

Prepared Remarks to the Jacksonville Pension Reform Task Force
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Part I

Good morning. It is my pleasure to present once again to the Jacksonville Task Force on Pension Reform. I would like to thank Bill Scheu and the Task Force for inviting us to share our research and analysis on Jacksonville's pension situation and potential routes going forward. We also thank the Mayor's Office, the City Council, and the Police and Fire Pension Fund for all the help they have given us. This is an important issue and we would like to help craft recommendations that will meet the needs of the city, of workers and retirees, and of taxpayers.

My name is David Draine and I am a senior researcher at the Pew Charitable Trusts. We have been studying the issue of public sector retirement systems since 2007; of all the bills coming due for states and cities, perhaps the most daunting is the one for pensions and retiree health benefits. We have partnered with the Laura and John Arnold Foundation to help improve retirement policymaking through data and analysis at the state and local level. We are also working with Jonathan Trichter of MAEVA Municipal Solutions to supplement our analysis and he will be presenting some of their findings today.

Jacksonville runs or participates in three pension plans—the Jacksonville Police and Fire Pension Fund, the Jacksonville General Employees Retirement System, and the Florida Retirement System. Of those, the Police and Fire Pension Fund is the most underfunded and will be the subject of my remarks.

I would like to make clear that these are preliminary findings and do not yet reflect a full review of all aspects of Jacksonville's pension challenges. Furthermore, these remarks do not include the input and insight we hope to gain from the next task force meeting where key stakeholders will have a chance to share their analysis and make recommendations.

I will start by presenting on three questions:

- How the Jacksonville Police and Fire Pension Fund is currently doing
- How the Mediated Settlement Agreement would affect plan finances and worker benefits
- How the Civic Council's pension proposal would affect plan finances and worker benefits

Jonathan Trichter will then share an analysis of bonding and other asset transfers to the Jacksonville Police and Fire Pension Fund as well as provide our initial examination of investment policies in the Fund. I will then conclude with some initial recommendations on disclosure and transparency and discuss next steps. After that we will welcome questions from both the Task Force as well as members of the audience.

There are eight numbers that can give a snapshot of the fiscal state of a retirement system. The number to start with is the actuarial liability—this is how much a retirement system should have on hand right

now to pay for the promises that have been made. This is a best guess by plan actuaries and it might end up too high or too low. An important thing to realize about the liability figure is that it assumes that the money set aside will generate investment returns over the years and decades until the bill is paid off. Going forward, that assumed return will be 7 percent though in the past the Police and Fire Pension Fund has assumed 8.5 percent returns. Based on the latest data released, the Jacksonville Police and Fire Pension Fund had a liability of \$2.76 billion as of October 2012.

Of course, for a pension plan liability to be fully funded means money has been set aside to pay for past promises. So to understand the health of a pension system one needs to know how much in assets have been set aside to pay for pension bills coming due and how that compares to the liability. The three numbers that are important are the assets in Jacksonville's Police and Fire Pension Fund, the shortfall in funding, and the percent funded. The combination of contributions from the City of Jacksonville, employee contributions, investment returns, and other sources has resulted in \$1.08 billion of assets in the Police and Fire Pension Fund. That leaves a shortfall of \$1.68 billion—that shortfall is called the Unfunded Actuarially Accrued Liability or UAAL. The end result is a pension plan that is just 39 percent funded, one of the worst we've seen in the state or cities we have looked at.

The impact of this can be seen in the rising costs experienced by the City of Jacksonville. There are four cost metrics that are useful in assessing a state or city pension plan. The first is the actuarial recommended contribution, or ARC; that is the measure of how much actuaries recommend be contributed to a pension plan in a given year. In 2012 that figure was a little over \$90 million though by 2014 it is projected to be \$150 million. Paying the ARC is the most important step policymakers can take to ensure that pension promises to workers and retirees will be kept. Thankfully Jacksonville has kept up with making these payments; this is in contrast with many other states and cities where policymakers have skipped payments in good times and bad.

The ARC payment is made up of two things—a component called the normal cost and a component called the amortization of the unfunded liability. Both are typically expressed as a percentage of the total payroll of plan members to help allocate these costs. The normal cost is simply an estimate of how much it would take to pay for benefits earned in a given year plus the administrative cost of running the plan. In the 2012 actuarial valuation that was estimated to be 38 percent of total payroll—for every \$100 the city of Jacksonville spends on public safety salaries, another 38 dollars will need to be set aside to pay for new benefits. The normal cost is the easiest way to quickly compare the generosity of two sets of benefits. In 1998 the estimated normal cost was a little under 15 percent of payroll. This more than doubling of the normal cost reflects the impact of both benefit increases over the subsequent years as well as changes in the plan assumptions.

