The Florida Senate

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Committee on Governmental Oversight and Productivity Senator James E. "Jim" King, Jr., President

IMPLEMENTATION OF THE NEW FUNDING STRUCTURE OF THE FLORIDA RETIREMENT SYSTEM

SUMMARY

The 2000 Florida Legislature enacted an alternative pension choice for the more than 600,000 employees participating in the multi-employer Florida Retirement System. As part of the two-year transition period preceding employee choice, the Legislature changed the method of assessing employer payroll contributions. The new "blended rate" system made assumptions about the numbers of current and new employees selecting the new plan and crafted a contribution rate weighted to these estimates.

The economic retrenchment following the worldwide economic recovery of the late 1990s proved these estimates wrong. Employees neither switched to nor enrolled in the investment plan regardless of the long-term soundness of this decision. The failure of these transfers to occur may affect the contribution rate structure of the FRS for the following year. With a concurrent legislative decision to set pension plan rates annually in general law, the 2003 Legislature may have to factor a revised set of expectations into the new rate structure for the next budget year.

BACKGROUND

The 2000 Florida Legislature enacted the most sweeping changes to public employee retirement since the creation of the Florida Retirement System (FRS) some thirty years earlier.[1] Until that time the FRS, and its predecessor separate systems, operated solely as a traditional defined benefit, or percent of final pay pension plan. In creating a defined contribution alternative, the Legislature recognized that a one-size-fits-all approach was unsuited to every circumstance. In the legacy defined benefit plan employees were assured of an annuitized benefit at retirement expressed as a percentage of average final compensation. The plan assumes all of the investment risk and the annuitized guarantee acts in place of any employee having an equity interest in or exposure to the plan's assets or liabilities.

Such plans are designed to reward long-term employment, if not within the same career and with the same employer, than certainly among any of the 800 employer-members of the FRS at all levels of state and local government. Pension portability is limited to the universe of these employers although the law does permit participants to purchase service from other public systems at their own expense.[2] Generally, a defined benefit plan works best for those who are career-oriented and who value stability and predictability over change. A defined contribution choice is better suited for those who change jobs frequently or prefer to self-direct their investment choices.

In addition to having the lowest administrative costs of any pension plan in the nation, the FRS has both the defined benefit Pension Plan and its new defined contribution Investment Plan qualified under the federal Employee Retirement Income Security Act (ERISA). It is believed that these two plans are the only state public pension plans so designated, even though federal law exempts government-sponsored plans from qualification.[3]

[1] Ch. 2000-169, Laws of Florida.

[2] Additionally, since 1990, s. 121.45, F.S., has permitted the Department of Management Services to enter into interstate compacts with other states for development ". . .of a proposal under which retirement credit may be transferred to or from Florida in an actuarially sound manner." No such compact is currently in effect.

[3] ERISA provides a standard of investment prudence and fiduciary conduct to which private pension plans must adhere. This qualification is also referenced in Part VII of ch. 112 and ss. 121.4501 and 215.47, F.S. Moreover,

While the stability and income assurance of the Pension Plan was its hallmark, that very rigidity made it unsuitable as a competitive recruitment tool in a changing labor market. The newly created defined contribution plan permitted employees to achieve a self-managed, portable, equity interest in their own accounts. With an earlier vesting schedule the Investment Plan afforded both current and new employees a full range of choices for the financial underpinnings of their own careers.[4] The defined contribution plan, normally the province of small or globally competitive employers, has come to dominate the pension marketplace. Even among some public employee groups, it is a major employee choice.[5]

The transition to the new plan took place over a two-year cycle with the first choice period allotted to state employees. Two remaining open enrollment periods were established for district school boards and community colleges ending in October 2002 and local governments[6] concluding in February 2003. Thereafter individuals could switch between the plans only once within their employment careers. A statutory formula calculates the present value of the accrued benefit and transfers it through a third-party administrator to a provider company selected by the participant.[7]

For the past three years the FRS has experienced an excess of assets over liabilities. While such a surplus is nominally a non-recurring item, the Legislature has chosen to allocate a portion of it across all employer groups to subsidize their payroll pension expense and to fund other plan changes.[8] For the year 2003 the total plan surplus is estimated at $12.8 billion with about $850 million available under the statutory formula for these purposes. The FRS fully paid off its unfunded liability in 1997 which, at its peak, reached $16 billion. With separate legislation partitioning the surplus into an available and non-available tranche,[9] FRS employers have enjoyed the effect of the market gains of the late 1990s for years following the nominal end of the recovery.[10] Any prolonged retrenchment in financial markets affects the surplus in like fashion. The below table indicates how recent changes to worldwide financial markets have affected FRS revenues, expenditures, and income.

