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Office of the Comptroller

Milwaukee County

Scott B. Manske • Comptroller

To: Theodore Lipscomb, Sr., Chairman, Milwaukee County Board of Supervisors

From: Scott B. Manske, Comptroller
Cynthia J. (CJ) Pahl, Financial Services Manager, Office of the Comptroller

Date: March 13, 2019

Re: Fiscal Analysis of Proposed Pension Ordinance Changes to M.C.G.O. 201.24 of the Employees' Retirement System – **UPDATED**

*****This fiscal analysis was updated March 13, 2019 to reflect a later than anticipated effective date for the proposed ordinance. The previous fiscal analysis (dated October 17, 2018) was calculated assuming a January 1, 2019, effective date. This updated fiscal analysis assumes an effective date of July 1, 2019. The only change to the fiscal analysis is the potential added interest owed by the County due to a start date of July 1, 2019. Possible interest owed by the County increased by approximately \$40,000 in this updated fiscal note and, if enactment is further delayed, would increase by approximately \$20,000 for each quarter after July 1, 2019.*****

SUMMARY

The proposed ordinance changes modify the current pension ordinances to make various operational changes and to create a for the handling of overpayments and underpayments. The proposed changes have certain provisions which cause a fiscal impact to the County. These provisions result in a potential payout by the County of \$2.2 million from the Pension Obligation Bond Reserve, of which \$1.6 million would be repaid to the Pension Obligation Bond Reserve by Pension System members and beneficiaries. This results in a maximum financial impact of \$0.6 million for the County.

Those provisions with fiscal impacts are related to:

Pension Effective Dates.

- Specifying when retirement payments commence and terminate, including backdrop payments.

Interest Rate Assignment.

- **Overpayment Recoupment - Option 1:** 1) Setting applicable interest charged to the County when it repays an overpayment debt on behalf of a member or beneficiary at five percent (5%) simple per annum or whatever is mandated by the Internal Revenue Service (IRS) in any Voluntary Correction Program (VCP) and 2) subsequent interest rate charged to the member or beneficiary on principal portion only to be zero (0%) percent for the first 12 months and five percent (5%) simple per annum until the principal is paid in full.
- **Overpayment Recoupment - Option 2:** Setting applicable interest charged by the Pension Trust when recouping overpayment debts from a member or beneficiary to five percent (5%) simple per annum or whatever interest rate is mandated by the IRS in any VCP.
- **Underpayments:** Setting applicable interest paid to the member or beneficiary when underpayment liabilities are reconciled between the Pension Trust and a member or beneficiary at five percent (5%) simple per annum.

Interest Forgiveness.

- **Overpayment Recoupment - Option 1:** Providing for the forgiveness of interest paid by the County on behalf of the member or beneficiary to the Pension Trust when agreeing to terms of recoupment.

Claim Period.

- **Overpayments:** Establishing a six-year claim period such that any overpayment debt that is older than six years is an overpayment debt owed to the Pension Trust by the County and not by the member or beneficiary.
- **Underpayments:** Establishing a six-year claim period such that any underpayment liability that is older than six years at the time of claim is not payable to the member or beneficiary by the Pension Trust.

De Minimus Rule.

- **Overpayments:** Establishing a de minimus amount such that any overpayment debt, inclusive of interest, that is less than \$165 is an overpayment debt owed to the Pension Trust by the County and not by the member or beneficiary.
- **Underpayments:** Establishing a de minimus amount such that any underpayment liability, inclusive of interest, that is \$75 or less is not payable to the member or beneficiary by the Pension Trust.

OVERVIEW

In 2014, a VCP was submitted to the IRS. The 2014 VCP contains thousands of cases with either underpayments, overpayments or both. In addition to the 2014 VCP, the Pension Trust had been maintaining a list of various other possible overpayments. Given the complexity of determining overpayment principal and interest and the volume of potential cases, the Comptroller engaged a known audit firm to assist in calculating the principal and interest due in the 262 potential overpayment cases identified. Of the 262 potential cases, 188 cases were identified as having overpayment errors. Three of the 188 cases were excluded from this fiscal note because they were in active litigation. Of the 185 cases to which this fiscal note applies, there were verifiable overpayments with principal owed of \$1.6 million and interest owed of \$0.6 million at a five percent (5%) simple per annum rate.

