Foster&Foster INC.

Actuaries and Consultants

Foster & Foster Memo

Regarding: Leroy Collins Institute Article, "Report Card: Florida Municipal Pension Plans"

Never before in the 32 year history of Foster & Foster have we felt compelled to issue a public response to a publication regarding Florida public pension plans, but the recent Collins Institute report was so far off the mark, we felt an immediate desire to respond.

As the actuaries for nearly 200 public pension plans in the State of Florida, we are qualified to comment on the accuracy of the findings in the article. It should be noted that our firm shares in the Institute's objective of attempting to improve transparency and increase public awareness of all pension funds in the State. With that said, however, the findings in this report were based upon actuarial information that the Institute clearly does not understand. While our objective in this response is not to attack the Collins Institute or the individual authors of their report, we feel a responsibility to correct many of their findings so that plan sponsors, taxpayers, and members of these plans do not draw the wrong conclusions or ultimately make misinformed decisions.

The report begins by stating that it "focuses on two critical measurements of a municipal pension funds' sustainability—funding levels and costs." The report goes on to assign letter grades to funds based upon funding levels and cost per active plan member. Unfortunately, the Institute (of non-actuaries), do not understand how funding levels are calculated, nor do they understand what makes a plan sustainable. Furthermore, we feel that it is borderline irresponsible to label a pension as passing or failing based upon these two measurements. The balance of our response will correct some of the misinformation found in their report.

First, let's address the issue of **sustainability**. Contrary to what the Institute may infer, the sustainability of a pension plan has very little to do with funding level or absolute cost. The sustainability of a pension plan has far more to do with the sponsor's ability to continue to make the annual payment each year. If the sponsor is flush with cash, the funding level or cost per member does not matter. Likewise, a plan could have a funded ratio of 100% and a relatively small annual payment, but if the sponsor's tax revenues will not support this payment, the plan's sustainability may be in question.

In its description regarding the sustainability of a pension plan, the Institute provides an illustration on page 1 (continued to page 2) that describes how an actuary determines the funded ratio. Unfortunately the Institute's example is materially incorrect, and this illustration helps to form the basis for their conclusions. The author describes how the plan's total liability of $4 million is calculated by discounting all of the projected future payments. This is a true statement. The author continues, however, to describe that the funded ratio of 75% is calculated by taking the $3 million in plan assets divided by the total liability ($4 million). Unfortunately, this characterization is false. The funded ratio is calculated by dividing the Actuarial Value of Assets (which the author also misrepresents) by the Actuarial Accrued Liability. The Actuarial Accrued Liability is NOT the present value of projected future payments. It is a description of the liability that is developed in accordance with one of a few acceptable actuarial cost methods. Depending upon which actuarial cost method you employ, you will develop significantly different answers. For example, there are plans that received an "A" grade that could have gotten "C" or "D" grades if a different actuarial cost method was used. Furthermore, plans who were given "C," D", or even "F" grades could have been given "A" grades if a different method was used. Not every public plan uses the same cost method. The point is that assigning letter grades to a subjective, non-uniform measure is dangerous, and reflects a material misunderstanding of the actuarial information being reflected.

After providing the erroneous funding level illustration, the Institute attempts to refute the "mortgage analogy" by stating that a plan with a 75% funding ratio "is misleading because it implies that the plan is well on the way to covering a fixed liability that is not due in full for many years." The author later attempts to simplify the mischaracterization by stating that "if the pension plan was terminated today and no further contributions were made to the fund, a pension plan that is 75% funded would be expected to pay about 75 cents on the dollar of pension benefits earned." Both statements are false. First, a portion of the sponsor's contribution each year is made to systematically improve the funded ratio, and many pension boards have made the decision to increase the size of the payments so that funding levels increase at a faster rate than what is statutorily required. Second, as mentioned in the prior paragraph, the funded ratio is dependent upon the actuarial cost method used, and is not a fair reflection of the percentage of earned benefits that are covered by current assets. In fact, it is possible that the plan with the 75% funded ratio in this illustration could cover 100% of the liabilities that have been accrued to date based upon current levels of compensation and service. So yes, a plan that has a 75% funded ratio could easily be 100% funded on a "plan termination" basis.

