MODERNIZING FLORIDA RETIREMENT

ANALYZING RECENT REFORM CONCEPTS

FLORIDA RETIREMENT SYSTEM (FRS)

Prepared by:

Pension Integrity Project

at Reason Foundation

January 2022

reason FOUNDATION

About the Pension Integrity Project

We offer pro-bono technical assistance to public officials to help them design and implement pension reforms that improve plan solvency and promote retirement security, including:

- *Customized analysis* of pension system design, trends
- *Independent actuarial modeling* of reform scenarios
- Consultation and modeling around *custom policy designs*
- Latest pension reform *research and case studies*
- *Peer-to-peer mentoring* from state and local officials who have successfully enacted pension reforms
- Assistance with *stakeholder outreach*, engagement and relationship management
- Design and execution of *public education programs* and media campaigns

Overview

This analysis follows Senate Bill 84 of 2021 and compares the version passed by the Florida Senate to an alternative package of policies derived from best practices implemented in other states. Policies considered best practices comprehensively address the challenges facing FRS stemming from legacy unfunded liabilities as well as a changing, more mobile public workforce.

Featuring for New Regular Class Hires:

- Opening a new defined benefit option with the same level of benefits, but features to reduce long-term governmental risks and costs
- Improving the current defined contribution FRS Investment Plan

For Legacy Employees and Liabilities:

- The current defined benefit FRS Pension Plan would remain for legacy workers and retirees, with no changes to current member and retiree benefits
- More realistic assumptions and accelerated debt payment policies that reinforce the state's commitment to fully funding and paying all promised benefits while minimizing long-term costs to taxpayers

The goal of the following analysis is to compare long-term costs and funding outcomes of various reform options to provide legislative policy guidance.

This is for information purposes only and does not constitute an endorsement of any particular reform concept.

Modeling Scenarios

Status Quo
(Baseline)

Represents the current state of FRS, no changes are made.

SB 84
(As Passed By the Senate in 2021)

Closes the DB Pension Plan to all new hires except Special Risk members. Includes no other funding or risk-related policy changes.

Alternative*
(Reduced Risk Choice)

Gives all Regular Class new hires the choice between a new, risk-managed, 50/50 cost sharing FRS Pension Plan and the current FRS Investment Plan with increased contributions.

Gradually lowers the FRS Pension Plan assumed investment return to 6% and adopts a 15-year layered amortization for any new unfunded liabilities.

* The following Alternative scenario includes **Regular Class new hires only**. Benefits for current members and all other classes of new hires will not be impacted by the policies to follow.

Scenario Details

Status Quo
(Baseline)

DB Pension Plan:
- No changes made

DC Investment Plan:
- No changes made

SB 84
(as Passed by the Senate in 2021)

DB Pension Plan:
- Closed to all new hires except for Special Risk members who are defaulted into the FRS Pension Plan

DC Investment Plan:
- No changes made

Alternative
(Reduced Risk Choice)

DB Pension Plan:
- All new Regular Class members choose between an improved DC plan (default) and a reduced-risk DB plan
- Includes 50/50 normal cost sharing
- 15-year amortization for any newly accrued UAAL
- ARR gradually reduced by 100bps over 8 years (eventually landing at 6%)

DC Investment Plan:
- Regular Class employee and employer contributions both increased by 200bps (totaling a 4% increase)

Note: This analysis assumes that FRS resets its amortization payments and actuarial valuation of assets once the plan achieves full funding. Alternative scenario includes Regular Class new hires only.

Stress Testing Scenarios Using Crisis Simulations

Stress on the Economy:

- Market watchers expect dwindling consumption and incomes to severely impact near-term tax collections – applying more pressure on state and local budgets.
- Revenue declines are likely to undermine employers' ability to make full pension contributions, especially for those relying on more volatile tax sources (e.g., sales taxes) and those with low rainy-day fund balances.
- Many experts expect continued market volatility, and the Federal Reserve is expected to keep interest rates near 0% for years and only increase rates in response to longer-term inflation trends.
- As deployed in the following analysis, recession = -24% returns in 2022, 11% returns in 2023-2025.

