The Florida Senate

Interim Project Report 2008-128 *October 2007*

Committee on Governmental Operations

OVERVIEW OF LOCAL GOVERNMENT PENSION PLANS

SUMMARY

More than two hundred and fifty units of local government sponsor over 500 retirement plans for their officers and employees. Nominal oversight of these plans is undertaken by the Department of Management Services through its Division of Retirement to assure compliance with constitutional and statutory provisions.

Employee compensation in the public sector heavily emphasizes benefits and thus places the employer in a commanding role. Existing state and recent federal provisions are making more stringent demands of pension plan sponsors. Recent changes to public revenue and expenditure practices in Florida will bring added pressure on public employers to moderate their total compensation costs. A number of local government plans provide indications that some of these financial imperatives, along with individual performance results, will challenge their ability to fund or to maintain their current benefit structures.

The report analyzes recent developments in federal and state law, reviews statistical reports on local government pension plans, and reaches conclusions on some near-term issues that may demand increasing attention by the Legislature and public plan sponsors. The report recommends specific statutory changes to assure disciplined funding practices among all public sector pension plans, changes to state agency oversight practices, and restraint in the conferral of new benefits.

BACKGROUND

More than two hundred fifty statutory units of local government - independent special districts and cities - sponsor their own pension plans for their officers and employees.[1] While Florida law does not mandate the creation of a pension plan for any public employer, only the smallest units of government do not provide some form of retirement or deferred savings program.[2] On October 31, 2006, 256 local government retirement systems reported assets with a market value of $19.6 billion among their more than 500 separate defined benefit plans.[3] The following table displays a financial profile of these plans:

Local Government Defined Benefit Plans[4]

	2005	2006
Payroll	$ 4,063,870,000	$ 4,618,875,000
Actives	94,823	98,913
Retirees	52,130	56,317
Assets	$17,154,385,588	$ 19,561,827,888
Contributions	$ 848,670,000	$ 1,033,642,000

All public sector pension plans must adhere to the provisions of s. 14, Art. X, State Constitution and its implementation through Part VII of ch. 112, Florida Statutes. Since 1987 these provisions require that all government retirement systems must prefund their promised benefits in a sound actuarial manner and amortize their assets and liabilities over specific time horizons.

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[1] Constitutional units of government - counties, school boards, state agencies including universities, sheriffs, tax collectors, clerks of the court, supervisors of elections, and property appraisers - are compulsory members of the multi-employer Florida Retirement System. Statutory units of local government, municipalities and special districts, are voluntary members.

[2] Department of Management Services, Florida Local Government Retirement Systems, *2006 Annual Report*, Appendix I and J, Tallahassee, FL. The report identified a variety of federally tax-sheltered vehicles embracing individual retirement accounts, simplified employee pensions, and deferred compensation plans used by municipalities and independent districts.

[3] Such plans are presumptively defined benefit, or percent of final pay plans, with pension benefits annuitized to the participant or survivor(s) at retirement.

[4] *2006 Annual Report*, p. 11.

Local government plans take a variety of combinations of three basic forms: general, police, and firefighter. Police and firefighter plans that comply with minimum funding provisions in chs. 175 or 185, F.S., receive a distribution of a portion of the insurance premium tax collected on policies issued in their boundaries.[5] Commentaries on the legislative history of these plans have discussed their transformation from isolated pay-as-you-go creatures into ones that have adopted a more structured funding and organizational discipline.[6]

Changes at the federal level have also affected government pension plans. In 1974 the Congress legislated the first of several successive requirements for protection of the assets of pension beneficiaries.[7] The Sarbanes-Oxley Act of 2002[8] imposed stringent reporting and governance standards on exchange-listed corporations that are themselves the primary objects of local government equity and debt investments. The Pension Protection Act of 2006[9] imposed new funding requirements on private and public sector plans to improve their solvency. The Government Accounting Standards Board has issued new guidelines on the valuation of workplace benefits and pensions that may further demand funding recognition in both the operating budgets and financial statements of all units of government that sponsor federally tax-sheltered benefits.[10]

The 1995 Legislature required additional financial reporting by government fiduciaries who manage investment accounts.[11] The 2007 Florida Legislature enacted two additional measures that will affect all local government plan sponsors. The first provided a statutory reduction in property taxes imposed by local governments, the principal funding source for salaries and benefits.[12] The second, a proposed constitutional amendment, offers the voters a referendum choice in the nature of the homestead exemption enjoyed by property owners with a primary Florida residence.[13] If approved, the constitutional amendment will directly affect the nature of future local government revenue and expenditure decisions.

