AGENDA Tuesday, September 8, 2009

Informational Sioux Falls City Council

4:00 p.m. at Carnegie

Town Hall

235 West 10th Street

1. Call To Order

2. City Council Staff Report

A. Updates by Debra A. Owen, City Clerk

3. Mayor Munson

4. Audit Committee

5. Fiscal Committee

6. Land Use Committee

7. Public Services Committee

8. City Council Open Discussion

9. Presentations

A. Help!Line Center: Community Trends by Carol Muller, Executive Director

B. Forward Sioux Falls Strategic Planning Update by Evan Nolte, CEO Chamber of Commerce; and Slater Barr, President Sioux Falls Development Foundation

C. Employee’s Retirement/Firefighter’s Pension Audit Report by Rich Oksol, Lead Internal Auditor

Employees Retirement Firefighters Pension 09-03

10. Adjournment

Date: 2009-09-08
SIRE Meeting ID: 922
Meeting Type: Informational Meeting

YouTube:https://youtu.be/XUJ0eIru-FI
Agenda Item: Not Assigned
Item ID: 40115

Employee's Retirement/Firefighters' Pension Audit
August 2009

Internal Audit
City of Sioux Falls, South Dakota

WHY INTERNAL AUDIT DID THIS AUDIT

This audit of the pension plans was conducted as part of our 2009 Annual Audit Plan. This audit was classified as an operational audit. The purpose of operational audits, in general, as stated in the annual plan may include performing an appraisal of the internal control structure, determining conformity with laws and policies, determining reliability of financial reporting and determining effectiveness and efficiency in meeting organizational goals. Operational audit reports indicate how well the activities of a department or division are performed, make recommendations for improvements and offer conclusions drawn from audit work.

WHAT WE CONCLUDED

Overall, the pension plans of the City of Sioux Falls are well managed. The overall financial health of the pension plans is strong despite a poor year (2008) for investment earnings. We made several recommendations to strengthen controls in specific areas. These recommendations along with management response may be found starting on page 14 of this report.

Table of contents

Introduction

The Sioux Falls City Council approved this audit as part of the 2009 Annual Audit Plan. This is the first internal audit report on the Employee's Retirement and Firefighters' Pension plans.

Background

The City of Sioux Falls operates two separate pension plans for its full-time employees. Firefighters belong to the Firefighters' Pension plan; police, management and general employees belong to the Employee's Retirement plan. The pension plans are defined benefit plans that provide retirement, disability and survivor benefits to employees. Defined benefit plans calculate retirement benefits based on years of service and final average salary multiplied by a certain percentage (the multiplier). A defined contribution plan, in contrast, is funded by employer and employee contributions. Benefits are based on the investment earnings of those contributions. The participant's investment decisions determine the funds available at retirement. Defined contribution plans are common in the private sector while most public employees at the federal, state and local level are covered by some sort of defined benefit plan. See Appendix B on page 17 of this report for more information on defined benefit plans and defined contribution plans.

The administration and management of the pension plans is accomplished by staff and management of Finance and Human Resources, as well as oversight by a board of trustees for each plan. The boards consist of appointed members from the community, employee members elected by plan participants, and the Mayor or the Mayor's appointee. Advice is provided by the City Attorney's office and other professionals such as investment advisors and actuaries. Professional investment managers handle the actual investment of plan assets and a bank is the custodian of plan assets. The two pension plans appear as fiduciary funds in the financial statements of the City of Sioux Falls.

Benefit payments and pension plan expenses are provided by a combination of employee contributions, employer contributions, and investment earnings. See Appendix A on page 16 for details.

The following is a summary of benefit provisions[1]:

FIREFIGHTERS' PENSION

Regular Retirement: *Eligibility* – Age 55 with 20 or more years of service; or sum of a member's age and years of service equals eighty (rule of 80) with a minimum retirement age of 50. *Annual Amount* – Final average pay compensation times the sum of a) 2.5% times the first 25 years of service, plus b) 1.5% times years of service in excess of 25 years. *Type of Final Average Compensation* – Average of last 3 years before retirement. Some lump sums are included.