"All-in Employer Cost" Explained

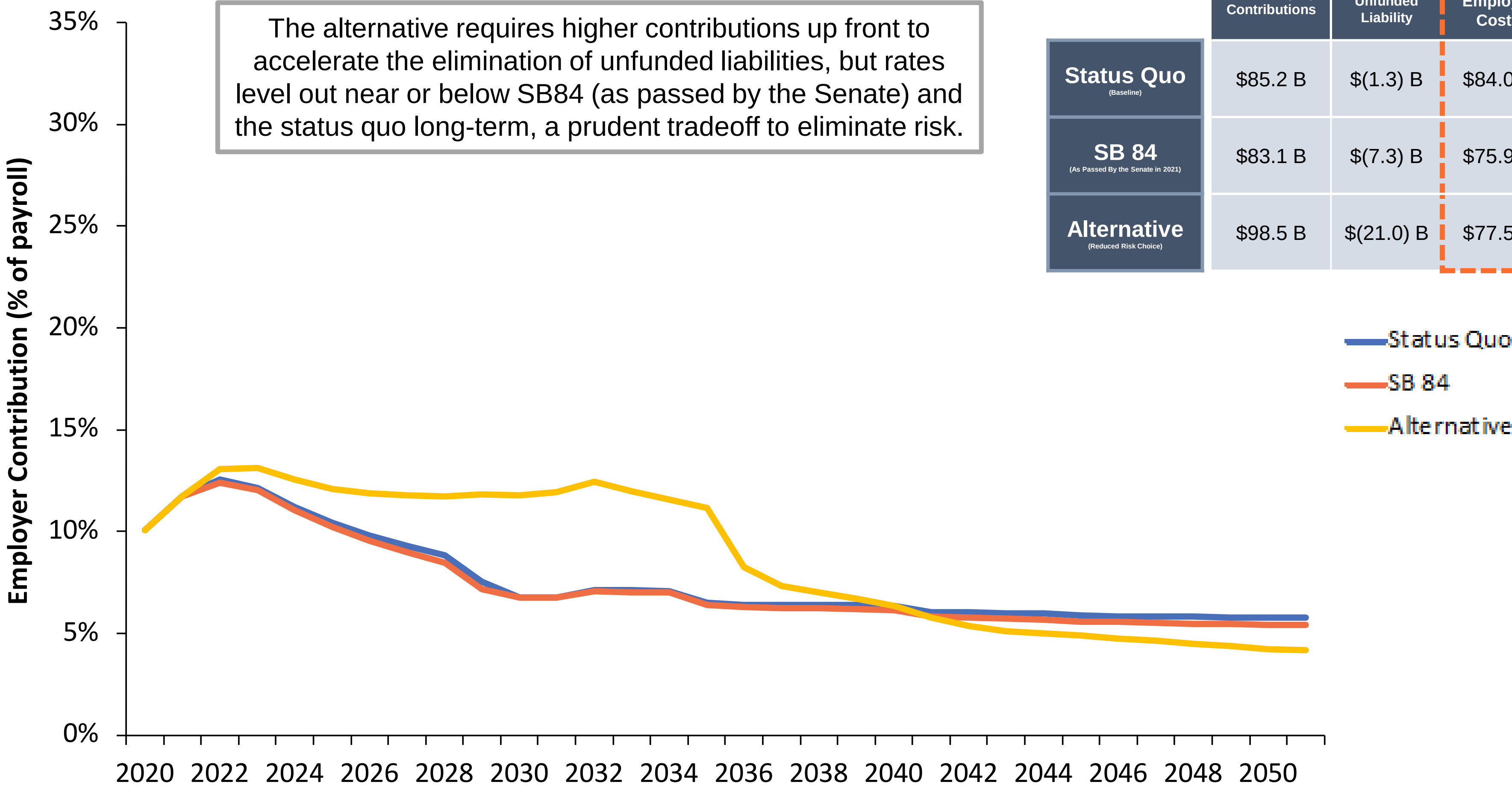
The true cost of a pension is not only in the annual contributions, but also in whatever unfunded liabilities remain. The "All-in Employer Cost" combines the total amount paid in employer contributions and adds what unfunded liabilities remain at the end of the forecasting window.

What if Experience Matches FRS Assumptions?

6.8% constant returns over 30 years

The alternative requires higher contributions up front to accelerate the elimination of unfunded liabilities, but rates level out near or below SB84 (as passed by the Senate) and the status quo long-term, a prudent tradeoff to eliminate risk.

	30-Year Employer Contributions	2051 Unfunded Liability	Total All-in Employer Costs
Status Quo (Baseline)	$85.2 B	$(1.3) B	$84.0 B
SB 84 (As Passed By the Senate in 2021)	$83.1 B	$(7.3) B	$75.9 B
Alternative (Reduced Risk Choice)	$98.5 B	$(21.0) B	$77.5 B

