State Affairs Committee

Wednesday, February 12, 2014
3:30 PM
Morris Hall (17 HOB)

Will Weatherford
Speaker

Jim Boyd
Chair

Committee Meeting Notice

HOUSE OF REPRESENTATIVES

State Affairs Committee

Start Date and Time:	Wednesday, February 12, 2014 03:30 pm
End Date and Time:	Wednesday, February 12, 2014 05:30 pm
Location:	Morris Hall (17 HOB)
Duration:	2.00 hrs

Retirement Systems Overview

NOTICE FINALIZED on 02/05/2014 16:12 by Love.John

FRS Overview

Florida Retirement System

Florida House of Representatives

State Affairs Committee

February 12, 2014

Florida Retirement System (FRS) *"At a Glance"*

- Annual employer contributions $1.6 billion
- Annual employee contributions $830 million
- Active participants 621,774
- Annuitants 334,682
- Funding ratio as of July 1, 2013 85.9 percent
- Market value of assets as of July 1, 2013 $131.7 billion

Florida Retirement System

- Established in 1970
- Provides retirement, disability, and death benefits
- Funded through employer and employee contributions and investment earnings
- Managed by the Department of Management Services and the State Board of Administration

Two Plan Options

- INVESTMENT PLAN (defined contribution plan)
  - Funded by employer and employee contributions
  - Participants determine how the funds in their accounts are invested (among various state-offered options)
  - Participants bear the risk of their investment decisions
  - 107,338 (17%) active members
- PENSION PLAN (defined benefit plan)
  - Retirement benefit is a formula-based payment that is funded by employer and employee contributions and investment earnings
  - Employer bears the investment risk
  - Fund managed by the State Board of Administration
  - 514,436 (83%) active members

Membership

Florida Retirement System

Participants

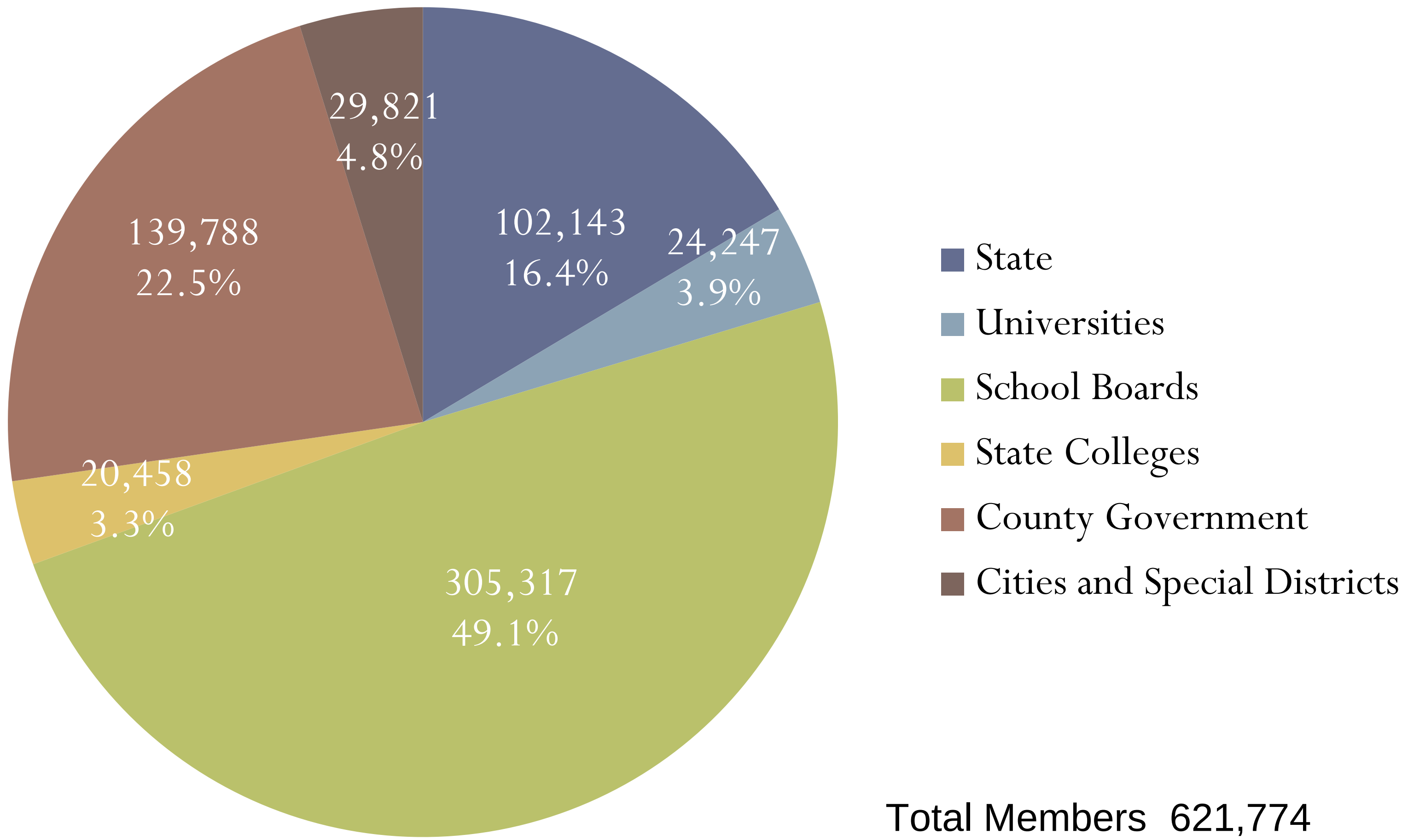
Required:

