \times C = \text{NRB}$$

A	Years of service
B	Benefit accrual percentage
C	Average salary
NRB	Normal Retirement Benefit



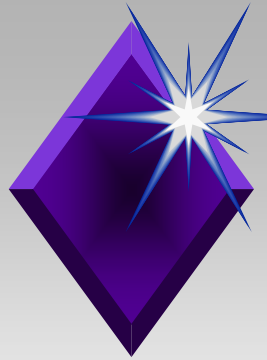
Benefit Options

- Normal Retirement
 - Date and amount of unreduced retirement benefit
- Early Retirement
 - Date and Amount of reduced retirement benefit
- Vesting
- Disability/Death
- DROP
- COLA
- Health Subsidy



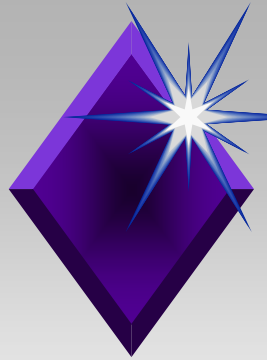
Advantages & Disadvantages of DB Plans

- From the Plan Sponsor Perspective
 - Advantages
 - Provide secure retirement vehicle for employees
 - Early retirement incentives
 - Death/Disability coverage can be built in
 - Professional investment
 - Lower investment expenses
 - Recruit and retain qualified employees
 - Disadvantages
 - Investment risk
 - Mortality Risk
 - Budgeting concerns



Advantages & Disadvantages of DB Plans

- From the Plan Participant Perspective
 - Advantages
 - Provide secure retirement vehicle for employees
 - Guaranteed retirement benefit
 - No investment risk
 - Removes uncertainty
 - Can not outlive retirement assets
 - Disadvantages
 - Usually longer vesting period
 - Can not be rolled over
 - Cannot be borrowed against



Defined Contribution & Deferred Compensation Plans

- A defined contribution plan defines the level of contributions to be made to the plan each year as a percentage (%) of compensation.
- Deferred compensation plans allow participants to voluntarily contribute on a pre-tax basis.
- Key Components
 - Investment management
 - Performance monitoring
 - Fiduciary responsibility
 - Advantages & Disadvantages



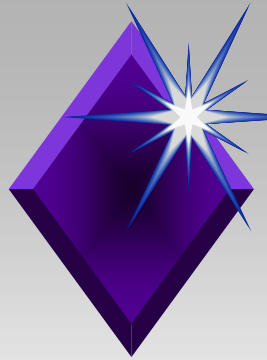
Investment Management

- Plans can have either professional investment management or provide for participant directed investing in individual accounts
- Participant directed investing is usually done through mutual funds
- Investment risk is born by the participant and not by the employer
- Easy to budget because the contribution rate is fixed



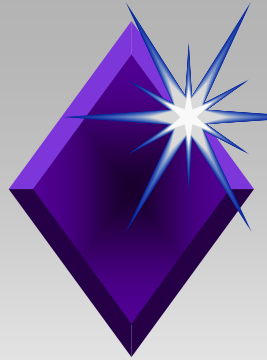
Fiduciary Responsibility

- The plan sponsor and/or a Board of Trustees of participant directed plans have a fiduciary responsibility to oversee the investment offerings
 - For professionally managed investing, a performance monitoring consultant should be hired to oversee the managers as with a defined benefit plan
 - For participant directed investing, performance monitoring of the mutual fund offerings should be performed to make sure the mutual funds in the program continue to meet the objectives of the participants



Advantages & Disadvantages of DC Plans

- From the Plan Sponsor Perspective
 - Advantages
 - No investment risk
 - Easy to Budget
 - Recruitment
 - Disadvantages
 - Uncertainty that employees will have security
 - Disability and Death insurance
 - Retention



Advantages & Disadvantages of DC Plans

- From the Plan Participant Perspective
 - Advantages
 - Shorter Vesting
 - Portability
 - Ownership
 - Can be borrowed against
 - Disadvantages
 - Uncertainty savings will be enough
 - No Disability and Death insurance
 - Investment risk

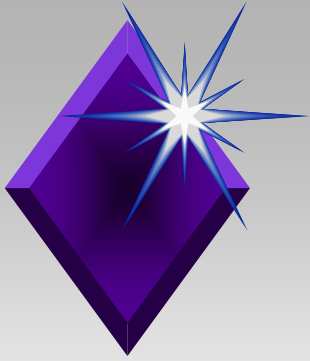


Florida Retirement System

- The FRS offers both Defined Benefit and Defined Contribution plan options.
- Proposed FRS Contribution Rates:

FRS Membership Class	Employer Contribution Effective 7/1/09*	Proposed Employer Contribution Beginning 7/1/10*
Regular	8.69%	11.64%
Special Risk	19.76%	28.57%
Judges	18.40%	32.27%
County, City, Sp. District. Elect. Offc.	15.37%	37.31%
Special Risk Adm.	11.39%	27.17%
Senior Management	11.96%	21.44%

* The rates shown above do not include the 1.11% health insurance subsidy contribution or the .05% administrative fee.