The amortization of the unfunded liability is the other piece of the ARC and represents the amount necessary to pay down any debt that has been accumulated by a pension fund. This is somewhat similar to a mortgage, in that the costs are spread out over a period of time, usually around 30 years. One difference is that actuaries usually try to keep costs steady as a share of payroll—in Jacksonville's case, amortization costs are projected to grow 3.25 percent a year until it is paid off. In 2012 the annual

contribution needed to make that year's payment to close the unfunded liability was 81 percent of payroll. In contrast, that cost in 1998 was a little under 13 percent of payroll—in other words, it has gone up more than 500 percent in just 14 years.

Employees in Jacksonville contribute 7 percent of pay towards their pension benefits. Right now this equals about 6 percent of total pension costs in 2012. In 1998 these contributions were about a quarter of total costs.

Our analysis cannot give a precise account of how these costs came about but we can point to three key things. First, increasing benefits retroactively added to the unfunded liability. For example, in 1996 a COLA was introduced. From 1995 to 1996, unfunded liabilities rose by more than \$125 million. Other changes included higher multipliers, the addition of the DROP plan, an improved death benefit, and increased health subsidies. Each of these changes increased both the unfunded liability and increased costs going forward.

Most of these benefits were offered at the tail end of a period of strong economic growth and strong investment returns. Subsequently plan assets fell in the aftermath of the Dot-Com bust—from 2000 to 2002, the reported actuarial assets of the pension plan dropped by \$190 million. The financial crisis of 2008 further strained an underfunded pension system though it is important to make clear that the pension challenges facing Jacksonville preceded the Great Recession.

Finally, plan assumption changes, most importantly dropping the investment assumption from 8.5 percent to 7 percent, led to a big increase in the reported unfunded liability. It is important to realize that this changes the numbers reported but ultimately the bill would have to be paid regardless. Lowering the discount rate means that liabilities and costs go up in the short-term but in the long-term putting more money into the fund will improve the funding situation.

An interesting consequence of this change is how fast the current unfunded liability is expected to grow. Pension accounting has liabilities grow at the assumed rate of return. So Jacksonville's \$1.68 billion unfunded liability is projected to grow at 7 percent a year rather than at the previous rate of 8.5 percent.

It is important to make clear that missed contributions are not a source of the unfunded liability. Unlike many other state and local plans, Jacksonville has made the full contribution recommended by the plan actuaries each and every year. In part this is due to strict Florida laws that ensure that whatever benefits are offered get paid for. The use of reserve accounts may have had an impact on city budgets but regardless of where the money came from, it went into the pension fund.

This rapid increase in Jacksonville's unfunded liability has led to a rapid increase in pension costs—both as the price tag for new benefits has gone up and as the contributions needed to pay down the accumulated pension debt has risen. The required contribution has gone up by 614 percent from 1992

to 2012. And going forward costs will go up even more. In 2012, the city set aside \$79 million to pay for pension costs and that bill is expected to be about \$148 million in 2014.

Comparing Jacksonville to the Florida Retirement System can be instructive in putting Jacksonville's figures in context. We will look at four measures—percent funded, normal cost as a share of payroll, amortization payment as a share of payroll, and share of normal cost covered by employee. The first tells us how the plan has done over time. The second lets us compare plans based on the level of benefits offered. The third is an indicator of the fiscal burden created by a plan's unfunded liabilities. The last lets us have a sense of how costs are split between employees and employers.

Jacksonville's Police and Fire Pension Fund is just 39 percent funded, in contrast to the public safety pensions in the Florida Retirement System which are slightly over 80 percent funded. As a result, the costs for paying down Jacksonville's unfunded liability is much greater than the bill for the Florida Retirement System. Employers in the Florida Retirement system need to set aside 8.13 percent. That is about a tenth of what the needs to be contributed to the Jacksonville Police and Fire Pension Fund.

