The Florida Senate

Interim Project Report 98-24 *November 1998*

Committee on Governmental Reform and Oversight Senator Charles Williams, Chairman

THE FLORIDA RETIREMENT SYSTEM: EMPLOYER RESPONSIBILITIES AND EMPLOYEE CHOICES IN A CHANGED EMPLOYMENT ENVIRONMENT

SUMMARY

The Florida Retirement System (FRS) concludes the decade free from a long-term pension debt carried from its beginning nearly thirty years earlier. Positioned as one of the nation's largest and most managerially efficient pension plans in terms of its nearly $80 billion asset base, its multi-employer design provides an inflation-adjusted annuity to some 800 state and local government employers, their 600,000 employees, and 166,000 retirees without employee participation. Yet the employment era it leaves is little like the one it enters. The employment market is less likely than ever to favor cradle-to-grave employer benevolence. The FRS's pension contemporaries favor limited employer financial exposure, expect employee contribution, and encourage their workforces to be more attentive to personal retirement planning.

This report recounts the history of Florida's largest public retirement system, examines the changing nature of pension plans generally, and identifies options for policy makers and others to consider in the internal and external design of employee benefit systems. It recommends a re-examination of the social objectives underlying benefit systems for Florida's largest public employee plan, provides several different options for discussion which complement a transition from a job-based to a performance-based environment, and cautions against precipitous benefit changes until a strategic workforce philosophy can be developed and communicated.

BACKGROUND

Less than thirty years have elapsed since the combination of four separate public pension plans into the newly created FRS. Established to stave off the impending insolvency of the Teachers' Retirement System (TRS), this modern day successor to the 1885 Confederate Pension Fund provides retirement income to 791 employer-members, their 600,000 employees, and 166,000 retirees. It ended FY 98 with a covered payroll of $17.2 billion and plan assets of $82 billion. Membership is compulsory and coverage is universal for constitutional entities, although about 8700 management and educational system staff participate in an optional annuity program in lieu of FRS enrollment. Statutory units of government enroll through resolution of their governing authority but may withdraw only by statute.

Structured as a federally tax-qualified *defined benefit* plan, the FRS provides a guaranteed, inflation-adjusted pension with survivors' benefits and disability income protection, and, since 1975 without employee participation. However, funding instability of the predecessor TRS plan brought lingering financial problems. Years of suppressed true payroll costs caused an unfunded liability which at its 1991 peak reached nearly $16 billion. Only in 1998 did the plan approach full-funding status and the assessment reduction of some 5% of payroll.

The FRS contains five separate membership classes with varying vesting and service requirements. More than ninety percent of members qualify for the Regular Plan with its ten-year vesting schedule and the attainment of the lesser of age 62 or thirty years of service for normal benefits. Remaining membership classes provide coverage for management, public safety, and constitutional officers. Accrual rates, or the nominal value of each service year, vary by membership class and range from a high of 3.33% for judges to a low of 1.6% for members of the Regular Plan. All of the plans are coordinated with Social Security and provide additional eligibility for a health insurance premium subsidy upon retirement. Plan members may choose from one of four annuity payment options at retirement. Full or discounted cash distributions of account proceeds are not permitted since the FRS annuitizes all promised benefits.

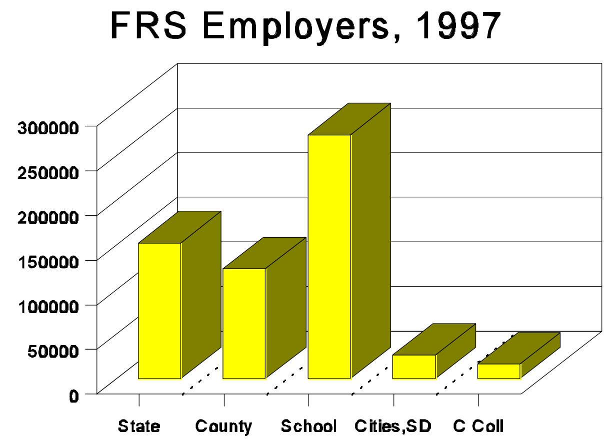
The impetus for this report stemmed from 1998 actuarial simulations of alternative pension funding choices, impending full-funding status of the FRS, and filing of legislation in both legislative chambers which sought to alter its organizational and benefit structure. This report is also influenced by another report, *Restructuring the Career Service System*, No. 98-26, which discusses related workplace and workforce issues.