Although the 2014 VCP contains many underpayments also impacted by this proposal, a detailed analysis of those payments was not done. This proposal sets the interest rate that is paid in underpayments and enacts a six-year claim period for the payout of underpayments. Generally, those provisions will mitigate some portion of the negative impact that will occur when all the underpayments are paid by the Pension Trust to members or beneficiaries.

Applying this proposed policy to the known overpayments, the maximum financial impact is \$0.6 million, which consists of \$2,000 in forgiveness due to the de minimus clause and \$0.6 million in potential interest waived under the policy for those members and beneficiaries selecting Overpayment Recoupment Option 1. The table below summarizes the fiscal impact.

County Financial Impact of Pension Ordinance Changes		
	Principal	Interest
Total Outstanding P&I	\$ 1,564,084	\$ 608,089
County Responsibility:		
Total Forgiven Due to De Minimus Rule	\$ 1,774	\$ 374
Total County Repayment	\$ 1,774	\$ 374
Potential County Responsibility:		
Potential Forgiveness of Interest Paid under Option 1	\$ -	\$ 607,715
Potential Total County Repayment	\$ -	\$ 607,715
MAXIMUM COUNTY LIABILITY	\$ 1,774	\$ 608,089

Because this policy uses funds in the Pension Obligation Bond Reserve to reconcile the overpayment debts and collections with the Pension Trust, there is no direct financial impact to the County's financial position until such time that no funds remain in the Pension Obligation Bond Reserve. As of January 1, 2018, there was \$5.1 million in the Pension Obligation Bond Reserve. When funds in the Pension Obligation Bond Reserve are fully depleted, the County will need to transfer funds from some other source (which will likely impact the County's financial position at that time) to sufficiently cover the reconciliation of any future overpayment debts with the Pension Trust.

For each additional quarter that this policy is not adopted and action is not taken to collect overpayments, additional interest of approximately \$20,000 accrues at a rate of five percent (5%) simple per annum raising the maximum financial impact by the same amount. It is extremely important to note that the maximum financial impact could increase by approximately \$0.9 million or more if the 2014 Supplemental VCP submitted to the IRS results in an interest rate other than the five percent (5%) simple per annum established by this policy.

Due to the initial contribution potentially made to the to the Pension Trust under this policy, there will likely be an increase in the Pension Trust assets which will have a positive impact on the County's annual required contribution (ARC) to the Pension Trust. However, absent this proposed policy, the Pension Trust would seek to collect these overpayments debts from affected members and beneficiaries, resulting in a positive impact on the County's ARC also once collected. Therefore, there are no fiscal savings from a reduction in the ARC that is attributable to the proposed policy.

Historically, the Pension Trust corrected overpayments and underpayments as part of its responsibility to ensure the Pension Trust and members and beneficiaries are "made whole." The proposed policy sets the guidelines for how the County should seek to recoup any overpayment debt it has acquired going forward. Generally speaking, any single overpayment or underpayment is not going to have an actuarial impact on the Pension Trust, which results in no fiscal impact on the County. It is worth noting, however, that in any event in which a significant number of members or beneficiaries are affected there could be a resulting actuarial impact to the Pension Trust assets or liabilities, which in turn could result in a fiscal impact on the County. Absent this proposed policy, these possibilities still exist, and therefore, there are no fiscal savings or costs attributable to the proposed policy.