When comparing benefits, we want to look at both the benefits that the Florida Retirement System currently offers to most public safety workers as well as the new benefit tier that workers hired after 2011 are eligible for. I want to quickly go over some of the plan provisions of the Jacksonville Police and Fire Pension Fund, the FRS benefits for members hired before 2011, and FRS benefits for new workers. The multiplier for Jacksonville police and fire workers, or the percentage of final average salary a retiree is entitled to as a retirement benefit per year of service, is 3 percent a year for the first 20 years and 2 percent a year for the next 10 years—meaning that a 30 year worker is entitled to 80 percent of his or her final salary. In the Florida Retirement System the multiplier is 3 percent for all years of service. Workers in the Police and Fire Pension Fund can retire starting at 20 years of service—pre-2011 workers in FRS need 25 years of service or to be 55 and post-2011 police officers and fire fighters need 30 years of service or to be age 60. Both PFPF and pre-2011 FRS employees are entitled to 3 percent cost-of-living-adjustments, or COLAs, but post-2011 FRS workers do not receive them.

These and other differences lead to drastically different costs for new benefits. The cost for pre-2011 benefits for public safety workers in the FRS was estimated to be 22.34 percent of pay, about one-third less than benefits in the Police and Fire Pension Fund. New benefits for workers hired after 2011 is a little more than half that price tag—the normal cost was estimated to close to 14 percent of pay or less than half the price-tag of Jacksonville public safety pensions. FRS employees now have to contribute 3 percent of their salary to the cost of their pensions, though prior to 2011 there were no employee contributions.

As has been discussed in the press, by policymakers, and now in this task force meeting, it is clear that attention needs to be paid to the Jacksonville Police and Fire Pension Plan to make sure that it is affordable now and in the future, to make sure that the promise is kept to current employees, and to make sure that future workers will be put on a secure path to retirement.

Ultimately Jacksonville's leaders, including the Mayor, the City Council, and the Police and Fire Pension Fund need to commit to comprehensive reform that will fix the city's pension problems once and for all. Any changes should honor benefits that already have been earned, as accrued benefits are legally protected.

In the end, comprehensive pension reform must accomplish three goals:

1. Develop a plan to responsibly pay down the unfunded liability over a reasonable period. Ideally, the plan should not impinge on funding for key services, hurt the city's overall economic viability, or push the cost too far into the future.
2. Adopt a reformed retirement system that is affordable, sustainable, and secure. The retirement system should ensure a secure retirement for workers and reduce the potential for unforeseen cost increases or benefit increases that don't get paid for to create future funding crises, threatening public workers and taxpayers.
3. Ensure that whatever plan the city offers enhances its ability to recruit and retain a talented public-sector workforce. Retirement savings are just one piece of total compensation, and policymakers must be thoughtful about how they allocate their limited dollars.

We are at the beginning of this process so we are not yet ready to offer any final analyses or recommendations. But we would like to briefly discuss two possible approaches. The first is the Mediation Settlement Agreement between the City of Jacksonville and the Jacksonville Police and Fire Pension Fund. The second is a proposal developed by the Civic Council of Jacksonville. We will briefly go over each in terms of what they do, what the projected fiscal impact will be, and what the impact might be on worker retirements.

The Mediation Settlement Agreement focuses on changing the benefits offered for new workers. Retirement eligibility will go from 20 years of service to 30 years of service and workers will need to spend 10 years in Jacksonville public safety to vest and earn any benefits. The multiplier will go down to 2.5 percent for all years of service. Furthermore, workers that leave before 30 years will have to wait until age 62 and will only get a multiplier of 2 percent. Employee contributions will also be increased, the DROP program will be replaced, and cost-of-living adjustments will be reduced. Other smaller changes include changing the calculation to determine the final salary that benefits are based off of and capping benefits.

The Agreement also includes an increase in contribution rates for current employees of 2 percent of pay, contingent on past salary reductions being reversed. Finally, governance changes are also part of the agreement: it changes how future administrators and board members are selected and switches the frequency of actuarial valuations to annual.

Preliminary estimates done in May by the actuarial firm Milliman suggest that these changes will reduce contributions needed in 2014 by \$45 million, though that includes a \$20 million one-time transfer, and have a long-term savings of \$1.2 billion over 30 years. Many of these savings will be long to arrive as most of the changes only affect new employees. Furthermore, this figure and the cost savings estimate for both this and the Civic Council plan are in nominal dollars and don't take into account inflation or the ability of the plan to invest.

