

# FLORIDA RETIREMENT SYSTEM (FRS) PENSION SOLVENCY ANALYSIS

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Prepared by:

**Pension Integrity Project at Reason Foundation**

**March 3, 2021**





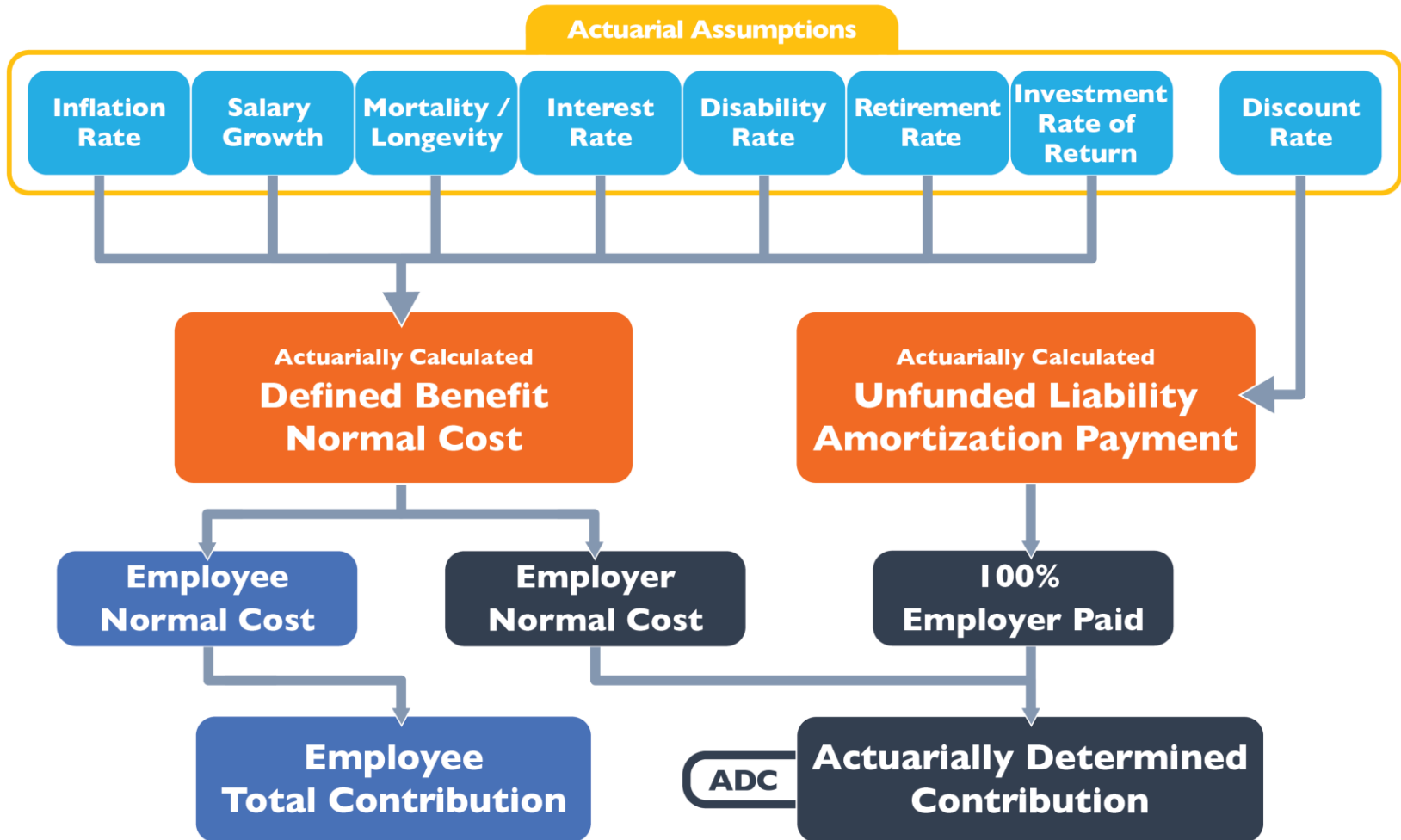
# About the Pension Integrity Project

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

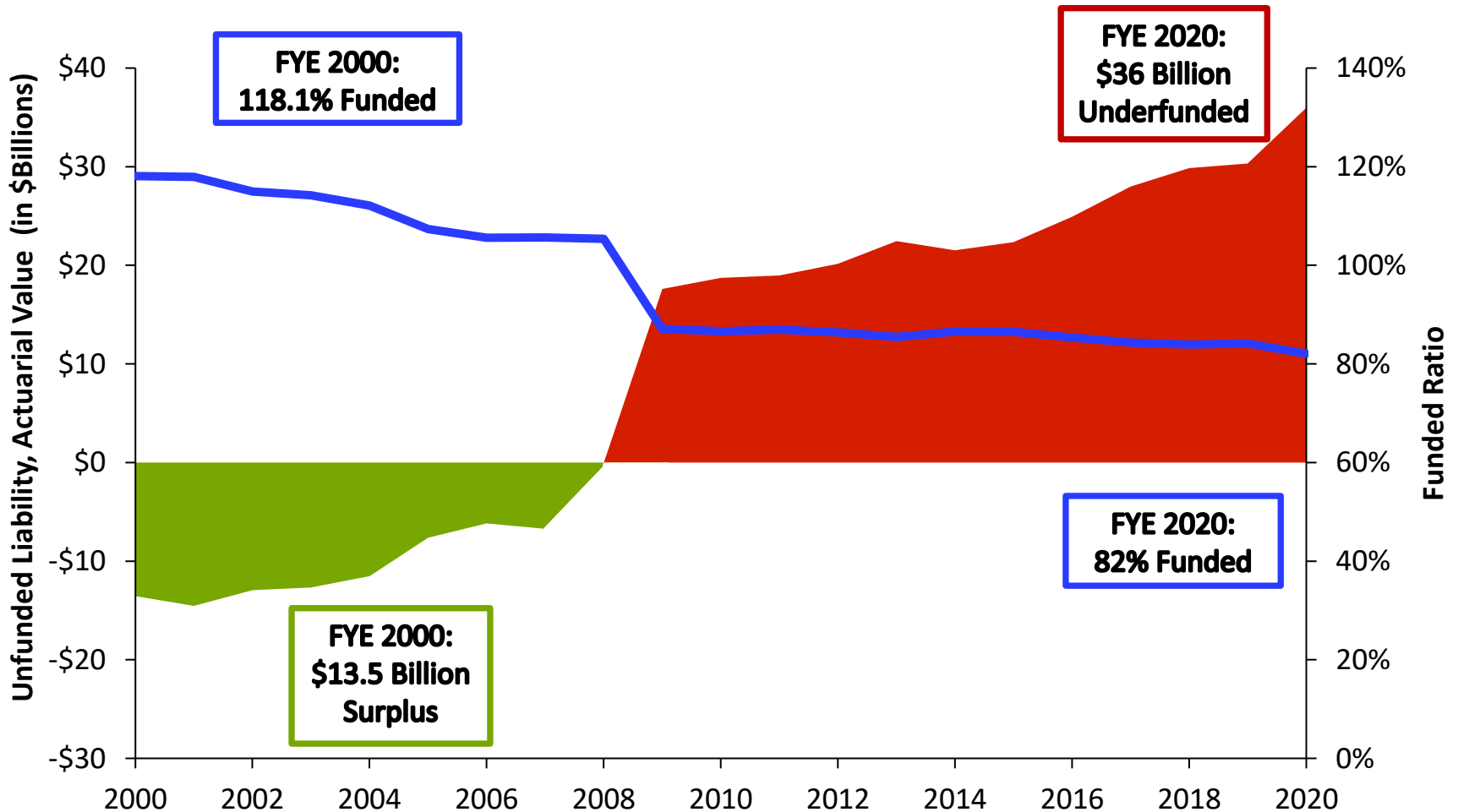


# How a Pension Plan is Funded





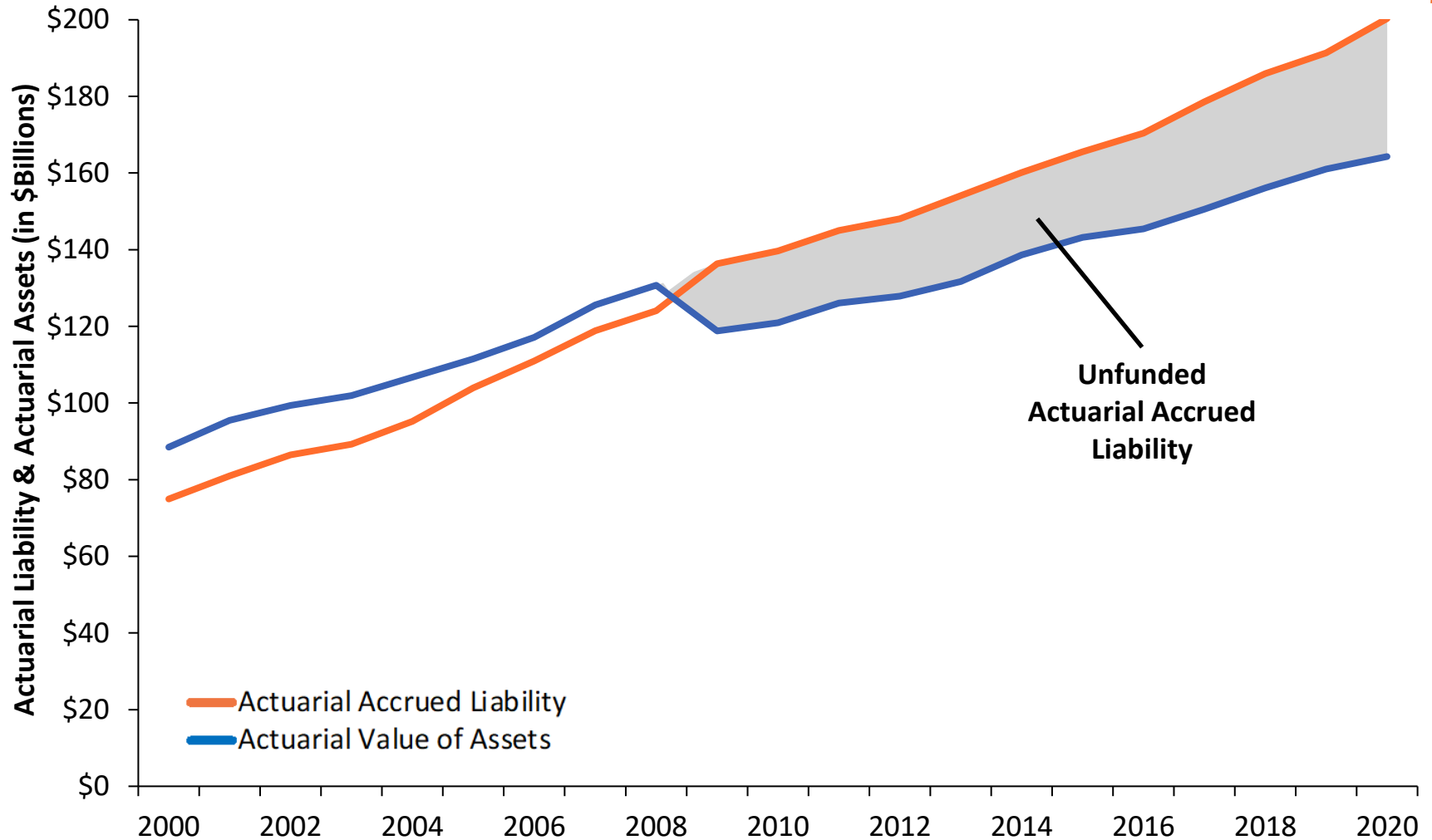
# A History of FRS Solvency (2000-2020)



Source: Pension Integrity Project analysis of FRS actuarial valuation reports and CAFRs.

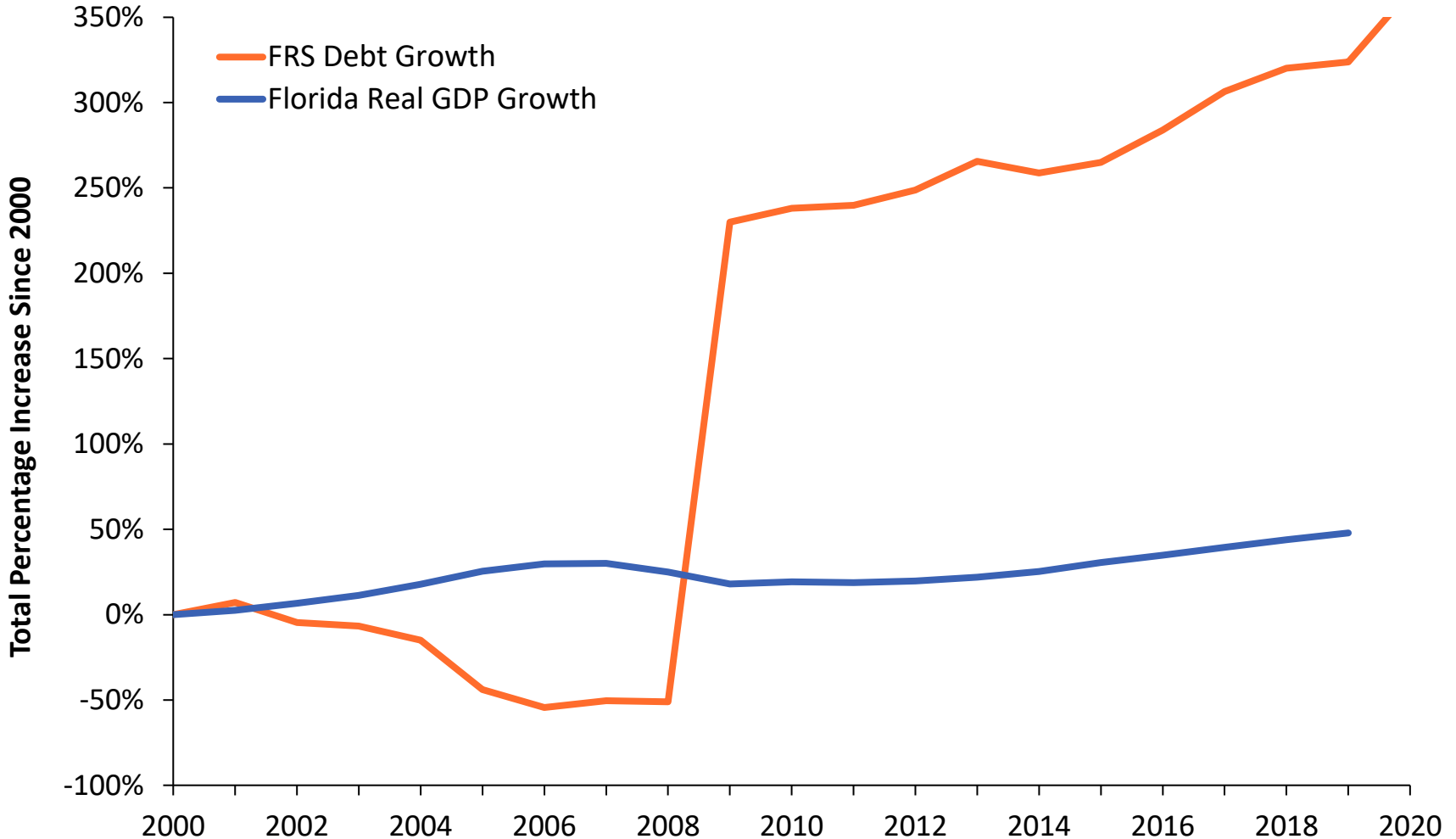


# FRS Liabilities are Growing Faster than Assets



Source: Pension Integrity Project analysis of FRS actuarial valuation reports and CAFRs.