PENSION COSTS

WHY ARE COSTS GOING UP ?



Pension Benefit – Big Picture

- Role of a Government's Pension Plans
 - Part of a 3-legged stool (pension, social security & savings)
 - Major element of benefit package
- Public Sector
 - No Federal oversight
 - Borrowing good practices – ERISA
- State Law – Issues
 - Chapter 112 – overseeing all pension plans
 - Chapter 175/185-Police & Firefighters-Premium dollars and minimum standards
 - Constitutional Rights-Labor Relations/Negotiations
- Accounting Standards
 - GASB 23 & 27

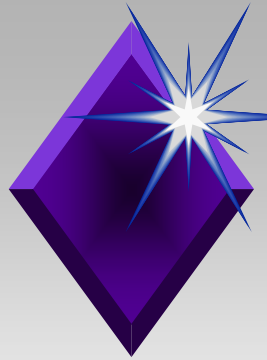


KEY ASSUMPTIONS



Formula

- Years of service X multiplier rate X final average compensation
- Years of service – 20/25/30
- Multiplier Rate per year of service
 - 1.6
 - 2.0
 - 3.0 or more)
- Definition of Compensation (Bonus and Overtime)
- Compensation average of what # of years (1/2/3/5)
- State Retirement System - Factor
 - Regular 1.6%
 - High risk 3.0%
 - Elected 3.0%
- Concern -Early retirement (20 and out, 25 and out, etc.)
 - Lengthened payment period
 - Shorter period for assets to grow



Investment Earning Rate (Discount Rate)

- Ranges from 7.0% to 8.5%
- Indicative of assumed long-term (30-50 years) average
- For 30+ years – typical 8.0%
- SBA has recently moved down to 7.75%
- Target may influence asset allocation
 - Add categories/complexity
 - Take on more risk
 - Driven by historical or projected relationship



Asset Allocation

- Should earning rate assumption affect asset allocation?
- Recent trends
 - Alternatives (Hedge Funds / Private Equity)
 - More international
 - More complicated
 - More Risk
- Typical balance – simple 60/40 (equity/bonds)
- What about a flip (40/60) and related impact and budget/funding?



Mortality

- How long will people live –on average
- Current, table choices-developed by actuarial industry
- Historical concern – life expectancy
 - Police and Firefighters – materially shorter
 - May be a myth
 - Once retired – largely similar
- What table are your plans using?
 - RP-2000 or 1983



Salary Growth

- Function of:
 - Cost of Living Adjustment (COLA)
 - Steps (common for Police & Fire)
 - Jurisdiction/employee population growth
- Material impact on amortization



Amortization Terms

- Statutory permitted – 30 years Is this reasonable in a plan with a 20 and out?
- Function of “Level percentage of pay” Cost Method
 - Design for easing “the sale” (or minimize pain) of new benefits
 - Negative Amortization Loan
 - Doubly bad when adding benefits to 175 & 185 plans
- Required dollars and percentage of pay (first year)
 - Not required – 30 year financial amortization (individual/total)
 - Should require 4 (not 2) elements (before elected board/body)



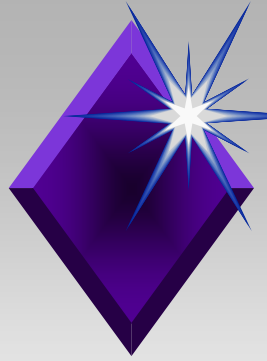
What Can/Should be done?

- Require the Actuary to provide a forward forecast:
 - With each report
 - With each change in either benefit and/or assumption
 - If using 30 amortization, should include 30 cost projection
- Revisit what are (or should be) reasonable amortization period
- Re-address the idea of a “reasonable pension benefit” and related employer cost



Pension Sustainability (?)

- Based on current program and salary growth assumption, what does the future hold?
- Three Legged Stool



Role of Finance Officer/ City Manager & Elected Officials

- Plan Administrator, Trustee
- Financial planner for the City
- Importance of Board of Trustees
- Short vs. Long-term perspective



Options(?)

- Closing a DB plan
 - Cost Savings
 - Short vs. Long-term
- Freezing a DB plan
 - With or Without Salary increases
- Decreasing future benefit accrual rate
- Moving to the FRS



QUESTIONS?

- Contact Information

Paul Shamoun

ptshamoun@flcities.com

1-800-342-8112