The Florida Senate

Interim Project Report 2008-129 *October 2007*

Committee on Governmental Operations

SETTING THE FLORIDA RETIREMENT SYSTEM PENSION PLAN RATES FOR 2008-2009

SUMMARY

The Florida Retirement System (FRS) is one of the leading public pension plans in the Nation and serves more than 900,000 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. The report also discusses briefly federal changes to pension law that will have an impact upon the FRS and active participants.

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 this multi-employer plan has grown to serve some 900 separate units of government with more than 665,000 active and 283,000 retired members and beneficiaries.[2] Constitutional units of 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 1.60-1.68% 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. Since 1975 the FRS has been non-participatory; 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.[3] The Department of Management Services (DMS) administers benefit payments through its Division of Retirement while the Board of Administration (SBA) is the investment manager. Consensus-based estimates of funding assumptions are provided by a statutorily authorized Actuarial Assumption Estimating Conference.[4]

For the past several years the Legislature has chosen to implement the recalculation of the required actuarial rates through annually enacted legislation.[5] These rates have been set below the long-term normal cost of 10%.[6] The difference is made up through a formula recognition of excess actuarial assets[7] remaining from

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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] The Florida Retirement System, *Annual Report*, July 1, 2005- June 30, 2006, Tallahassee, FL: 2006.

[3] 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.

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

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

[6] On February 8, 2005, the SBA transmitted its reservations on this funding practice. It reported five departures from recommended practice, citing those which used surplus recognition to subsidize long-term costs. Beginning in 2005, the Legislature committed itself to a longer term financial plan, a portion of which will reduce the excess reliance upon surplus actuarial assets and return funding of the FRS to normal cost. State of Florida, *Long-Range Financial Outlook, Fiscal Year 2008-09 through 2010-11,* Fall 2007 Update, Tallahassee, FL, pp. 92-95.

[7] Officially designated a Rate Stabilization Mechanism;

the elimination of unfunded liabilities and superior investment performance during the economic recovery that ended in early 2000.[8] Valuations of the FRS occur after the close of the previous fiscal year and are usually received at the close of the prior calendar year.

FRS, Statutory Percentage Payroll Contribution Rates for DB and DC Plans, FY 2007-08[9]

Retirement Class	DB	DC
Regular	8.69 %	9.00 %
Senior Management	11.96	10.95
Special Risk	19.76	20.00
Special Risk Admin.	11.39	11.35
Elected Officers - State	13.32	13.40
Elected Officers - Local	15.37	16.20
Justices and Judges	18.40	18.90
DROP	9.80	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 47:100 at the end of 2006 - and this itself has led to calls for deliberate funding recognition of this beneficiary group.[10] The "immunization" of these promised benefits from disruptive economic cycles would counsel investment discipline to provide assurances that its expanding beneficiary group is shielded from economic cycles. Immunization is already a 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.[11] 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 diversified market investments.[12] As returns become more predictable they decline, forcing an increase in the employer contribution rate.[13] Immunization may be an unwelcome salve to a wound that is self-inflicted.[14] In mid-2007 the Board of Administration reformulated its investment guidelines to place more of its FRS assets into non-domestic equities and domestic fixed income classes. In so doing it concluded that its legacy practice may not generate the returns for the servicing of its rising benefit demands.[15]

Three financial assumptions underpin the FRS: investment returns of 7.75%,[16] wage increases of 5%,[17]

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s. 121.031, F.S.

[8] Among *Fortune 1000* 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.

[9] Sections 121.71 and 121.72, F.S; as amended by HB 7085, 2007 Regular Session; ch. 2007-84, Laws of Florida. 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.

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

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

[12] 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.

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

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

[15] State Board of Administration, *Florida Retirement System: Defined Benefit Plan Investment Policy Statement*, Tallahassee, FL: May 15, 2007.

[16] Revised from 8.00% for 2005 and subsequent actuarial valuations. A lower percentage assumes a more difficult investment climate with higher contribution rates.

[17] 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*

and post-retirement increases of 3%. The preliminary results of the September 24, 2007 meeting of the Actuarial Assumptions Estimating Conference pointed to a healthy FRS, with assets far exceeding liabilities.[18] The plan continued its over-funded status that permits recognition of excess assets to support the employer-paid rate structure. From the participant standpoint, a lessening of recognized salary increases can cause a shortfall in expected retirement income relative to inflation. From the employer's standpoint, reduced payroll costs stabilize near-term operating budgets and retirement plan costs.

The Congress recently enacted legislation to address long-standing problems in private sector pensions.[19] In so doing it provided additional options for public pension plans largely exempt from federal regulation. Public plans will now be authorized to offer 401(k) supplements to their main plans (termed a DB/K"), employees may receive in-service pension distributions, and plans may permit purchase of additional service credit to enhance the final benefit.

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.[20] The DMS prepared a discussion paper that briefed several possible options.[21] None of the options was implemented.

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 three years ago. Recent study in that state has questioned the usefulness of large-scale retirement attritions that effect only marginal results with higher costs.[22] Caution should rule any such initiative as attrition can both minimize infrastructure costs and overestimate savings.[23] 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.

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 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 though it is not without considerable risk. 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. In light of these factors the FRS should be averse to the implementation of new or enhanced benefits until the plan reaches a normalized funding status.

Experience Study Results of the Florida Retirement System, October 2004.

[18] The Actuarial Assumption Estimating Conference, *Florida Retirement System, The Actuarial Assumption Estimating Conference, Including Preliminary July 1, 2007 Actuarial Valuation Results*, September 24, 2007.

[19] H.R. 4, The Pension Protection Act of 2006, Public Law 109-280, 120 Stat. 780.

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

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

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

[23] The City of San Diego, CA 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.