# FRS Unfunded Liabilities are Growing Faster than the Florida Economy



Source: Pension Integrity Project Analysis of FRS valuation reports and CAFRs, Federal Reserve of St. Louis Data for the Florida gross domestic product.



# Makeup of FRS Pension Plan Contributions

	FY2021 Contributions	
	% of Payroll	\$ Value
<b>Total Employees</b>	<b>3.00%</b>	<b>\$1,136,206</b>
<b>Total Employer</b>	<b>11.37%</b>	<b>\$4,066,581</b>
<i>Employer (Normal Cost)</i>	6.60%	\$2,258,445
<i>Employer (Debt Amortization)</i>	4.77%	\$1,808,136
<b>Total FRS Contributions</b>	<b>14.37%</b>	<b>\$5,202,787</b>

*The Florida Actuarial Conference sets FRS contribution rates*

*On occasion, Conference rates have differed with plan actuarial recommendations.*



# Current Retirement Option Sets

## FRS Pension Plan

### Type:

- Final Average Salary Defined Benefit Pension Plan

### Final Average Salary:

- Average of the 8 highest years

### Multiplier:

- 3%

### Vesting:

- 8 years

### Normal Retirement Eligibility:

- Any age @ 33 YOS or vested by age 65

### Regular Member Contribution:

- 3.09% for Normal Cost
- 4.30% for Unfunded Liability Payment (beginning FY2019-20)

### Employee Contribution:

- 3%

## FRS Investment Plan

\*default option as of January 1, 2018

### Type:

- Defined Contribution Retirement Plan

### Employee Contribution:

- 3%

### Employer Contribution:

- 3.3% to member IP account
- 3.56% to legacy FRS Pension Plan unfunded liabilities

### Vesting:

- 1 year

### Investment Options:

- Investment Funds, Target Date Funds

### Default Investment Strategy:

- Target Date Funds





# REVIEWING PRIOR REFORMS

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# Major Reforms to FRS

## 2000 – House Bill 2393

- Provided a defined, participant-directed contribution (DC) plan option to FRS members.
- One-year vesting for the portability of employer contributions.
- Based retirement benefits on market returns rather than a fixed benefit guarantee.
- Existing members given the option to switch future FRS participation into the DC plan without losing their already earned pension benefits.

## 2011 – Senate Bill 2100

- Created a new benefit tier for “special-risk” new hires.
- Renamed the FRS defined benefit plan the Florida Retirement System “Pension Plan”.
- Renamed the FRS defined contribution plan from the Public Employee Optional Retirement Program to the Florida Retirement System “Investment Plan.”
- Eliminated post-retirement increases on pension benefits earned after July 2011.
- Decreased both employer and employee contribution rates effective July 2012.
- Led to unfunded accrued liabilities decreasing from \$16.7 billion to \$15.6 billion.

## 2017 – Senate Bill 7022

- Defaults new employees hired after January 2018 into the FRS Investment Plan (DC plan) if no election taken after eight months of employment.



# Previous Reforms Have Not Set the FRS Pension Plan on a Path to Long-Term Sustainability

- The historic 10-year bull market has not helped FRS recover
    - The 2008 financial crisis weakened FRS's funded status, but since then markets have recovered while pension funding has not.
  - Reducing benefits in 2011 reduced some costs at the expense of inflation protection for retirees, but it did not fundamentally address why pension debt continues to grow.
  - Defaulting new FRS members into the Investment Plan in 2018 was better aligned with workforce mobility trends and reduced future financial risk, but it did not address why pension debt has persisted for a decade.
  - For three straight years (2016, 2017 & 2018) FRS's consulting actuary has warned that the assumed rate of return is not reasonable.
  - Additional reforms are necessary to ensure long-term solvency.
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# FRS Remains Unsustainable Despite Recent Reforms



## Challenge #1:

### FRS Defined Benefit Pension Plan Still Not on a Path to Solvency

- A. Overly optimistic assumed rate of return creates unnecessary risk.
- B. Unmet actuarial assumptions and slow-paced changes to those assumptions increases unfunded liabilities over time.
- C. Insufficient employer contributions inhibits plan assets from compounding growth over decades.
- D. Discount rate misaligned with risk, underpricing pension cost and undervaluing FRS unfunded liabilities.

## Challenge #2:

### FRS Defined Contribution Retirement Plan Not Built for Retirement Security.

- An inadequate contribution rate is shortchanging worker retirement security.



# CHALLENGE #1

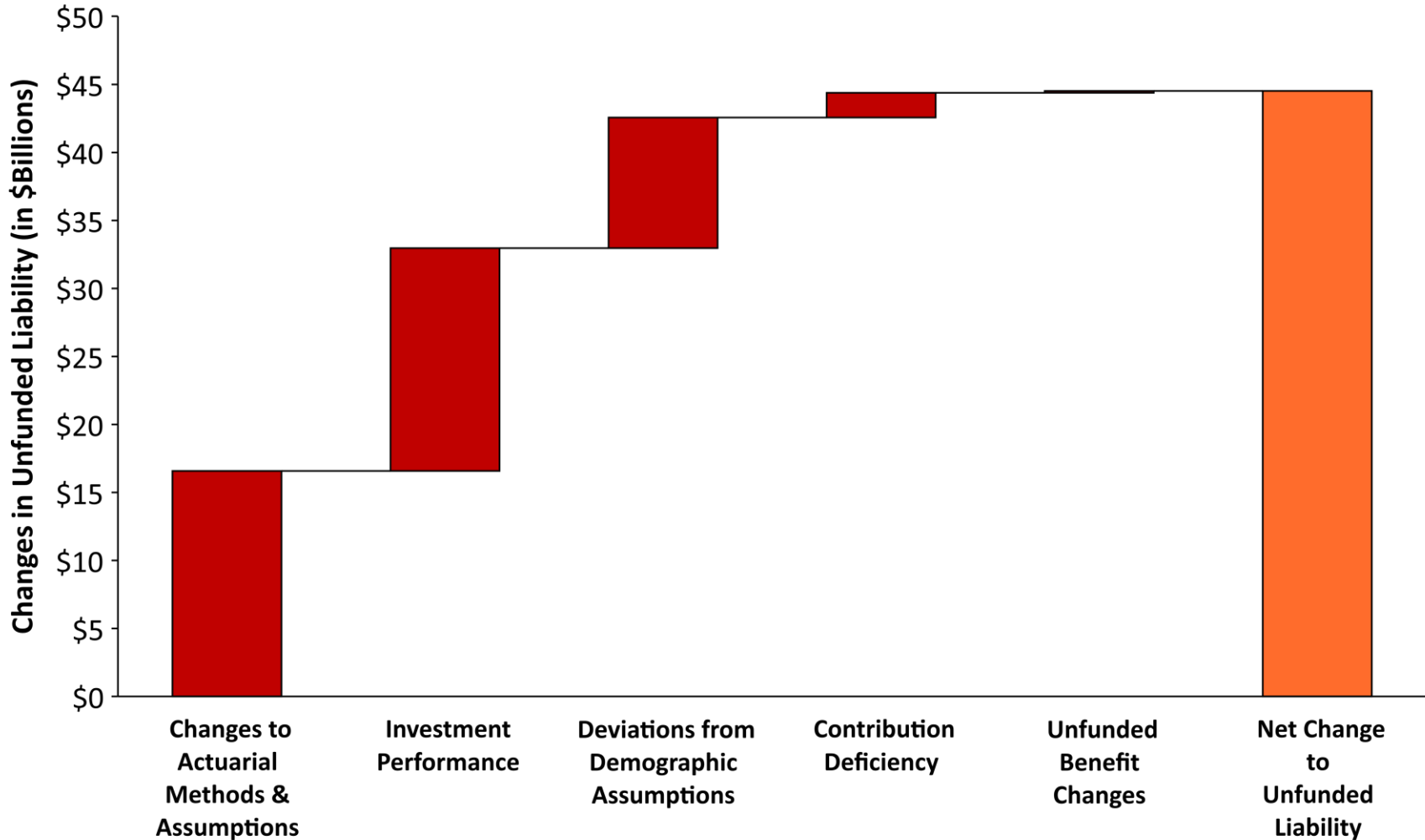
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- FRS Pension Plan is still not on a path to long-term solvency.



# Composition of FRS Pension Plan Debt

Actuarial Experience of FRS, 2009-2020



Source: Pension Integrity Project analysis of FRS actuarial valuations. Data represents cumulative unfunded liability by gain/loss category.



# Driving Factors Behind FRS Pension Debt

- A. Changes to Actuarial Methods & Assumptions** to better reflect current market and demographic trends have exposed over \$16.6 billion in previously unrecognized unfunded liability.
- B. Deviations from Investment Return Assumptions** have been the largest unintended contributor to the unfunded liability, adding \$16.4 billion since 2008.
- C. Insufficient contributions** contributed \$1.8 billion to FRS unfunded liability since 2008.
- D. Undervaluing Debt** through discounting methods has led to the tacit undercalculation of required contributions.



# OVERLY OPTIMISTIC ASSUMED RATE OF RETURN

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- **Unrealistic Expectations:** Despite the recent change to 7.0%, the Assumed Investment Return for FRS continues to expose taxpayers to significant investment underperformance risk.
- **Underpricing Contributions:** The use of an unrealistic Assumed Return has likely resulted in underpriced Normal Cost and an undercalculated Actuarially Determined Contribution.



# FRS Actuaries on Current Return Assumption



*Notable disagreement persists regarding the FRS investment return assumption.*

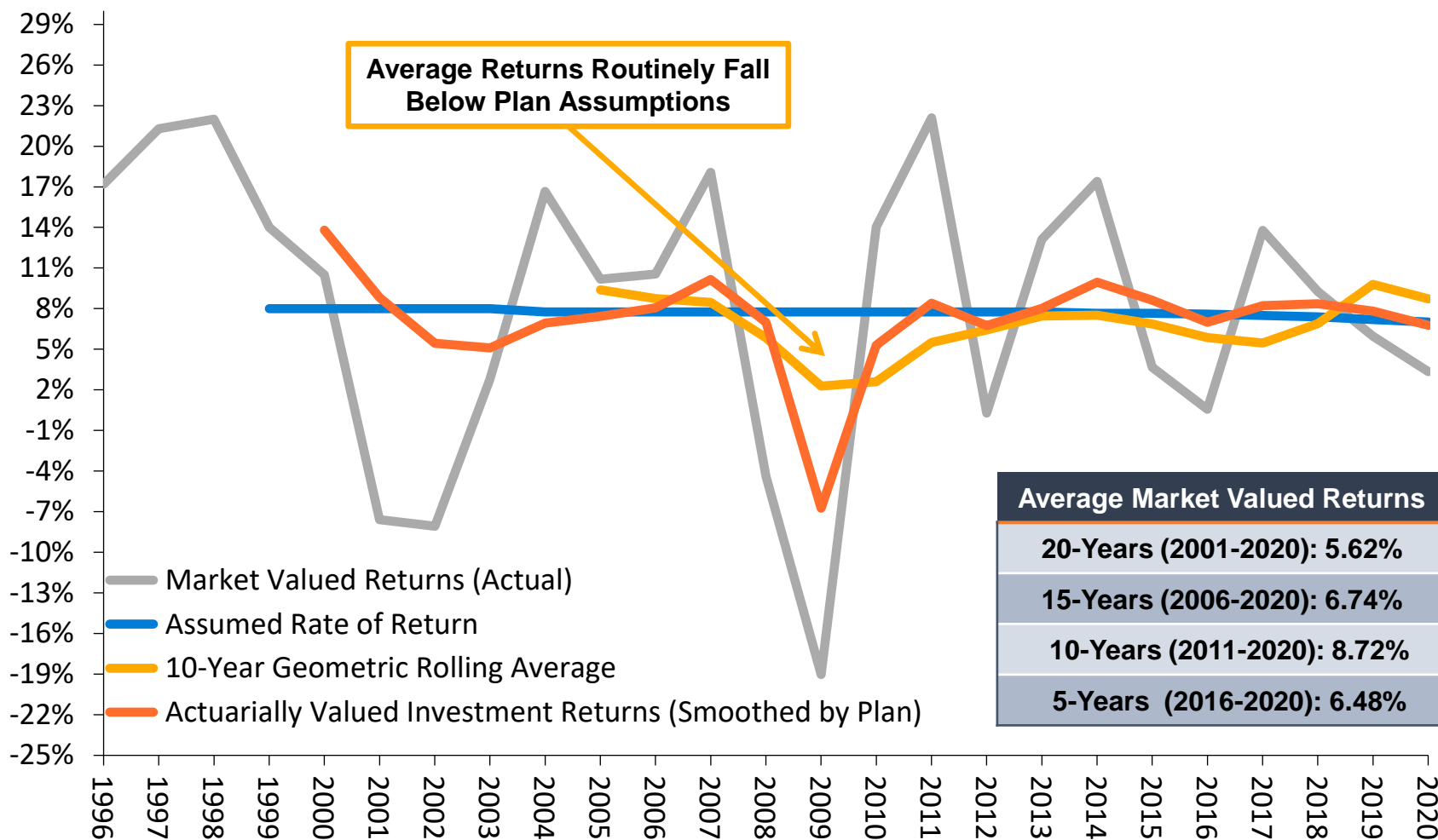
- All models developed in 2017 by Milliman and Aon Hewitt had 50th percentile geometric average annual long-term future returns in the 6.6%-6.8% range.
- Models developed in 2018 by Milliman and Aon Hewitt show the average annual long-term future returns in the 6.4-6.7% range, yet FRS Actuarial Assumption Conference adopted a 7.4% return assumption.
- Presenters at the 2020 FRS Actuarial Conference suggested return assumptions within the range of 6.46% (Aon) to 6.56% (Milliman), with a lower inflation assumption of 2.1% to 2.2% relative to the previous conference assumption of 2.6%.
- The 2020 FRS Actuarial Assumption Conference adopted a 7.0% return assumption.