[1] City of Sioux Falls Employee's Retirement System/Firefighters' Pension Annual Actuarial Valuation Report, December 31, 2008

Example: A firefighter age 55 with 25 years of service and a final average pay of $55,000 would be eligible to retire with an annual pension equal to 63 % of his or her final average pay or $34,650 annually.

Member contributions: 8% of compensation (salary)

Post-Retirement Cost-of-Living Adjustments (COLAs): An annual increase equal to 100% of the June Consumer Price Index (CPI) change each year with a cap of 3%. The first increase is granted after 36 months of retirement.

Retirees and Beneficiaries as of December 31, 2008: 141 with $33,152 average annual benefits per recipient.

EMPLOYEE'S RETIREMENT

Regular Retirement: *Eligibility* – General members: age 55 with 30 or more years of service, or age 60 with 5 years service. Police members: age 50 with 25 years of service, or age 60 with 15 years of service. *Annual Amount* – General members: 1.8% of final average pay times years of service. Police: final average pay times the sum of a) 2.5% times the first 25 years of service, plus b) 1.5% times years of service in excess of 25 years. *Type of Final Average Pay* – Highest 3 consecutive years out of last 10. Some lump sums are included.
Example: A general employee age 60 with 20 years of service and a final average pay of $45,000 would be eligible to retire with an annual pension equal to 36% of his or her final average pay or $16,200 annually.

Member contributions: Police: 8% of compensation (salary); General: 3% of compensation (salary)

Post-Retirement Cost-of-Living Adjustments (COLAs): An annual increase equal to 100% of the June Consumer Price Index (CPI) change each year with a cap of 3%. The first increase is granted after 36 months of retirement.

Retirees and Beneficiaries as of December 31, 2008: 436 with $23,247 average annual benefits per recipient.

See Appendix A on page 16 of this report for detailed information on asset valuations, plan expenses and benefit payments on the two pension plans of the City of Sioux Falls.

Scope, objectives and methodology

The audit scope included comparison and review of data from 1998 to 2008. We audited the two pension systems: Employee's Retirement and Firefighters' Pension.

The audit objectives were:

1. Evaluate the overall internal control structure.

2. Determine whether benefit payments are made to eligible persons.
3. Determine whether benefit payments are correctly calculated.
4. Determine if cost-of-living-adjustments (COLAs) are properly applied.
5. Determine if controls are in place to verify that retirees and beneficiaries are still alive.
6. Determine if the disability pension process is reasonable and administered in compliance with city ordinance.
7. Evaluate the overall financial health of the pension systems.

Our methodology included interviews with staff and management, attendance at pension board of trustees meetings, review of pension file documentation, review of payroll data and extensive research into public pension systems. We also reviewed the summary plan descriptions of the two pension systems, chapter 35 of city ordinances, the minutes of various boards of trustees meetings, and actuarial and financial reports. We were guided in our audit work by two documents produced by the Association of Public Pension Fund Auditors (APPFA): *Statements of Key Investment Risks and Common Practices to Address Those Risks* (July 2000) and *Operational Risks of Defined Benefit and Related Plans and Controls to Mitigate Those Risks* (July 2003).

Results

OBJECTIVE ONE: OVERALL INTERNAL CONTROL STRUCTURE
Internal control[2] consists of five interrelated components that work together to help achieve:

- Effectiveness and efficiency of operations (including the safeguarding of assets)
- Conformity with laws, regulations and policies
- Reliability of financial information

The five components of internal control are:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

Control environment: also known as "tone at the top". It is the most important component of internal control. Control environment includes the control consciousness of management and staff as well as experience and competence.

What we considered when assessing the control environment:

- Experience of management in operating a pension system.
- Composition of the Boards of Trustees and observations of the oversight they provide in fulfilling their fiduciary duties.
- Sufficient staff to conduct activities and lack of staff turnover.

[2] Committee of Sponsoring Organizations of the Treadway Commission (COSO) website, www.coso.org

- Written policies and procedures and assignment of responsibility and authority among management, staff and boards.

Risk assessment: Risk assessment is the identification and analysis of various risks that can interfere with the accomplishment of objectives.

What we considered:
- The basics of the two pension plans are not subject to frequent change.
- A written investment policy guides the boards and management in identifying and managing the risks of the investment portfolios.
- Outside consultants are employed as necessary to help identify risks.