FINANCIAL IMPACTS

Each of the provisions below has a fiscal impact. Some of these financial impacts are calculable, and others are not. Based on the calculable data available, the maximum County financial impact would be \$0.6 million. And although the proposed changes will result in future financial impacts, due to the character of the changes, it is not possible to calculate what the financial impact of these changes will be in future years. It is, however, likely to be substantially less than the financial impact described here. Moreover, the proposed changes are likely to result in efficiencies in administering the Pension Trust, which should provide additional savings through streamlined processes and reduced errors.

- **Commencing a retirement benefit on the first day of the month immediately following a member’s date of retirement and terminating that benefit on the last day of the month in which the member or beneficiary dies. This also includes setting the date of backdrop to the first day of the month immediately following a member’s date of eligibility, or some other first day of the month thereafter.**
 - The direct financial impact to the County results from potential changes to employee behavior at retirement due to the proposed changes. Current eligible employees could choose to retire earlier in the month, later or around the same time. Retiring earlier or later would provide a salary savings or a salary cost, respectively. Those retiring around the same time would have no fiscal impact. The fiscal savings or cost of this provision is incalculable because it is not known how employees will react to this change.

Although the Pension Trust expenses may be slightly reduced by eliminating a partial month payment at the commencement of the benefit, conversely, the expenses are slightly increased by allowing a full month payment at the termination of the benefit. Back drop payments are similar in that Pension Trust expenses may be slightly reduced by eliminating a partial month payment at the commencement of the back drop, but conversely, the expenses may be slightly increased by paying a slightly higher monthly benefit amount due to the nominal increase in service credit and the full month payment at the termination of the benefit. While these scenarios do not have a direct financial impact on the County, they may either increase or decrease the expenses of the Pension Trust which ultimately impacts the County.

- **Assigning an interest rate on overpayment recoupment options and on underpayment reconciliations at five percent (5%) simple interest per annum.**
 - **Overpayment Recoupment Option 1:** The County is repaying the Pension Trust on behalf of the member or beneficiary for the total outstanding principal and interest owed as of a date certain. Under this option, the County also agrees to forgive the member or beneficiary for any interest paid to the Pension Trust. Five percent (5%) simple interest per annum results in a lower maximum financial impact for the County in option 1. As shown in the table below, a five percent (5%) simple interest per annum results in a potential maximum interest liability of \$608,000 for all known overpayments.

Interest Rate	Interest Owed as of 5/31/2019
5 % Simple	\$608,000

5 % Compound	\$805,000
8 % Simple	\$983,000
8 % Compound	\$1,545,000

The above amounts assume an interest calculation that pays all principle owed as of May 31, 2019. If the principal is not paid off as of May 31, 2019, additional interest will accrue and result in a higher maximum financial impact to the County. Furthermore, if the principal is paid off on May 31, 2019 (or some subsequent date) at five percent (5%) annual simple and the 2014 VCP results in a different interest rate owed, the County would incur additional fiscal costs to pay the difference.

Option 1 may also result in additional interest accruing on the outstanding principal balance. The policy provides a 12-month grace period at zero (0%) interest for members or beneficiaries that choose option 1. After 12 months, the principal balance would accrue five percent (5%) simple interest per annum. *Any interest earned under this provision reduces the County's maximum financial liability.*

- Overpayment Recoupment Option 2: Generally, this is the status quo, with the exception that the interest rate applicable is now set in ordinance. This policy sets the interest owed from the date the overpayment is made to five percent (5%) simple interest per annum. Although there is no direct financial impact on the County, five percent (5%) simple interest per annum generally reduces the amount that could have been collected under a higher interest rate scenario. In a higher interest rate scenario, the collections of the Pension Trust would be higher, which would have a more positive financial impact on the County.
- Underpayment Reconciliation: Setting a five percent (5%) annual simple interest when the Pension Trust reconciles underpayments with members or beneficiaries reduces the overall cost of reconciliation for the Pension Trust. While this does not have a direct financial impact on the County, it does reduce the expenses of the Pension Trust which ultimately benefits the County.
- **Enacting a claim period for the correction of overpayments and underpayments.**
 - Claim period for overpayments: The period for which a member or beneficiary is responsible for the repayment of an overpayment is limited to those overpayments made within the six years immediately preceding the date of claim. The County would be responsible for repayment of any overpayments older than six years. Cases with overpayments older than six years would result in a direct financial cost to the County as the County would be the responsible party for any overpayments six years or older. This provision is written prospectively, such that any payment made after January 1, 2019 will have a six-year claim period attached to it. This provision will not apply retrospectively so there will be no financial impact related to this provision until at least 2025.