FRS Contribution and Benefit Trends, FYs 1999 and 2001, $ 000,000[11]

FY	Employer Payroll	Benefit Payments	Investment Income
1999	$ 3160	$ 2315	$ 1158
2001	$ 2078	$ 2796	($ 7826)

Combined with lower hiring levels among state employers and smaller growth among non-state entities, the negative cash flow and reduced investment income can combine to significantly impact these excess amounts. The below employer payroll pension contribution rates display the subsidized FY 2002-03 rates and the effect on FY 2003-4 if funding of the system returns to its unsubsidized, normal cost. The DC rate is fixed in law and does not vary as a function of investment gains or losses.

section 14, Art. X, State Constitution requires funding of all public pension plan benefits in a sound actuarial manner.

[4] Since the 1980s, personnel in the university and community college systems and designated managerial personnel may also enroll in separate optional annuity defined contribution plans in lieu of FRS membership.

[5] The number of defined benefit plans insured by the Pension Benefit Guaranty Corporation declined from 114,400 in 1985 to 35,200 in 2001. By 1998, total plan assets were evenly divided between both plan types. Employee Benefit Research Institute, *Issue Brief: An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans.* September 2002.

[6] All county employers including constitutional entities, and those municipalities and special districts voluntarily electing membership in the FRS.

[7] Participants may allocate their assets from among listed funds offered by five competitively procured provider companies and a sixth, unbranded choice selected by the SBA.

[8] The FY 2002 offset to normal employer costs from available excess FRS assets is $1,237,000,000.

[9] Section 121.031, F.S.

[10] Assets are valued on a five-year rolling average. The respective actuarial/market values of the asset earnings for the five currently recognized years beginning in 1998 and ending in 2002 are 16.31/21.87%; 14.80%/13.76%; 13.79%/10.82%; 8.82%/-6.93%, and 5.44%/-7.62%, respectively. The assumed rate of return is 8%.

[11] Excludes other income, expenditures, and refunds. Florida Retirement System, *Annual Report,* July 1, 2000-June 30, 2001, Schedule A.

FRS Employer Payroll Contribution Rates, Blended DB and DC, FYs ’03 and ‘04[12]

CLASS	DB 02-03	DB 03-04	DC
Regular	4.50 %	9.87 %	9.00 %
Sp Risk	14.75 %	22.89 %	20.00 %
SRAS	5.30 %	12.58 %	11.35 %
Elect - S	8.15 %	15.43 %	13.40 %
Elect - L	10.60 %	17.52 %	16.20 %
Judicial	14.60 %	20.54 %	18.90 %
Sen Mgt	4.80 %	11.68 %	10.95 %
DROP	8.00 %	11.56 %	N/A

The current rate structure is based on a proportional “blending” of defined benefit/defined contribution participant enrollment assumptions. Estimates of the numbers of persons electing the Investment Plan were calculated and the proportional share of payroll costs were factored into the overall rate charged employers. As is discussed below, these election estimates proved incorrect and funding adjustments may be required by the 2003 Legislature.

METHODOLOGY

The report reviews the recent history of the changes to the Florida Retirement System begun by the 2000 Legislature. It relies on documents generated by the FRS investment manager, the State Board of Administration (SBA), and the plan actuaries retained by the benefit payer, the Division of Retirement in the Department of Management Services.

FINDINGS

The first quarter in 2000 is generally recognized as the high point of the economic recovery that persisted for the prior decade. One year later the economy was in recession.[13] At the peak of the recovery the FRS reached a market value of $110 billion. By August 31, 2002, the portfolio’s market value declined to $85.3 billion. Total U.S. stock equity values declined by $ 9 trillion over that same period.

It was at this time that estimates were developed for the expected transition to the Investment Plan beginning in mid-2002. The initial estimates anticipated a cumulative asset transfer range between $8 billion and $13 billion and a plan-wide enrollment of 178,000 employees. Subsequent recalculations reduced the estimate to 150,000. The SBA developed a comprehensive individual, group and Internet-enabled information and education program for participants to engage in informed decision-making.