Control activities: Control activities are the policies and procedures that help ensure that management directives are achieved. They help ensure that the risks identified in the risk assessment process are effectively mitigated. Control activities may include such things as authorizations, management oversight, reconciliations, physical security of assets and segregation of duties.

What we considered:
- We identified key controls utilized by the pension management to mitigate the various risks associated with pension systems including both investment risks and operational risks.
- We tested the operation of these controls.

Information and communication: Information and communication underlies the other four components of the internal control integrated framework. Effective information and communication provides information in a form and time frame that allows employees to carry out their duties.

What we considered:
- The boards of trustees for both pension plans meet on a regular basis.
- Management reports significant issues to the boards.
- Staff size is sufficient to allow for adequate communication of control related issues.
- Benefit provisions and related policies are communicated to pension participants.

Monitoring: Monitoring refers to oversight by management or external parties of how well controls are operating. It could also involve an assessment by employees using such methodologies as checklists.

What we considered:
- External auditors and internal auditors audit various aspects of the pension plans.
- Management's control activities allow for supervision and review of benefit payments.
- Actuarial valuation reports are done annually to determine funding requirements.

Our conclusion based upon our audit work is that the overall internal control structure is properly designed and operating effectively. We did identify opportunities to strengthen controls in specific areas. See page 14 of this report.

OBJECTIVE TWO: PAYMENTS MADE TO ELIGIBLE PERSONS

We reviewed the internal controls in place to ensure that only eligible persons receive benefit payments. We further tested a sample of pension file documentation. **We concluded that controls are sufficiently designed and operating to provide reasonable assurance that only eligible persons are receiving benefit payments.**

OBJECTIVE THREE: PENSION BENEFITS CORRECTLY CALCULATED

We reviewed the internal controls in place to ensure that pension benefits are correctly calculated. We tested a sample of pension file documentation. **We concluded that controls are sufficiently designed and operating to provide reasonable assurance that benefits are correctly calculated.**

OBJECTIVE FOUR: COST-OF-LIVING ADJUSTMENTS CORRECTLY APPLIED

Section 35-56 of City code allows for redetermination of retirement allowances based upon changes in the Consumer Price Index for All Urban Customers (CPI-U) as computed by the United State Department of Labor. These redeterminations are commonly referred to as cost-of-living adjustments or COLAs. The two pension plans allow for an annual COLA for pension retirees and beneficiaries equal to the CPI-U from June of the previous year. This adjustment is capped at a maximum of 3%. Pension recipients do not receive any COLA for the first 36 months after they begin receiving pension benefits.

We reviewed the procedures used to determine the CPI-U and apply the COLA to pension benefits and tested a sample of transactions to determine if the COLA was applied correctly according to the provisions of section 35-56 of City code. **We concluded that COLAs are being correctly calculated and applied.**

OBJECTIVE FIVE: VERIFYING THAT PENSION RECIPIENTS ARE NOT DECEASED

A risk to pension systems is that benefit payments will continue to be paid to recipients who are deceased. This can occur as part of a fraud scheme or through error. For example, the City of Atlanta, GA experienced a fraud scheme in their pension plans whereby $2.1 million was paid to 454 pensioners after their death.[3] Recently, a similar situation was discovered in the City of Cincinnati, OH retirement system.[4]

While pension management has some controls in place to help ensure that benefits are not paid to deceased retirants and beneficiaries, these controls could be stronger. Currently, the pension systems rely upon families to notify Human Resources when a family member dies. Additionally, Human Resources staff reviews obituaries to

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[3] City of Atlanta, Office of City Internal Auditor, *Payments to Deceased Pensioners,* March 2004

[4] Cincinnati Enquirer article June 8, 2009 *Dead City Worker Kept Getting Checks*

identify pensioners who have died. Occasionally, a bank will notify the City of a bank account being closed because of a death and that direct deposits from the City cannot be accepted. In 2003, the City used the services of a consultant to perform a death audit. A death audit is a search of various databases including the Social Security Administration to try and identify pension recipients who may be deceased. In 2003, the consultant reported that none of the City pension recipients appeared to be deceased based on their search of databases**. See recommendation four on page 14 of this report**.