There are two additional thoughts to consider with regards to the funded ratio that have not already been mentioned. In addition to being largely dependent upon the actuarial cost method chosen, it is also dependent upon the age of the plan, much like a mortgage. When someone purchases a home and makes a 20% down payment, he is 20% funded in his house. A 20% funded ratio for that individual should not be frowned upon, and if that individual had increased the ratio up to 40% in 10 years, that would not be too bad either. The same can be said for pension plans. Many of Florida's municipal

pension plans have not been around as long as others, and therefore it is unfair to compare these plans to one another.

Secondly, there are many municipalities that have deliberately lowered their funded ratios in order to serve an alternative purpose. Fort Myers and Cape Coral, for example, have implemented Early Retirement Incentive programs to provide increased pensions to employees in return for immediate retirements. The idea is that the cities would be able to replace the older, higher-paid workers with younger, lower paid workers. In some cases, the retirees were not even replaced. Did this tactic lower the funded ratios? Yes. Did it increase pension costs per member? Yes. Did it also likely save the cities millions of dollars in annual cash outlays and prevent a citywide layoff? Yes. The pension plan, therefore, was a tool to accomplish a financial and human resources objective. By lowering the funded ratios in the pension plans, the cities were able to balance their budget, restructure their workforce, and save cash in a difficult economic time.

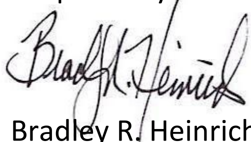
It is stated on page 5 of the report regarding the "D" and "F" plans that a "full market recovery should not be expected to fundamentally improve the condition of these pension plans." We are not sure on what basis the Institute makes this observation. Our firm is the actuary for several of these plans, and we vehemently disagree with this conclusion. In fact, for each of the plans listed that we represent, the Boards have made a conscious decision to ramp up funding over the next 10 years to completely pay for the underperformance of the market in the last ten years. If the actuarial assumptions are met prospectively, these plans will see dramatic declines in funding requirements ten years from now.

The Institute comments that the general plans tend to be better funded than either police or firefighter plans, and that general plans tend to make up a larger percentage of grade "A" plans and a smaller percentage of grade "F" plans. While this is true, the author leaves it up to the reader's imagination as to why this might be. The reason is mostly because police and firefighter plans are partially funded by taxes on auto and home insurance premiums for city residents. The premium tax dollars are partially used to offset the funding requirements for the city, and partially used to facilitate pension plan improvements for the membership. These improvements are typically always made retroactively, but also are usually highly subsidized (if not fully funded for) by prospective premium tax dollars. So, for example, let's say that City X Firefighters' Pension Plan has a funded ratio of 80%. City X approves an improvement to the plan that reduces the funded ratio to 70%, but the improvement will be entirely paid for by prospective state premium tax revenues. The City's annual cost has not increased whatsoever, but the funded ratio dropped by 10%. Should this plan receive a poorer "grade" even though an outside source is covering a piece of the bill? Since premium tax revenues only subsidize police and fire plans, naturally these plans tend to be richer and have lower funded ratios than general employee plans.

In conclusion, while we appreciate the Collins Institute's initiative to provide an evaluation of Florida's public pension plans, we believe that assigning letter grades to these plans based upon two subjective factors is misleading at best, and could potentially result in decisions that adversely affect the lives of those who serve the public. As actuaries who consult to plans in other states, we can say that the Florida public pension system is far better than anywhere else. First, the plans are administered by an independent Board of Trustees, who is entrusted to ensure that the plans operate efficiently and effectively. The sponsors are required to contribute AT LEAST the minimum required contribution set by the actuary (as approved by the Board), which is developed in accordance with the Actuarial Standards of Practice and reviewed by the actuaries at the Florida Division of Retirement. The system itself is very sustainable and has adequate checks and balances. The costs of these plans, unfortunately, have risen substantially over the last decade primarily due to the poor investment market, not because they have been mismanaged, misguided, or manipulated.

Finally, the Senate Bill 1128 requires that the Florida Division of Retirement develop a more comprehensive evaluation of our public plans. Our understanding is that these plans will be evaluated based upon a laundry list of different criteria (as opposed to two). While we believe that this will still likely be a subjective measure, we expect it to be more comprehensive and informed. In the meantime, let's shift our focus away from the subjective actuarial criteria for purposes of evaluating these plans, and focus rather on the benefits and associated costs with providing lifetime benefits for public servants. If these costs have risen to unsustainable levels when compared to the overall operating budget, then we should all work together to find ways to bring these costs in line. Until then, the plans will take care of themselves.

Respectfully submitted,



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