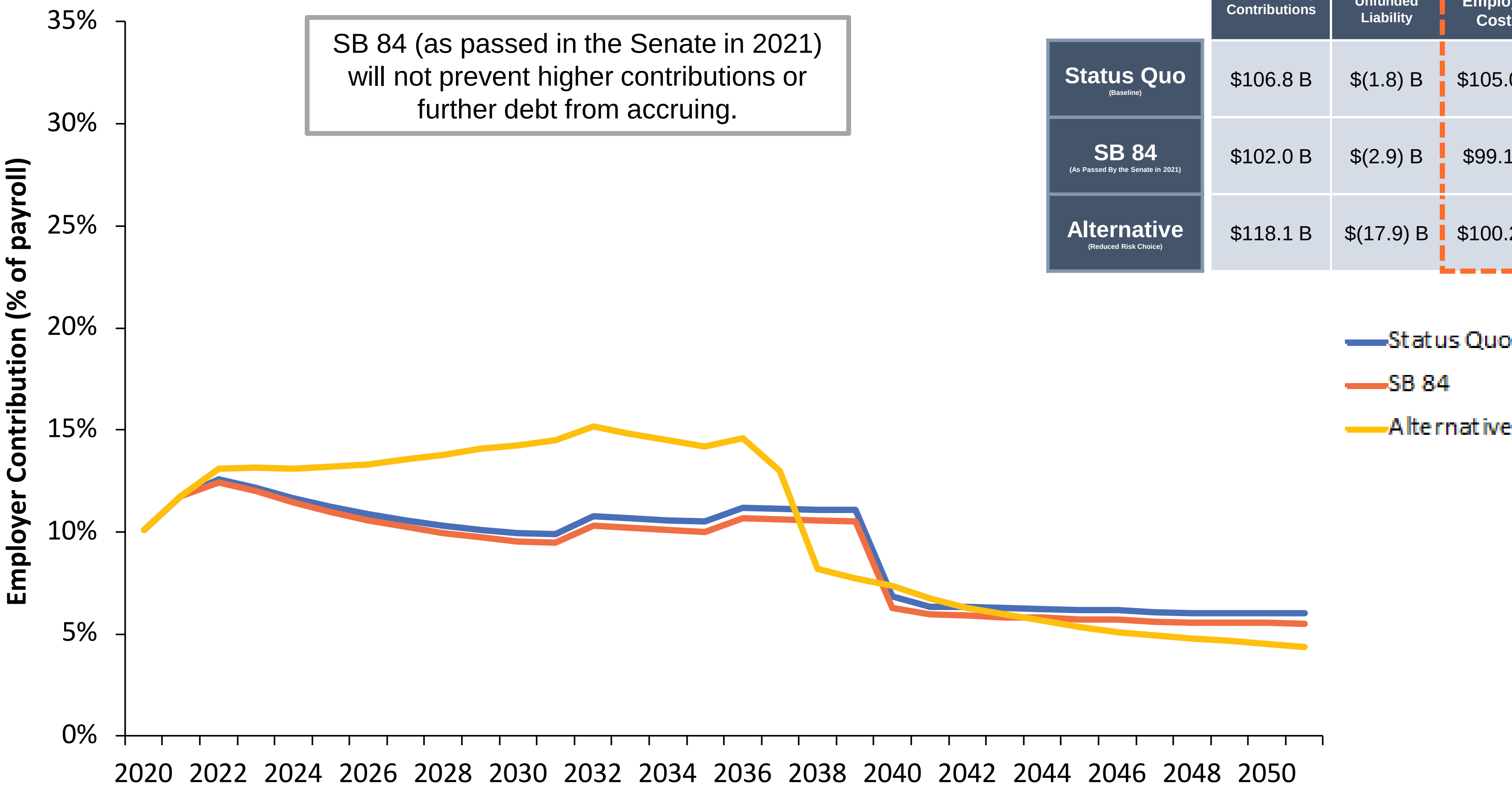


Source: Pension Integrity Project actuarial forecast of FRS. State is assumed to make 100% *actuarially* required contributions. Values are rounded and adjusted for inflation.

What if FRS Experiences One Bad Year?

0% Return in 2022 + 6.8% constant returns following

	30-Year Employer Contributions	2051 Unfunded Liability	Total All-in Employer Costs
Status Quo (Baseline)	$106.8 B	$(1.8) B	$105.0 B
SB 84 (As Passed By the Senate in 2021)	$102.0 B	$(2.9) B	$99.1 B
Alternative (Reduced Risk Choice)	$118.1 B	$(17.9) B	$100.2 B