Year	FRS Assumed Rate of Return
2001	8.00%
2002	8.00%
2003	8.00%
2004	7.75%
2005	7.75%
2006	7.75%
2007	7.75%
2008	7.75%
2009	7.75%
2010	7.75%
2011	7.75%
2012	7.75%
2013	7.75%
2014	7.65%
2015	7.65%
2016	7.60%
2017	7.50%
2018	7.40%
2019	7.20%
2020	7.00%



## Challenge I-A: Investment Returns

# Investment Return History, 1996-2020



Source: Pension Integrity Project analysis off FRS actuarial valuation reports and CAFRs.

## Challenge I-A: Investment Returns

# Investment Returns vs. Assumptions



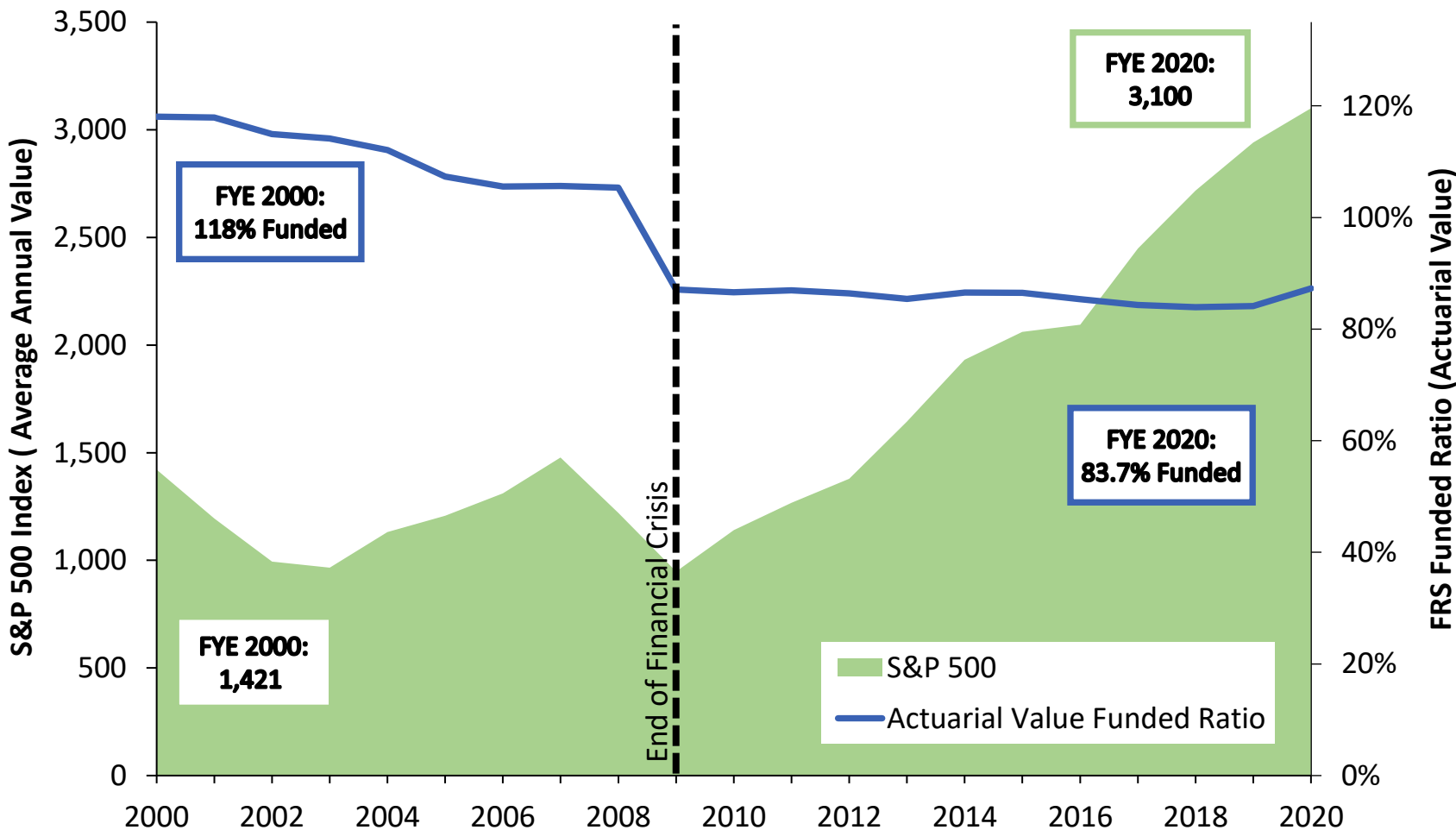
- FRS historically assumed an investment return rate as high as 8.00% before lowering the assumption to 7.75% in 2004. The plan has adjusted the assumption annually since in 2014, to reach the current 7.0% for 2021.
- FRS expanded investments in high-risk holdings in a search for greater investment returns over the past decade.
- The FRS Pension Plan investment portfolio's trends have not matched long-term assumptions:

Average Market Valued Returns	Average Actuarially Valued Returns
<b>20-Years (2001-2020) 5.62%</b>	<b>20-Years (2001-2020): 6.81%</b>
<b>15-Years (2006-2020) 6.73%</b>	<b>15-Years (2006-2020): 6.83%</b>
<b>10-Years (2011-2020): 8.72%</b>	<b>10-Years (2011-2020): 7.98%</b>
<b>5-Years (2016-2020): 6.47%</b>	<b>5-Years (2016-2020): 7.63%</b>

Note: Past performance is not the best measure of future performance, but it does help provide some context to the problem created by having an excessively high assumed rate of return.



# FRS Funded Ratio Did Not Recover Despite a Historic Decade for the Stock Market



Source: Pension Integrity Project analysis of FRS actuarial valuation reports and Yahoo Finance data.



# New Normal: The Market Has Changed

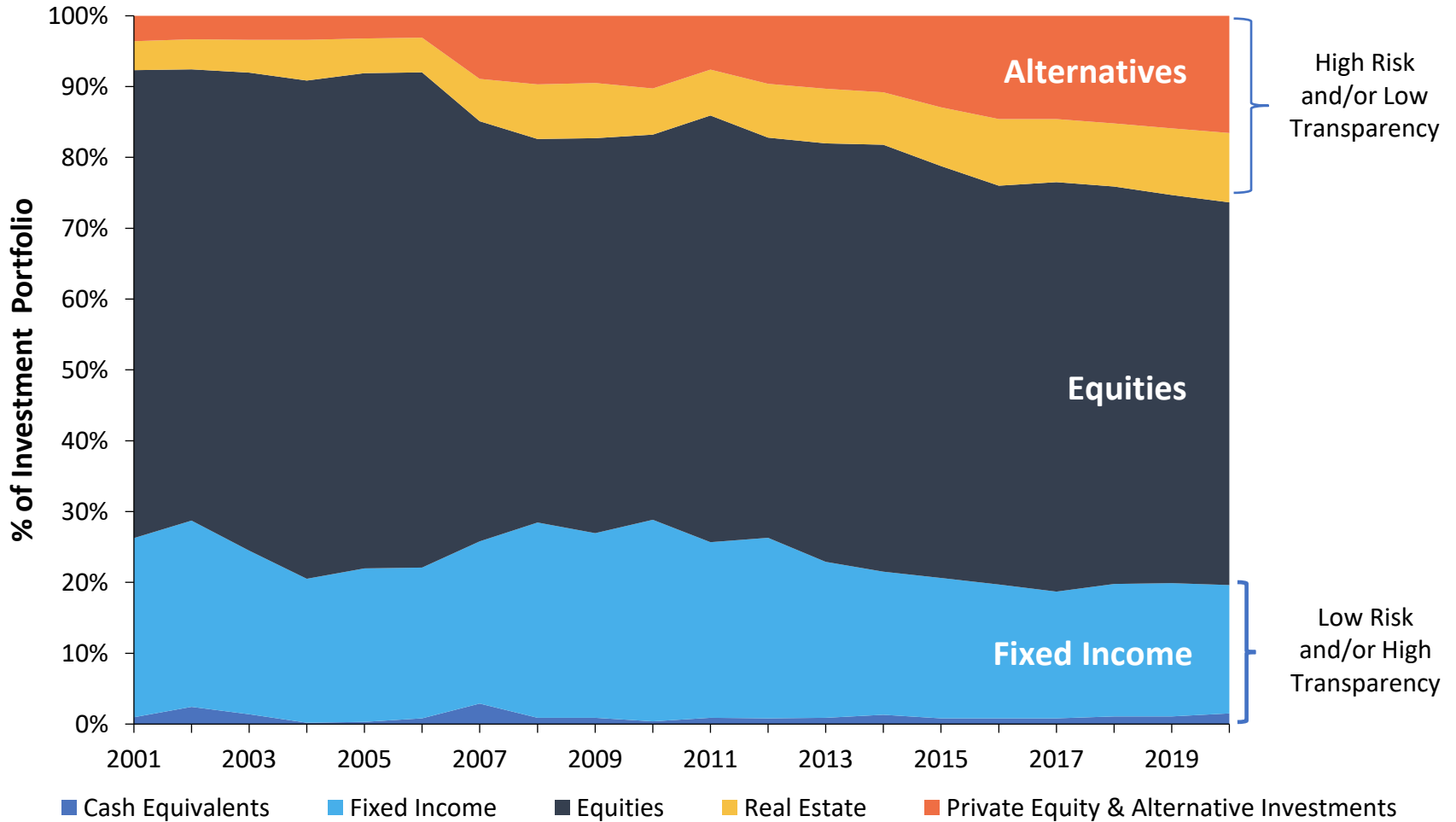
The “new normal” for institutional investing suggests that achieving even a 6% average rate of return in the future is optimistic.

1. Over the past two decades there has been a steady change in the nature of institutional investment returns.
  - 30-year Treasury yields have fallen from near 8% in the 1990s to consistently less than 3%.
  - New phenomenon: negative interest rates, designates a collapse in global bond yields.
  - The U.S. just experienced the longest economic recovery in history, yet average growth rates in GDP and inflation are below expectations.
2. McKinsey & Co. forecast the returns on equities will be 20% to 50% lower over the next two decades compared to the previous three decades.
  - Using their forecasts, the best-case scenario for a 70/30 portfolio of equities and bonds is likely to earn around 5% return.
3. The FRS Pension Plan 5-year average return is around 6.48%, well below the assumed 7% return assumption.



# FRS Asset Allocation (2001-2020)

## Expanding Risk in Search for Yield



Source: Pension Integrity Project analysis of FRS actuarial valuation reports and CAFRs.

# Probability Analysis: Measuring the Likelihood of FRS Achieving Various Rates of Return



Probability of FRS Pension Plan Achieving A Given Return Based On:								
Possible Rates of Return	FRS Assumptions & Experience		Short-Term Market Forecast				Long-Term Market Forecast	
	Based on FRS Assumptions	FRS Historical Returns	BNY Mellon 10-Year Forecast	JP Morgan 10-15 Year Forecast	Research Affiliates 10-Year Forecast	Horizon 10-Year Market Forecast	BlackRock 20-Year Forecast	Horizon 20-Year Market Forecast
9.00%	19%	8%	13%	9%	8%	21%	31%	31%
8.00%	30%	16%	23%	17%	15%	32%	43%	44%
7.50%	36%	21%	29%	21%	20%	38%	50%	51%
7.00%	43%	28%	37%	27%	25%	45%	56%	57%
6.50%	50%	36%	44%	34%	32%	52%	62%	64%
6.00%	57%	44%	52%	41%	39%	59%	68%	70%
5.50%	64%	53%	60%	49%	47%	65%	74%	76%

Source: Pension Integrity Project Monte Carlo model based on FRS asset allocation and reported expected returns by asset class. Forecasts of returns by asset class generally by BNYM, JPMC, BlackRock, Research Affiliates, and Horizon Actuarial Services were matched to the specific asset class of FRS. Probability estimates are approximate as they are based on the aggregated return by asset class. For complete methodology contact Reason Foundation. Aon is the outside investment consultant to FRS. FRS assumptions are based on Aon Assumptions. Horizon is an external consulting firm that surveyed capital assumptions made by other firms.

# Probability Analysis: Measuring the Likelihood of FRS Achieving Various Rates of Return



## FRS Assumptions & Experience

- A probability analysis of FRS historical returns over the past 20 years (2000-2020) indicates only a modest chance (28%) of hitting the plan's 7.0% assumed return.
- FRS's own investment return assumptions imply a 43% chance of achieving their investment return target over the next 20 years.

## Short-Term Market Forecast

- Returns over the short to medium term can have significant negative effects on funding outcomes for mature pension plans with large negative cash flows like FRS.
- Analysis of capital market assumptions publicly reported by the leading financial firms (BlackRock, BNY Mellon, JPMorgan, and Research Affiliates) suggests that over a 10-15 year period, FRS returns are likely to fall short of their assumption.

## Long-Term Market Forecast

- Longer-term projections typically assume FRS investment returns will revert back to historical averages.
  - ✓ The "reversion to mean" assumption should be viewed with caution given historical changes in interest rates and a variety of other market conditions that increase uncertainty over longer projection periods, relative to shorter ones.
- Forecasts showing long-term returns near 7.0% likely also show a significant chance that the actual long-term average return will fall far shorter than expected.
  - ✓ For example, according to the BlackRock's 20-year forecast, while the probability of achieving an average return of 7.0% or higher is about 56%, the probability of earning a rate of return below 5.5% is about 26%.