- State
- School boards
- County governments
- Universities
- State colleges

Optional:

- Municipalities
- Special districts

Active Membership by Employer



Total Members 621,774

Class Structure and Benefits

Florida Retirement System

Class Structure

- Regular Class – Members who do not qualify for membership in other classes within the FRS
- Special Risk Class – Law enforcement officers, firefighters, correctional officers, correctional probation officers, paramedics, EMTs, certain professional health care workers within Department of Corrections and Department of Children and Families, and certain forensic employees
- Special Risk Administrative Support Class – Former special risk members who are transferred or reassigned to an administrative support position
- Elected Officers' Class – Members who hold specified elective offices
- Senior Management Service Class – Senior management level positions assigned or authorized by law

Pension Plan Benefit Calculation

- Years of Service X Accrual Rate X Average Final Compensation
  - Example: 30 (years of service) X 1.6% (accrual rate) X 40,000 (average final compensation) = $19,200 (annual benefit)

Class	Years of Service		Accrual Rate
	Pre-July 1, 2011	Post July 1, 2011	
Regular	30	33	1.60%
Special Risk	25	30	3.00%
Special Risk Admin. Support	25	30	1.60%
Senior Management Service	30	33	2.00%
Elected Officers' - Judges	30	33	3.33%
Elected Officers' - Others	30	33	3.00%

Disability Benefits

- Disability retirement requires total and permanent disability from all employment
- Available to both Pension Plan and Investment Plan members
- In-line-of-duty disability benefits are available from first day of employment: 65% of AFC – Special Risk
  - 42% of AFC – Other
- Non-duty disability retirement requires eight years of creditable service : 25% of AFC

Survivor Benefits

- In-line-of-duty survivor benefits for Pension Plan members provide one-half of salary at the time of death payable for the spouse's lifetime or until the youngest dependent child reaches age 18
  - Available from first day of employment
- Non-duty survivor benefits for Pension Plan members provide a lifetime benefit to a spouse or disabled dependent child, or until age 25 for a non-disabled child
  - Members must vest in order to be eligible

Deferred Retirement Option Program (DROP)

- Established in 1998
- Allows members to retire and continue working for up to:
  - 5 Years: Most members
  - 8 Years: K-12 Instructional Personnel
- Pension benefits accumulate in the FRS Trust Fund
  - Earn 6.5 percent interest and 3.0 percent Cost of Living Adjustment, if enrolled in DROP before July 1, 2011
  - Earn 1.3 percent interest, if enrolled in DROP on or after July 1, 2011
- Members must terminate FRS employment after completing DROP

