The Florida Senate

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Committee on Governmental Oversight and Productivity Senator Nancy Argenziano, Chair

EMPLOYER PAYROLL CONTRIBUTION RATES FOR THE FLORIDA RETIREMENT SYSTEM

SUMMARY

Though young in comparison to its state peers, the Florida Retirement System (FRS) continues to enjoy superior returns for its more than 800,000 members and beneficiaries. The report recommends the setting of rates that permit recognition of the plan's changing participant base but without disruption to its long-term investment strategy, program integrity, or employer affordability.

BACKGROUND

The Florida Retirement System (FRS) was created in 1970 as the successor entity to two separate state and local government pension plans. By 1972 it combined the operations of four separately constituted state pension plans.[1] Over the years it has grown to serve 837 separate units of government with some 595,000 active and 209,000 retired members and beneficiaries. More than three-quarters of its employer-members are property tax-based local governments. Constitutional units of local government are compulsory members; statutory units are optional members.

The FRS is a *defined benefit plan* (DB) in which the participant receives an annuitized benefit expressed as a percentage of average final pay. It has six membership classes with annual benefit accrual rates ranging from 1.60% to 3.33% over nominal twenty-five or thirty-year terms of normal service. Since 2001 the FRS has permitted newly hired and existing employees to choose between this legacy plan and a *defined contribution* (DC) alternative which gives members a controllable equity interest in their investments. The FRS is a non-contributory plan in which public employers make all of the payroll contributions. Enrollment is universal and automatic upon hiring and a vested benefit occurs at six years' service in the DB plan and at one year in the DC alternative.[2] The Department of Management Services (DMS) administers benefit payments while the Board of Administration (SBA) is the investment manager. Consensus-based estimates of funding assumptions are provided by an Actuarial Assumption Estimating Conference.[3]

For the past several years the Legislature has chosen to implement the recalculation of the required actuarial rates through annually enacted legislation.[4] These rates have been set below the long term normal cost of 10%.[5] The difference is made up through a formula recognition of excess actuarial assets[6] remaining from the elimination of unfunded liabilities and superior investment performance during the economic recovery that ended in early 2000.[7] Valuations of the FRS occur

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[1] The Teachers' Retirement System (TRS); State and County Officers and Employees' Retirement System (SCOERS); the Judicial Retirement System; and the Highway Patrol Pension Fund.

[2] On August 21, 2005, the United States Department of Labor proposed a rule to provide automatic enrollment in employee 401(k) retirement plans by large employers. About one in five plans do so today.

[3] Section 216.136(12), F.S.

[4] Art. X, s. 14, State Constitution, requires all public sector pension plans to prefund promised benefits in a sound actuarial manner.

[5] On February 8, 2005, the SBA advised on its reservations on this funding practice. It reported five departures from recommended practice, principally citing those which used surplus recognition to subsidize long-term costs.

[6] Officially designated a Rate Stabilization Mechanism; s. 121.031, F.S.

[7] Among *Fortune 100*0 companies, pension funding levels have swung from a $300 billion surplus in 2000 to a $200 billion deficit in 2005. Unrealistic assumptions and high equity exposure in a declining market contributed to this $500 billion shift. Watson Wyatt *Insider*, July 2005.

after the close of the previous fiscal year and are usually received at the close of the calendar year.

FRS, Statutory Percentage Payroll Contribution Rates for DB and DC Plans, FY 2005-06[8]

Retirement Class	DB	DC
Regular	6.67 %	9.00 %
Senior Management	9.29	10.95
Special Risk	17.37	20.00
Special Risk Admin.	8.76	11.35
Elected Officers - State	11.33	13.40
Elected Officers - Local	14.07	16.20
Justices and Judges	17.49	18.90
DROP	8.22	NA

METHODOLOGY

The project reviews the FRS rate structure and discusses contemporary issues relating to investment strategy and changes to the public workforce being experienced in Florida and elsewhere. It relies upon current and past work papers developed through the statutory estimating conference process.

FINDINGS

The FRS is a young plan in terms of chronological age but it is also dealing with the phenomenon of increased retirements of children from the World War II generation hired during the government expansion of the 1960s and 1970s. The ratio of retirees to active employees continues to increase - from 24:100 in 1995 to 43:100 today - and this itself has led to calls for deliberate funding recognition of this beneficiary group.[9] The "immunization" of these promised benefits from disruptive economic cycles can produce a robust discussion. A maturing plan would want to counsel investment discipline to provide assurances that its expanding beneficiary group is shielded from economic cycles. Immunization is already a permitted directive to the portfolio composition of the supplemental retirement plan for eligible employees of the Institute of Food and Agricultural Sciences (IFAS) at the University of Florida.[10] But the IFAS plan will be soon facing a serious reconsideration of its funding base due to this structure and a declining participant base. A rapid immunization strategy can change investment discipline so markedly that a risk-averse posture transforms the plan into one reacting to a market, not participating in it. A pension plan seeking to avoid risk by also avoiding gain can find itself engaged in complex hedging strategies or increasing its ownership of government securities at the expense of equity market investments.[11] As returns become more predictable they decline, forcing an increase in the employer contribution rate.[12] Immunization may be an uncomfortable salve to a wound that is self-inflicted.[13]

Three financial assumptions underpin the FRS: investment returns of 7.75%,[14] wage increases of 5%,[15] and post-retirement increases of 3%. Going forward the wage and return assumptions may seem a bit high as salary increases are trending downward to the historic inflation rate of 3.5% and are contending with employee wage hikes outside of the pension formula. Repeating the returns of the 1990s may be similarly strained and governments are adopting a number of less labor-intensive strategies to restrain direct workforce growth. From the participant standpoint, a

[8] Sections 121.71 and 121.72, F.S; ch. 2004-293, LOF. The above amounts represent contributions for normal benefits only and exclude statutory additives for a retiree health insurance premium subsidy, disability, and administration. DB contribution amounts vary with investment performance; DC amounts are fixed by statute.