OBJECTIVE SIX: DISABILITY PENSION PROCESS

The City pension plans offer both duty disability and non-duty disability pensions to employees who suffer from potentially permanent injury or disease, are not able to work and have not yet reached the normal retirement age. Such a provision is common to public employee pension plans. A risk to pension plans is that the disability determination process will be abused. Employees may claim disabilities to collect early pensions when they are, in fact, able to work. The primary control the City uses to stop disability pension abuse is medical examinations of potentially disabled employees by a physician (pension medical director) hired by the pension system. A thorough initial exam by the medical director is performed. The pension board of trustees must approve any disability pension, whether duty-related or non-duty, based on the report of the medical director. Regular reexaminations are scheduled to determine if there has been any change in the condition of the retiree that would allow them to return to work.

We reviewed section 35 of City code that addresses disability pensions. We reviewed pension file documentation. **We concluded that the pension disability process as administered by the City is in compliance with code and that the process the City uses to verify disability is reasonable to prevent the risk of abuses.** We noticed in our review of documentation that one disability recipient had not been reexamined for a number of years following the initial disability determination examination. However, Human Resources staff had detected this error and management had approved a process to correct the weakness in procedures so that reexaminations would be scheduled and documented.

OBJECTIVE SEVEN: OVERALL FINANCIAL HEALTH OF PENSION SYSTEMS

2008 was a bad year for investment returns. Many pension funds across the United States fell short of actuarial assumptions of return on investments. The three sectors that pension funds usually invest in are equities (stock market), debt (bonds) and real estate. All these sectors performed poorly in 2008. However, our audit conclusion based on an evaluation of five financial indicators is that the overall financial condition of the City of Sioux Falls pension systems is strong.

We did note that the actuarial assumption of investment returns has been that the pension plan assets would generate an average rate of return of 8%. This is a common assumption of investment return used by many public pension and private sector plans.[5] However, this assumption has been lowered by the board of trustees starting this year to 7.75%. This change was driven by current market conditions. The pension actuary uses

[5] *How Should Public Pension Plans Invest?* D. Lucas and S. Zeldes, January 2009

a process called five-year smoothing[6] to deal with the year-to-year fluctuations in investment returns. Smoothing could be considered a method to mitigate funding risk. By using five-year smoothing, more consistency is achieved in the annual required contribution (ARC) recommended by the actuary. (See page 11 for more information on the ARC). Five-year smoothing is a common technique employed so that one very bad or very good year of investment returns does not result in a large variation in the ARC. Investment returns are averaged over a five-year period. Most large pension funds use some form of smoothing.

The primary risk to a pension system is that plan assets will be insufficient to provide promised benefits to plan participants. Plan assets come originally from contributions from employees and the employer (City). These funds are then invested by asset managers under oversight of the boards of trustees and professional investment advisors. Over time, investment earnings provide the majority of revenue needed to pay promised benefits and pension plan expenses. See Appendix A for detailed information on plan assets, revenues, benefit payments and expenses.

The following financial indicators were reviewed during our audit work:

- A calculation of the assets to benefits ratios for the years 1998, 2003 and 2006-08.
- Whether annual required contributions (ARC) have been made for the past 10 years.
- An examination of the funded ratio history for 2003-2008.
- An examination of the unfunded actuarial accrued liability as a percentage of payroll.
- A calculation of the ratio of active members to retired members.

Assets to benefits ratios

The assets to benefits ratio of a pension plan is a commonly used financial indicator. The ratio is calculated as follows:

Pension plan assets
Divided by
Annual pension benefits paid

A warning trend is decreasing value of pension plan assets compared to benefits paid.[7]

<u>Pension Plan Assets (Employee's Retirement) to Annual Benefits Paid</u>

Year	Ratio
1998	28.2
2003	24.9
2006	27.9
2007	28.1
2008	18.7

[6] *The CPA Journal online,* New York State Society of CPAs, July 2007
[7] *Evaluating Financial Condition: A Handbook for Local Governments*, ICMA, 2003

Conclusion: With the exception of 2008, the average ratio shows a modest increase from 2003 to 2007. A higher ratio is better than a lower ratio. The ratio does not indicate serious problems in the management or design of the pension plan. (Note that the results for 2008 are skewed due to a bad year for investment returns).