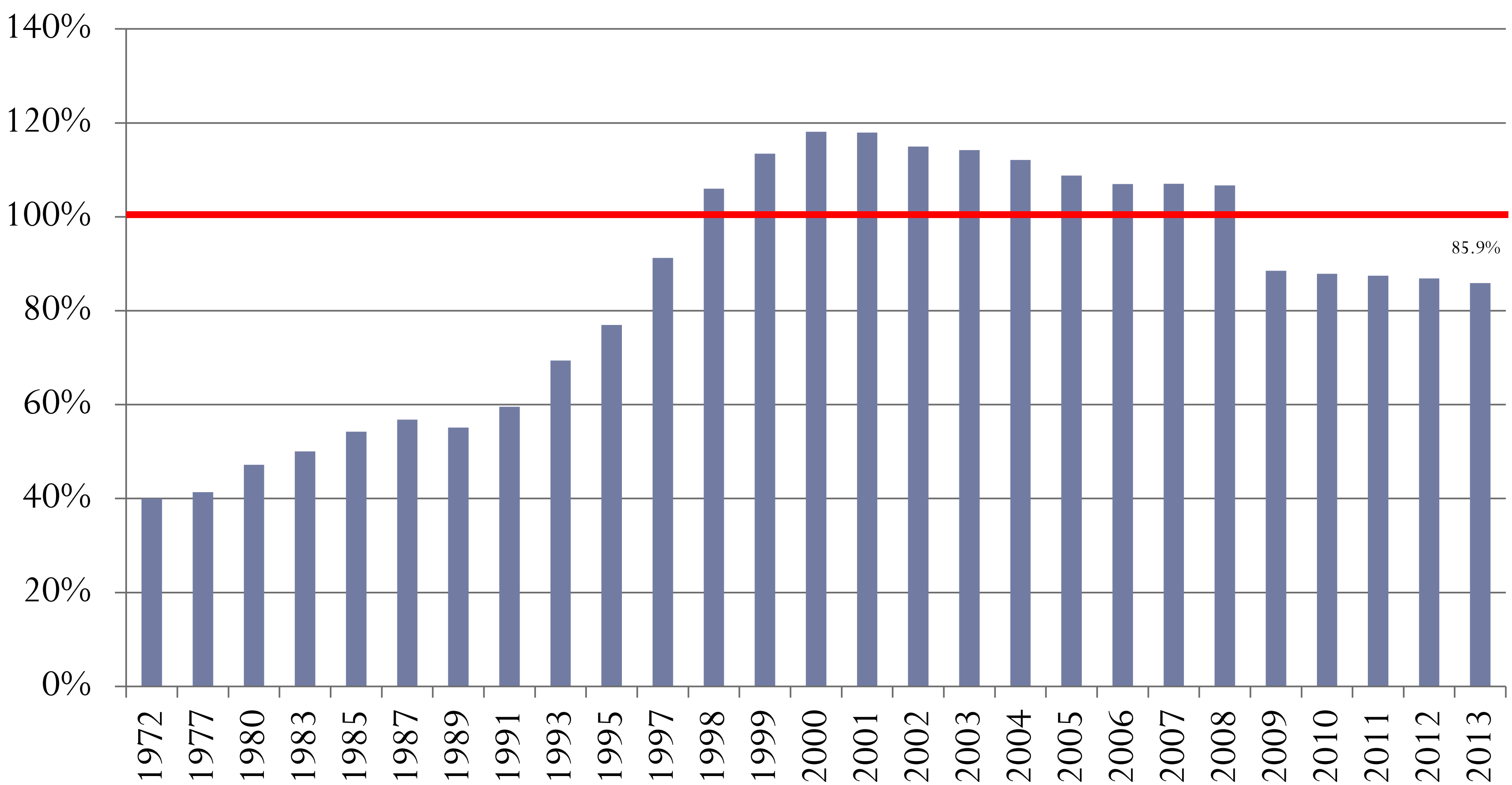
Pension Plan Funding

FLORIDA RETIREMENT SYSTEM

Contribution Rates and Funding Status

- Actuarial valuation is performed annually on the Pension Plan to determine funding status and employer contribution rates
- Employer contribution rates are set annually in law
  - Legislature generally adheres to the recommended rates and funds accordingly in the General Appropriations Act for education entities and state funded entities
- As of July 1, 2013, the Pension Plan had an actuarial funding level of **85.9** percent
  - Unfunded Actuarial Liability (UAL) of **$21.6** billion
    - As required by law, the UAL must be amortized within 30 plan years
    - For FY 2013-14, $500 million in recurring General Revenue Funds was appropriated towards payment of the UAL (State, Universities, State Colleges, and School Boards)