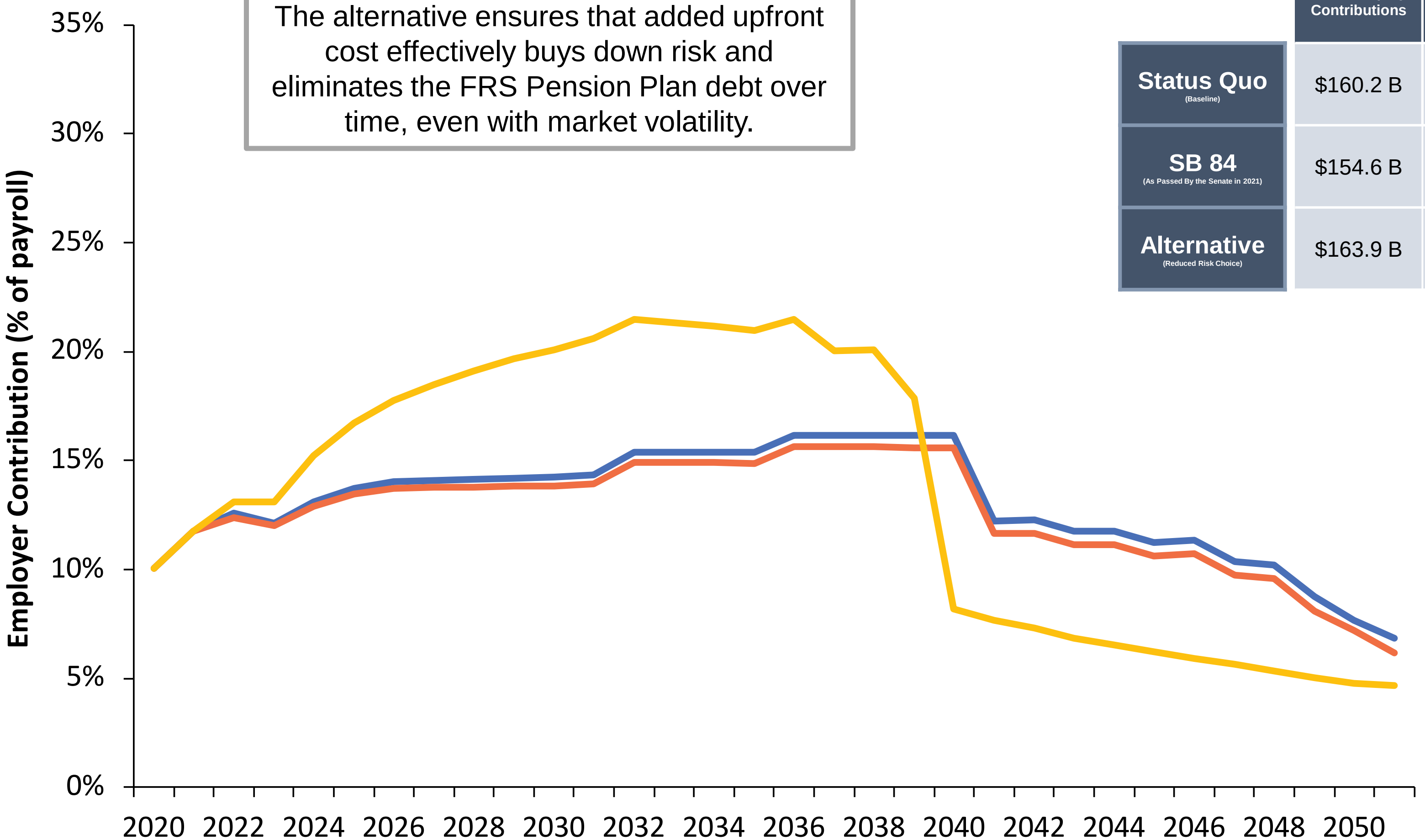
Source: Pension Integrity Project actuarial forecast of FRS. State is assumed to make 100% *actuarially* required contributions. Values are rounded and adjusted for inflation.

What if FRS Experienced Another Recession?

Recession and recovery 2022-26 + 6.8% constant returns following

The alternative ensures that added upfront cost effectively buys down risk and eliminates the FRS Pension Plan debt over time, even with market volatility.

	30-Year Employer Contributions	2051 Unfunded Liability	Total All-in Employer Costs
Status Quo (Baseline)	$160.2 B	$0.9 B	$161.1 B
SB 84 (As Passed By the Senate in 2021)	$154.6 B	$0.9 B	$155.5 B
Alternative (Reduced Risk Choice)	$163.9 B	$(15.5) B	$148.4 B