Pension Plan Assets (Firefighters' Pension) to Annual Benefits Paid

Year	Ratio
1998	30.1
2003	25.8
2006	24.7
2007	23.7
2008	16.1

Conclusion: The trend in the ratio appears to be a modest decrease from 1998 to 2007. The ratio does not indicate serious problems in the management or design of the pension plan. (Note that the results for 2008 are skewed due to a bad year for investment returns).

Annual required contributions (ARC)
One indicator of pension fund health is to determine if the annual required contribution is being consistently made. Both the employer (City) and the employee (through a payroll deduction) make contributions to the pension plan. These contributions are then invested to provide a revenue stream to pay plan benefits and expenses. The employee contribution is a fixed percentage of compensation (3% for general and management employees, 8% for public safety employees). The employer contribution fluctuates every year depending upon investment earnings, among other factors. The pension plan actuary determines the amount of the employer contribution.

We noted that the City (employer) has made 100% of required contributions for each of the past 10 years based upon our examination of the pension plans' actuarial reports.[8] While not conclusive, payment of the ARC is a positive sign of pension fund financial health.

Funded ratio history
The funding ratio[9] is determined as follows:

Plan assets
Divided by
Actuarial accrued liability

The funding ratio for the City of Sioux Falls is as follows:

Year	General/Management	Police	Fire
2003	97.0%	91.8%	98.4%
2004	94.9%	90.5%	93.1%

[8] Annual Actuarial Valuation Reports, Gabriel Roeder Smith & Company
[9] *The Funding Status of Locally Administered Pension Plans*, The Center for State & Local Government Excellence, October 2008

2005	93.6%	90.7%	92.0%
2006	96.5%	94.6%	94.3%
2007	98.1%	94.1%	95.3%
2008	94.4%	89.4%	91.2%

Source: Annual Actuarial Valuation Report, December 31, 2008, pages A-9, A-11

"If a state or local government is following an actuarially sound funding plan, a funding ratio of 80 percent is considered adequate, as the funding plan in time should eliminate the shortfall."[10]

The two City of Sioux Falls pension plans more than meet the 80 percent threshold that many experts believe indicates a healthy funding level. One way of looking at the funding ratio is this: in 2008, the general/management portion of the Employees' Retirement fund had a funding ratio of 94 percent. For every dollar in liability, the pension fund has 94 cents in assets (and 20 years to fund the remaining 6 cents).

We became aware during our research that the measurement of liabilities is critically dependent upon the costing method. The most common method used by state and local pension plans is the *entry age normal* (EAN) method.[11] This is also the most conservative costing method. The City of Sioux Falls pension plans use the EAN costing method.

Unfunded actuarial accrued liability as percentage of payroll

The unfunded actuarial accrued liability (UAAL) is the amount of the actuarial accrued liability not covered by the current plan assets. To use the UAAL as an indicator of pension fund financial health, the UAAL can be calculated as a percentage of salaries and wages as follows:

Pension obligations (UAAL)
Divided by
Salaries and wages

A warning trend is increasing pension obligations as a percentage of payrolls.[12]

City of Sioux Falls

Year	Firefighters'	Employee's
2004	63%	34%
2005	74%	39%
2006	53%	22%
2007	45%	18%
2008	85%	42%

[10] *Why Don't Some States and Localities Pay Their Required Pension Contributions?* Center for Retirement Research at Boston College, May 2008

[11] *The Funding Status of Locally Administered Pension Plans*, The Center for State & Local Government Excellence, October 2008

[12] *Evaluating Financial Condition: A Handbook for Local Governments*, ICMA, 2003

Generally, with the exception of 2008, the trend has been decreasing pension obligations as a percentage of salaries and wages. Because of poor investments returns in 2008, the UAAL increased substantially.

Ratio of active members to retired members
A measure of a pension fund's health is whether the active members (employees not yet retired) outnumber the members receiving benefit payments (retired employees). A negative trend would be an increasingly smaller ratio of active members to retired members.

