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OFFICE OF PROGRAM POLICY ANALYSIS
& GOVERNMENT ACCOUNTABILITY

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FRS Defined Contribution Plan Costs Are Typically More Predictable; the Fiscal Impact of Requiring New Employees to Enroll in the Plan Is Influenced by Many Factors

at a glance

Most states (39) provide only defined benefit retirement plans to their employees, although defined contribution plan costs are more predictable. The Florida Legislature has considered several proposals to close the defined benefit Pension Plan and require all new employees to join the defined contribution Investment Plan. This action would provide increased certainty in the level of required employer contributions to the FRS over time and may reduce certain costs. However, closing the Pension Plan would increase funding requirements for those employees who remain in the plan. Future costs of the two plans are dependent on many variables, and the Legislature has requested an actuarial study to estimate these costs.

Scope

As directed by the Legislature, this report is part of a series that reviews the Florida Retirement System (FRS). This report compares the FRS's defined benefit Pension Plan to the defined contribution Investment Plan and answers three questions.

1. What are the major advantages and disadvantages of defined benefit and defined contribution plans?
2. What types of retirement plans are offered by other states?
3. How would requiring all new employees to join the defined contribution plan affect employer costs?

Background

The two retirement plans within the Florida Retirement System (FRS) are the defined benefit Pension Plan and the defined contribution Investment Plan.

The defined benefit Pension Plan, established in 1970, provides members with a lifetime pension payment based on their age, years of service, average salary, and retirement membership class.[1] During Fiscal Year 2008-09, the Pension Plan had 572,887 active participants and 289,602 retirees. The plan had a net asset market value of $99.6 billion as of June 30, 2009.[2]

The defined contribution Investment Plan, created in Fiscal Year 2000-01 and first offered in Fiscal Year 2002-03, does not provide members with guaranteed lifetime retirement benefits. Benefits are based on how much the employer contributes to the plan, the types of investment options selected by the employee (e.g., stock and bond mutual funds), and how well these

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[1] The FRS consists of five retirement classes—regular, special risk (law enforcement officer, firefighters, etc), special risk administrative support, senior management service (e.g., employees who fill management positions), and elected officers.

[2] An additional 32,921 members were in the Deferred Retirement Option Plan.

investments perform over the employee's lifetime. As of June 30, 2009, the Investment Plan had 95,529 active participants. In addition, 21,139 individuals had left the plan, placing their funds in another employer's retirement plan or taking their funds in a lump sum. The plan had a net asset market value of $4.08 billion as of June 30, 2009.

Most FRS members are employed by local government entities. Membership in the Florida Retirement System is compulsory for all full- and part-time employees working in a regularly established position for a state agency, county government, district school board, state university, community college, or participating city or special district. As shown in Exhibit 1, school board and county government employees comprise more than two-thirds of active members in both the Pension Plan and the Investment Plan.

Two state agencies administer the Pension Plan and the Investment Plan. The Department of Management Services' Division of Retirement and the State Board of Administration (SBA) manage the two retirement plans. The **Division of Retirement** provides administrative services to both plans by tracking enrollment, receiving employer contributions, and publishing membership statistics in its annual report. For the defined benefit plan, the division calculates retirement benefits and disburses retirement checks. The **State Board of Administration** is responsible for investing FRS Pension Plan Trust Fund monies to help ensure that investment returns are sufficient to fund current and future pensioners. It also administers the defined contribution Investment Plan. Additionally, to help public employees make informed financial decisions regarding their pensions, the board coordinates with the Division of Retirement to operate the MyFRS Financial Guidance Program, which provides FRS members information and guidance through several methods, including a website and toll-free help line.

Employer contributions and investment income fund the two plans. Pension benefits for members of the defined benefit plan are funded primarily by returns generated by fund investments and employer contributions.[3] Defined contribution plan benefits are funded primarily by employer contributions and investment earnings.