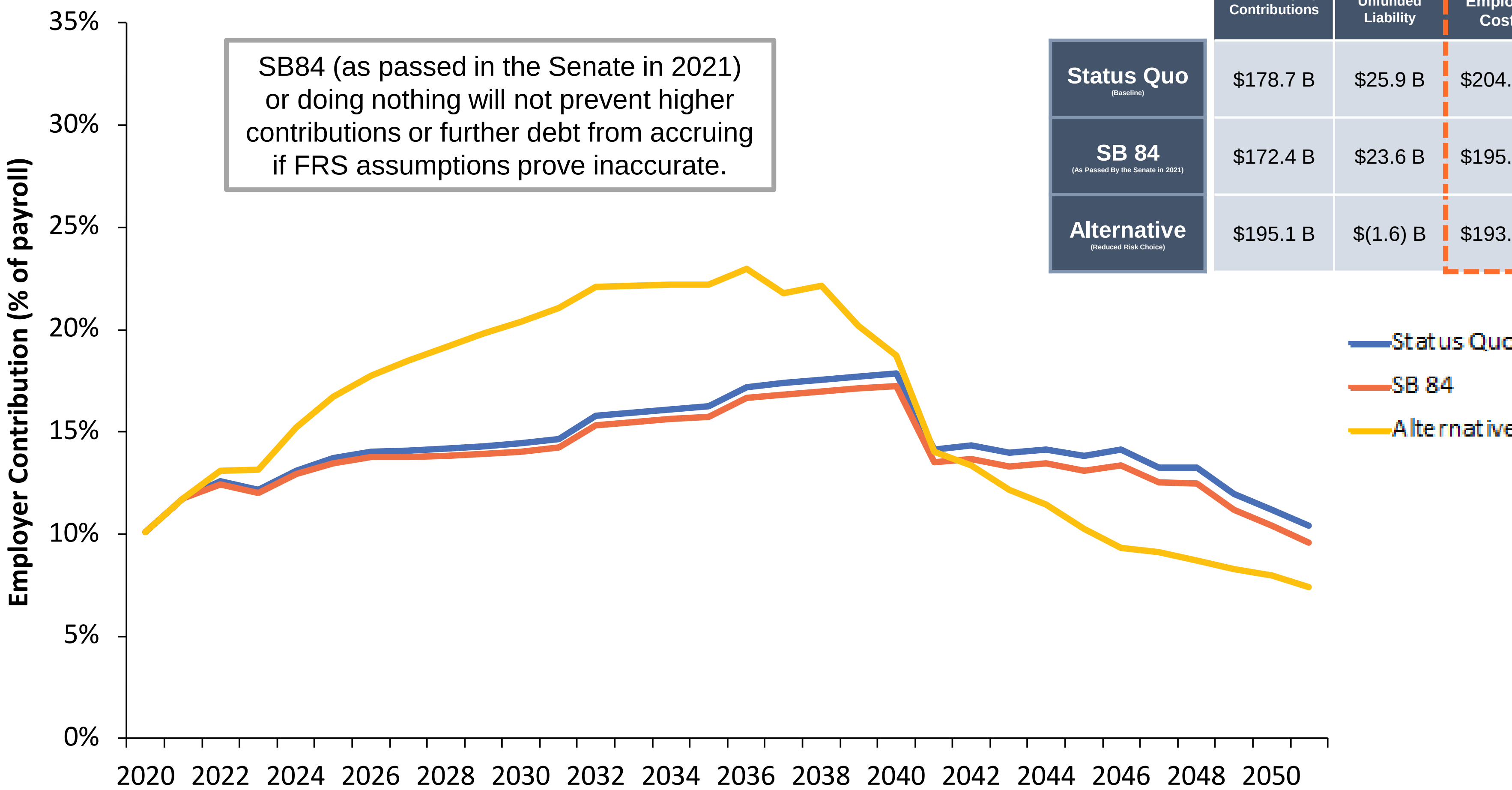


Source: Pension Integrity Project actuarial forecast of FRS. State is assumed to make 100% *actuarially* required contributions. Values are rounded and adjusted for inflation.

What if FRS Faces Severe Market Turmoil?

Recession and recovery 2022-26 + 6% constant returns following

	30-Year Employer Contributions	2051 Unfunded Liability	Total All-in Employer Costs
Status Quo (Baseline)	$178.7 B	$25.9 B	$204.5 B
SB 84 (As Passed By the Senate in 2021)	$172.4 B	$23.6 B	$195.9 B
Alternative (Reduced Risk Choice)	$195.1 B	$(1.6) B	$193.5 B



Source: Pension Integrity Project actuarial forecast of FRS. State is assumed to make 100% *actuarially* required contributions. Values are rounded and adjusted for inflation.