At the conclusion of the first enrollment period for state employees, themselves some 25% of total plan membership, fewer than 6% of eligible participants had elected to join the new plan and only $112 million of assets had changed hands.[14] The plan administrator reported about one-third of state employees making an active choice out of 155,480 eligibles, with 94% of them electing the Pension Plan. Fewer than 3% of those switching chose the hybrid option, that is, a freezing of the current Pension Plan benefit with subsequent contributions directed to the Investment Plan. Interestingly, a disproportionate number of younger and shorter service employees chose the Pension Plan despite the education materials indicating this alternative to be of lesser benefit than the Investment Plan.[15]

Enrollment data for education employers revealed an even more decided preference for the status quo at the completion of that enrollment period in November. Suffice it to say that the estimated Investment Plan enrollments significantly also fell short of estimates. Cumulative enrollment statistics through December 6, 2002, are displayed below:

FRS Choice Statistics Through December 6, 2002

Group	DB	IP	Hybrid	Total
State	155560	8792	244	164596
ED	290766	7620	275	298661
Tran$fer		$182		

[12] Sections 121.71 and 121.72, F.S. Excludes additional payroll costs for DC participant disability coverage and retiree health insurance subsidy in s. 112.363, F.S., not part of normal cost.

[13] In its September 27, 2002 “Economic Outlook” the SBA discussed the additional role that stock options played in the $148 billion misstatement of 2001 wage and salary income by the U.S. Department of Commerce.

[14] Education materials were oriented toward each participant making an active enrollment choice. The law, however, provides that a failure to take any action, a passive choice, defaults the participant into the Pension Plan; ss. 121.4501(4), F.S.

[15] State Board of Administration, “Statistical Recap for State Employees,” September 27, 2002.

Theory would suggest this to be a surprise inasmuch as the education field is one in which portability and mobility are dominant features. But here, too, practicality may have won the day: these workforces are also long-serving and inclined to view a familiarity with durable, employment-based benefits as a better choice than a market result.[16] A number of these employers also use salary step plans which are "back-loaded," that is more generous to those with longer service than to those with shorter service. Education-based employers also have large non-instructional workforces - paraprofessional, food service, administrative support, transport, and maintenance - less suited to job change.

At this early juncture some analysis of the actual trends suggests that a variety of factors are at work. *First*, the overall uncertainty of the economy may be reinforcing behaviors that stress stability, even among those for whom the Pension Plan is not the prudent choice. In a full-employment economy, pension portability would be consistent with career progression through job change. In a retrenching economy, an Investment Plan choice may be perceived as synonymous with both equity and job loss.

Second, the State of Florida is not in the direct hiring mode it once was. Almost 40% of the state budget is comprised of special category appropriations, or lump sum payments to contractual providers, few of whom create defined benefit plans for their employees.[17] New job growth is, in effect, occurring outside of public employment even though it is underwritten with public funds. To that extent, investment plan choice is occurring, although it is off-budget and cannot be measured as easily. The residual workforce, in flat or negative growth, is populated with individuals well-positioned in the defined benefit plan. Over the past three years there has been an almost 30% increase in the number of annuitants per 100 active members. The rising presence of these retirees will soon come to dominate the covered workforce, unless hiring trends are altered.

And, *third*, governments across the board are populated with employees beginning their exit into retirement. These retirement benefits are fixed in pension plans which reward longer service. It is reasonable to assume that such long-serving employees will be motivated financially to remain just where they are.

And, *fourth*, more than two-thirds of the assets transferred to the Investment Plan were allocated among products offered through the SBA's own in-house funds. This high degree of confidence in the management expertise of the investment manager seems to indicate a much more circumspect view of the outside financial markets. It may also suggest a preference for generic products when the underlying reputation of the manager is established and well-known.

RECOMMENDATIONS

The dramatic differences between expected and actual enrollments in the Investment Plan are not surprising given the shift in the economy which started in late 2000. There are a number of policy changes which can influence these numbers in different directions, but these lie outside the scope of this report.

Clearly, what will be required for the FY 2004 budget will be a recalculation of the assumptions used in employee selection and the development of a revised blended rate structure which addresses an available surplus.

[16] A 2000 legislatively commissioned study of education majors in the State University System revealed that health and retirement benefits were the most important workplace benefits cited by respondents. Salary considerations ranked third. *Education Majors' Teaching Expectations and Views on Job Benefits: A Census of Education Majors at Florida State University*. Florida State University, February, 2000.

[17] The 1995 Legislature also permitted local government employers to discontinue their FRS membership by January 1, 1996. The 78 cities, public hospitals, and special districts exercising this option prospectively enrolled new employees in their successor plans.