All of these changes are cumulative, and they make an already complex benefit marketplace that much more demanding.

METHODOLOGY

The report compiles statistical information collected annually by the Division of Retirement on each of the 500 local government retirement plans. It reviews relevant portions of chs. 112, 121, 175, and 185, F.S. and publications on the history of local government retirement statutes. Because this report attempts to highlight trends and conditions only it will suggest items of further interest which may require more detailed analyses than it alone can provide. The analysis has been coordinated with the Legislature's Office of Program Policy Analysis and Government Accountability (OPPAGA). It relies on a reporting profile of local government pension plans developed by the Division of Retirement. This report does not analyze supplemental pension plans or deferred compensation plans offered by the same public employers. This report also does not assume that the characteristics of the universe of plans studied represents the attributes of any specific plan, which may be above or below the nominal indicators reported.

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[5] Sections 175.101 and 185.08, F.S.

[6] Address by Thomas A. Waddell, Esquire, before the 14th Annual Municipal Pension Fund Administrator's Conference. Orlando, FL: September 9-10, 1982. The most comprehensive legislative publication on this subject was authored by Ms. Sharon K. Lowe, Chief Legislative Analyst of the Florida House of Representatives' Employee and Management Relations Committee. *State Subsidized Police and Fire Pension Plans: How did the Legislature intend for plans receiving moneys under chapters 175 and 185 of the Florida Statutes to be regulated?* Tallahassee, FL: October 1994, 56 pp.

[7] The Employee Retirement Income Security Act of 1974, Public Law 93-406, 88 Stat. 829.

[8] Public Law 107-204, 116 Stat. 745.

[9] Public Law 109-280, 120 Stat. 780.

[10] Of principal concern to public entities are Statement No. 50, *Pension Disclosures - An Amendment of GASB Statements No. 25 and No. 27*; Statement No. 47, *Accounting for Termination Benefits*; Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*; and Statement No. 43, *Financial Reporting for Postemployment Benefits Plans Other Than Pensions*.

[11] Chapter 95-194, Laws of Florida.

[12] Chapter 2007-321, Laws of Florida. The main funding sources for local pension finances are employer and employee contributions, and, for police and firefighter plans only, proceeds of the insurance premium tax. Other sources, such as fines and forfeitures, provide incidental amounts.

[13] Chapter 2007-322, Laws of Florida.

FINDINGS

The Division of Retirement is required to review each local government pension plan at three-year intervals. Internal actuarial staff in its Bureau of Local Retirement Systems review plan documents for evidence of compliance with relevant portions of ch. 112, F.S. This effectively equates to less than a single day of review activity per net day of state employment.[14] Large or complex plans may take additional time, smaller ones less. The division operates under a code of practice of "reasonableness" in which its standards of actuarial review are measured against the normative standards of the practice of actuarial science, that is, the advanced mathematical science of mortality and risk. Reasonableness is a moving standard and, in agency practice, resides in only a few staff. The division has indicated it would like to augment its capacity in this regard and is exploring additional resource support as part of its agency budget request.

There are no specific criteria in statute, other than time, to determine which plans should be reviewed beyond the exercise of the clinical judgment of the reviewer. A plan with a million dollars in assets is thus a peer to one with a billion subject to the reviewer's exercise of reasonableness in how it presents its financial statements. There also is no specific statutory requirement for the presentation of a separate audit by a unit of local government of its pension fund. The submitted financial statements may be a part of the governmental unit's full financial filings which are themselves audited, but they do not stand apart by law.[15] Florida law does mandate separate disclosures by units of local government in their investment of funds.[16]

There are several key indicators affecting pension plan operations: asset size, funded ratio, liability growth, payroll growth; and assumptions. Each plays an individual and a component role in assessing a plan's viability. Small **asset** plans have little financial flexibility and may be inordinately dependent upon funding sources over which they have little control, such as the insurance premium tax, other than by expanding their boundaries through annexation. When low revenue capacity is coupled with a high benefit structure, a small plan will experience the stresses rapidly, since its limited revenue means restricts its ability to diversify its asset base.