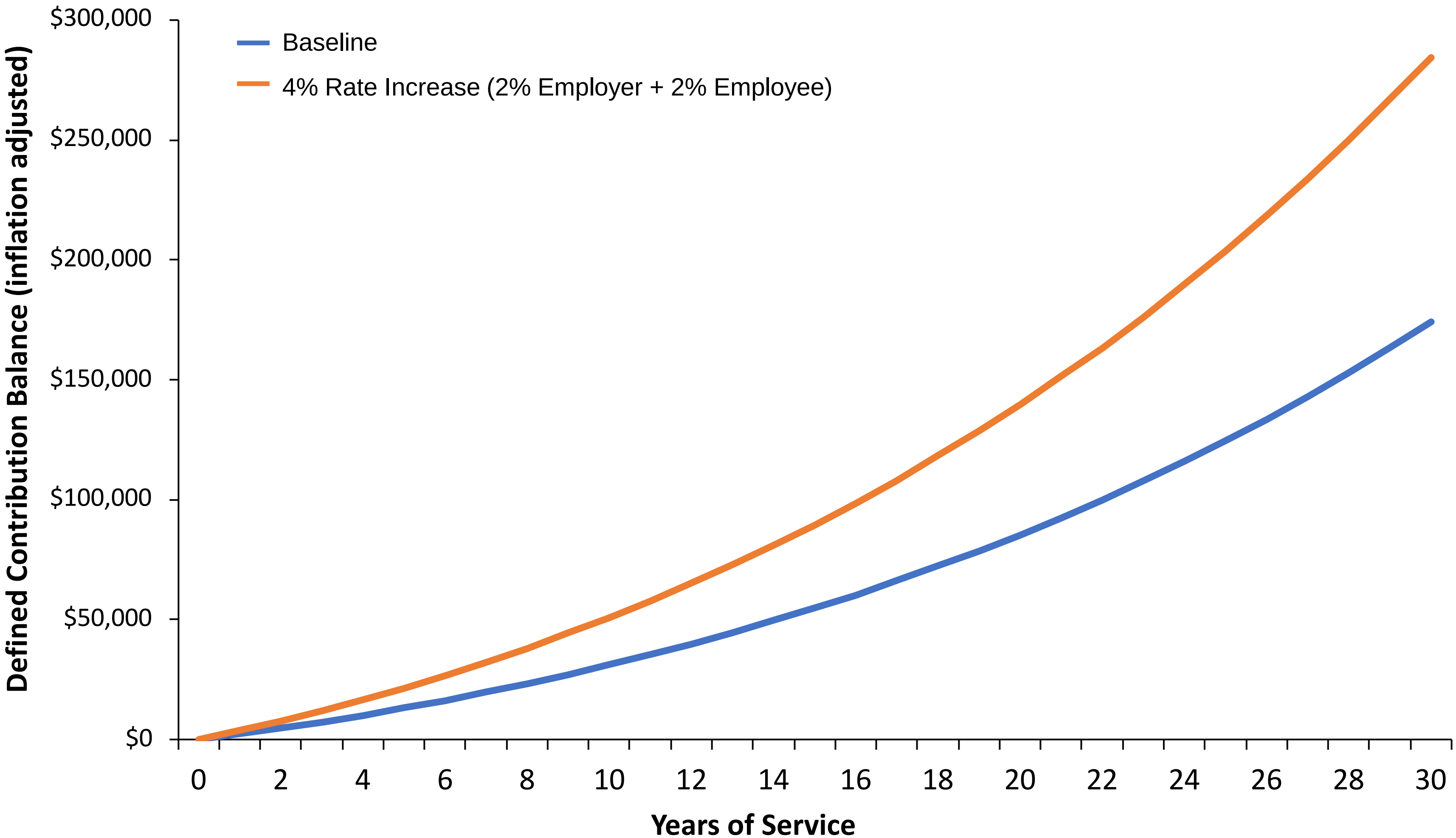
Long Term Results of Different Scenarios

	6.8% Returns (FRS Assumption)			One Recession + 6.8% Returns			One Recession + 6% Returns		
	30-Year Employer Contributions	2050 Unfunded Liability	Total All-in Employer Costs	30-Year Employer Contributions	2050 Unfunded Liability	Total All-in Employer Costs	30-Year Employer Contributions	2050 Unfunded Liability	Total All-in Employer Costs
Status Quo (Baseline)	$85.2 B	$(1.3) B	$84.0 B	$160.2 B	$0.9 B	$161.1 B	$178.7 B	$25.9 B	$204.5 B
SB 84 (As Passed By the Senate in 2021)	$83.1 B	$(7.3) B	$75.9 B	$154.6 B	$0.9 B	$155.5 B	$172.4 B	$23.6 B	$195.9 B
Alternative (Reduced Risk Choice)	$98.5 B	$(21.0) B	$77.5 B	$163.9 B	$(15.5) B	$148.4 B	$195.1 B	$(1.6) B	$193.5 B

Source: Pension Integrity Project actuarial forecast of FRS. State is assumed to make 100% *actuarially* required contributions. Values are rounded and adjusted for inflation.