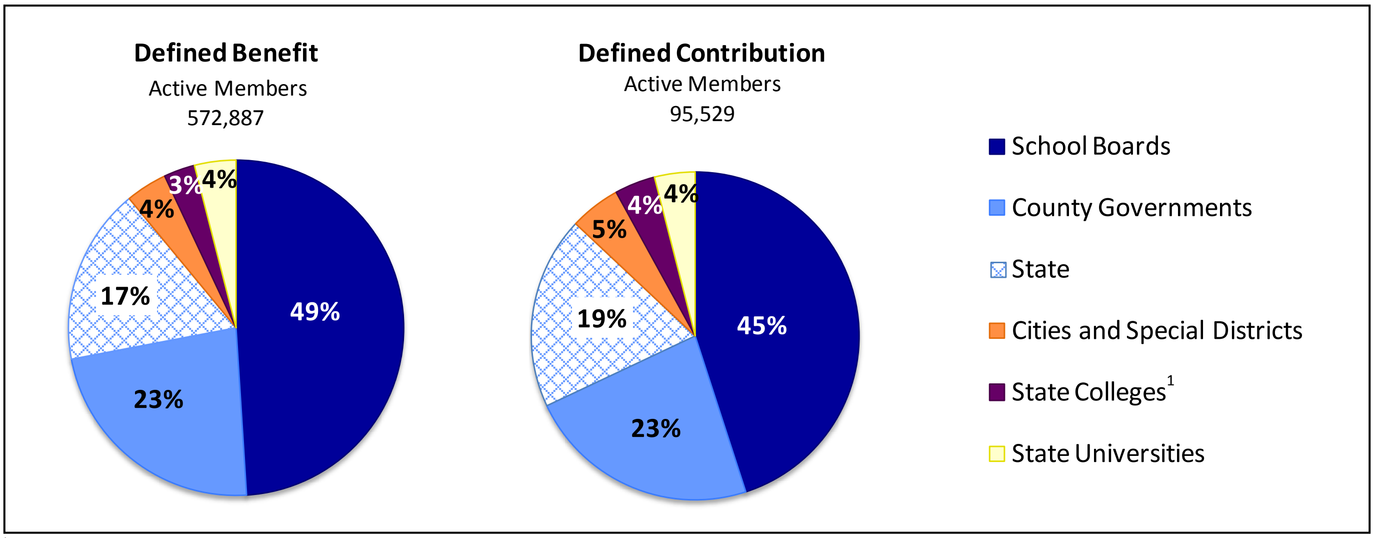
Employer contribution rates for the ***defined benefit Pension Plan*** are established to cover the plan's 'normal costs' and amortize its unfunded actuarial liability. Normal costs are the portion of the actuarial present value of pension benefits allocated to a specific year. The Division of Retirement's contracted actuary estimates the value of future pension benefits by applying to plan data various demographic assumptions, such as member's life expectancy, age at retirement, terminations prior to vesting, disability rates, and economic assumptions, such as the plan's rate of return on investments. The actuary then computes a normal cost rate, which represents a constant percentage of payroll required to be contributed each year beginning with the date from which benefits initially accrue to the projected date of retirement, to cover the expected cost of benefits. The actuary also estimates the plan's unfunded actuarial liability, which represents the amount of pension liabilities not covered by contributions made at the normal cost rate or plan assets. Unfunded actuarial liabilities are created when a plan's actual experience does not match the demographic and/or economic assumptions (e.g., members live longer than predicted, the rate of return is lower than expected, or retroactive benefits are provided). Florida statutes require that the Pension Plan's unfunded liability be amortized over a 30-year period.

For the ***defined contribution Investment Plan***, the Legislature established an employer contribution rate designed to mirror the defined benefit Pension Plan's normal cost rate for each membership class in Fiscal Year 1999-00. The percentage of salary deposited in Investment Plan participants' accounts has not changed since the plan was implemented.

[3] The SBA reported that over the past 20 years, approximately 64% of Pension Plan benefit payments have been funded by investment gains.

Once costs for the two plans are determined, the Legislature requires all FRS employers to use a uniform contribution rate system. Under this system, employer contributions are based on blended rates equal to the percentage of the total payroll for each FRS membership class or subclass regardless of which retirement plan a member elects to join. For Fiscal Year 2009-10, the blended employer contribution rates for both plans ranged from 8.69% for Regular Class members to 19.76% for Special Risk Class members. Using blended rates is intended to provide greater stability and certainty in budgeting; provide greater fiscal equity and uniformity for FRS employers; and allow employees to make their retirement plan selection decisions free of employer influence.

Exhibit 1
Most Members of the FRS Defined Benefit and Defined Contribution Plans Are Employed by Local Governments, Schools, and Universities



[1] The Florida College System (formerly the Community College System) comprises public postsecondary educational institutions that grant two- and four-year academic degrees.

Source: The Division of Retirement.

Questions and Answers —

What are the major advantages and disadvantages of defined benefit and defined contribution plans?