- Claim period for underpayments: The period for which the Pension Trust is responsible for reimbursing members or beneficiaries for underpayments is also limited to those made within the past six years. Any underpayments six years or older would not be owed to the member or beneficiary. Cases with underpayments older than six years would not result in a direct financial impact to the County but would reduce the expenses of the Pension Trust which ultimately benefits the County. This provision is written prospectively, such that any payment made after January 1, 2019 will have a six-year claim period attached to it. This provision will not apply retrospectively so there would be no financial advantage related to this provision until at least 2025.
- **Providing for the forgiveness of interest paid by the County on behalf of the member or beneficiary to the Pension Trust when agreeing to certain terms of recoupment.**
 - As discussed previously, Overpayment recoupment Option 1 allows the County to repay the Pension Trust on behalf of the member or beneficiary for the total outstanding principal and interest owed as of a date certain. The policy also allows the County to then forgive the member or beneficiary for any interest paid to the Pension Trust. If each of the members or beneficiaries with known overpayments (except those possibly forgiven under the claim period rule) select Overpayment Recoupment Option 1, the County would have a maximum liability of \$0.6 million. It is likely that some members or beneficiaries will chose "Option 2", which then reduces the County's maximum liability by the total amount of interest owed by that member or beneficiary.

The maximum liability for the forgiveness of interest of \$0.6 million assumes an interest rate of five percent (5%) simple per annum. *The 2014 Supplemental VCP could result in a different interest rate which could increase the maximum liability by as much \$0.9 million.*

This fiscal note does not address potential financial liabilities created by this policy in the future. Although there will likely be costs associated with this policy in the future, it is likely to be substantially less than the amount reported here. And since these costs will be paid from the Pension Obligation Bond Reserve, there is no direct fiscal impact to the County's bottom line until the Pension Obligation Bond Reserve requires replenishment.

- **Establishing a de minimus amount such that certain debts are not collectible and certain liabilities are not payable by the Pension Trust.**
 - Overpayment de minimus rule: The policy establishes a de minimus amount such that any overpayment debt, inclusive of interest, that is less than \$165 is an overpayment debt owed to the Pension Trust by the County and not by the member or beneficiary. Of the known overpayment cases, 31 cases at five percent (5%) simple interest result in an amount less than \$165, for a total financial cost to the County of approximately \$2,000.
 - Underpayment de minimus rule: The policy establishes a de minimus amount such that any underpayment debt, inclusive of interest, that is less than \$65 is not payable by the

Pension Trust. Although the underpayment de minimus rule does not result in a direct financial impact to the County, it does reduce the expenses of the Pension Trust which ultimately is an advantage to the County.

BUDGETARY IMPACT

The policy proposes using funds from the Pension Obligation Bond Reserve to make the initial payment of principal and interest to the Pension Trust for those that choose Overpayment Recoupment Option 1. The total principal and interest (at five percent (5%) simple per annum) owed for ALL known overpayments is \$1.6 million and \$0.6 million, respectively. Because there are sufficient funds in the Pension Obligation Bond Reserve to make the entire payment of \$2.2 million, additional funds would not be needed. Therefore, there would be no budgetary impact in the current year. If the Pension Obligation Bond Reserve were completely depleted, additional funds would need to be added to fund this policy. At that time, there could be a budgetary impact.