Funded ratio indicates the percentage departure from full funding of a plan's promised benefits, with one hundred percent being the nominal objective. The overall direction is key, not necessarily any one year's performance. A progressively declining ratio can indicate the plan's investment experience or management may be impaired. When liability growth exceeds asset growth this could be due to a variety of ordinary or extraordinary forces. A change in valuation methods also could accelerate liability recognition if a more conservative method is adopted.[17] **Liability growth** which consistently exceeds asset growth is an indicator that benefits could be underfunded or that additional benefits have been approved. **Salary and payroll growth** are critical variables since defined benefit plans confer the most lucrative benefits in the final years of service.[18] Declining payrolls accentuate funding difficulties while increasing payrolls moderate them. Any reductions in covered workforce directly affect these numbers as a rising benefit expense must be spread over fewer participants. **Assumptions** play a critical role in plan management especially when actual investment returns or salary increases depart markedly from projected ones. In such circumstances plans can quickly become over- or under-funded.

City and special district pension plans are small to moderate in size with typical plan assets comprising $10 million or less. Nearly one-half of the plans report fewer than 50 active members each. Of greater concern is the distribution of funded ratios. Thirty-three plans have ratios of fifty percent or less. Almost four out of every ten plans fall under seventy percent. Asset size or equity allocations alone are not precise indicators of overall health or risk as there are many examples of over- and under-funded plans with a small asset base. But it is likely that the greatest concentration of risk lies in small asset and membership plans with liabilities far greater than assets. These, taken together, are signs that should be taken with serious concern

[14] Calculated at 2080 hours per year less official holidays, sick, and annual leave, and professional recredentialing.
[15] Section 218.32, F.S.
[16] Section 218.415, F.S.

[17] There are several accepted actuarial valuation methods for public pensions plans with the *entry age normal method* used frequently in Florida. In that method assets and liabilities are amortized over the projected career of a participant and the resulting contribution requirement is expressed as a level percent of pay.
[18] A defined contribution plans works in the opposite way: it confers benefits early in a participant's career as its structure assures only a contribution, not a final benefit result.

The growing presence of retirees along with increased payments has similarly affected plan operations. There are 57 local pension plan retirees for every 100 active employees, two more than in 2005.

Direct financial comparisons with the larger FRS may not be appropriate in many cases since a number of local plans exclude Social Security coverage, have higher benefits, have specialized participants, or contain very different total compensation policies. These distinctions are important and point to the difficulty in making one-to-one comparisons.

In its recently issued survey of city and county pension plans, Wilshire Associates points to general trends in tax-supported retirement systems.[19] It notes a high concentration of equity investments, an improving funded ratio, although still below 100 percent, but with expected investment returns greater than can reasonably be expected.

There are individual local plan attributes which present interesting anomalies, three of which are presented below. One large and well-funded plan was itself sponsored by a municipality that was facing insolvency and required state intervention under ch. 218, F.S. This was attributable to the municipality's revenues being consumed by its pension plan, financial reporting misstatements, and employee transgressions that jeopardized its tax-supported citizen services.[20] Extraordinary actions by the Governor, Legislature, and a specially convened financial oversight panel led to corrective actions. Another medium size plan sought statutory changes so that it could further expand its security holdings into specialty markets not generally well-understood. This same plan was also experiencing a progressively declining funded ratio that left one-third of its benefits unfunded. Interestingly, it was this same plan whose governing authorities indicated their opposition to the adoption of full funding measures enacted by the 1959 Legislature.[21] Still another medium size city approached the Legislature a few years ago seeking a three-year moratorium on employer contributions to its plans. A natural disaster coupled with the conferral of additional benefits significantly impaired its ability to fund the plans. That relief was not forthcoming since it would have violated the full funding provisions of the state constitution. Ultimately this local government closed one of its three plans and transferred future coverage in the closed plan to the FRS.

Since 1999, Florida law has required that additional insurance premium tax monies must first be used for *additional* pension benefits, thus limiting the ability of public employers to use these growth moneys to service the *existing* base.[22] The anomaly that presents itself is that a plan gets access to new moneys only to the extent that it increases its benefit exposure. A plan with an eroding funded ratio gets quick cash but at the expense of additional future liabilities it may later find unaffordable.

The division reports that it is receiving new applications for membership in one or more of its classes in the FRS at the rate of two to three a month. These local governments are citing to the division the financial inability to afford their existing plans and are seeking to close them down either entirely or to new members. Almost one-half of the local governments who exited the FRS under a law change effective January 1, 1996, have rejoined citing similar reasons. Such actions will stabilize the existing and successor plan incrementally but the residual pension plan expense of the local government may still remain over time if the remaining workforce is itself high cost and the local government has limited future revenues. A plan foregoes its right to receive insurance premium tax monies whenever it joins the FRS or otherwise falls out of compliance with the provisions in chs. 175 or 185, F.S.