FRS Investment Plan Value with 4% Increase

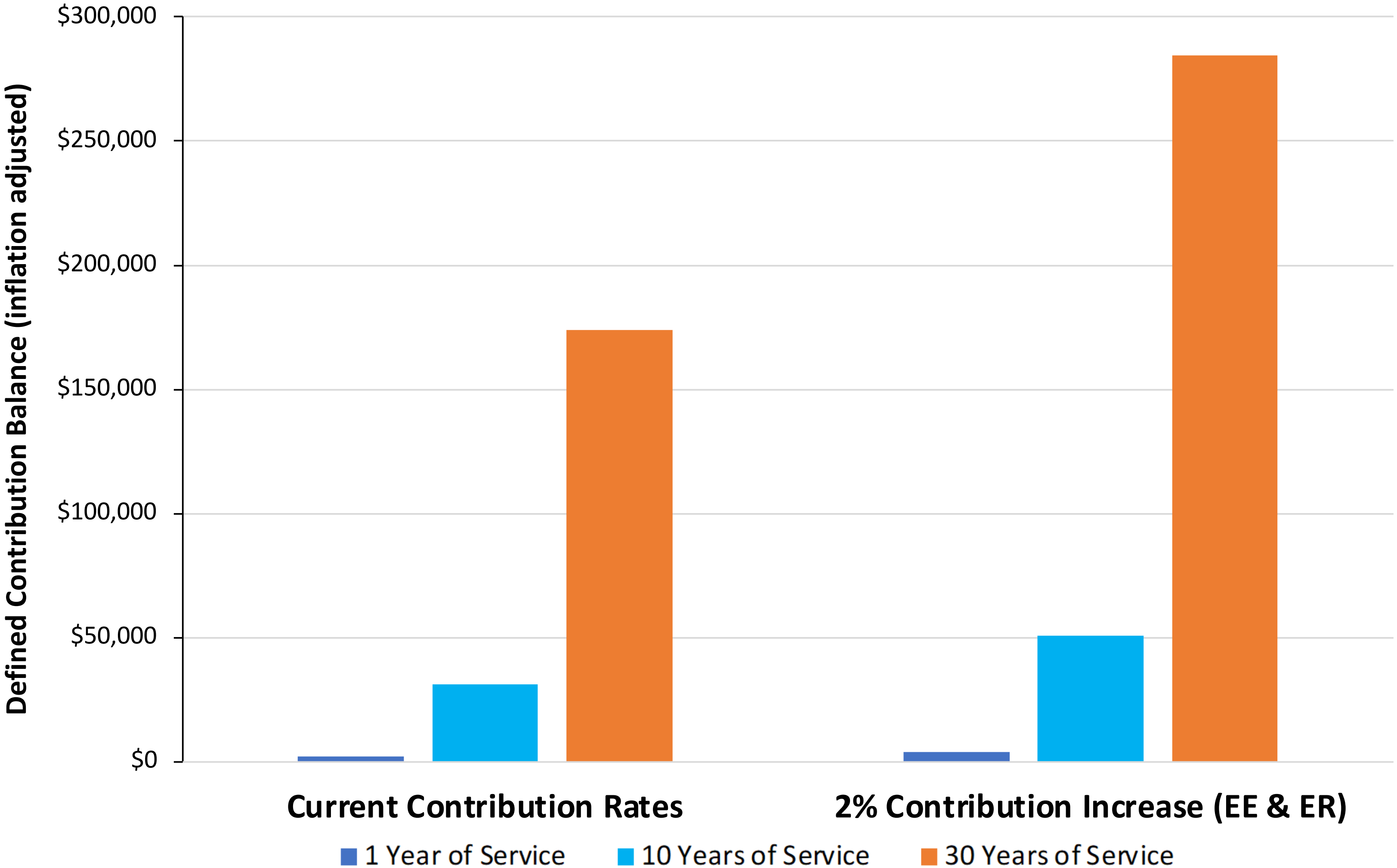
New Regular Class employee starting at age 30 w/ $36,191 salary



Source: Pension Integrity Project analysis of FRS Investment Plan. Assumes 6% constant returns and 2% inflation. Values are adjusted for inflation.

FRS Investment Plan Value with 4% Increase

New Regular Class employee starting at age 30 w/ $36,191 salary



Source: Pension Integrity Project analysis of FRS Investment Plan. Assumes 6% constant returns and 2% inflation. Values are adjusted for inflation.

For the Same or Less Cash, There's A Better Way

Reform Objectives	Status Quo (Baseline)	SB 84 (As Passed By the Senate in 2021)	Alternative (Reduced Risk Choice)
Keeping Promises *Ensure the ability to pay 100% of the benefits earned and accrued by active workers and retirees*	NO	NO	YES
Retirement Security *Provide retirement security for all current and future employees*	SOME	NO	YES
Predictability *Stabilize contribution rates for the long-term*	NO	SOME	YES
Risk Reduction *Reduce pension system exposure to financial risk and market volatility*	SOME	SOME	YES
Affordability *Reduce long-term costs for employers, employees*	SOME	SOME	YES
Attractive Benefits *Ensure the ability to recruit 21st Century employees*	NO	NO	YES
Good Governance *Adopt best practices for board organization, investment management, and financial reporting*	SOME	SOME	N/A

Key Takeaways

- Closing the DB Pension Plan to new hires could save between $8 billion to $10 billion in long-term costs depending on market outcomes, but the plan is still very vulnerable to market underperformance similar to the previous 20 years.
- Increasing contributions into the DC Investment Plan would improve retirement security and improve its long-term viability.
- De-risking the legacy DB Pension Plan (lower ARR + shortened amortization schedules for new debt) would greatly improve the ability of FRS to reach full funding, even under market stress scenarios.