# RISK ASSESSMENT

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- How resilient is FRS to volatile market factors?

# Important Funding Concepts



## Employer Contribution Rates

- **Statutory Contributions:** Annual payments usually based on a rates set in state statute, meaning contributions remain static until changed by legislation.
- **Actuarially Determined Employer Contribution (ADEC):** Unlike statutory contributions, ADEC is the annual required amount FRS's consulting actuary has determined is needed to be contributed each year to avoid growth in pension debt and keep ERS solvent.

*Statutory rates are more susceptible to the political risk inherent to the legislative process and often result in systemic underfunding, especially when legislatively established rates fall short of what plan actuaries calculate as necessary to ensure funding progress.*

## All-in Employer Cost

- 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.

## Baseline Rates

- The baseline describes FRS current assumptions using the plan's existing contribution and funding policy and shows the status quo before the 2020 market shock.

### Quick Note:

With actuarial experiences of public pension plans varying from one year to the next, and potential rounding and methodological differences between actuaries, projected values shown onwards are not meant for budget planning purposes. **For trend and policy discussions only.**

# Stress Testing FRS 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.

## Methodology:

- Adapting the Dodd-Frank stress testing methodology for banks and Moody's Investors Service recession preparedness analysis, the following scenarios assume one year of -24.6% returns in 2020, followed by three years of 11% average returns.
- Recognizing expert consensus regarding a diminishing capital market outlook, the scenarios assume a long-term investment return of 6% once markets rebound.
- Given the increased exposure to volatile global markets and rising frequency of Black Swan economic events, we include a scenario incorporating a second Black Swan crisis event in 2035.

## Stress Testing Scenarios:

1. Assumed Rate of Return
2. 6% Fixed Annual Return
3. 2020-23 Crisis + 6.0% Fixed Annual Returns
4. 2020-23 Crisis + 2035-38 Crisis + 6% Fixed Annual Returns

# Scenario Comparison of Employer Costs

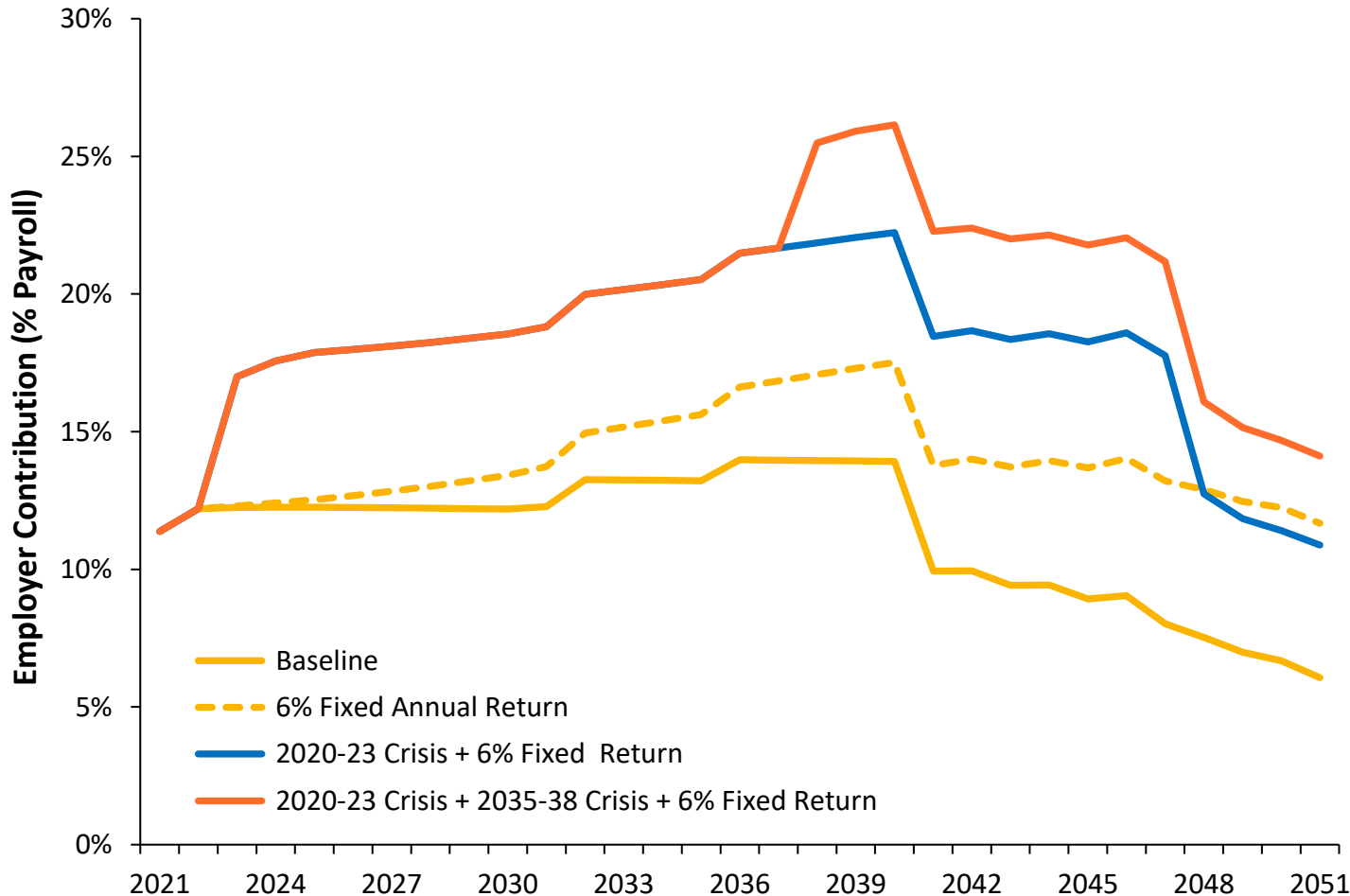
Scenarios	Actuarial Contributions		
	30-Year Employer Contributions	2050 Unfunded Liability (Market Value)	Total All-in Employer Costs
Baseline (Actuarial)	\$137.6B	\$0.6B	\$138.2B
6% Fixed Annual Return	\$172.6	\$35.6B	\$208.2B
2020-23 Crisis + 6% Fixed Return	\$223.9B	\$32.3B	\$256.2B
Two Crises + 6% Fixed Return	\$245.2B	\$45.2B	\$290.4B

Source: Pension Integrity Project actuarial forecast of FRS. All values are rounded and adjusted for inflation. State is assumed to make 100% *actuarially* required contributions. The “All-in Cost” includes all employer contributions over the 30-year timeframe, and the ending unfunded liability accrued by the end of the forecast period.

# FRS Stress Testing: All-in Employer Cost Projections

## How a Crisis Increases FRS Costs

Discount Rate: 7.0%, Assumed Return: 7.0%, Actual Return: Varying, Amo. Period: Current



Scenarios	Total All-in Employer Costs
Pre-Crisis Baseline	\$138 B
6% Fixed Annual Return	\$208 B
2020-23 Crisis + 6% Fixed Annual Return	\$256 B
Two Crises + 6% Fixed Annual Return	\$290 B

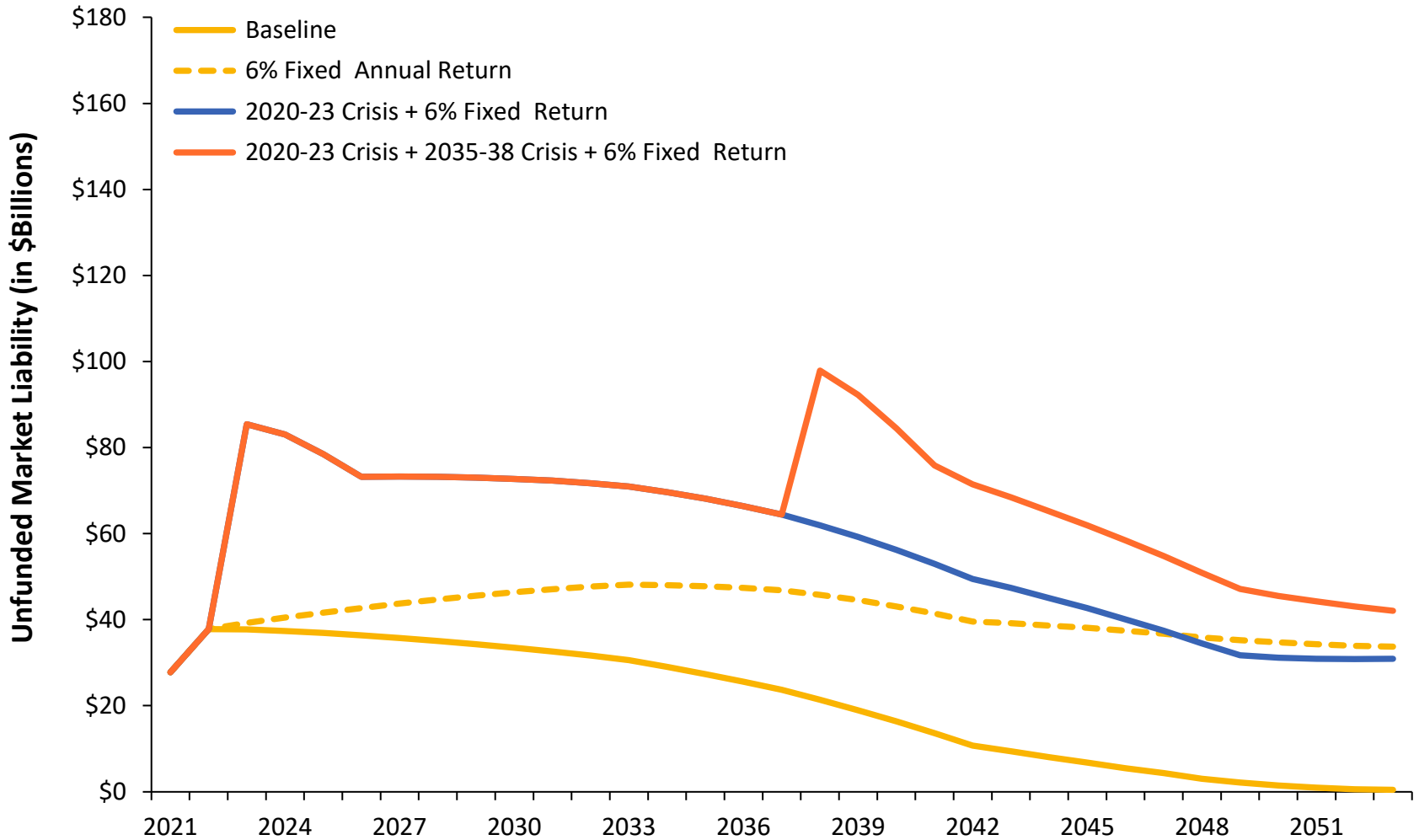
Source: Pension Integrity Project actuarial forecast of FRS. Values are rounded and adjusted for inflation. State is assumed to make 100% actuarially required contributions. The "All-in Cost" includes all employer contributions over the 30-year timeframe, and the ending unfunded liability accrued by the end of the forecast period.

# FRS Stress Testing: Unfunded Liability Projections

## Unfunded Liabilities Under Crisis Scenarios



Discount Rate: 7.0%, Assumed Return: 7.0%, Actual Return: Varying, Amo. Period: Current

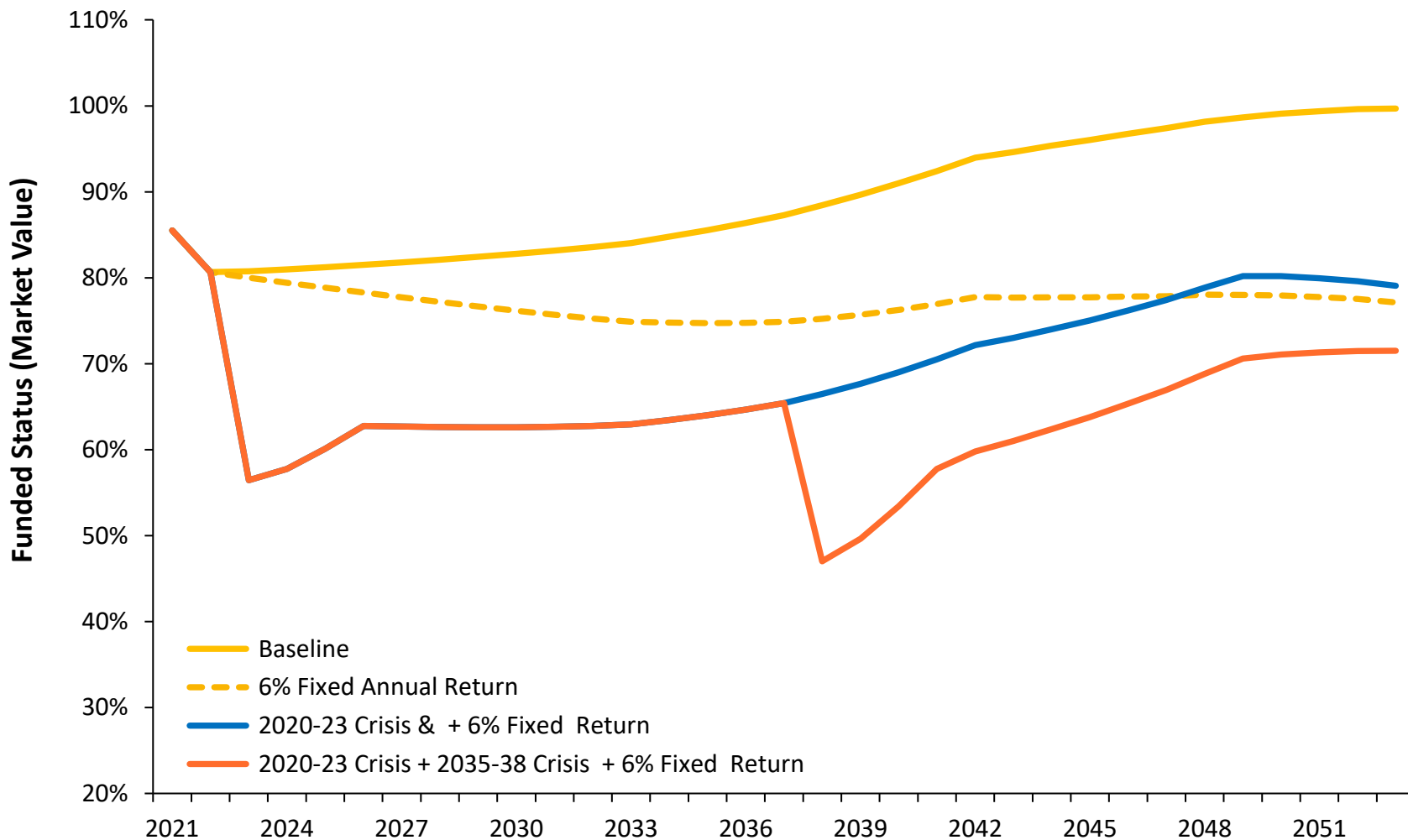


Source: Pension Integrity Project actuarial forecast of FRS. Values are rounded and adjusted for inflation. State is assumed to make 100% *actuarially* required contributions. The "All-in Cost" includes all employer contributions over the 30-year timeframe, and the ending unfunded liability accrued by the end of the forecast period.