METHODOLOGY

Research for this report involved historic materials developed by the State Board of Administration (SBA) and the Division of Retirement. Many of these are records maintained in the ordinary conduct of business, but others are derived from the mandate given these two agencies by Section 18 of Chapter 98-413, Laws of Florida, to collaborate on a review of the structure and purposes of pension benefit administration for its member employees. Still other materials were culled from the wealth of bibliography available from business and employee sectors. Finally, the report builds on information developed from actuarial simulations of alternative funding strategies commissioned during the 1998 Legislative Session and prepared by consultants hired by the SBA and the Division of Retirement.

FINDINGS

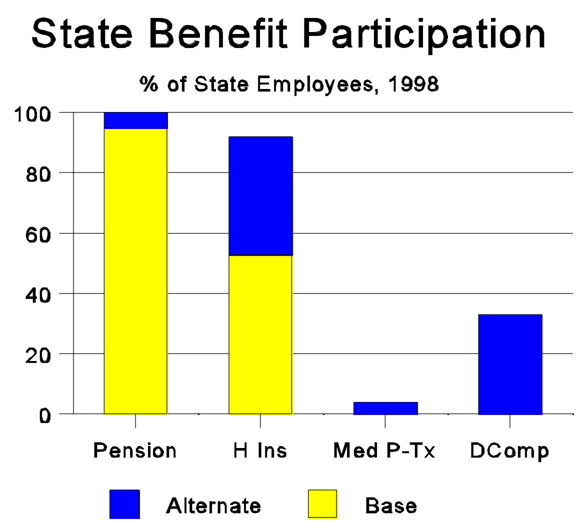
An examination of the nation's fifth largest public-sector pension plan is concurrently a study of two different agencies: a constitutional (SBA), the investment arm; and the Division of Retirement, a statutory entity responsible for benefit payment and oversight of all other government-sector pension plans. The SBA is the Governor, Comptroller, and Treasurer acting in their collective capacities as the legal fiduciaries for investment policy, subject to the requirements of ch. 215, F.S. The division is a relatively autonomous entity that, despite its placement within the Department of Management Services, reports directly to the Governor and administers the retirement statutes contained in ch. 121, F.S. Both entities and the policy-making bodies of their employer-members, are further disciplined by the provisions of Art. X, s. 14, State Constitution, which require full-funding of pension benefits for all public employees on an actuarially sound basis.



About 75% of the FRS's employer-members are found at the local government level. A profile of the employees themselves is also revealing. A typical active employee is a 44-year old female with eleven years of service earning $28,674 annually. The prototypical sixty-one year old annuitant receives an average gross annual benefit of $11,364 for twenty-one years of service. The progressive leveling of hiring, coupled with an increased number of employees reaching retirement, age has seen the ratio of annuitants to active employees rise. There are now roughly 27 annuitants per active employee, up 17% in the last four years. Although relatively young in terms of plan and membership age, the FRS will be experiencing significant maturation in the near term due to policy changes on retirement statutes and the generational surge of retirees hired during the 1960s.

Minimum service, or vesting, requirements for the FRS are quite conservative in comparison to similar public plans. Many states have shortened their vesting levels to five or three years, thus permitting employees to achieve some expectation of benefit coverage early in their careers. A lower qualifying period tends to increase payroll costs as more employees qualify for a pension. The ten-year vesting schedule for most FRS members reduces payroll costs as employees who leave prior to that date forfeit contributions made on their behalf. Only faculty and managerial employees receive the choice of enrolling in a personally-owned *defined contribution plan* with its immediate vesting and portability provisions.

