FPPTA PENSION PLAN DATA CENTER:

Understanding Florida's 481 Local Defined Benefit Pension Plans: Terms and Definitions

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INTRODUCTION TO FPPTA

FPPTA®
FLORIDA PUBLIC PENSION TRUSTEES ASSOCIATION
SINCE 1984

The Florida Public Pension Trustees Association (FPPTA) is a membership organization, founded in 1984, as a not-for-profit organization. FPPTA is established for the purpose of providing education and information for and about the Florida public pension systems, and advocating for defined benefit pension plans.

Education is FPPTA's primary mission. We safeguard public retirement plans by offering rigorous education programs designed to prepare trustees to perform their duties with confidence, expertise and fiduciary responsibility. Ethics and best practices are dominant in our programs. Our **Certified Public Pension Trustee** (CPPT) designation is nationally recognized by industry professionals and continuing education is required to maintain certification.

FPPTA Trustee Schools are presented twice a year and offer Certified Public Pension Trustee program sessions, as well as continuing education sessions.

FPPTA Annual Conference focuses on a macro-perspective of the industry and public pension landscape through presentations by nationally known speakers, panels and discussions.

FPPTA: The **VOICE** of Florida's Public Pensions
The **ADVOCATE** for Defined Benefit Pensions

PLAN CHARACTERISTICS

Employee Groups: Local public sector employees in Florida (those working for cities) are mostly covered by the local retirement system, while state and county employees, including teachers, and local plans opting to join the state plan, are covered by the Florida Retirement System (FRS) or a local defined contribution account. Florida's 481 local plans cover general employees, police officers, firefighters, and miscellaneous employees.

Number of Plan Participants: The total number of plan participants includes active members (currently employed), retired members (former employees currently receiving benefits from the plan and DROP members), beneficiaries (collecting benefits on behalf of deceased employees), and terminated vested members (former employees who are eligible to receive benefits from the plan upon reaching retirement age).

Plan Status: Plan status is Active Plan (also referred to as an Open Plan, as new employees are eligible to enroll in the plan); Closed Plan (new employees are not eligible to enroll, but enrolled employees continue to accrue pension benefits); or Frozen Plan (no new employees can enroll and no benefit accruals for continuing employees). In closed plans, the new employees are either covered by the Florida Retirement System (FRS) or participate in a defined contribution account, such as a 401(a) account.

Employees Covered by Social Security: When Social Security was established in 1935, state and local government employees were excluded from coverage. Over the years, these plans were given the ability to opt-into Social Security coverage for their employees. Nationwide, about 75 percent of state and local retirement systems have opted for coverage, with about 25% still not covered. The majority of that 25% are police, firefighter and teacher retirement plans.

VALUE OF PLAN ASSETS

Market Value of Assets (MVA): The fair market value of assets (MVA), including DROP accounts, is the final reported price of plan assets in the capital markets, as measured at close of the last day of the fiscal year (usually September 30). The Actuarial Value of Plan Assets (AVA), on the other hand, is the smoothed value of the plan's assets and is used for performing an actuarial valuation in order to determine the amount of pension contributions the employer will have to make each year to fund the actuarial liability. This smoothing of the market value mitigates the effects of large fluctuations in the market value, and lowers the volatility in the employer's contribution from one year to the next.

Unfunded Accrued Liability (UAL): For funding purposes, this is the amount by which the actuarial accrued liability (AAL) exceeds the actuarial value of assets (AVA) accumulated to finance the obligation. The Actuarial Accrued Liability (AAL) is the portion of the present value of the plan's total projected pension benefits attributable to service already credited as of the valuation date. This includes all of the present value of benefits for retirees and beneficiaries currently receiving benefits and inactive members who have not yet commenced their benefits.

Current Valuation: It is the ratio, expressed as a percentage, of the assets of a pension plan to its liabilities. Specifically, the ratio is the market value of plan assets divided by actuarial accrued liability (AAL). It is also referred to as the pre-funded ratio – meaning it is the percentage of funds on hand now to play for present and future pension obligations.

Actual Market Value Rate of Return: This is a measure of the total investment performance of the portfolio over the fiscal year. It is expressed as a percentage, reflecting the gain on investments as a percentage of the market value of assets. The gain in investments is calculated by starting with the increase in asset value from beginning to end of period, and adjusting for investment expenses, contributions, benefit payments, and administrative expenses.

Assumed Rate of Return: This is an estimated measure of the long-term investment performance of the assets invested in the pension fund. The investment return assumption reflects the long-term (often 30 years) anticipated returns on the plan's target asset allocation as reflected in the Investment Policy Statement. This assumption is typically constructed using a building block approach, by considering various factors including the time value of money, and growth in earnings, dividends, and interest. It is based on the weighted average of the long-term expected rates of return of the different asset classes which make up the pension plan's investment portfolio. Assumed rate of return is often used interchangeably with the terms "Expected Return on Assets" and "Discount Rate."