## FRS Stress Testing: Unfunded Liability Projections

# Unfunded Benefits Remain Under Crisis Scenarios

Discount Rate: 7.0%, Assumed Return: 7.0%, Actual Return: Varying, Amo. Period: Current



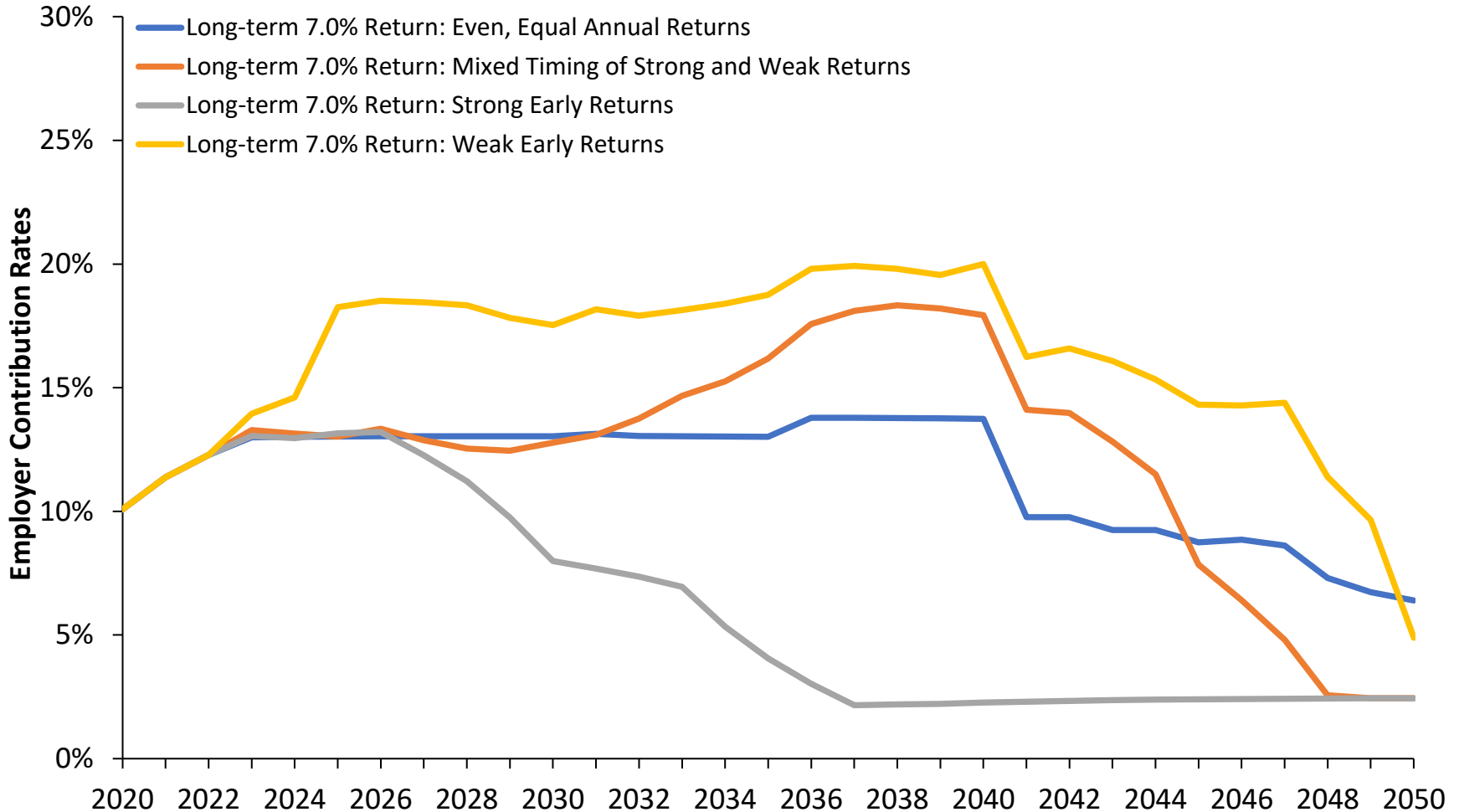
Source: Pension Integrity Project actuarial forecast of FRS. Values are rounded and adjusted for inflation. State is assumed to make 100% *actuarially* required contributions. The "All-in Cost" includes all employer contributions over the 30-year timeframe, and the ending unfunded liability accrued by the end of the forecast period.



### 30-year Funded Ratio Forecast

# All Paths to a 7.0% Average Return Are Not Equal

Long-Term Average Returns of 7.0%



Source: Pension Integrity Project actuarial forecast of FRS plan. Strong early returns (TWRR = 6.99%, MWRR = 8.26%), Even, equal annual returns (Constant Return = 7.0%), Mixed timing of strong and weak returns (TWRR = 6.98%, MWRR = 6.97%), Weak early returns (TWRR = 7.0%, MWRR = 6.26%) Scenario assumes that FRS pays ADEC contribution rates each year. Years are plan's fiscal years.





# Forecasting the Impact of Market Volatility

## Random Variable Analysis

### What is it?

- Model generates 10,000 different random investment return scenarios, creating ranges in required contributions and funding outcomes
- This analysis displays 50 percent of all outcomes that are closest to the median outcome

### Why use it?

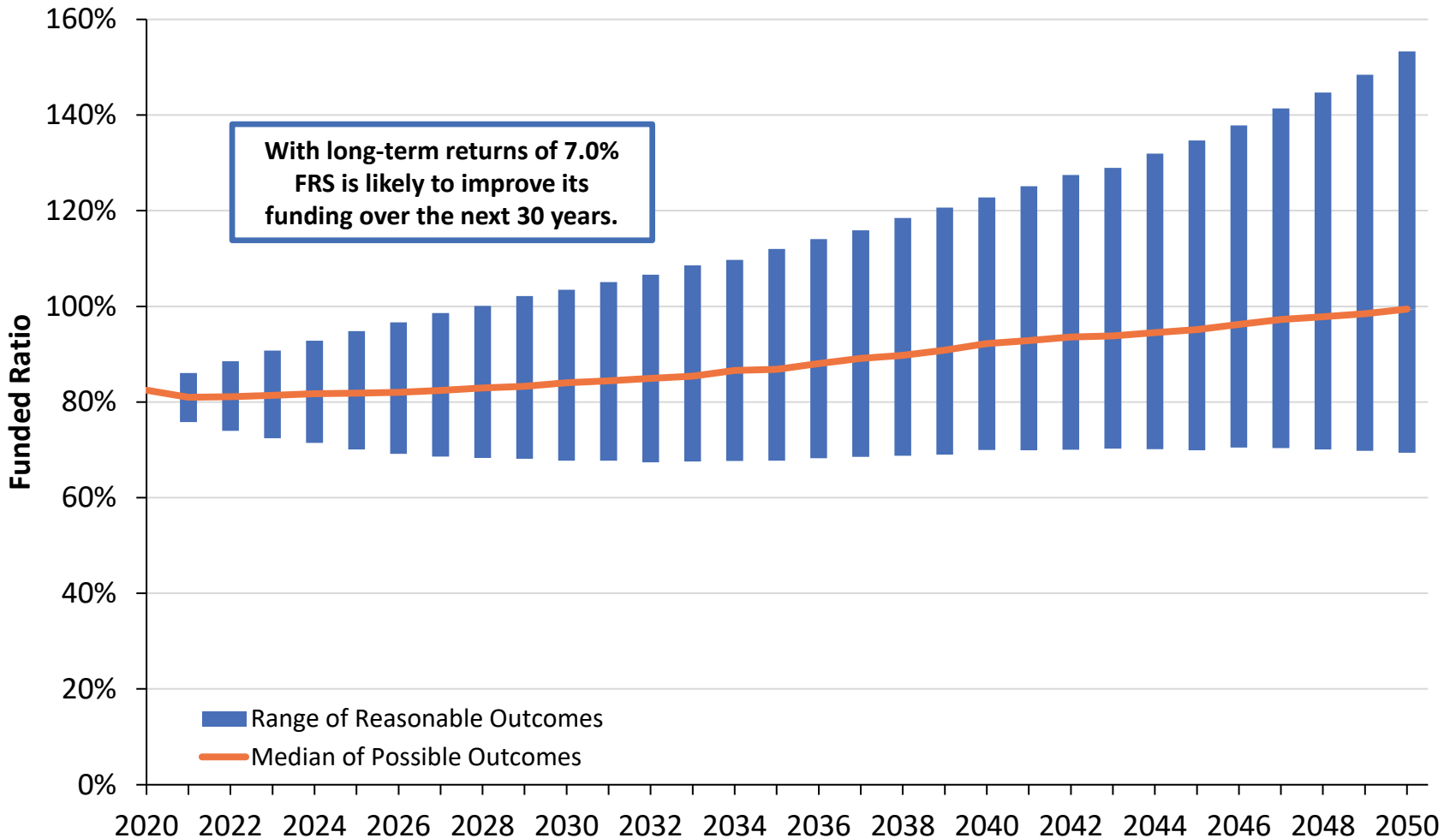
- Using a large sample of potential 30-year return scenarios can show the differences in how plan's funding will react to high or low investment fluctuations.
- The cone of displayed outcomes and the median illustrates the level of risk placed on the plan
- A narrow cone suggests a plan is more resilient—and has less investment risk—than that of a wider cone



### 30-year Funded Ratio Forecast

# Funded Ratios are Expected to Improve

Long-term Average Returns of 7.0%



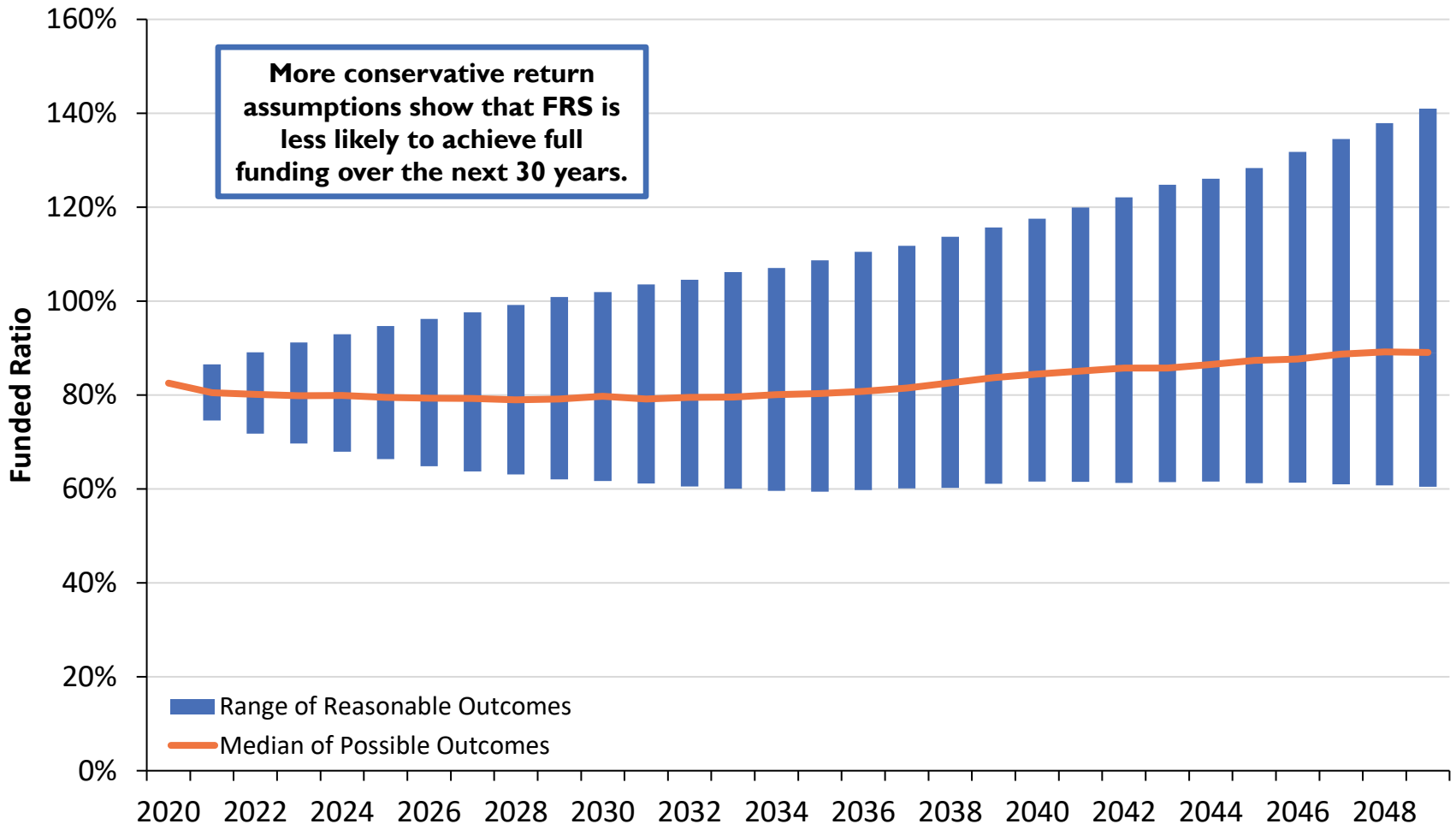
Source: Pension Integrity Project actuarial forecast of FRS plan based on FRS return and risk assumptions. Range of Reasonable Outcomes represents the 50% of possible outcomes closest to the median.