Unusual also in its result, if not its design, is that the principal benefit systems available to state employees bear some relationship to their financial participation. As the below table indicates, when the employer bears the primary incidence of cost or risk, participation is at its highest. Where employee shared responsibility is offered, participation rates decline. Pension plan coverage is made available to all public employees whatever type is selected and 95% of the employees are covered by one or more health insurance. In the state's pre-tax medical program, however, less than 4% of the workforce shelters its out-of-pocket health care expenses free from federal taxation. With out-of-pocket medical expenses approaching 39% of total health care costs and an estimated $246 in average employee savings, increased participation can yield significant personal savings now being exported to the federal treasury.

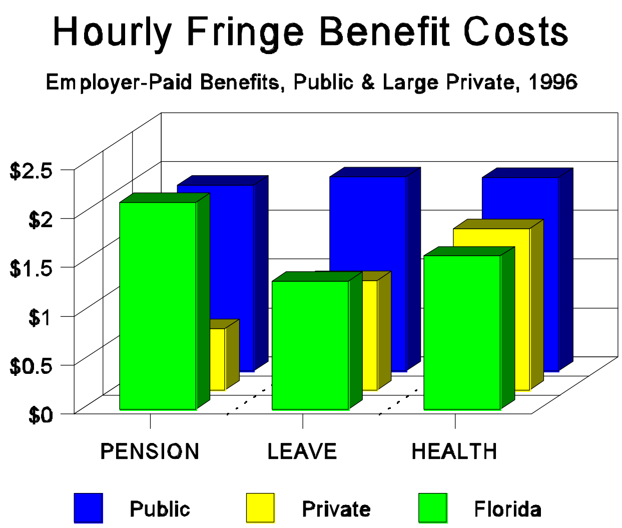


Then, too, this program must compete with dozens of other supplemental insurance products available to employees also offered on a pre-tax premium basis. The deferred compensation program still commands less than one-third participation nearly twenty-five years after its enactment. Several states have begun implementation of supplemental benefit plans to encourage personal savings at all salary levels. Such arrangements give employees an ownership interest in the attainment of performance standards and also encourage personal savings behavior. With the implementation of Performance-Based Program Budgeting (PB^2) by the 1994 Legislature, such a defined contribution addition to their base pension system may further sensitize employees that there are tangible results realizable from the achievement of outcomes.

While investment policy and benefits administration are highly structured, the plan is assembled around an actuarial assumption process which is both deceptively simple and relatively invisible. Three critical economic assumptions - investment return (8%), salary growth (7.25%), and payroll growth (5.5%) - are established by an informal working group of legislative and executive branch staff for certification to the plan actuaries. The actuaries then construct individual payroll contribution rates for the five plan types which are, in turn, electronically transmitted to the employer-members for their imposition. Contribution rates are fixed in statute at the succeeding legislative session following each biennial plan valuation. By law the Legislature commissions a second-opinion valuation of the plan for a determination of the reasonableness of the FRS actuaries' methodology. Unlike other consensus-based economic estimation systems contained in ch. 216, F.S. for construction of the state budget, this estimation process is not sanctioned in law, only in custom. A 1998 attempt at altering these assumptions, for demographic reasons discussed below, proved difficult to explore and debate as few legislators were ever exposed to the mechanics of their development and the complex software translations involved in the state's own computerized budgeting system. Payroll savings in the order of hundreds of millions of dollars are possible through the altering of these assumptions by even one-quarter of one percent. Generally, lower assumed rates of investment return produce higher payroll costs; higher assumptions on salary growth also condition the same result.

There is reason to believe that public workforce expansion has crested from its meteoric rise through the 1970s and 1980s. The Career Service System enters its third successive year of overall net negative position growth and local government employment projections envision only about a 2% growth rate. The children of World War II parents hired during the 1960s are reaching retirement age, further assisted by the 1997 Legislature's decision to add a fifth, deferred retirement program. At the same time Florida has aggressively exported employment opportunities to the private sector in the form of privatized services and the use of casual labor. Twenty-seven percent of the state budget is comprised of contracted services and another 43,000 individuals are employed under Other Personal Services contracts for seasonal or task-specific activities. A defined benefit plan is unlikely to be offered, if available at all, in these alternate employment circumstances.