Defined benefit and defined contribution plans each have advantages and disadvantages. As shown in Exhibit 2, a major advantage of defined contribution plans from an employer's perspective is that their costs are generally more predictable than the costs of defined benefit plans. With a defined contribution plan, elected officials or their designated representatives (e.g., a board of trustees) decide what percentage of payroll to deposit into participants' accounts, and the employer has little or no financial responsibility once these contributions are made. Government entities offering defined contribution plans are not responsible for covering shortfalls should the contributions be inadequate or investment returns be insufficient to cover actual retirement needs, and they do not need to fund actuarial studies of the plans' funding status. However, a disadvantage of defined contribution plans is that in order to provide retirement benefits comparable to those included in a defined benefit plan, funding requirements may be higher because individual accounts typically are more expensive to manage than are the aggregated funds of employees in large defined benefit pension plans; these large plans may be able to reduce their investment costs through economies of scale. In addition, defined contribution plans may be less attractive to individuals who seek long-term public service careers because the retirement benefits are typically lower for the same employer contribution rate. Thus, defined contribution plans may not adequately fund a member's retirement needs unless the contribution rates are increased to provide a more comparable retirement benefit.[4] Research indicates that long-term career employees value employment and retirement security, and are more likely to be attracted to defined benefit plans.

Defined benefit plans also have various advantages and disadvantages. For example, defined benefit plans are managed by professional money managers rather than employees and tend to generate higher investment returns than defined contribution plans. However, defined benefit plans carry investment risks, as the plan is responsible for covering shortfalls if investment returns are lower than anticipated or if other actuarial assumptions are not met.[5] In addition, defined benefit plans typically do not offer employees the ability to transfer plan assets to another program, which may not be attractive to individuals who do not intend to remain with one employer throughout their careers.[6]

[4] Reduced retirement benefits may result in increased reliance on social programs, such as Medicaid and food stamps.

[5] Contribution levels for defined benefit plans are established by actuarial studies that estimate future benefit costs based on key demographic and economic assumptions, such as projected employee pay raises, attrition, disability, and life expectancy, and investment return rates.

[6] FRS Pension Plan members have a degree of portability because they can retain their pension benefits as long as they are employed by any of the 964 FRS employers.

Exhibit 2
Defined Contribution and Defined Benefit Plans Offer Advantages and Disadvantages to Employers and Plan Members

	Defined Benefit Plans	Defined Contribution Plans
Description	Provide retired participants a lifetime guaranteed benefit payment based on the participant's years of service, average salary, membership class, and age at retirement.	Employers contribute a guaranteed amount that can be invested by participants during the course their career, within the investment options provided by the plan. The amount accumulated at retirement is based on the performance of these investments.
Investment returns	Investment returns generally are higher because professional money managers invest fund assets for the long term, spreading market risks over all participants and taking advantage of buying opportunities.	Investment returns are generally lower because employees tend to pick low-risk, low-return investments.
Investment costs	Investment costs (e.g., fees paid to investment managers) tend to be lower for large public plans due to economies of scale.	Costs are typically higher because individual accounts must be managed and do not benefit from economies of scale.
Administrative costs	Administrative costs vary, depending on the complexity of plan. Benefit levels of individual employees must be tracked over time, and regular actuarial valuations must be conducted to determine appropriate contribution rates.	Administrative costs vary, depending on complexity of plan. Individual investment accounts must be maintained, and some plans, including Florida's Investment Plan, provide investment education services to members.
Investment risks	The plan assumes investment risks.	Participants assume investment risk. Poor investment performance may reduce their retirement benefits.
Portability	Accruals are not portable outside the retirement plan, cannot be transferred to another employer's plan, and employees forfeit pension benefits if they leave prior to the vesting period.	After a short vesting period, the participant is entitled to transfer accruals to another employer's qualified plan or to a qualified plan approved by the Internal Revenue Service.
Types of employees attracted to plan	Defined benefit plans are attractive to long-term career employees who desire retirement security.	Defined contribution plans are attractive to short-term employees who wish to participate in a plan that is portable and do not plan to have a career with employers within the same retirement plan.

Source: OPPAGA literature review.

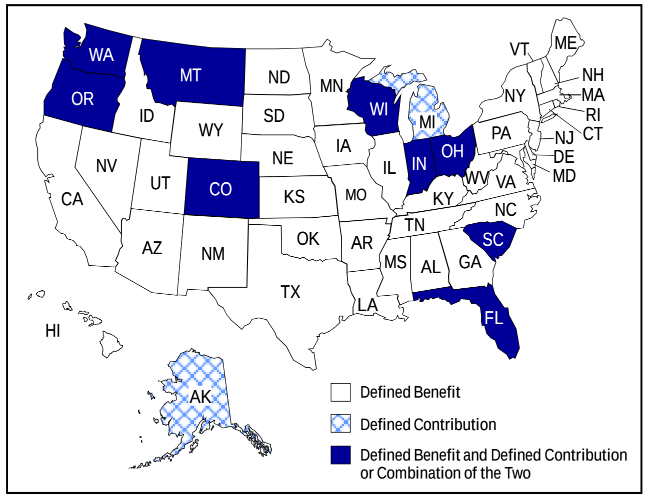
What types of retirement plans are offered by other states?