FUNDING REQUIREMENT

Percentage of Payroll: Total required contribution (employer and employees) divided by total payroll of active participants. There is no interest adjustment included. One issue to think about is whether or not a plan has DROP members. If so, these members usually don't make a contribution, so the question remains, is their pay included in the total payroll? If it is, then the funding requirement as a percentage of payroll is skewed. Perhaps a better indicator of the budget impact of pensions is to consider **the cost of pension as a percent of General Fund revenue, instead of payroll.**

Percentage by Employees: The percentage of pay deducted from the employees' salary as their contribution to the pension plan's funding. Almost all Florida local plans require a contribution by the employees. The exceptions are excess plans, DROP plans, 175/185 share plans, volunteer firefighters, supplemental plans and some closed and frozen plans. It is important to keep in mind that public employees not covered by Social Security tend to contribute a higher amount to make up for the loss of Social Security benefits at retirement.

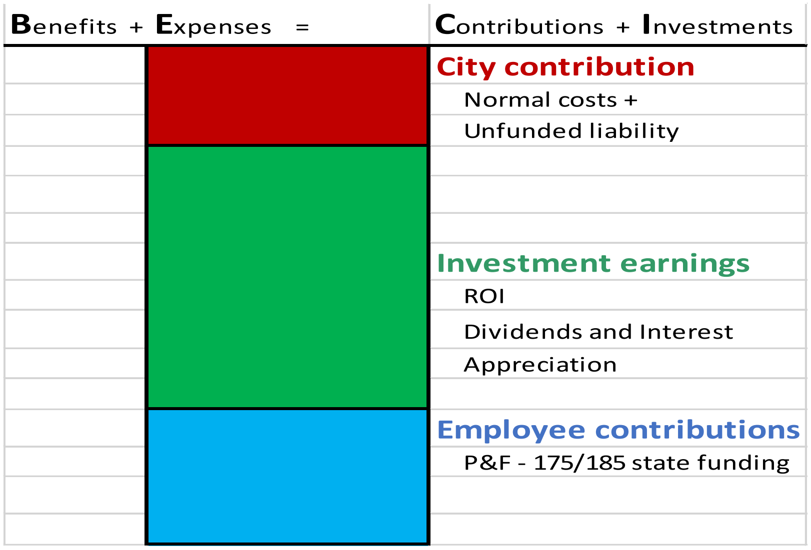
Valuation Basis Total Dollar Contribution: This reflects the required total annual contribution from all sources to fully fund the pension plan. These funds come from employee contributions, employer contributions, return on investments, and state funding (if it is a police or firefighter plan, called 185 or 175 contributions). Contributions will vary based on the Florida Statute Chapter assumption.

Local Plan Funding: Funding for the plans comes from employee contributions, employer contributions, return on investments, and state funding (if police or firefighters are participants in the plan). Full funding is required each year as determined by the actuarial valuation that takes into consideration past performance, and changes in assumption that may come as a result of an experience study.

The employee contribution is determined by the collective bargaining agreement between the union representing employees and the city as the employer. State funding comes through monies collected on homeowners' insurance policies and auto insurance policies. It is called 175 funds (for firefighter participants) and 185 funds (for police participants). Investment earnings are based on the market value of the return on investments, and smoothed over basically five years, to mitigate volatility in annual market value returns, which in turn influence the employer contribution.

The funding remaining, needed to reach full funding of the plan for each year, is assigned to the city. The city's contribution varies year-to-year, with smoothing helping reduce spikes in the amount. The graph below shows the three sources of funding needed to reach full funding each year. The benefits and expenses for the next year must be funded by an equal dollar amount of contributions and investments.

To determine full funding, the actuary determines two contribution amounts needed: normal costs (costs associated with one additional year of service by each participant) and the unfunded actuarial accrued liability (UAAL) costs (shortfall from the prior years, amortized over a number of years, usually 30). Normal costs are higher for an active plan, as new members are being added, thus new liabilities are being added to the plan resulting in increased benefit accruals.



Over time, investment earnings finance a majority of the costs of public pension plans. According to the U.S. Census Bureau, for the 30 years between 1990 through 2020, investment earnings accounted for 61 percent of public pension revenues. A recent study based on FY21 data from the National Association of State Retirement Administrators shows that investment earnings represented 64% of revenue; employer contributions made up approximately 25 percent, and employee contributions were around 11 percent.

Asset Allocation: Public pension asset allocations are developed by the trustees, taking into consideration the plan's projected benefit payments, expected contributions, and future investment earnings. Since 1989, on a national basis, investment earnings have accounted for approximately 61 percent of all public pension revenues.