A distinguishing feature of private sector pension arrangements is its *defined contribution* nature. Such a design limits employer costs, encourages employee savings behavior, and shifts the ethic of compensation away from benefits and toward salary. The employer promises only a contribution, not a result. This feature alone eliminates the possibility of creating unfunded liabilities since such a design can never represent a result greater than it contributory promise. This plan design choice is gaining popularity with several states, having been fully or partially implemented in Michigan and Washington. An emerging, third pension variant, a *hybrid plan*, combines the features of defined benefit and contribution to give the employee the expectation of a fixed benefit with personally-directed investment choice.



A comparison of 1996 public and private sector employer costs reveals public sector wages at a level 50% greater than their large private sector counterparts but retirement plan costs more than three times as costly. About one-third of the aggregate difference displayed above can be attributed solely to the existence of the unfunded liability. The remaining difference can be attributed to its non-participatory, guaranteed nature.

Low state employee participation in this choice, only 77 out of some 1600 in the Senior Management Class has been noted in prior legislative reviews. Managerial recruitment practices focus internally and identify staff already well-invested in the existing benefit structure. Nearly 8,700 post-secondary school faculty, on the other hand, opt for its coverage given the contractual nature of their employment and the internationally competitive recruitment market in which they participate. But a transition to a defined contribution system is neither simple nor a panacea. Among the issues to be decided are voluntariness of choice, public or private administration, plan management expenses, full disclosure of fees and comparable rates of return in comparison with the base plan, the non-career orientation of the plan design, and the different effects on wage earners at opposite ends of the salary continuum. Because the FRS is a multi-employer plan early consideration must be given to whether this centralized apparatus is appropriate any longer for the individualized employment decisions which its decidedly non-state members must make. All of these elements are generational choices and, like the painful discussions characterizing the role of Social Security in the next millennium, their resolution must occur in advance of a generation of workers yet to be hired.

Some two to three dozen bills are filed each year in the legislature on retirement benefits, few of which seek their curtailment. A practical consequence to a defined contribution switch would be a lessening of the significance of statutory enhancement of benefits since employees would be responsible for their own investments. The converse to this would hold equally true. Significant erosion of their pension investments, due either to adverse economic fortunes or imprudent investments, could yield a deferred retirement or greater reliance upon public assistance programs due to retirement income shortfalls. This latter circumstance would expose those employees at the lower end of the salary scale to the greatest risk given their lack of discretionary spending. And the risk would come in two different forms, the first in the real and absolute loss of principal, and the second in a reliance upon commercial annuity contracts with their lower yields and higher surrender charges.

An even more subtle consequences of a change in ethic occurs over time. A lowering of the vesting schedule or in the time frame for final benefit calculation would add upward cost pressure to the FRS. Such plan enhancements would then represent an investment in the base plan adverse to its conversion to a defined contribution alternative. A competing offset to such a circumstance would be creation of a cash balance plan in which untested members of the FRS would receive a discounted payout of their account for rollover to another tax-qualified plan. But this, too, would be at an additional expense to the plan and could require a payroll contribution rate increase.

All of the above permutations of choice place a premium on the articulation of clearly-defined generational objectives for any employer-sponsored retirement system. In the succeeding sections of this report some discussion will take place on the context of these choices and the development of alternatives to the base plan. The discussion will then shift to the deliberations of the working group of public officials commissioned to formally review these issues.