### 30-year Funded Ratio Forecast

# How Do Missed Returns Impact Funded Ratios?

More Conservative Long-term Average Expected Returns



Source: Pension Integrity Project actuarial forecast of FRS plan using the return and risk assumptions of the Monte Carlo analysis.

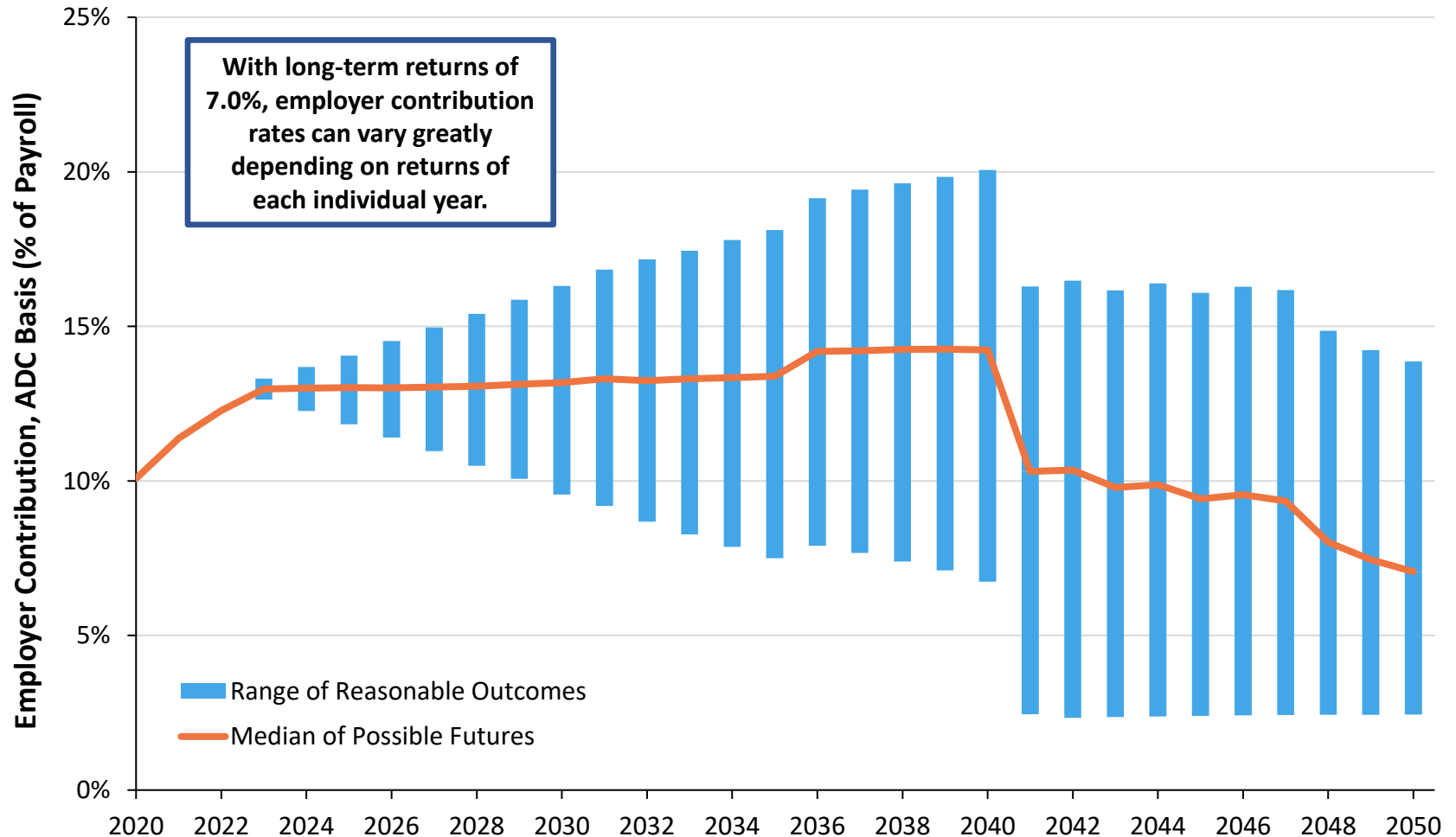
Conservative returns are 5.56%, which are the result of combining the long-term capital market assumptions from four prominent financial firms (see slide 22).



# 30-year Employer Contribution Forecast

## If FRS Performs as Expected, Rates Can Still Vary

Long-term Average Returns of 7.0%

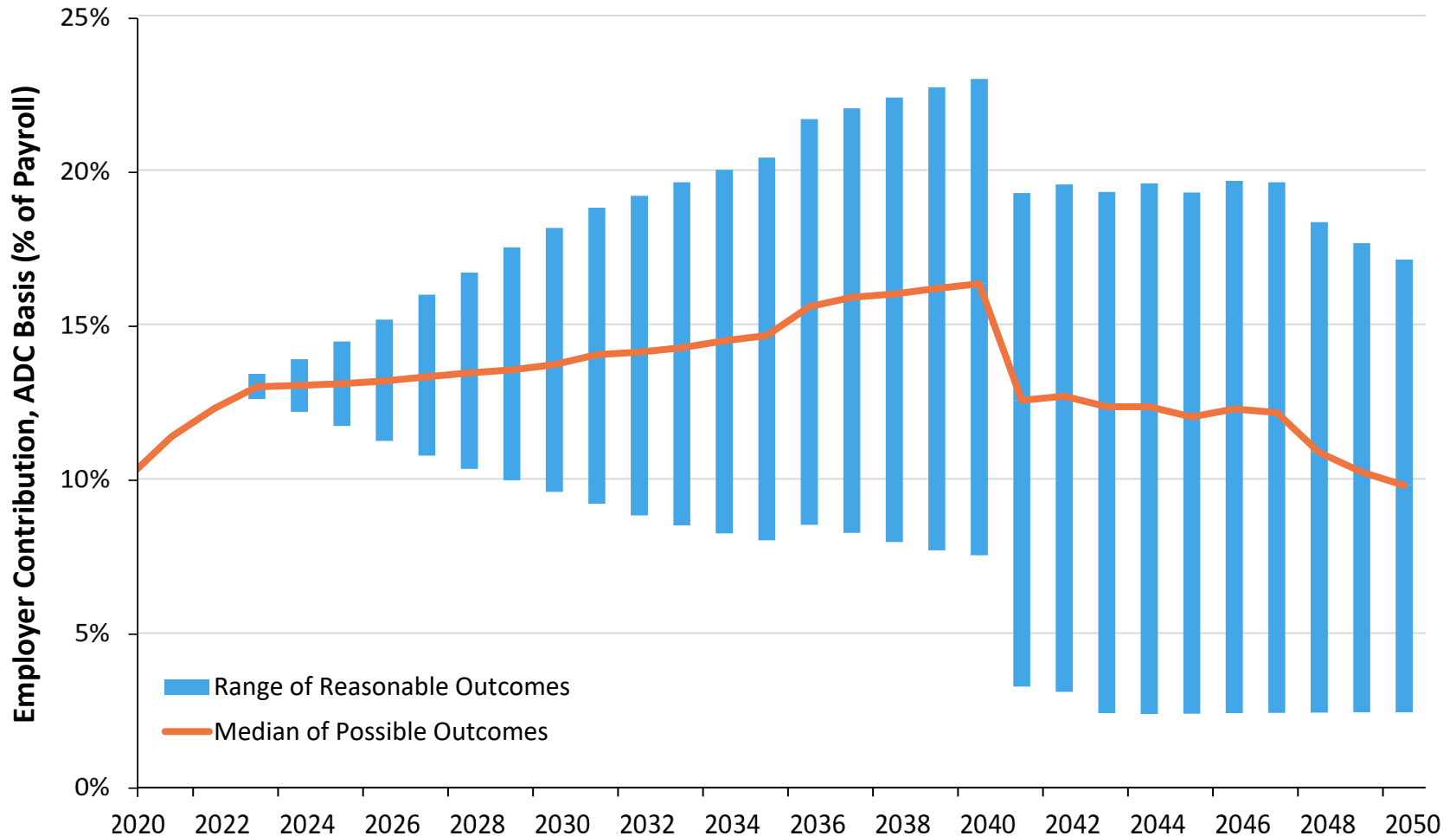


Source: Pension Integrity Project actuarial forecast of FRS plan based on FRS return and risk assumptions. Range of Reasonable Outcomes represents the 50% of possible outcomes closest to the median.

### 30-year Employer Contribution Forecast

# If FRS Underperforms, Expect Higher Contribution Rates

More Conservative Long-term Average Expected Returns



Source: Pension Integrity Project actuarial forecast of FRS plan using the return and risk assumptions of the Monte Carlo analysis. Conservative returns are 6.3%, which are the result of combining the long-term capital market assumptions from four prominent financial firms (see slide 22).



# Sensitivity of Normal Cost Under Alternative Assumed Rates of Return

Amounts to be Paid in 2020-21 Contribution Fiscal Year, % of projected payroll

Assumed Return	Gross Normal Cost	Employer Normal Cost	Employee Normal Cost
<b>7.0%</b> (FYE 2020 Baseline)	10.23%	7.23%	3.0%
<b>6.5%</b>	11.41%	8.41%	3.0%
<b>6.0%</b>	12.73%	9.73%	3.0%
<b>5.5%</b>	14.20%	11.20%	3.0%

Note: These alternative gross normal cost figures should be considered approximate guides to how much more normal cost should be under different discount rates. Any policy changes should be based on more precise normal cost forecasts using detailed plan data. Alternative normal cost rates based reported liability sensitivity from the FYE 2020 FRS CAFR.



# OUTDATED AND AGGRESSIVE ACTUARIAL ASSUMPTIONS AND METHODS

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- The act of aligning assumptions with realistic expectations spotlights systemic risk in the form of unfunded liabilities.



## Challenges from Outdated and Aggressive Actuarial Assumptions

### Actuarial Assumptions vs. Actual Experience

- Deviations between actuarial experience and assumptions, and delays updating those assumptions, has led to an underestimation of the total FRS Pension Plan liability.
- Adjusting actuarial assumptions to reflect the changing demographics and new normal in investment markets exposes hidden pension cost by uncovering existing but unreported unfunded liabilities.
- If aggressive assumptions continue to misprice pension benefits, FRS experience will continue to deviate from the plan's expectations and allow for the continued growth of unfunded liabilities.





# Challenges from Outdated and Aggressive Actuarial Assumptions

## Actuarial Assumptions vs. Actual Experience reluctance

### What's the difference between "accruing" UAL and "exposing" UAL?

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- Generally, each assumption used by plan actuaries to calculate the cost of benefits over time come with the inherent risk of being wrong any given year resulting in unfunded liabilities.
- When an assumption is off, and assets actuaries were expecting from a given source are not contributed to make up the difference, the plan passively accrues unfunded.
- When an assumption is deliberately adjusted in a way that increases the probability of the expected outcome, cost hidden in the assumption are exposed, resulting in unfunded liabilities increasing in exchange for a more stable assumption and contribution rate.

	Accruing UAL	VS.	Exposing UAL
Investment Return Assumption	Overestimating investment returns short the FRS Pension Plan of expected contributions and increased unfunded liabilities slowly over time.		Lowering investment returns to reflect market conditions instantaneously exposes accrued but unfunded pension benefits.



# INSUFFICIENT CONTRIBUTIONS

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- Since 2002, FRS pension contributions have often fallen short of levels calculated by FRS actuaries as being needed to ensure solvency, resulting in a need for much higher contributions today.

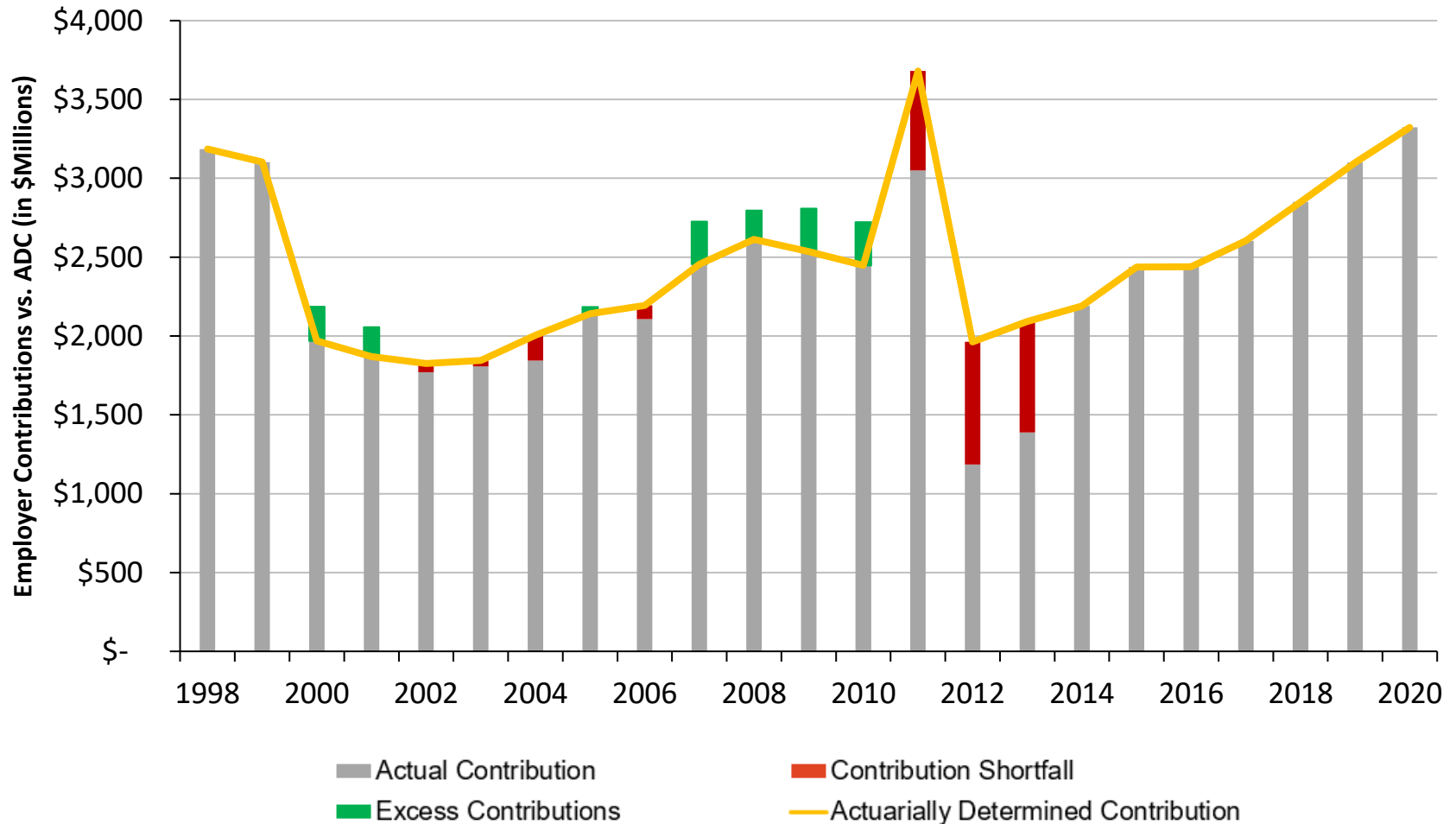
# Imprudent Funding Policy is Creating Structural Underfunding for FRS



1. From 2011-2013, FRS employer contributions failed to meet the actuarially determined contribution (ADC), increasing the Unfunded Actuarial Liability by \$2.45 billion.
2. In 7 of the past 17 years, employer contributions have been less than the interest accrued on the pension debt (e.g., negative amortization), which allowed for the unfunded liability to grow in absolute terms.
3. The 30-year period FRS uses to pay off unfunded liabilities is greater than the Society of Actuaries' recommended funding period of 15 to 20 years, resulting in higher overall costs for the plan
  - Due to the long 30-year closed amortization schedule used to pay off the annual unfunded liability employer pension contributions have not always kept up with the interest accrued on the pension debt.

