9. **OLD BUSINESS**

b. Finance Issues

ii. General Employees' Pension Plan (Councilman Congress)

1. Report from council liaison on special meeting and status

MEMORANDUM

DATE: February 3, 2012

TO: City Council

FROM: Doug Congress, Councilman

SUBJECT: Status of General Employees' Pension Plan

Please find attached a report that I have prepared detailing the status of the General Employees' Pension Plan. I will be prepared to discuss the report at the City Council meeting on February 7, 2012.

RECOMMENDATIONS TO CITY COUNCIL

GENERAL EMPLOYEE PENSION PLAN

In early December, the City received a notification from the state's Department of Management Services indicating that the General Employee Retirement Plan (GERP) actuarial report for years 2008 to 2010 was not accepted. Specifically, a major factor for this rejection was the plans inability to meet its 7.5% interest rate assumption. "*Plan annualized investment returns through 9/30/10 were -5.57%, .081% and 4.35% per annum over the last three, five and eleven plan-year periods, respectively, ending on 10/1/10. Given these results, the 7.5% valuation interest assumption produces substantial experience losses and is not a reasonable actuarial assumption*."

In response to the notification, a conference call including representatives from the Florida Division of Retirement was made in the latter part of December. The discussion centered on the proactive measures the City has taken to improve the health of the Plan. Specifically, reduction of plan benefits which immediately reduced the unfunded liability by almost $2M, commitment to paying down the unfunded liability by an additional lump sum payment of $2M, and changing to a more conservative amortization method of the unfunded accrued actuarial liability (UAAL). The measures each play a significant role to improve the plan's health, but were not reflective in the actuarial reports due to their subsequent occurrence.

On January 4th, the City received notification from the Department of Management Services that in consideration of these proactive measures set forth by the City, "***the Plan is now state accepted***". But the acceptance letter did again address the assumption rate, stating, *"please have your actuary review this assumption before continuing its use."*

The General Employee Pension Board of Trustees (GEPB) met on January 18, 2012 to discuss the 7.5% interest rate currently assumed by the plan. More important than state compliance, the GEPB regarded this warning as an opportunity to visit not only the rate assumption, but also other plan assumptions, in an effort to ensure the future health and viability of the plan. Further, the GEPB discussed other specific plan assumptions that directly impact the plans unfunded liability, including methodology of valuing assets, amortization of investment gains and losses and the actuarial cost method.

UNFUNDED ACCOUNTING ACTUARIAL LIABILITY

The 2010 actuarial report reflects plan assets of approximately $11.9M and plan liabilities of approximately $24.8M, leaving the plan with unfunded liabilities (assets minus liabilities) of more than $12.8M. The plans funded ratio at the time of the report was 48.24% (assets/liabilities).

Assets – Liabilities = UAAL

11.9M – 24.8M = 12.8M

Assets/Liabilities = Funded Ratio
11.9M/24.8M = 48.2%*

HEALTHY as per the State > 80%
***Slight difference from actual due to rounding**

Per the State, a "healthy plan funded ratio" should exceed 80%. In absolute numbers, the plan assets would need to increase from $11.9M to about $20M – meaning the plan would need an $8.1M cash infusion to be considered healthy.

Several variables affect the calculation of the UAAL. Specifically, methodologies as to how to value and recognize plan assets and liabilities. One of the biggest factors in calculating the liabilities (the future benefits to be paid to participants) is the assumed rate of return assumption.

INVESTMENT RATE OF RETURN ASSUMPTION

The General Employees Retirement Plan's assumed rate is 7.5%, which is conservative compared to the 8.0% return assumed by the vast majority of public pension plans[1]. Nevertheless, the plan investments over this past decade have substantially underperformed. The effective return for the plan for the ten years ended has been close to zero – nowhere near the anticipated 7.5% return. This shortfall is easily the single greatest element impacting the UAAL.

During the GEPB meeting, it was agreed that the rate of return assumption is not the only component that should be addressed. Factors including how asset gains and losses are valued and how the UAAL is amortized play a significant role in how the UAAL is determined. In fact, both Doug Lozen, the plan actuary, and Burgess Chambers, the plan investment manager, agreed that while the 7.5% return assumption should be reduced in future years due to the possible closure[2] of the plan, it is not necessary to do so immediately. This reduction should occur gradually (step down) in increments consistent with plan liquidity needs. As participants begin drawing on their benefits, the investments should be more liquid to allow for benefit payouts; therefore, investment returns will naturally be lower, as should the assumed rate. The professionals both concurred that the rate should be reduced based on a 30-year cost projection that illustrates when these benefit payouts occur.

[1] Sanibel Police Pension assumed rate is 8.0% and Florida Retirement System is 7.75%. The National Association of State Retirement Administrators performed a survey of 126 public plans – only 9 have a lower rate than 7.5%.
[2] The second reading and public hearing is scheduled to occur at the 2/7/12 council meeting regarding ordinance 12-002 which closes the plan to new hires.

Based upon the plans current investment model, simulations show that the assumed rate of 7.5% should be attained 75% of the time. Burgess Chambers feels this is acceptable and indicates the rate does not need to be immediately addressed.