At this juncture, four critical elements affecting total compensation policy are presented:

What strategic purposes can be achieved through the linkage of multiple public workforces and performance expectations? Report 98-26 discussed the three parallel workforces maintained by the State of Florida: *full-time equivalents* who have an expectation of permanence and are recipients of fully-paid or heavily subsidized employer benefits; *casual labor* created by agencies themselves on an as-needed workload basis without benefit coverage; and *service providers*, contractually obligated to public agencies who may provide their own market-based benefits. The failure to establish an integrated, strategic workforce plan undermines the ability at establishing a policy direction that sets performance, or any other tangible goal, as a desired objective. Simply stated, all of these institutional or individual participants receive funding through the same source but no one plays by the same benefit rules. Performance objectives have been established for agencies but have not migrated to the employees themselves. A temp workforce of 5% in the private sector is not uncommon; for State of Florida agencies it is some five times that level. Clearly, there are factors at work other than seasonal workload. Employees work in a salary-suppressed environment where the only recourse is to rely upon the benefit benevolence of their employer for their remaining service. The shielding of state employees from successive years of health insurance premium adjustments was partially responsible for the depletion of its self-insured reserve and the grave financial circumstance experienced in 1997. Holding retirement as the ultimate objective of public service breeds all of the harsh stereotypical images associated with it. Florida law recognizes only one way of being hired but five different ways of retiring (normal, early with penalty, DROP, early with annuity, phased). An abrupt shift in benefit dynamics, while potentially salutary to the financial interest of the employer, may prove quite disruptive to employees if other complementary messages are not communicated.

Should the legacy multi-employer FRS maintain its centralized organization? Individual public employers may wish to customize a system to suit their own needs. Such is the norm for most municipalities and their general employees. Independent municipal police and firefighter pension plans have been organized since the 1930s and still receive state financial subsidies. The FRS is itself a local government system in terms of its membership profile, an artifact of its 1970 creation, with centralized, state agency administration. In this regard it is atypical from the more than 400 local public pension plans it oversees and are governed at a sub-state level. While employees can benefit from greater access to customized products they will also have to face possible wage contributions and the direct imposition of plan expense fees now assumed by the FRS. With an equity investment expense ratio of .17%, the SBA compares more favorably than any other large scale commercial investment houses it surveyed in 1998. Expense fees suppress total plan return requiring better performance or greater risk to produce comparable results. A one basis point fee on the prior year asset base is the cash equivalent of $8.2 million. The SBA reported a net fee spread among its domestic equity peers from 3 to 110 basis points. Additionally, some public employers may have affiliated marketing relationships with such providers which provide them with indirect testimonial income. In any alternate arrangement there may be no statutory or ordinance guarantee that the contribution rate would remain fixed. It could rise or fall on the basis of overall financial conditions or the nature of labor agreement process. A large migration of employees from one plan to another may also induce adverse selection from the predecessor plan and precipitate another unfunded liability.

Is the provision of adequate retirement income an inherent expectation of public employment or a shared consequence of personal financial planning? This is perhaps the most fundamental policy issue to be decided. It involves choosing between the *social insurance* model of benefit compensation and its competing *annuity-welfare* model. The former envisions government as the engine of market development, assuring equity and universal entitlement to a minimum benefit level. It is not a pension in an actuarial sense since it may bear no relationship to income adjusted for investment earnings. It is the present ethic of the Social Security System and, arguably with the health insurance subsidy, one attribute of the FRS as well.

The latter model holds the individual responsible for retirement income and de-emphasizes income redistribution from richer to poorer. The employer may provide for a cash distribution or annuitization of benefits and then discharge itself from further responsibility. The retiree receives what was contributed and earned, nothing more. This provision is also a distinguishing feature of the FRS: accrual rate times years of service multiplied by average final compensation yields pension benefit. However, it is the employer that bears all investment risk, including streams of unfunded liabilities.

As displayed above, U.S. wage-earners have exhibited a declining rate of personal savings, although this may be offset by the rising value of their retirement accounts. In a noncontributory system this elevates the employer's role in benefit adequacy. But the fundamental question remains: is it the employer's or the employee's responsibility to ensure pension income and what relationship should exist between salary levels, benefits, and the market? Unlike the social insurance attributes of Social Security, the FRS links income earned strictly

with benefits received, assures the system is actuarially sound and not "pay-as-you-go," and diversifies its investment portfolio to disperse its assets in products other than debt issuance of its employer-members. But the present compensation systems in which State of Florida employees participate bring the greatest mobility early in a career, not later, yet provide vesting and pension computation only after this crest has been achieved.