Most states (39) provide only a defined benefit plan for the majority of their employees. However, as shown in Exhibit 3, two states, Alaska and Michigan, require all newly hired regular class employees to enter a defined contribution plan.[7] The remaining nine states, including Florida, either offer employees a choice between enrolling in a defined benefit plan or a defined contribution plan, or operate a system that has elements of both types of plans.[8] Some states also restrict eligibility for their plans (see Appendix A).

Two states, Nebraska and West Virginia, have recently closed their defined contribution plans to new members because these systems had produced insufficient retirement income for members. Nebraska has required the majority of its public employees to enroll in a defined contribution plan since 1964. However, over the 20 years leading up to 2002, the average return for defined contribution plan investments was lower than the average return for defined benefit plan investments (7% versus 11%). As a result, employees in the defined contribution plan received considerably lower pension incomes than those who retired from the defined benefit plan. In 2003, Nebraska gave defined contribution plan members the choice of remaining in the plan or enrolling in a cash balance plan that provided a guaranteed 5% minimum rate of return on their individual accounts.[9]

In 1991, West Virginia required new school employees to enroll in a defined contribution plan. However, in 2005, the state determined that these employees had difficulty retiring because their investment accounts had low balances—the average account had a balance of $33,944, and participants over age 60 had average balances of $23,193. The state subsequently closed its defined contribution plan to new members and required them to a join a defined benefit plan.

Exhibit 3
Most States Offer Public Employees Defined Benefit Plans



Source: OPPAGA review of state retirement system publications, summer 2009.

How would requiring all new employees to join the defined contribution plan affect employer costs?

If all new employees were required to join the Investment Plan, employer contribution rates will initially increase; however, employers may have rates that are more predictable.

In recent years, the Legislature has considered proposals to close the FRS defined benefit plan and require all new employees to join the defined contribution Investment Plan. This action may provide increased certainty in the level of required employer contributions to the Florida Retirement System over time, as investment risks would be increasingly shifted to employees.

[7] Alaska requires all employees to enroll in the defined contribution plan. Michigan state police and public school employees participate in a defined benefit plan, while all other employees participate in the defined contribution plan.

[8] For example, Indiana and Oregon require employees to enroll in plans that combine aspects of both defined benefit and defined contribution plans, while Washington gives employees a choice between a defined benefit plan and a plan that combines aspects of both defined benefit and defined contribution plans.

[9] A cash balance plan is a defined benefit plan in which the employer manages assets, employees have individual accounts, and investment returns above a pre-determined level remain the assets of the employer.

As noted by a February 2009 Division of Retirement analysis of a bill that would have closed the Pension Plan to new members, compulsory participation in the Investment Plan would increase the required uniform contribution for those employees who would be grandfathered in the Pension Plan. This would occur due to several factors, including the cost of funding Pension Plan benefits being spread among a decreasing number of members, fewer plan participants leaving employment prior to vesting, and the age of plan participants increasing more than would otherwise be expected.

To date, actual contributions paid by employers for the defined benefit Pension Plan and defined contribution Investment Plan have been the same since the Investment Plan was established in 2002. This is the result of a statutory requirement that employer contributions be based on a uniform contribution rate for all membership classes that is sufficient to fund the benefit obligations of both retirement plans. [10]

[10] The Legislature has used surpluses in the defined benefit plan to reduce contributions to both the Pension Plan and the Investment Plan. These surpluses existed between Fiscal Years 1998-99 through 2008-09, and ranged up to $14.5 billion in Fiscal Year 2000-01. The Legislature used $12.3 billion of these surpluses to reduce employer contributions and fund benefit improvements. The surpluses primarily existed because investment returns exceeded the levels actuarially required to fund pension obligations. These surpluses are now depleted, and in Fiscal Year-2008-09, the pension plan incurred an actuarial deficit of $15.4 billion. As a result, required contributions to the FRS will increase beginning in Fiscal Year 2010-11.

The Legislature has requested that the Division of Retirement commission an actuarial study to estimate the overall fiscal impact of closing the defined benefit Pension Plan to new members. This study will be completed during the 2010 Legislative Session.