Historical Actuarial Funding Ratio



Employer and Employee Contribution Rates FY 2013-14

Membership Class	Normal Employer Contribution 'Blended Rates'	UAL Employer Contribution 'Blended Rates'	Total Employer Contribution 'Blended Rates'	Employee Contribution Rates
Regular Class	3.53%	2.19%	**5.72%**	3.00%
Special Risk Class	11.00%	6.83%	**17.83%**	3.00%
Special Risk Admin. Support Class	4.17%	30.56%	**34.73%**	3.00%
Senior Management Service Class	4.81%	12.27%	**17.08%**	3.00%
Elected Officers' Class:				
Leg-Atty-Cabinet	6.52%	24.85%	**31.37%**	3.00%
Judges	10.05%	17.00%	**27.05%**	3.00%
County/City	8.44%	23.36%	**31.80%**	3.00%

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Retirement Systems Overview

Retirement System Overview

February, 2014

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Basic Plan Types

- Traditional pension plan (defined benefit or DB plan)
  - FRS Pension Plan is one of these
  - Fixed benefits for employees, with no investment risk exposure
  - Variable cost for employer, with all the investment risk exposure
  - Benefits more generous for long career employees ("back-loaded")
- Defined contribution plan (DC plan)
  - FRS Investment Plan is one of these
  - Fixed contributions for employer, with no investment risk exposure
  - Variable benefits for employees, with all the investment risk exposure
  - Benefits are evenly earned throughout career ("generally more portable")
- Risk-sharing plans
  - Combination DB + DC plan
  - Cash balance plan
  - Other more exotic flavors (e.g. target benefit, shared-risk DC, collective DC)

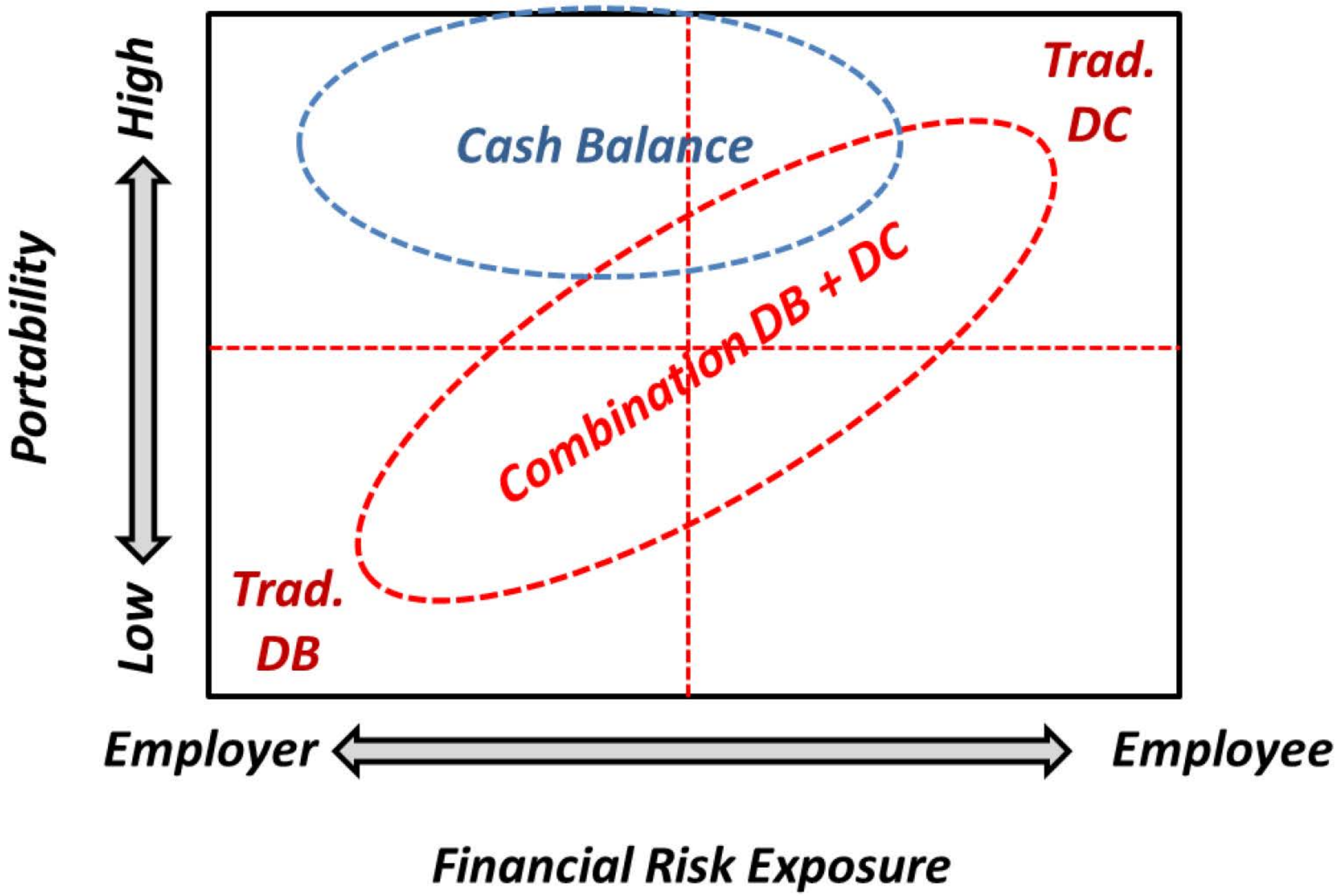
Risk-Sharing Plans: Combined DB + DC Plan