The FRS is a relatively generous plan in terms of contribution rates while its employer-members are relatively modest wage payers. One tends to offset the other. At age 62 typical FRS retirees can expect to receive about 50% of their average best five years' salary for thirty years' service. In practice, an average career length is only two-thirds of this amount and FRS pension income alone equates to a food-stamp level of income for a family of two. This modest amount, when combined with Social Security and the health insurance subsidy, would raise total employer-derived pension income to some 70%-80% of salary. Competing pension systems and their economic assumptions can undercut these costs to the substantial economic benefit of the public employer or support them to the significant advantage of the employee. The critical variable becomes the imputed time horizon for employment: is it to be a single-employer career with a dedicated pension plan or a distributed one with variable career choices?

How can total compensation systems build in a degree of employee ownership in the quality of their collective work efforts? With the passage of PB^2 the Legislature made a commitment to elevate the importance of outcomes in public enterprise. Quality was as important as quantity. Not since the incorporation of analytical techniques into the state budgeting system in the 1960s had there been a statutory discipline to the achievement of results other than an accounting imperative of a balanced budget. This was not the first attempt at changing the silent understanding which has characterized public sector employment: that it mattered more how *much* was done than how *well* it was accomplished. *First*, in successive years of budget policy the Legislature created monetary incentives to universities and community colleges to reduce their time-to-graduate requirements for more efficient use of educational capital. Increased expectations of performance in both student and teacher competencies were concurrently developed for the realization of a more effective product. Still, there remains a significant structural investment in enrollment-based funding which has proven to be resistant to change. *Second*, the implementation of a direct contract between the student and performance exemplified in the Academic Scholars Program transformed the student into a consumer and the college enrollment process into a competitive enterprise. The academic institution must earn the enrollment from the graduating senior providing it since it is now pre-funded and is accompanied by the attainment and maintenance of a superior standard of work. And, *third*, the initial attainment and subsequent maintenance of a minimum knowledge base has been incorporated into human service professional positions in the Department of Children and Families.

The SBA was commissioned by s. 18 of ch. 98-413, L.O.F., to collaborate on a study of the building blocks of the FRS and, ultimately, convene a forum for a discussion of many of these issues. In the prior year, the Legislature received the report of the Workforce 2000 Commission which attempted to start the discussion of these subjects. The 1998 statute specifically called for a review of the assumptions used in the construction of the FRS, their relevance in light of recruitment and retirement practices, an examination of the economic universe in which the FRS operates, and anticipated economic forces which may affect workforce and salary trends. A working group of legislators and investment principals was assembled to undertake this review. Its first meeting, scheduled for October 22, was rescheduled to November 6. At that meeting the principals learned of the legal and actuarial background upon which the plan is constructed. At the next meeting on December 4 they will undertake simulations of alternative choices on its assumptions and participant base.

RECOMMENDATIONS

The FRS enters the next millennium in a sound financial and efficient administrative posture but its benefit design may not be well suited to workplace changes new generations of workers will encounter. **As work increasingly comes to be defined in terms of performance, which must be demonstrated, jobs can no longer be considered entitlements, which are to be guaranteed**. Accordingly, a three-tiered reformatting of pension administration is suggested for discussion. These tiers allow policy makers to incrementally adjust their expectations as to how reflective the public infrastructure should be of private enterprise while maintaining the distinctive organizational structure unique to tax-supported institutions.

Tier 1: Assumes - Current law and administration.

A. Create a legislative/executive benefits estimating conference in Ch. 216, F.S., to make assumptions on the public workforce and its benefits visible and accessible. This process now exists for many of the state administered entitlement programs for protected populations. Only state employee health insurance is presently covered in the estimation conference structure. The existing staff-directed estimation process is disciplined and has worked well but its opaqueness may not be well-suited for the openness represented of governmental institutions and which has been the state's hallmark since 1966.