# Actuarially Determined Employer Contribution History, 1998-2020

## Actual v. Required Contributions



Source: Pension Integrity Project analysis of FRS actuarial valuation reports and CAFRs.

# Negative Amortization: Understanding the Current Funding Policy

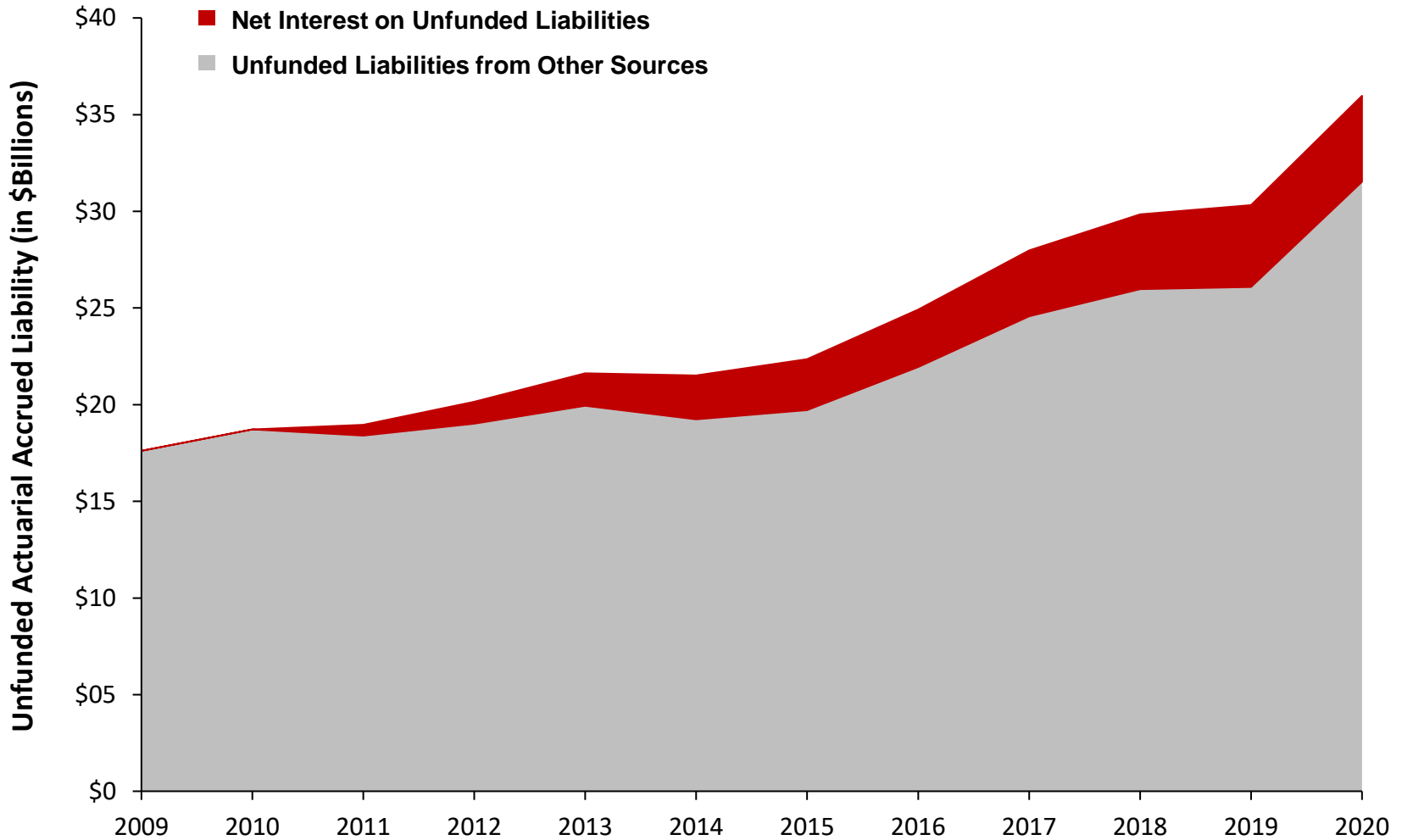


- From 2011-2013, FRS employer contributions failed to meet the actuarially determined contribution (ADC), increasing the Unfunded Actuarial Liability by \$2.45 billion.
- Starting in the 1998 actuarial valuation, the Legislature required all UAL bases in existence to be considered fully amortized, since the plan was in a surplus position.
- As part of the funding policy selected by the Florida Legislature, the actuarially calculated contribution rate is based on a “layered” approach that includes closed 30-year charge and credit bases for the amortization of any accrued UAL.
- The Unfunded Actuarial Liability (UAL) is amortized as a level percentage of projected payroll on which UAL rates are charged in an effort to maintain level contribution rates as a percentage of payroll during the specified amortization period if future experience follows assumptions.



## Negative Amortization Growth (2009-2020)

# Net Interest on the Debt as a Portion of UAAL



Source: Pension Integrity Project actuarial analysis of FRS plan valuation reports and CAFRs



# DISCOUNT RATE AND UNDERVALUING DEBT

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- The discount rate undervalues the measured value of existing pension obligations.

# FRS Discount Rate Methodology is Undervaluing Liabilities



1. **The “discount rate” for a public pension plan should reflect the risk inherent in the pension plan’s liabilities:**
  - Most public sector pension plans — including FRS — use the assumed rate of return and discount rate interchangeably, even though each serve a different purpose.
  - The **Assumed Rate of Return (ARR)** adopted by FRS estimates what the plan will return on average in the long run and is used to calculate contributions needed each year to fund the plans.
  - The **Discount Rate (DR)**, on the other hand, is used to determine the net present value of all the already promised pension benefits and supposed to reflect the risk of the plan sponsor not being able to pay the promised pensions.



# FRS Discount Rate

## Methodology is Undervaluing Liabilities



- 2. Setting a discount rate too high will lead to undervaluing the amount of pension benefits actually promised.**
  - If a pension plan is choosing to target a high rate of return with its portfolio of assets, and that high assumed return is then used to calculate/discount the value of existing promised benefits, the result will likely be that the actuarially recognized amount of accrued liabilities is undervalued.
  - Milliman, argues the discount rate for calculating the total pension liability should be equal to the return assumption.
- 3. It is reasonable to conclude that there is almost no risk that Florida would pay out less than 100% of promised retirement income benefits to members and retirees.**
  - State law requires protect pension benefit payouts. Florida State Statutes § 121.011-121.40; 121.4501-121.5912 & Florida Administrative Code 60S-4
- 4. The discount rate used to account for this minimal risk should be appropriately low.**
  - The higher the discount rate used by a pension plan, the higher the implied assumption of risk for the pension obligations.

# Sensitivity Analysis: Pension Debt Comparison Under Alternative Discount Rates

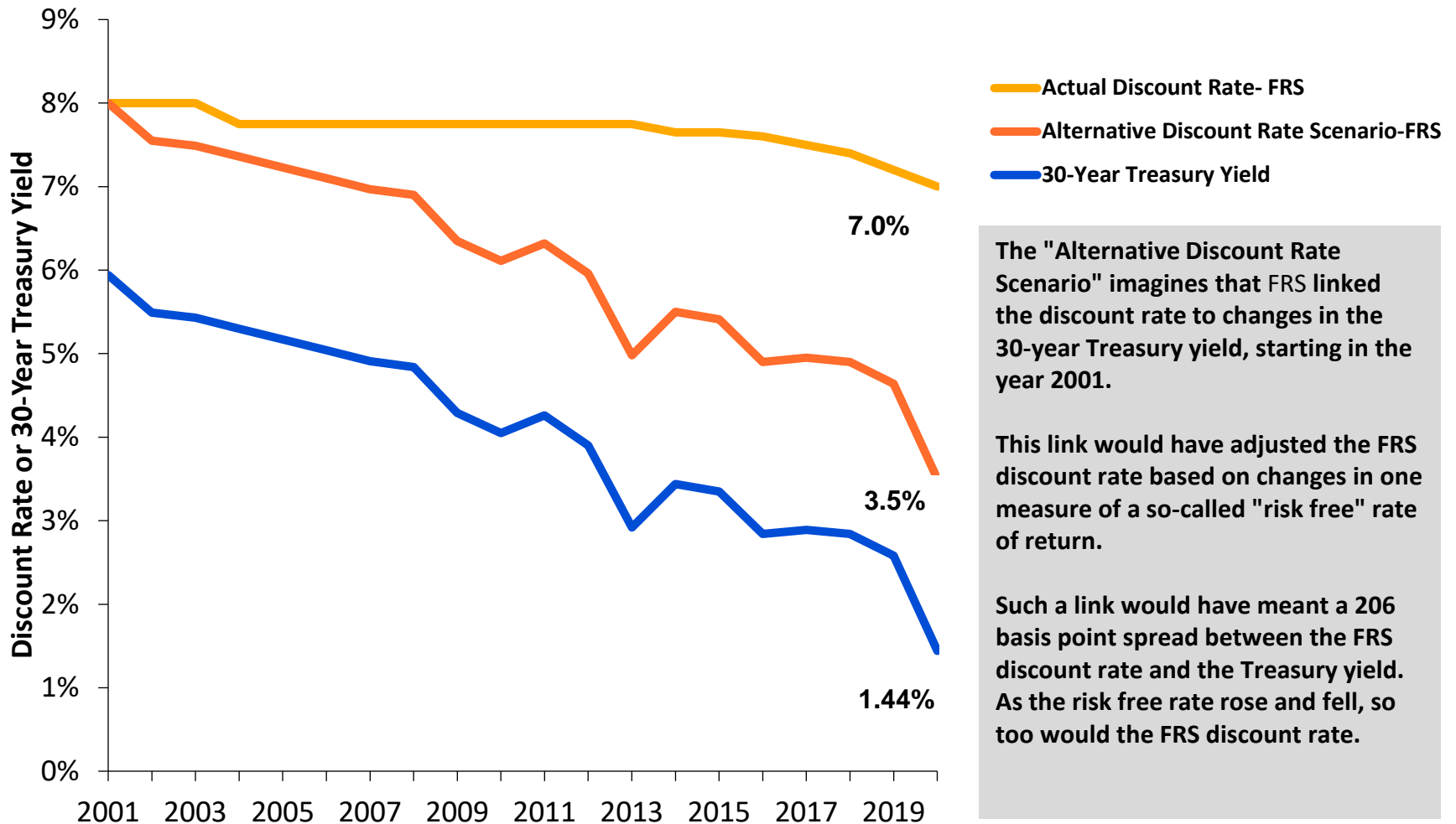


Discount Rate	Funded Ratio (Market Value)	Unfunded Liability (Market Value)	Actuarial Accrued Liability
<b>7.0%</b> (FYE 2020 Baseline)	80.7%	\$38.7 billion	\$200.3 billion
<b>6.5%</b>	76.1%	\$50.8 billion	\$212.3 billion
<b>6.0%</b>	71.6%	\$64.0 billion	\$225.6 billion
<b>5.5%</b>	67.3%	\$78.5 billion	\$240.0 billion

Note: Both baseline and alternative unfunded liability figures should be considered approximate guides to unfunded liability projections under various discount rates. Any policy changes should be based on more precise actuarial liability forecasts using detailed plan data. Alternative unfunded liability is based on reported liability sensitivity from the FYE 2020 FRS CAFR.



# Change in the Risk-Free Rate Compared to FRS Discount Rate (2001-2020)



The "Alternative Discount Rate Scenario" imagines that FRS linked the discount rate to changes in the 30-year Treasury yield, starting in the year 2001.

This link would have adjusted the FRS discount rate based on changes in one measure of a so-called "risk free" rate of return.

Such a link would have meant a 206 basis point spread between the FRS discount rate and the Treasury yield. As the risk free rate rose and fell, so too would the FRS discount rate.

Source: Pension Integrity Project analysis of FRS actuarial valuation reports and Treasury yield data from the Federal Reserve.



# CHALLENGE #2

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- The FRS defined contribution plan is not built for retirement security.