For about the same or less funding, alternative reform concepts could outperform SB84 (as passed by the Senate) by improving the DC contribution rates, eliminating the FRS unfunded liability, adopting more prudent investment return assumptions, and paying down new unfunded liabilities much faster to avoid high interest.

- Providing a new risk-managed FRS Pension Plan option for new members would allow the state to continue to provide flexible options and reduce long-term costs.

Defined Benefit Reform Best Practices

1. **Adopt Better Funding Policy, Risk Assessment, And Actuarial Assumptions**
   - Lower the assumed rate of return to align with independent actuarial recommendations.
   - These changes should aim at minimizing risk and contribution rate volatility for employers and employees.
2. **Establish A Plan To Pay Off The Unfunded Liability As Quickly As Possible**
   - The Society of Actuaries Blue Ribbon Panel recommends amortization schedules be no longer than 15 to 20 years.
   - Reducing the amortization layering period would save the state billions in interest payments.
3. **Review Current Plan Options To Improve Retirement Security**
   - Consider offering additional retirement options that create a pathway to lifetime income for employees that do not stay in public service.

Defined Contribution Reform Best Practices

1. **Contributions Should Meet Benefit Adequacy Standards**
   - Financial experts strongly recommend contributions 10 to 15 percent of pre-tax earnings into a retirement account.
   - Older workers with a closer retirement horizon and inadequate savings may need to contribute even more.
2. **Encourage Use of Target Date Funds**
   - Well-designed DC plans should also offer the correct age appropriate investment mix. This is generally accomplished by using target date funds that adjust investment risk to the employee's retirement horizon to protect the value of the account from market fluctuations as the worker nears retirement.
3. **Expand Lifetime Income Options to Improve Retirement Security**
   - The mix of proprietary investment funds and reasonably priced target-date funds give participants adequate "one-choice" options. However, without guaranteed investments included in the target-date portfolio constructions and options like deferred annuities the FRS Investment Plan will continue to limit members' lifetime income options.
   - Despite a lifetime annuity option being available to members, generally the distribution choices offered by the FRS Investment Plan limit its attractiveness as a true, core retirement option.

4-Part Pension Debt Mitigation Plan

Pension debt is a concern for all Florida policymakers, taxpayers and retirees, current and future, because its cost seeps through city and state budgets, smothering community programs like spilled oil on vegetation. Like an oil spill, there must be a clear process to end the emergency and set all impacted parties on a better path forward.

Part 1: *Cap the Spill*

- Launch Improved Retirement Benefit Options to Provide New Hires

Part 2: *Clean the Mess*

- Set Florida's Public Pension Systems on a Closed Amortization Schedule

Part 3: *Build in Preventative Measures*

- De-risk Current Actuarial Assumptions and Set a Closed Payment Schedule for Future Unfunded Liabilities

Part 4: *Plan for the Future*

- Routinely Stress Plans to Identify Trends and Set Automatic Adjustments

Questions?

Pension Integrity Project at Reason Foundation

Zachary Christensen, Managing Director

zachary.christensen@reason.org

Truong Bui, Managing Director

truong.bui@reason.org

Steven Gassenberger, Policy Analyst

steven.gassenberger@reason.org

Len Gilroy, Senior Managing Director

leonard.gilroy@reason.org

APPENDIX

Contribution Comparison

Rates Used by States with Primary DC Plans

State	Plan	Employee Type	No DB Option	Does Not Participate in SS	Employee Contribution	Employer Contribution	Total Contribution
OH	STRS	Teacher		X	14.00%	9.53%	23.53%
CO	PERA	General		X	10.50%	10.50%	21.00%
AZ	PSPRS	Safety			9.00%	9.00%	18.00%
OH	PERS	General		X	10.00%	7.50%	17.50%
MT	PERA	General			7.90%	8.63%	16.53%
AK	TRS	Teacher	X	X	8.00%	7.00%	15.00%
ND	PERS	General			7.00%	7.12%	14.12%
SC	SCRS	General			9.00%	5.00%	14.00%
AK	PERS	General	X	X	8.00%	5.00%	13.00%
PA	PSERS	Teacher			7.50%	3.50%	11.00%
PA	SERS	General			7.50%	3.50%	11.00%
OK	PERS	General	X		4.50%	6.00%	10.50%
MI	PSERS	Teacher			3.00%	7.00%	10.00%
MI	SERS	General			3.00%	7.00%	10.00%
UT	URS	General			0.00%	10.00%	10.00%
FL	FRS	General			3.00%	3.30%	6.30%

Note: Rates displayed for Florida FRS are for the Regular Class, which most new workers fall under.