B. Revalidate the existing assumptions of the FRS.

As the FRS approaches full-funding status its operating costs will decline. But its building blocks still assume a growth in direct, state agency employment which has crested and is in decline. Such employment-based assumptions may have overreached what was required in order to achieve a reduction in the unfunded liability. Other assumptions make other, subtle judgments about employees' salary growth which can have significant motivational consequences. The Working Group also learned that state agency promotional practices consume a greater share of salary dollars than legislatively approved pay raises. This has an indirect but real effect on the growth of a participant's final compensation used in benefit calculations. Not only do these building block assumptions have payroll cost implications in the near term but they must consider the increasing number of employees about to retire who may not be replaced. Policy investments in public safety personnel and reductions in school class size reflective of adding additional instructional and support personnel may also act as offsetting forces to natural membership decline. All of these issues must be discussed and factored into the financial future of the legacy plan.

C. Make available to all state employees an FRS-supplemental, defined contribution account which is performance-based and funded out of the salary package. Give every employee the opportunity to establish a personal savings account which links job accomplishments with rewards. For the first year provide 100% of the funding; in succeeding years require a 50/50 match. Such a plan could be considered the state's own investment in a performance-based, individually-owned IRA. The present evolution of PB^2 has yet to make the direct link between employee and performance. This alternative also reinforces the legislature's nominal enactment of PB^2 with an ownership interest in its success. **Provision should also be made for modifying state law to permit such supplemental plans to be offered by the same employer.**

D. Forego any enhancements to the base pension plan pending the establishment of a workforce philosophy which identifies supportive relationships of the three current, separate workforces. The simultaneous but uncoordinated funding of three separate workforces, discussed in Report 98-26, sends mixed messages as to the importance of public employment and what benefit structures are relevant. The widespread use of the Special Category Appropriation has encouraged the development of market-based, defined contribution pension arrangements as alternatives to the FRS. It is this legislative policy which has opened the discussion on alternative, competitive benefit systems. Proposals advanced early in 1998 to provide partial benefits for casual labor employees would have increased payroll costs without determining the respective roles of each of the workforces.

Tier 2: Assumes - Tier 1 changes plus personal choice.

A. Offer to all prospective and unvested employees the opportunity to participate in the Optional Annuity Program now offered only to managerial and college academic employees. Employees should be able to make their own career decisions on the basis of employment, not just benefits provided at the end of the career. This will require a compensation ethic shift to salary and away from benefits; to tangible, productive accomplishments and away from deferred rewards upon cessation of an active career. This shift may pose employer risks, especially for sensitive employment categories such as public safety, where turnover can pose staffing difficulties.

B. Establish a continuous education and counseling system to advise employees about the importance of personal savings and long-term financial planning. Employees need to establish an identity for their retirement years separate and apart from the needs of their employer. Such is not now the case. Creating a dependent relationship does not foster either party's best long-term interests. Practical ways of increasing employee participation in personally-directed savings vehicles can be effective countermeasures against employment inertia, can make the necessity for controlling governmental costs less personally threatening, and can take the pressure off of other, less well-funded benefit systems to provide total retirement income protection.

Tier 3: Change the ethic of the benefit plan. Assumes - Tier 1 and Tier 2 changes.

There is a role for the FRS defined benefit plan. It is efficient and has produced an impressive long-term result through many economic cycles. It utilizes the powerful synergies of internal and external managers and spreads its investments across a multitude of equity and debt instruments. But its design may be less well suited to a mobile workforce which chooses not to make life-long commitments to public sector employment. The development of cash balance plans are hybrid variations of a defined benefit design. They give the expectation of a fixed benefit with personal investment choice. Such a conversion takes adequate lead time, approval by the Internal Revenue Service, and must be accompanied by sustained employee education. If the Legislature seeks to maintain its 1994 commitment to peformance management, a hybrid plan may be the best evolution of the FRS.

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