ASSUMPTIONS

- The amounts included in this fiscal note are based off a review conducted by Baker Tilly of 262 files marked as potential overpayment issues by RPS. Baker Tilly worked with RPS staff to determine what amounts were owed by these 262 members and beneficiaries. Baker Tilly determined that of the 262 files marked as potential overpayment cases by RPS, 188 had overpayment errors with a total of \$1.8 million in principal and \$0.7 million in interest. Subsequently, RPS staff provided the Comptroller with assurance that the calculations done by Baker Tilly were reasonable. The Comptroller has not been provided with any updates to the original list of 262 files, but it is possible that additional overpayments exist or amounts have changed that are not included herein.
- Of the 188 case files with overpayment errors, three cases were determined to be in litigation and therefore, this ordinance does not apply. Members or beneficiaries with overpayments that are currently in litigation are not able to take advantage of Overpayment Recoupment - Option 1 to avoid the obligation to repay applicable interest as a matter of right because they are already seeking a resolution of the dispute over their pension benefit through the court system. As a result, the fiscal impact of those cases is not included in this analysis. However, to put those litigated matters into context, if all 3 matters currently in litigation were to be resolved through Overpayment Recoupment - Option 1, the cost to the County would be \$276,000 in principal and \$104,000 in interest.
- This fiscal note assumes that the proposed five percent (5%) simple interest on overpayments and underpayments applies to those liabilities that the County assumes. If the 2014 Supplemental VCP requires a different interest rate, the amounts payable by the County provided herein will change.
- The proposed policy commits the County to paying the full principal and interest to the Pension Trust on behalf all members and beneficiaries that choose Overpayment Recoupment Option 1. The assumption is that members or beneficiaries will reimburse the County for the full principal paid to the Pension Trust on their behalf. It is likely that there will be cases in which the principal is not fully repaid to the County. Although this results in an expense to the County, it is not included as a fiscal impact because that scenario is possible under the status quo.

- This fiscal note also assumes that the Pension Trust will actively seek to collect all overpayments related to “death overpays” and that the County would only be potentially responsible for interest. Of the known cases, there is approximately \$140,000 in outstanding principal and \$26,000 in outstanding interest owed by members or beneficiaries that are deceased. The County may be responsible for some or all the principal and interest in the future in these cases. The County would have likely been responsible regardless of this policy, so therefore, this fiscal note assumes no fiscal impact for the principal owed due to death overpayments. This fiscal note does assume that the interest could be forgiven and includes the \$26,000 in the maximum financial impact the County could incur from the proposed policy.
- With respect to potential financial savings achievable from a reduction in the County’s ARC, this fiscal note assumes none. In terms of overpayments and underpayments, a change to the ARC would be a result of either an actuarial change in liabilities or an actuarial change in assets attributable specifically to this ordinance.

Changes in Pension Trust liabilities occur when a retirement benefit is recalculated; however, this change offsets the change in liabilities that occurred when the retirement benefit was originally calculated. For example, prior to retirement, actuarial valuations project Employee X’s liability at one amount, and allocate that charge to the County. If at retirement an erroneous retirement amount was granted to Employee X, the subsequent actuarial valuation would likely result in an adjustment to the total pension liability to account for the difference between the projected and actual liability for Employee X. This adjustment is then offset by another adjustment to the liability once the error is identified, and the actual retirement amount recalculated. The two adjustments offset each other. Furthermore, the correcting of retirement amounts is not a new practice, but one that has been exercised historically. Therefore, any change to the ARC due to liability modifications is not a direct result of these proposed ordinance changes and would have occurred regardless.

Currently, the Pension Trust assets change as overpayments are recouped and underpayments are paid out. The proposed ordinance changes do not affect this; rather, the proposed ordinance change is directing who is responsible for fulfilling the repayment obligation for overpayments in certain situations. In other words, the Pension Trust under both current ordinances and proposed ordinances is required to be made whole and although a change to the assets may result, assets would have changed regardless of who made the payment. Therefore, any changes to the ARC due to asset modifications is not a direct result of these proposed ordinance changes and would have occurred regardless.



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