[9] OPPAGA, *Report 04-70: Multi-Year Projections of Retirement System Funding Should Be Provided to the Legislature*, October 2004.

[10] Section 121.40(13)(a), F.S.

[11] Presentation by Bill Clark, Deputy Director, NJ Division of Investment, *Two Years After 9/11/01, Impact on Institutional Plans: Rethinking the Paradigm*, www.interdependence.org/presentations. A frequent academic advocate of pension immunization has been Zvi Bodie who, with Michael Clowes, has popularized this complex subject in the book *Worry-Free Investing: A Safe Approach to Achieving Your Lifetime Financial Goals*, NY, Financial Times Prentice Hall: 2003.

[12] See also Board of Administration, *SBA Response to OPPAGA's Preliminary and Tentative Report*, October 6, 2004.

[13] Commentary on the vagaries of financial markets are by no means confined to Florida. See Kotlikoff, L and Burns, S, *The Coming Generational Storm*, Cambridge, MA: MIT Press, 2005.

[14] Revised from 8.00% for 2005 and subsequent actuarial valuations. A lower percentage anticipates a more stringent return environment with higher contribution rates.

[15] Inclusive of an inflation increase of 3.50%. MillimanUSA, *Florida Retirement System Actuarial Valuation as of July 1, 2003*, Appendix A, p A-7. These assumptions were revised to include a general salary inflation of 4% and a price inflation of 3% in the 2004 mortality and morbidity study. Milliman, *June 30, 2003 Experience Study Results of the Florida Retirement System*, October 2004.

lessening of recognized salary increases can cause a shortfall in expected retirement income. From the employer standpoint, benefit costs are suppressed in the short-term.

The preliminary results of the October 21, 2004, meeting of the Actuarial Assumptions Estimating Conference pointed to a healthy FRS, with assets far exceeding liabilities.[16] The plan continued its over-funded status that permits recognition of excess assets to support the employer-paid rate structure. Favorable investment returns coupled with revised expectations should provide changes to the rate structure within a narrow, but increasing, band.

Other jurisdictions have begun to examine their workforce demographics, having concluded that serious consideration should be given to advancing the retirement of those nearing the end of their careers. They do this for various reasons but principally these states are attempting to change the delivery of public services from direct to indirect means or to leverage their payroll obligations to replenish vacated positions with those commanding lower salaries. Florida's governor formalized interest in this issue in a 2004 directive that called for specific study and development of one or more such legislative proposals.[17] The DMS prepared a discussion paper that briefed possible options.[18]

Public sector retirement plans tend to be unique creatures with features customized to the particular governmental jurisdiction. Early retirement initiatives are no less so. The states of Virginia, Illinois, Michigan and New York have enacted such changes in the past several years, each different from the other with varying degrees of success and expense. California enacted similar changes some four years earlier but its former governor vetoed more sweeping ones two years ago. Recent study in that state has questioned the usefulness of large-scale retirement attritions that effect only marginal results with higher costs.[19] Shorter-term financial horizons preoccupy California but recommendations offered to its new administration did suggest that limited retirement incentives can provide an outcome beneficial to employer and employee. Caution should rule any such initiative as attrition can both minimize infrastructure costs and overestimate savings.[20] Since a portion of the rationale used for such initiatives contemplates additional sourcing of government functions to the private sector, there may be an accompanying reduction in employee headcount but no in-kind change in the totality of government service delivery scope or costs.

Florida's recent experience is instructive in this regard. In the ten fiscal years ending in June 30, 2006, appropriations for indirect, vendor-delivered services doubled. The two-to-one ratio of vendor to state employee service dollars of 1995 is now four-to-one in a state budget that has increased at more than twice the rate of overall inflation.[21]

RECOMMENDATIONS

The FRS is in a period in which the investment gains of a prior decade may be more difficult to replicate. A reconsideration of expected returns may only slightly increase employer costs. It could also season the plan to a more normalized cost structure necessitated by a more disciplined investing environment and a changed participant base without the resort to complete repackaging of its assets.

Early retirement legislation can assist governments looking to realign their human capital assets. But only disciplined and executable changes to business processes can avoid strategic losses in knowledge capital to the implementing governments, unforeseen costs to future generations of taxpayers, or social costs to affected participants who realize reduced retirement income as they begin to fully bear increased health care costs.

[16] The Actuarial Assumption Estimating Conference, *Preliminary July 1, 2004 Actuarial Valuation Results*, October 21, 2004.

[17] Executive Order Number 2004-89, s. 7.

[18] Department of Management Services, *Managing Human Capital - A 'First Step' Retirement Incentive Lump Sum Pay-Out*, September 29, 2004.

[19] California Performance Review, *Controlling Retirement Incentive Costs*, Sacramento, CA, 2004.

[20] The City of San Diego, CA recently experienced the worst of all possible pension worlds: higher retirement costs, reduced affordability, and criminal indictments of plan fiduciaries. *Report of Investigation*, San Diego, CA, September 16, 2004. A retrospective review of the State of Virginia's experience indicated similar problems as replenishment rates eroded much of the promised savings. Joint Legislative Audit and Review Commission of the Virginia General Assembly, *The 1991 Early Retirement Incentive*, Richmond, VA: May 3,1995.

[21] Ten-year analysis of Special Category Appropriations, LAS/PBS, July 2005.