The Florida Department of Management Services reports asset allocations of investments by all local defined benefit pension plans. Below are major asset classes that are commonly found in an Investment Policy Statement and asset allocation for Florida public pension plans.

Equities are stocks or any other securities that represent ownership interest in a business.

> **Domestic Equities** are those individual securities or index funds or mutual funds where the issuing companies are all domiciled **American companies traded on the various stock exchanges**. The function of a domestic stock is to divide the ownership interest of a given company equally among the number of shares outstanding for that company. The three types of domestic stocks are common stock, preferred stock and convertible preferred stock.
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> **International Equities** are those securities where the issuing companies or index funds or mutual funds are domiciled outside the United States. They represent an opportunity

for investors to diversify their portfolios and may help with improved diversification and lower volatility compared to allocating 100% to US-only equities.

Fixed Income (bonds) investments follow the same guidelines as above and can be domestic or international. Investing in **International** fixed income may result in similar benefits as investing in international equities above Fixed income broadly refers to those types of investment securities that pay investors fixed interest (periodic coupon payments, often semi-annually) until its maturity date. At maturity, investors are repaid the principal amount invested. Government and corporate bonds are the most common types of fixed-income products. Fixed income instruments usually reflect lower returns (yields) and lower risks compared to equities. These are a key component of a plan's asset allocation because they lower portfolio risk (volatility of returns) and can offset some of the interest rate risk inherent in the pension liabilities.

Cash or cash equivalent is used by plans to meet immediate cash flow needs or used to park funds resulting in the liquidation of one investment before moving them to another. There are critical in meeting unforeseen liquidity requirements.

Real Estate, considered one form of an alternative investment, is usually treated as a separate asset class. These are considered to be return-seeking assets (similar to equities), but may help with risk reduction without giving up much return. Most real estate investments are through a REIT (Real Estate Investment Trust), which are essentially real estate mutual funds. Real estate investments come in many forms, in some cases, a pension plan will own a building or piece of land as part of their real estate allocation. A REIT is a trust that uses pooled money to invest in property and/or mortgage loans; REITs are granted special tax considerations and are traded on major exchanges; there are several benefits over actually owning properties, and they pay dividends and are valued based on measures similar to stocks.

Alternative investments are alternatives to the above investments. They include a broad range of nontraditional investments and investment strategies that are often viewed as more risky than traditional investments in insolation. However, they can help in lowering portfolio risk as part of a balanced well-diversified portfolio because of low correlation (directional relationship) with other major asset classes. Alternative investments include **private equity and/or private credit markets, hedge funds, managed futures, art and antiques, commodities, and derivatives contracts**.

Other assets are just that – anything not classified above.

Investment Policy Statement:

Most public funds adopt an Investment Policy Statement to guide the investment of assets. A Government Finance Officers Association (GFOA) Best Practice "Creating an Investment Policy," states in part:

> A written investment policy is the single most important element in a public fund's investment program. An investment policy should describe the most prudent primary objectives for a sound policy: safety, liquidity, and yield. It should also indicate the type of instruments eligible for purchase by a government entity, the investment process, and the management of a portfolio. Such a policy improves the quality of decisions and demonstrates a commitment to the fiduciary care of public funds, with emphasis on balancing safety of principal and liquidity with yield. Adherence to an investment policy signals to rating agencies, the capital markets, and the public that a government entity is well managed and is earning interest income suitable to its situation and economic environment.

The GFOA recommends that all pension boards adopt a comprehensive written investment policy and review and update its policies on an annual basis.

Trustee Role: When the economy and investment markets are booming, pension plans see the benefits through return on investments, greater assets, and declining unfunded liabilities, resulting in the plan sponsor making a smaller annual contribution. When the economy and markets experience a crisis and/or go into a recession, the opposite occurs.

Trustees are often held answerable for any and all changes in the pension plan: increased contributions, downturns in the markets, poor performance, and the economy. In truth, trustees have no control over any of these. Their control comes in two areas:

1. Setting a suitable assumed rate of return (as this rate is reduced, the required contribution from the plan sponsor increases), and,
2. Investing the funds in a diversified portfolio (in a market they don't control) to obtain reasonable returns with a prudent amount of risk – a portfolio that is rebalanced to adjust for changes in return expectations for different asset classes and to comply with the investment policy asset class targets.

Being a trustee is not an easy job. However, with all the expertise trustees and administrators possess about a difficult subject (that others have little understanding), it is their job to educate the plan sponsor, the media, plan's active members, retired members (including beneficiaries) and terminated vested members about how a public pension operates and the advantages of a guaranteed pension benefit to the city and its residents.