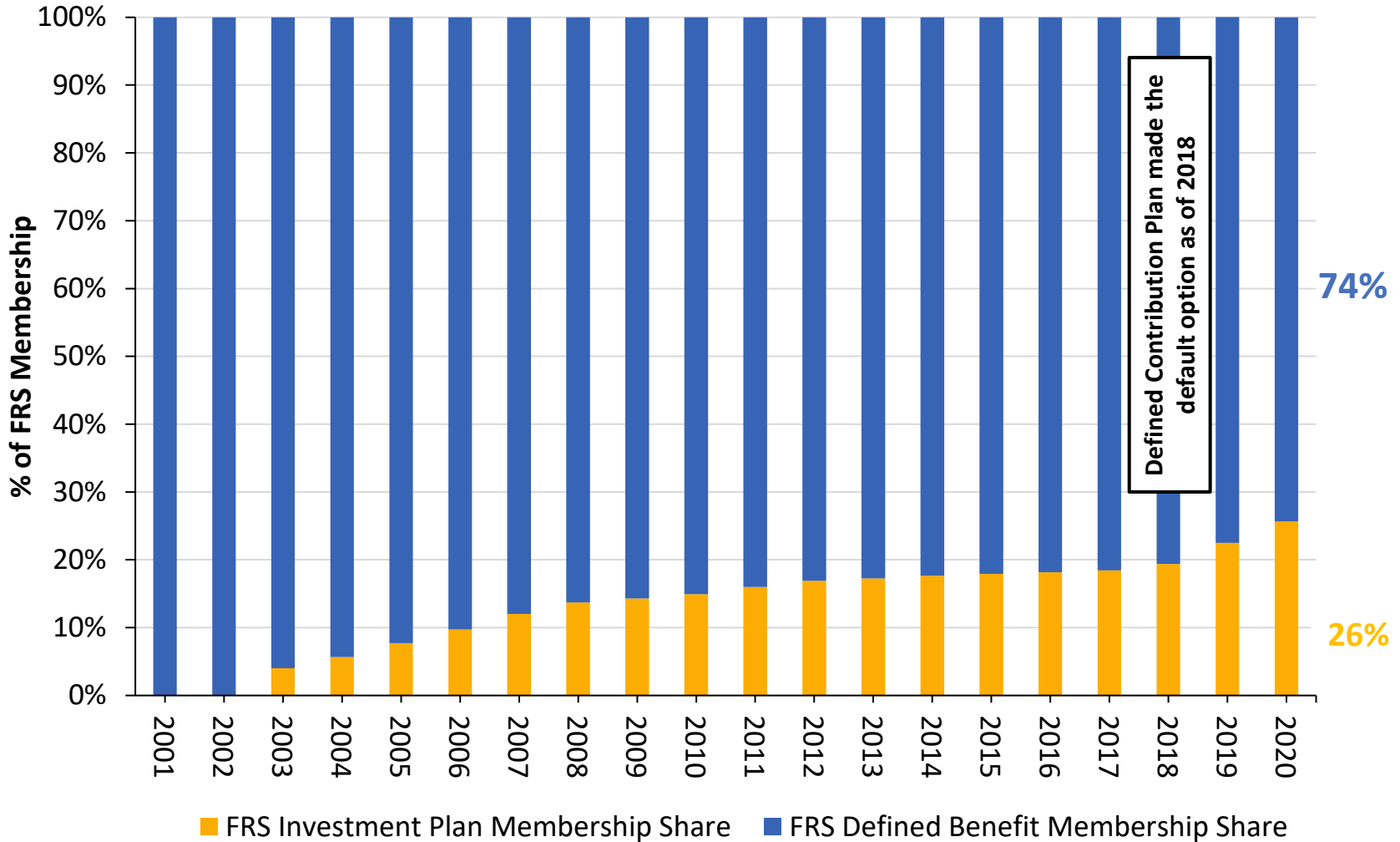


# FRS Defined Contribution Plan Overview

- The FRS defined contribution retirement plan—the FRS Investment Plan—is the state’s current default (as of 2018).
  - ✓ Members are vested after one year of service in the FRS Investment Plan.
- Employees may choose to receive their account balance at the end of employment as a lump sum or take periodic withdrawals either on demand or by a pre-determined payout schedule.
- The FRS Investment Plan has shown consistent growth since its introduction in 2002.
  - ✓ FRS Defined Contribution Plan members currently account for nearly 23% of total FRS membership and 26% of total FRS payroll.
- The Legislature can increase or decrease the amount employers and employees contribute to plan members’ accounts.



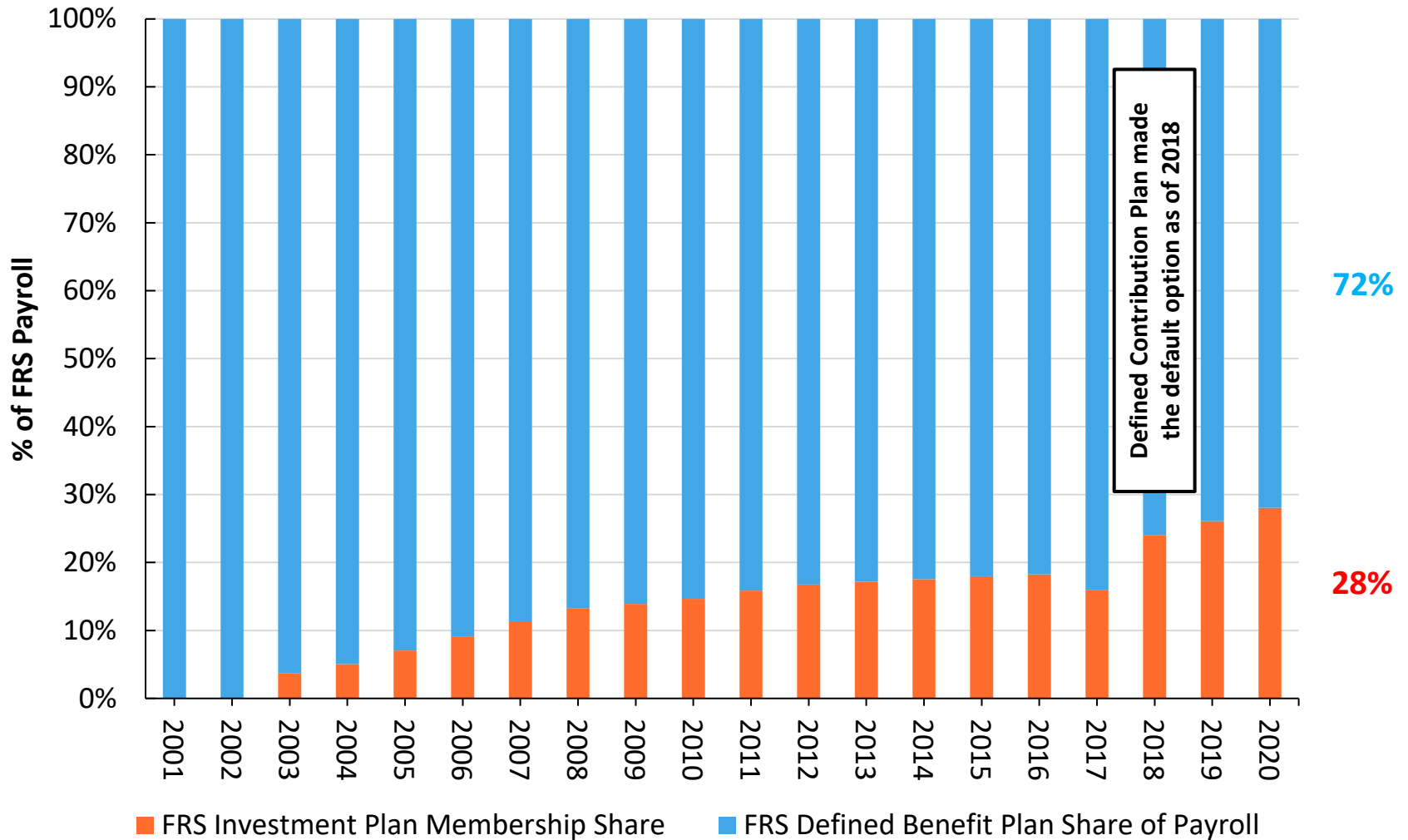
# FRS Membership Allocation: DB+DC Plans



Source: Pension Integrity Project analysis of FRS CAFR reports



# Change in FRS Payroll Share: DB+DC Plans



Source: Pension Integrity Project analysis of FRS CAFR reports



# FRS Investment Plan Funding

- Current FRS Investment Plan contribution breakdown:

## From Employee:

3.0% to member Investment Plan account

## From Employer:

3.30% to member Investment Plan account

+ 3.44% to legacy FRS Pension Plan unfunded liabilities

- Best practice says employers should continue making payments towards their legacy pension debt as if all new hires were still entering the Pension Plan.



# Inadequate Contribution Rates are Jeopardizing Retirement Security



- The aggregate 6.3% FRS Investment Plan contribution rate falls far below industry standards for retirement benefit adequacy.
- Industry leaders, retirement experts and independent studies consistently estimate 10% to 15% of annual income to be required to provide adequate retirement income.
  - For regular plan members alone contribution rates need to rise at least 400 basis points to provide retirement security.
  - Higher contribution rates may be required for older workers to achieve adequate savings for retirement due to chronic underfunding.



# FRS Investment Plan - Gold Standard Score

Gold Standard	FRS Investment Plan
<p><b>Defined Plan Objectives</b>  <i>Ensure plan objectives are define in writing as part of a comprehensive benefits policy statement.</i></p>	<b>No</b>
<p><b>Communication and Education</b>  <i>Ensure members are educated on the available choices and have all relevant information to make competent retirement choices.</i></p>	<b>Yes</b>
<p><b>Auto Enrollment</b>  <i>Enroll new employees into the FRS Investment Plan by default.</i></p>	<b>Yes</b>
<p><b>Adequate Contributions</b>  <i>Replace approximately 80% of a worker's final salary.</i></p>	<b>No</b>
<p><b>Retirement Specific Portfolio Design</b>  <i>Offer "one-touch" investment options for employees who are not sophisticated investors and do not want to avail themselves of in-plan investment advice.</i></p>	<b>Some</b>
<p><b>Benefit Portability</b>  <i>Safeguard the ability to recruit highly mobile 21<sup>st</sup> Century employees.</i></p>	<b>Yes</b>
<p><b>Offer Distribution Options</b>  <i>Provide members with a variety of asset distribution methods while limiting borrowing.</i></p>	<b>Some</b>
<p><b>Disability Coverage</b>  <i>Offer a separate disability insurance benefit from a quality insurer.</i></p>	<b>Some</b>

Source: Pension Integrity Project analysis of FRS CAFR reports and "The Gold Standard In Public Retirement System Design Series" [brief](#).



# FRS Investment Plan - Gold Standard Score

Objective	Gold Standard	FRS Investment Plan
<b>Defined Plan Objectives</b>	Defines objectives in writing as part of a comprehensive “benefits policy statement” or at least within a “retirement plan policy statement.”	There is little reference in the FRS Investment Plan material that specifically speaks to plan objectives. The “Summary Plan Description” states, “Each FRS plan is designed to provide you with a good foundation for financial security when considered along with Social Security, other retirement programs, and your own personal savings (including savings accounts, IRAs, and deferred compensation programs offered through your employer, among other resources).” This statement falls short of stating plan objectives as it is too general and without supporting detail.
<b>Communication and Education</b>	Educated members on the available choices and relevant information needed to make competent retirement decisions.	The plan sponsor offers various tools for communicating with and educating employees about the different retirement plans available. Once a choice is made by the employee to join the FRS Investment Plan, a good amount of material is available including investment education. The plan also offers robo-advice to participants at no additional charge.
<b>Auto Enrollment</b>	Defaults members into a defined contribution retirement option if no other option is selected upon hire.	New hires are enrolled into the FRS Investment Plan by the end of their eighth month of employment when no other option is selected, providing the member with maximum asset mobility by default.
<b>Adequate Contributions</b>	Replace approximately 80% of a worker’s final salary.	A major challenge facing the FRS Investment Plan is the inadequacy of the combined 6.3% FRS Investment Plan contribution rate (3% Employee /3.3% Employer) to fund lifetime financial security, even in combination with social security and reasonable personal savings. Retirement experts agree that a total contribution rate of between 12% and 15% is necessary over a career to adequately fund retirement when combined with social security and personal savings.
<b>Retirement Specific Portfolio Design</b>	Offer “one-touch” investment options for employees who are not sophisticated investors and do not want to avail themselves of in-plan investment advice.	The FRS Investment Plan offers a solid mix of proprietary investment funds with acceptable fees and a series of reasonably priced target-date funds for participants preferring a “one-choice” option. However, it would be preferable to see some guaranteed investments included in the target-date portfolio constructions, and not offering deferred annuities limit a member’s financial flexibility.
<b>Benefit Portability</b>	Safeguard the ability to recruit highly mobile 21st Century employees.	Accumulations attributable to employer contributions into the FRS Investment Plan are vested in the employee after one year of service. Accumulations attributable to employee contributions are, of course, immediately vested. While much shorter than the FRS pension plan, the one-year vest is somewhat longer than ideal. Full and immediate vesting would be preferred.
<b>Offer Distribution Options</b>	Provide members with a variety of asset distribution methods while limiting borrowing.	The standard distribution method offered under the FRS Investment Plan is a lump-sum withdrawal upon separation of service. The employee can roll this distribution over to an IRA or take periodic distributions. 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.
<b>Disability Coverage</b>	Offer a separate disability insurance benefit from a quality insurer.	The FRS Investment Plan’s disability coverage is the same as the FRS Pension Plan. In fact, FRS Investment Plan assets are transferred to the FRS Pension Plan upon a member becoming disabled to help fund the benefit. While the consistency between plans is ideal, the FRS disability benefit is not available until an employee has eight years of creditable service.



# FRAMEWORK FOR SOLUTIONS & REFORM

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# Policy Objectives

- **Keeping Promises:** Ensure the ability to pay 100% of the benefits earned and accrued by active workers and retirees
- **Retirement Security:** Provide retirement security for all current and future employees
- **Predictability:** Stabilize contribution rates for the long-term
- **Risk Reduction:** Reduce pension system exposure to financial risk and market volatility
- **Affordability:** Reduce long-term costs for employers/taxpayers and employees
- **Attractive Benefits:** Ensure the ability to recruit 21st Century employees
- **Good Governance:** Adopt best practices for board organization, investment management, and financial reporting



# 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 schedule 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. Adopt Better Funding Policy

- 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. Encourage Use of Annuities for Improved 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 deferred annuities the FRS Investment Plan will continue to limit a members' financial flexibility.
- 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.



# Questions?

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