- Employees earn benefits in both a DB plan, and in a DC plan. For example:
  - Employee contributions flow into a DC plan.
  - Employer provides a DB plan with modest benefits.
- Total benefit is the sum from both plans.
- Simple to implement and understand.
- Has long history -- typical large company arrangement through mid 90's.
- Shared risk exposure between employee and employer.
- Currently used by 10 states.

Risk-Sharing Plans: Cash Balance Plan

- Looks like DC plan to employees, but…
- Accounts are “notional” accounts with no investment options (employer responsible for investing).
- Interest credits are defined, and partially guaranteed by employer (leaving employer with some risk and possible unfunded actuarial liability).
- Definition of the interest credit provision is the primary design issue:
  - Could be a fixed rate (e.g. 5% per year)
  - Could link to an outside rate (e.g. Treasury bill + 1%)
  - Could be based on fund returns (e.g. 4% plus 50% of returns over 4%)
- At retirement the account is usually paid as lump sum, but can also be annuity.
- Currently used by 5 states.

Mapping the Options



Investment Risk = Uncertain Results

- About 70% of benefit payments are funded from investment returns, and 30% from employee/employer contributions.
- With a mix of 70% equities and 30% bonds, the expected return over time might be 7.25% per year.
- But actual return experience is very uncertain over a 33 year period (i.e. length of employee career)
  - Could be as low as 3.5% (10^{th} percentile)
  - Could be as high as 10.5% (90^{th} percentile)
- This level of risk is difficult to handle for either employers (in DB plan) or employees (in DC plan).

Comparing the Options

- Assume the same level of expected cost for each type of plan:
  - Employee contributions at 3% of pay
  - Employer contributions at 3.5% of pay (for Regular Class employee)
- Key issues for comparison:
  - What are the expected benefit levels?
    - For a full career employee?
    - For a mid-career termination?
  - How much uncertainty is there in the benefit level (i.e. how much can they deviate from the expected amount)?
  - How much uncertainty is there in the employer cost?
    - If employer is providing either full or partial guarantees for some benefits, then unfunded liabilities will be generated if results are worse than assumed.
    - These unfunded liabilities will affect the required employer contribution rates on a prospective basis.