Agency Response

In accordance with the provisions of s. 11.51(5), *Florida Statutes*, a draft of our report was submitted to the executive director of the State Board of Administration and the Secretary of the Department of Management Services for review and response. The Secretary's written response is included in Appendix B.

OPPAGA supports the Florida Legislature by providing evaluative research and objective analyses to promote government accountability and the efficient and effective use of public resources. This project was conducted in accordance with applicable evaluation standards. Copies of this report in print or alternate accessible format may be obtained by telephone (850/488-0021 or 800/531-2477), by FAX (850/487-3804), in person, or by mail (OPPAGA Report Production, Claude Pepper Building, Room 312, 111 W. Madison St., Tallahassee, FL 32399-1475). Cover photo by Mark Foley.

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Gary R. VanLandingham, Ph. D., OPPAGA Director

Appendix A

Some States Restrict Eligibility for Retirement Plans

Most states (39) offer their public employees defined benefit retirement plans, while three offer a defined contribution plan only and nine offer employees a choice between the two types of plans or a single plan with aspects of each. Some states restrict eligibility for the various plans, as described in Table A-1 below.

Table A-1
Several States Have Restrictions on Who May Join Specific Retirement Plans

State	Plans
California	Employees must enroll in the Alternate Retirement Program, a mandatory savings plan for certain new, first-time state employees hired on or after August 11, 2004. Alternative retirement program members are converted to the defined benefit plan after two years.
Hawaii	Vested employees can switch from a defined benefit plan to a defined contribution plan if the employee terminates employment prior to reaching the normal retirement age.
Indiana	Police and firefighters participate in a defined benefit plan, and all other employees participate in a combination plan, which includes a defined benefit plan and a supplemental annuity savings account.
Louisiana	Employees of the Board of Regents, University of Louisiana System Board of Trustees, Board of Supervisors of Louisiana State University and Agricultural and Mechanical College, Louisiana Community and Technical Colleges Board of Supervisors and other boards that manage institutions of higher education may elect to participate in a defined contribution plan.
Maryland	Faculty members and administrators employed by public higher education institutions may choose to participate in a defined contribution plan.
Michigan	State police and public school employees participate in a defined benefit plan while state employees hired on or after March 31, 1997, participate in a defined contribution plan.
Minnesota	Members of the governor's staff, legislative staff, and elected officials have the option of participating in a defined contribution plan.
Mississippi	Most employees participate in a defined benefit plan. Some members employed by institutions of higher learning may choose to participate in a defined contribution plan.
Montana	New employees may choose to participate in a defined benefit or defined contribution plan.
Nebraska	Judges, state patrol, and school employees participate in a defined benefit plan. Employees participating in the state and county retirement system have a cash balance plan, which is a defined benefit plan in which employees have individual accounts that are managed by professional money managers who determine how all employee monies will be invested.
Ohio	Employees may choose to participate in a defined benefit plan, a defined contribution plan, or a plan that combines elements of a defined benefit plan and a defined contribution plan.
Washington	Employees may choose to participate in a defined benefit plan or a plan that combines elements of a defined benefit plan and a defined contribution plan.
Wisconsin	Employees participate in defined benefit and defined contribution plans simultaneously. Upon retirement, the employees' benefits are calculated for both plans and the employees' retirement benefits are based on the higher of the two calculations.

Source: OPPAGA review of state retirement publications, summer 2009.

Appendix B

DEPARTMENT OF MANAGEMENT Services

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Secretary Linda H. South

March 5, 2010

Mr. Gary R. VanLandingham, Director
Office of Program Policy Analysis and
Government Accountability
111 West Madison St., Room 312
Tallahassee, FL 32399-1450

Dear Mr. VanLandingham:

We have reviewed your preliminary and tentative report, ***FRS Defined Contribution Plan Costs Are Typically Lower and More Predictable; Fiscal Impact of Requiring New Employees to Join the Plan Influenced by Many Factors.***

The department will implement or assist other entities in implementing any options the Legislature should choose to designate.

We appreciate your staff's efforts and cordial working relationship over the past few months. If you need additional information, please contact Steve Rumph, Inspector General, at 488-5285.

Sincerely,

Linda H. South
Secretary

cc: James Finch, Chief of Staff
David Faulkenberry, Deputy Secretary
Sarabeth Snuggs, Director of Retirement
Elizabeth Irvin, Legislative Affairs Director
Linda McDonald, Communications Director

We serve those who serve Florida.