Employees' Retirement

Year	Active members	Retired members	Ratio
1999	750	356	2.1
2000	761	369	2.1
2001	789	368	2.1
2002	808	374	2.2
2003	839	383	2.2
2004	854	396	2.2
2005	872	409	2.1
2006	878	417	2.1
2007	886	430	2.1
2008	899	436	2.1

Firefighters' Pension

Year	Active members	Retired members	Ratio
1999	149	97	1.5
2000	150	99	1.5
2001	151	100	1.5
2002	162	102	1.6
2003	164	112	1.5
2004	163	122	1.3
2005	166	128	1.3
2006	178	133	1.3
2007	177	137	1.3
2008	182	141	1.3

In both plans, there are more contributors (active members) than retirees and beneficiaries; this is a positive financial indicator. The ratio for the Employee's Retirement plan is very steady over the past 10 years. The ratio for the Firefighters' Pension plan shows a slightly decreasing trend. A possible explanation is that there is an increasingly larger percentage of retired firefighters because they are permitted to retire at a younger age (early 50's) than the general employees.

Recommendations

1. Documentation of process and procedures. We recommend that management document the process and procedures performed by the primary staff member in Human Resources involved in the processing of pension payroll. Such processes and procedures should be documented so that in the temporary or permanent absence of this employee another employee could perform the tasks. Without such documentation, the risk is that pension processing could be delayed or that opportunities for errors could increase as another employee attempted to perform the various duties.

2. Control to detect unauthorized changes to pension amounts. We recommend that management consider strengthening controls to detect changes to pension amounts. While unauthorized changes to pension amounts might be detected by the actuarial firm employed by the pension system, such detection might not occur until the firm did the annual actuarial valuation. A possible control might be a monthly reconciliation of the total pension benefits. Such reconciliation should be performed by an employee not involved with the monthly processing of the pension payroll.

3. Control to detect unauthorized additions. This recommendation is similar to recommendation two. A reconciliation should be performed of the total number of pension records from month to month so as to detect on a timelier basis any unauthorized additions to the pension payroll. Such reconciliation should be performed by an employee not otherwise involved with the processing of the pension payroll.

4. Database search to identify retirees or beneficiaries who may be deceased. We recommend that management consider hiring a consulting company to perform death audits on a regular basis to provide reasonable assurance that retirees or beneficiaries receiving benefits are not deceased. Such death audits can be performed for a very reasonable cost. Many large pension systems mail affidavits to pension recipients on an annual basis and require affidavits to be signed and returned. However, given the history of the City's pension systems and the relatively small size of the two pension plans, we believe that a regular database search (death audit) is a less intrusive and more cost effective control.

5. Consideration of an actuarial audit. We recommend that management and the pension boards consider hiring a firm to perform an actuarial audit. The purpose of an actuarial audit would be to:
   - Review the actuarial assumptions such as rate of returns on investments, inflation rate, rates of disability, employee turnover, et cetera.
   - Review the application of the funding method to determine if it is reasonable and meets generally accepted actuarial standards.
   - Independently calculate the actuarial value of the pension assets.
   - Independently calculate the total liabilities of the pension plans.

- Overall, express an opinion on the reasonableness, completeness and accuracy of the annual valuation results.

Such an audit is beyond the skills of an internal audit group and is usually performed by an actuarial firm. Actuarial assumptions and calculations are critical to determining the annual required contribution by the City to the pension plans. An actuarial audit is a recommended control activity to mitigate the risk that the pension system's actuary is using poor assumptions or making incorrect calculations.[13] While this is not yet a common practice, it is being employed by more pension boards. Some governments are mandating such audits by law.[14] We recommend that management and the board of trustees give consideration to contracting for such audits on a regular basis, for example, every five years.

Management response

On page 10 of the report, last paragraph dealing with investment return assumption, you noted that the change in investment rate assumption from 8% to 7.75% was "driven by market conditions." Management notes that the decision to reduce the investment assumption by .25% was driven by market expectations and this change was made before the market downturn. The Board, and management, try to proactive not reactive. We believe the investment assumption reduction was a proactive move, not a reactive move.

Management would respond that with respect to recommendations 2 and 3(pg. 15, unauthorized pension changes or additions) that we have already implemented additional control procedures.

Conclusion

We concluded that the City of Sioux Falls pension plans are properly administered and that, overall, both operational and investment risks are being identified and mitigated. We appreciate the cooperation and courtesy shown to us by staff and management while conducting this audit.