Current DB Plan (FRS Pension Plan)

- Full career employees have very good benefits. For a Regular Class employee retiring at age 65 with 33 years of service, the benefit will be 53% of average pay.
- Mid-career terminations have relatively small benefits. An employee terminating with 15 years of service might receive a benefit (deferred to age 65) that is about 25% of what they would get if they kept working for 33 years.
- There is no uncertainty in the employee benefits (fully guaranteed).
- There is significant uncertainty in the employer cost due to investment risk that can create unfunded liabilities (or surplus assets).
  - Historical total cost rates have been as low as 5.8% and as high as 18.2%. Adjusting for a 3% employee contribution, the range of employer cost would have been from 2.8% to 15.2% of payroll.
  - The theoretical employer cost to fund benefits for a full career employee might be:
    - Expected cost = 3.5% of payroll
    - Low cost, with very good investment performance = 0% of payroll
    - High cost, with very poor investment performance = 12% of payroll

Current DC Plan (FRS Investment Plan)

- Full career employees receive benefits equal to about 50% of those for the Pension Plan. The reasons for this are:
  - Investment returns are lower,
  - More of the employer dollars go towards mid-career terminations, and
  - The cost of buying a lifetime annuity is significantly higher.
- Mid-career terminations have much larger benefits than under the DB plan – in the range of 50% to 70% higher.
- There is significant uncertainty in the employee benefits.
  - Depending on investment performance, they could be 50% higher, or 30% lower.
  - At the low end, employee replacement rates might fall below minimum desired levels.
- There is no uncertainty in the employer cost.

Combination DB + DC Plan (3% Employee Contributions to DC Plan)

- Full career employees receive benefits equal to about 80-85% of those for the Pension Plan. This reflects a blending of the pure DB results and the pure DC results.
- Mid-career terminations have benefits that fall between the pure DB plan and the pure DC plan. They might be about 40% higher than for the DB plan.
- There is some uncertainty in the employee benefits, due to the DC portion of the benefit.
  - Depending on investment performance, they could be 15% higher, or 6% lower.
  - At the low end, employee replacement rates are much less likely to fall below minimum desired levels.
- There is uncertainty in the employer cost, due to the DB portion of the benefit.
  - Depending on investment performance, they could be as low as 1.5% of pay, or as high as 9% of pay.
  - This level of uncertainty is about a 35% reduction in the risk for a pure DB plan.

Cash Balance Plan

- Full career employees will receive benefits roughly equal to those under the pure DC plan. These will be about 50% lower than for a pure DB plan, and about 40% lower than those under a Combination DB+DC plan. As with the pure DC plan, this is because:
  - More of the employer dollars go towards mid-career terminations, and
  - The cost of buying a lifetime annuity is significantly higher.
- Comparable to the pure DC plan, mid-career terminations have much larger benefits than under the DB plan, and larger than under the combination DB+DC plan.
- There is uncertainty in the employee benefits.
  - ***The results are very sensitive to how the interest credit provision is defined.***
  - At the low end, employee replacement rates might fall below desired levels, but the downside risk to employees is much less than in a pure DC plan.
- There is uncertainty in the employer cost.
  - ***The results are very sensitive to how the interest credit provision is defined.***
  - If investment risk is shared, then the uncertainty should be less than for a pure DB plan.

Risk-Sharing Plans: Comparison Summary

- **Assume both risk-sharing options have the same expected employer cost as the current FRS retirement system**
- Benefits for full career employees: better under combination DB + DC
- Benefits for mid-career terminations: better under cash balance
- Uncertainty of employer cost / exposure to unfunded liabilities:
  - For combination DB + DC the risk might be reduced by about 35% relative to current Pension Plan
  - For cash balance plan, uncertainty depends critically on how the interest credit provision is designed
- Uncertainty of employee benefits:
  - For combination DB + DC the risk of severe shortfall is much lower than for the current Investment Plan
  - For cash balance plan, uncertainty depends critically on how the interest credit provision is designed – but the risk will be lower than for current Investment Plan
- Ease of implementation and administration: better for combination DB + DC
- Impact on investment policy:
  - For combination DB + DC there would be no significant impact.
  - For cash balance plan, a separate investment policy from the pension plan might be needed to address liquidity needs and the interest credit requirements.