Lastly, on May 15, 2007, the Board of Administration approved a complete transformation of the policies that drive the asset allocation decisions for the Florida Retirement System.[23] Beginning June 1, 2007, the Board began a one-year, phased redeployment of its assets from domestic into foreign equities and increased allocations to its fixed income and alternative equity classes.[24] In doing so it concluded that the

[19] Wilshire Consulting, *2007 Report on City & County Retirement Systems: Funding Levels and Asset Allocation*, Santa Monica, CA: September 14, 2007.

[20] A statement of the background is available in *In the Matter of the City of Miami, Florida, Cesar Odio, and Manohar Surana*, Initial Decision Release No. 185, Administrative Proceeding, File No. 3-10022, U.S. Securities and Exchange Commission, Washington, DC: June 22, 2001.

[21] "Police Pensions Are Threatened By Rebates Bill," Florida *Times-Union*, May 30, 1959, p. 1.

[22] Chapter 99-1, Laws of Florida.

[23] The Board maintains twenty-eight separate accounts with the FRS Trust Fund as its largest.

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

legacy practice may not generate the returns needed for the proper servicing of its rising benefit demands. While such a conclusion may not be shared by all local government plans given the diverse nature of their workforces and benefits, it does serve as an indicator that the nation's fourth largest public pension plan has determined that traditional asset allocation decisions may no longer be appropriate.

RECOMMENDATIONS

1. The Division of Retirement should seek additional resource support for its pension plan oversight duties. The current practice may be more responsive to the production cycle and division funding than the financial necessity to provide a thorough review of the plans. With some $20 billion of plan assets under review, this is a case where a little money well invested results in much more money saved.

2. The division should consider the convening of a rules development workshop[25] for the creation of an objective risk-based method of plan reviews. This would eliminate treating all plans as peers and permit the necessary professional time to be focused on ones which reflect an inordinate risk to their sponsors or beneficiaries. Plans which present acute or chronic difficulties could be properly prioritized. Whether such a system should be based upon asset size, funded ratio or other indicators should be left to exchanges among the workshop participants. A plan sponsor would be notified of the risk assessment and can manage accordingly. Qualitative indicators that are functions of clinical judgment can then be equalized with quantitative ones that are factual.[26]

3. While there may be value in requiring separate audits of pension plans, this would add only an increment of disclosure obtainable through the financial review process already embedded and publicly accessible in law. No change to law is recommended at this time.

4. The exercise of reasonableness in the division's own rules permits a review of the current and prior year periods. This "look-back" could embrace a total of six years. What may have seemed reasonable under a prior period can be reexamined in a subsequent one and questioned. As part of the rules development workshop the division should receive some input on whether the law governing this should be amended to give some certainty to the reviewed local government plans such that the past remains just that, without jeopardizing the underlying actuarial integrity of the review process.

5. The division's actuary has made specific recommendations for amendments to chs. 175, 185, and 112, F.S., to facilitate additional plan disclosure and funding compliance. These recommendations are presented in the 2006 Annual Report cited above and are endorsed by the division. The division has offered additional recommendations on similar subjects to effect compliance with a portion of the Pension Protection Act.

6. Systemic changes to local government revenues will add momentum to a reconsideration of their employee benefits. If current trends hold, additional local governments will be considering redeploying their total compensation and seeking the safety of someone else's treasury to sustain their workforces. The greater likelihood is that, short of other systemic changes, this will be the Florida Retirement System. Given the uncertainties associated with this developing situation, restraining the enhancement of public employer-funded pension benefits at all levels of government would seem to be the more prudent course of action. This is especially true where the units in question are coping with volatility in their primary funding source, the property tax. Senate Interim Report 2008-127 provides an analysis of how total compensation can be redeployed without additional pension plan risk.

7. The Legislature should devote continuing oversight to the operation of local government pension plans. The dramatic increase in the ratio of retired to active employees in local government plans - 57 per 100 at the local pension level, 47 per 100 at the FRS level - means that even larger amounts of investment earnings or tax support will have to be generated to sustain the payment of rising future retiree benefits.

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[25] Authorized pursuant to s. 120.525, F.S.

[26] This item is not unique to the FRS. On August 14, 2007, the Securities and Exchange Commission was advised by the congressional Government Accountability Office that it, too, needed a more precise method of assessing risk in its regulation of brokers and dealers in the aftermath of widespread national misconduct in the brokerage industry. United States Government Accountability Office, *Securities and Exchange Commission: Steps Being Taken to Make Examination Program More Risk-Based and Transparent*. GAO-07-1053, August 2007.