[13] *Statements of Key Investment Risks and Common Practices to Address Those Risks,* Association of Public Pension Fund Auditors, July 2000
[14] State of Alaska, state statute 37.10.220(a)(10)

APPENDIX A

Sources: Annual Actuarial Valuation Reports; City of Sioux Falls Comprehensive Annual Financial Report

EMPLOYEE'S RETIREMENT REVENUES

Year	Employee Contribution	Employer Contribution	Investment Income
2004	$1,718,969	$5,261,202	$24,644,820
2005	1,829,649	5,769,159	17,035,074
2006	1,907,951	5,975,325	33,030,851
2007	2,001,290	7,896,489	19,937,351
2008	2,065,615	7,710,786	(71,138,091)

FIREFIGHTERS' PENSION REVENUES

Year	Employee Contribution	Employer Contribution	Investment Income
2004	$ 729,784	$1,269,502	$9,856,321
2005	733,442	1,448,282	6,666,149
2006	804,140	2,096,083	12,813,932
2007	832,892	2,716,461	7,602,334
2008	856,843	2,685,905	(26,092,662)

EMPLOYEE'S RETIREMENT EXPENSES AND ASSET VALUATIONS

Year	Retirement Benefits	Contribution Refunds	Miscellaneous Expenses	Assets Year-End
2004	$7,403,924	$ 188,094	$ 758,667	$195,242,186
2005	8,014,168	182,999	1,055,818	210,623,083
2006	8,662,750	189,338	1,253,516	241,431,606
2007	9,262,791	199,779	1,416,037	260,388,129
2008	10,005,006	275,474	1,429,420	187,316,539

FIREFIGHTERS' PENSION EXPENSES AND ASSET VALUATIONS

Year	Retirement Benefits	Contribution Refunds	Miscellaneous Expenses	Assets Year-End
2004	$3,130,455	$ 27,170	$ 366,281	$ 76,532,749
2005	3,460,068	1,038	467,077	81,452,439
2006	3,755,563	133,085	539,948	92,737,998
2007	4,173,282	42,932	611,256	99,062,215
2008	4,440,801	22,529	633,148	71,415,823

PENSION FUND INVESTMENTS AS OF 12/31/2008

Type	Fair Value	% of Total
Cash deposits	$ 258,221	0.1%
Money market fund	2,496,688	1.0%
US Treasury & agency obligations	2,954,282	1.1%
Municipal obligations	580,702	0.2%
Corporate obligations	46,138,843	17.9%
Domestic fixed income-index fund	35,253,524	13.7%
Domestic stocks	109,598,282	42.5%
International stocks	48,290,706	18.8%
Real estate mutual funds	11,932,079	4.6%
Total	$257,503,327	

APPENDIX B

Private pension plans and public employee plans
Most non-public employees are not covered by traditional defined benefit (DB) plans. Many companies have made the switch from DB plans to defined contribution (DC) plans such as 401(K)-style plans. However, some large corporations still offer DB plans to their employees.

Percent of Workers Covered by a Pension Type and Sector, 2004[15]

	DB only	DC only	Both
State & local government	80%	14%	6%
Private	10%	64%	26%

Note: only 17 percent of Fortune 100 companies have a 401(K)-style pension plan as their primary plan.

While private sector employees are almost always covered by social security regardless of the type of pension plan offered by their employer, some state and local employees are not covered by social security.

Percent of Worker Covered by Social Security, 2006[16]

State & local government	72%
Private	98%

Other differences between private DB pension plans and public DB pension plans include[17]:

- Private sector employees do not contribute to defined benefit plans; state and local employees are almost always required to contribute a portion of their pay.
- Public plans are generally free from regulatory costs. Private plans must comply with the Employee Retirement Income Security Act (ERISA) of 1974.
- Public plans tend to invest more aggressively than private plans and are about as well funded as private plans.
- Public plans usually offer better benefits than private plans and offer cost-of-living adjustments. Private plans almost never offer COLAs.
-