OTHER ELEMENTS AFFECTING THE UAAL

Next, the GEPB discussed other assumptions impacting the UAAL, including how the plan assets are valued and how the plan amortizes (and funds) the UAAL gains and losses. These two factors have an impact of spreading out the UAAL over time, and "smoothes" the funding requirements of the plan. Instead of funding the actual gains or losses realized by the plan for a particular year, these smoothing techniques allow for minimal funding which create unfunded liabilities.

ASSET VALUATION METHOD

On the asset side of the ledger, the plan utilizes a method to value plan assets called "smoothing". Instead of valuing the assets at the current market rate (mark to market), they are valued at the average annual market value rate of return for the last four years. The 2010 actuarial report reflects the average for the last four years as a -1.42% loss; comparatively, the actual return for the 2010 plan year was an 8.14% gain. The purpose of this method is to minimize the fluctuations often recognized by the market on an annual basis. In this instance, instead of reaping the benefits of a large gain (and subsequently a lower UAAL), the method recognizes a small loss, which results in an increase in the UAAL. Of course, this loss is the result of large losses incurred in two of the three prior years.

AMORTIZATION METHOD

On the liability side of the ledger, the plan currently amortizes UAAL gains and losses over a 10-year period. In addition to the interest rate assumption previously discussed, other actuarial assumptions that affect the UAAL include employee turnover, salary changes and mortality rate. Contributions aside, the UAAL is continually expanding or contracting based on the plans actual performance verses the actuarial assumptions. Using the 10-year amortization method, the net effect of these differences is paid down over 10 years instead of in the year incurred[3]. The 2010 plan report, for example, represents a UAAL loss incurred during the year of approximately $932,000. Instead of funding the full amount of this loss, the assumption amortizes the contribution payout over 10 years. In contrast, paying a loss at the time of occurrence would eliminate future increases to the UAAL, but could also create large fluctuations in annual funding requirements.

[3] Until 2008, the method used for amortizing gains and losses was over a 30-year amortization. The State required the plan to change to a more conservative 10-year methodology.

FROZEN INITIAL LIABILITY

The actuary recommended that the GEPB consider changing the actuarial cost method to the Frozen Initial Liability method (FIL). This method is a conservative approach to funding the plan because it pays off any annual gains or losses incurred by the time the average active member retires. As a result, by the time the last active member retires, no gains and losses would exist. Additionally, this would freeze the current UAAL from incurring future gains and losses and simply allow the liability to be written down over a straight period of time, similar to a home mortgage loan. This approach could also create great volatility in annual funding requirements.

CONCLUSION

On February 10th, 2012, the GEPB will meet to discuss the draft of the 2011 actuarial report along with the impact of implementing the assumption changes described above. The actuary has "tightened" the assumptions to address both the impact of asset smoothing and the funding amortization. The draft report also incorporates the effect of changing to the FIL cost method.

It is necessary for the GEPB to understand the financial impact of these changes. Incorporating these revisions could dramatically affect the volatility of future annual funding requirements by the City. Of course, the risk of making no changes could result in an increasing UAAL, interest costs, state plan rejection, and ultimately, forced changes to comply.

Based on the City's proactive measures and effective communication, compliance was quickly reinstated by the state.[4] The focus again is ensuring the plan is adequately funded to provide the future benefits promised in a manner that is affordable for the City. It is imperative the GEPB thoroughly understand the ***present and future*** effect on the plan by incorporating any of the proposed assumption changes.

RECOMMENDATIONS

One of council's goals this year is to "sustain and strengthen the city's financial stability, and more specifically, to develop a long-term debt early retirement plan." Implementing a GERP philosophy that minimizes the UAAL and creates a "healthy" plan is consistent with this goal. Based on this, Council should consider the following:

1. Provide the GEPB the following directives:

---

[4] The plan actuary, investment manager, and attorney were very complimentary of the City. Based on their experience, the priority and expediency in which the state rejection was handled is atypical.

a. Review assumption amendments as provided with the 2011 actuarial draft report and provide Council with a recommendation as to any changes.

b. Provide direction to the actuary to perform a 30-year cost projection in order to understand the timeline of projected benefit payouts and liquidity needs of the plan. Based on this information, derive a "step down" approach of the investment assumption rate and a revised investment allocation plan.

c. Accept the 2011 actuarial report void of any assumption changes to allow for the adequate vetting of (a) and (b). Recommendations should be for the plan year ending 2012.

2. Council review unreserved surplus balance in the general fund and make additional lump sum payments to the UAAL as deemed appropriate. In effect, council can choose to eliminate any additions to the UAAL. This will provide the same benefit as "tightening" plan assumptions AND will allow the GEPB ample time to complete their plan review.

3. Allow for the City to fund the plan at the beginning of each fiscal year instead of monthly. Not only will this reduce interest expense at a rate of 7.5%, but will also provide the plan funds to invest earlier (as opposed to waiting for monthly payments to be made) and increase return potential.

TIMELINE

2/3/12 – Receive draft valuation report for 2011 from Doug Lozen to include alternative methods of reducing UAAL

2/7/12 – City Council meeting

2/10/12 – GEPB meeting to review and accept 2011 draft valuation report

2/17/12 – Final 2011 actuarial valuation report due

Feb 2013 – Accept actuarial report which incorporates Council approved assumption changes after hearing recommendations made by GEPB.

Oct 2013 – Begin funding plan in accordance to the new assumption changes.