The Florida Senate

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

SETTING THE FRS 2005 RATES AND PROVIDING INCENTIVES FOR CRITICAL STAFFING

SUMMARY

The multi-employer Florida Retirement System (FRS) concludes its financial year with an actuarial surplus relatively unaffected by the decline and partial recovery of world financial markets. Legislation setting the current rate structure expires in July 2004 and will require an additional rate bill to prevent the setting of default contribution rates that will substantially increase current employer assessments. The size of the surplus and its durability since its 1998 creation has attracted the attention of the United States Department of Health and Human Services. That federal agency has opined that the FRS must refund excess employer contributions to the federal treasury as an offset to federal reimbursement for state grants-in-aid programs. The 2003 Legislature used the FRS as a recruitment and retention tool for critical public infrastructure. In so doing it joined the ranks of other state pension plans that use enhanced retirement income as a lever in meeting important public policy initiatives. The report recommends continued caution in the use of non-recurring surplus pension funds for recurring purposes and recommends that tailored use of pension incentives can meet longer term public policy objectives.

BACKGROUND

The Florida Retirement System (FRS) is a multi-employer pension system providing both defined benefit and defined contribution pension choices for its more than 800 employer and 625,000 employee participants. Investment management is undertaken by the Board of Administration with benefit payments made by the Department of Management Services. Defined benefits are payable through one of four annuity payment options that permit unreduced and survivors' income. Participants in this plan are permitted to partition their benefit into a Deferred Retirement Option Program (DROP) during their last five to eight years of service.[1] Its defined contribution or *Investment Plan* permits the employee to have full equity ownership in personally directed investment choices. Both plans are funded entirely by the employer with rates set uniformly within the six membership classes.[2] For the past several years the FRS has recognized gains from its actuarial surplus to subsidize the normal cost of the plan. The surplus recognition is authorized in s. 121.031, F.S., and allows recognition of a portion of excess assets to temporarily offset total retirement system costs or the costs of other benefit improvements.

METHODOLOGY

The report uses materials developed through the FRS Actuarial Assumption Conference created in s. 216.136(12), F.S., and other materials maintained by the Board of Administration and the Department of Management Services.

FINDINGS

Pension plans throughout the nation have struggled to meet their financial obligations following the recession of 2000 and the lagging financial recovery. Plans with heavy fixed income investments fared better than those with high equity exposure. However, any sustained recovery with higher interest rates will erase those

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[1] The 2003 Legislature extended by three years the five-year maximum participation term in DROP for public school instructional personnel in grades kindergarten through 12.

[2] The membership classes, their respective accrual rates and normal service in years are: Regular Class (1.6%-1.68%/30); Special Risk (3.0%/25); Special Risk Administrative Support (1.6%/25); Senior Management (2.0%/30); Elected Officers (3.0%/30); and Judges (3.33%/30).

recession-induced gains. The FRS experienced a correction typical of its peers with a two-year peak-to-valley swing of some $22 billion. Since the late 1980s the FRS has moved toward greater equity concentration with about three-quarters of its investments in that class.[3] It has also begun to repackage its management of assets from an active to a passive operation. While equity exposure produces volatility during market corrections, the asset class has proven to be a stellar performer in recoveries, allowing the overall plan to produce significant gains in excess of liabilities.[4]

The very existence of the surplus, or its more formal title of "negative unfunded accrued actuarial liability," has produced an anomaly of its own. As part of a periodic audit of federal funds, the United States Department of Health and Human Services indicated that the surplus was "in excess of amounts reasonable and necessary to fully fund benefits."[5] It directed the FRS to reduce funding levels or refund $267 million in excess contributions to the federal treasury. The Department of Management Services rejected the analysis and conclusions and in a series of correspondence exchanges with the federal agency indicated it would contest the claim. No quick resolution of this claim is anticipated and in jurisdictions where similar claims have been lodged final resolution has compromised or eliminated altogether the requested repayments.

The 2003 Legislature also implemented pension plan changes that permitted the use of retirement benefits as a professional recruitment tool. Facing a known depletion of classroom teachers for the next decade, Florida has had to devise multiple means of addressing instructional shortages, only aggravated by a state constitutional requirement of improved classroom student to teacher staffing. The 2003 legislation loosened the statutory restrictions on the reemployment of retired teachers and permitted instructional personnel participating in the deferred retirement option plan to extend their participation by another three years. While these initiatives do not address fully the systemic depletion in the teaching ranks, they do reflect a growing use of benefit plans as recruitment tools for new generations of public employees. Among the types of pension inducements used elsewhere are increasing the ability to purchase retirement credit with or without prior public service, progressive accrual rates to reward retention, and higher pension calculation formulae to boost the final benefit. Some of these changes have been introduced over the years as individual bills. The only appreciable change that has been enacted into law, however, was the lowering of the vesting schedule to 6 years in 2001.

RECOMMENDATIONS

There appears to be satisfactory financial capacity to maintain the use of the pension surplus for rate subsidy. Over time, however, that attraction will become a distraction as the use of a nonrecurring revenue source for recurring purposes will produce a sustained imbalance of revenues. The actual cost of providing benefits will inevitably approach normal cost. While the plan actuaries[6] estimate the composite rate charged FRS employers will rise only 10 basis points next year (11.62% to 11.72%), the gap between present cost and normal cost is some 400 basis points.

Though a young system in comparison to its peers, the FRS must contend with the financial consequences of increased retirements and lessened workforce additions. This will place upward pressure on benefit costs that can be offset only by greater investment return, and risk, or by lower investment expectation. Except for the creation of the personally directed *Investment Plan*, no sustained dialog has developed on the proper role to be played by the employer and the employee in the assurance of adequate retirement income. As the delivery means for governmental services becomes less direct and more pluralistic, the types of private sector initiatives used to address this behavior will become more important.

Lastly, the use of targeted pension improvements is well-developed in both public and private sectors, although it is frequently exercised only in times of retrenchment. Their greatest value is in shaping a workforce for the future that implements a business plan that combines a desired labor force with a proven delivery process.

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[3] Equity investments are distributed across domestic and foreign equity, real property, and alternative asset classes. About a quarter of fund assets are invested in fixed income and cash.

[4] The actuarial value of excess assets over liabilities declined by only $200 million during the prior fiscal year leaving a pension "surplus" of $12.7 billion.

[5] Department of Health and Human Services, Office of Inspector General, "Audit of the Reasonableness of Florida Pension Charges to the Federal Government for State Agency Employees, Report Number A-04-02-00012, September 2003.

[6] Milliman USA, October 10, 2003 presentation to the Actuarial Assumption Conference.