DEFINED BENEFIT / DEFINED CONTRIBUTION

Employer-provided pension benefits generally fall into two broad categories: a defined benefit (DB) plan or a defined contribution (DC) plan. Most public employees are covered under some form of DB plan. The City of Sioux Falls offers a DB plan to full-time employees. In a DB plan the employee receives a guaranteed level of benefit payments that is based upon a formula of years of service, final average pay and a multiplier. In a DC plan the employee sets aside a set percentage of salary or wages into a tax-deferred individual account such as a 401(K) plan. The employer may also contribute a certain percentage into the employee's account. Any retirement benefits that

[15] The National Association of State Retirement Administrators
[16] Social Security Administration, Congressional Budget Office, US Census Bureau
[17] Center for Retirement Research at Boston College

the employee receives will be from the contributions and investment earnings in that individual account. The employee is normally responsible for the investment decisions.

The issue of defined benefit versus defined contribution pension plans is a very controversial issue. Many corporations have shifted their new employees from traditional DB plans into DC plans to save money. Recently, the governor of California proposed shifting new state employees from DB plans to DC plans because of the State of California's fiscal crisis.[18]

Advocates of DC plans would argue the following advantages of DC plans:[19]

- DC plans contain costs. DC plans are fully funded upfront.
- DC plans create investment choice. Employees make the investment decisions.
- DC plans allow worker freedom and plan portability. This is particularly appealing to younger works.

Advocates of DB plans would argue the following advantages of DB plans:[20]

- DB plans provide a higher payout at retirement.
- DB plans attract people to public service and retain them once hired.
- DB plans offer guaranteed, predictable benefits.
- DB plans create an incentive to retire and promotion opportunities for younger workers as older workers retire.

The big question is whether switching from a DB plan to a DC plan saves the organization money.

Advocates of maintaining DB plans argue that any budget savings would not be realized for many years. Administrative costs would increase as two plans would have to be administered, a DB plan for the current employees and a DC plan for the recently hired. Employees hired under the "old" plan are generally protected from plan switching.[21]

Administrative expenses for DC plans are usually much higher that DB plans.[22]

<u>2006 Administrative Expenses</u>

Defined benefit plans:	0.30% (of plan assets)
Defined contribution plans:	1.10% (of plan assets)

An explanation for increased administrative costs is that DC plans maintain individual accounts. DB plans do not maintain individual accounts. Most DC plans use mutual funds to invest money. The average expense ratio ranges from 0.60 percent for bond funds to about 0.75 percent for stock funds.

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[18] Governor Schwarzenegger, State of the State address, 2005
[19] The Heartland Institute, John Nothdurft, October 2008
[20] *Myths and Misperceptions of Defined Benefit Contribution Plans,* National Association of State Retirement Administrators, November 2002
[21] White paper, National Association of State Retirement Administrators, November 2002
[22] US Census Bureau (2006) and HR Investment Consultants (2007) cited by The Center for Retirement Research at Boston College, January 2008

The Illinois Municipal Retirement Fund in 1999 estimated that replacing the DB plan with a DC plan would increase the administrative costs from 0.44 percent of plan assets annually to 2.25 percent of plan assets annually.

A case study for DC versus DB plans happened in the state of Nebraska. In the 1960s, the Nebraska legislature created a DC plan for state and county workers. Teachers, judges and highway patrol officers were already covered under a DB plan. In 2002, the state legislature of Nebraska replaced the DC plan with a plan whereby assets are managed by the employer but participants have separate accounts. "On average, the investment returns in the School Employees, State Judges and State Patrol defined benefit plans were 11 percent for the past 20 years while state and county employees averaged 6 and 7 percent on average."[23] In general, the DB plan produced better results for employees than the DC plans for about the same expense to the employer (state of Nebraska). An extensive educational plan had apparently done little to improve employees' financial literacy.

Many research studies have shown that private sector DC plan participants achieve poorer investment returns than those returns achieved by large pension funds.[24] Studies attribute the poorer results to higher investment costs, poor market timing and investment mistakes such as lack of diversification.[25]

[23] Nebraska Public Employees Retirement Systems newsletter, 2002
[24] *State and Local Pension Fund Management,* J. Peng, 2009
[25] *Investment Returns: Defined Benefits vs. 401(K) Plans,* A. Munnell, J. Libby, J. Princivalli, 2006