The employer normal cost for the benefits offered to a new worker is estimated to be in the ballpark of 10 percent of pay, close to one-third of what it is currently. In other words, while the savings will take some time to materialize, they will eventually be substantial. Most of those savings will come from offering benefits to new workers that will be significantly less than what current employees enjoy.

The following chart shows the retirement wealth workers will accrue under the current plan as well as the Mediation Settlement Agreement. The way it is represented is by showing retirement wealth as a percentage of salary. Retirement wealth encompasses all aspects of a retirement benefit including multipliers, salary calculations, retirement age, and COLAs. That makes it a useful tool to compare what workers might expect out of a retirement benefit.

Benefits for workers will be lower under the Mediation Settlement Agreement and the proposed plan will have a sharp spike in retiree benefits at 25 years of service when workers are eligible for early retirement, a sharper jump than under the current design. Jacksonville policymakers will need to consider whether such a change will help or hinder their retention of public safety workers.

The Civic Council also suggested a course of action for Jacksonville on pensions. New workers would get a benefit largely similar to that under the Mediation Settlement—including a target normal cost of about 10 percent of pay. One difference is retirement eligibility. The Mediation Settlement has retirement at 30 years of service but with access to early retirement at 25 years of service. Workers who leave before 25 years of service end up with a substantially reduced benefit. The Civic Council proposal includes neither the reduction in benefits before 25 years of service nor the spike in benefits after 25 years of service.

Another difference is the impact on current employees. The Civic Council proposal asks current employees to bear part of the sacrifice through a reduction of the multiplier on current workers down to 1.5 percent of pay for future service only. One interesting implication is that if the City Council's plan goes through, some current employees might end up worse off than if they were in the new plan. If there is a goal to keep current employee benefits equal to or higher than what new employees will get, policymakers will want to consider either tweaking the benefits for current employees or making the new plan optional for those already in the Jacksonville public safety workforce.

Projected employer costs for the benefits offered to new workers under the Civic Council proposal are similar to the Mediated Settlement Agreement—approximately 10 percent of payroll. Because there will

be an impact on current employees, the total reduction in employer contributions was estimated to be approximately \$2 billion over the next 30 years. Once again, these are nominal dollars.

An important point to make about the Civic Council proposal is that changes to current employee benefits would likely face legal challenges as in many states case law either forbids or is silent on changing future accruals for those currently in the pension plan.

These are some points to consider regarding the two plans that have received the most discussion in Jacksonville. As said, these are preliminary findings and we intend to explore these plans and other proposals more thoroughly over the coming months. Whatever the new plan will be, it should provide real retirement security for workers while being affordable and sustainable. It should be designed to match the recruitment and retention needs of the city's police and fire departments. And it should make sure that costs are predictable so the city isn't paying 3 percent of payroll in one year and 110 percent of payroll in another.

With that, I would like to turn the floor over to Jonathan Trichter for his analysis of bonding and asset transfers as well as some figures on the Jacksonville Police and Fire Pension Fund's investment performance.

Part II

Thank you Jonathan for that analysis. I would like to close off by making a preliminary recommendation and then describing what we see as the next step for this process. Following that, we are looking forward to your questions.

Earlier I mentioned that we were not showing the relative contributions that benefit increases, investment losses, and assumption changes made to the \$1.68 billion unfunded liability. In other words, we know those three things were factors but we can't put numbers behind them. And that is because the data simply aren't there. We have gotten full cooperation from the Mayor's Office and the Police and Fire Pension Fund—they don't have the necessary data either to have a complete picture of the health of the plan. This is because actuarial valuations are typically done on a three-year basis in Jacksonville and there is too much going on in a three-year period for analysts and actuaries to be able to accurately understand what has changed from valuation to valuation. As such, we have some recommendations going forward for the Task Force to consider that would improve the disclosure and transparency of the Jacksonville Police and Fire Pension Fund in future years and enable policymakers, plan administrators, and the public to have a better understanding of the health of the system.

Foremost, we would recommend annual actuarial valuations so policymakers can have up-to-date information on the health of the pension plan. While some small plans conduct valuations every two or every three years, plans of this size typically conduct valuations on an annual basis. Particularly when benefit provisions and actuarial assumptions are being changed, it is important for the plan to be

assessed yearly so elected officials, plan administrators, and the public can see the impact of these changes. This is particularly critical because, as we've seen, simply paying the contributions into the plan did not keep the Jacksonville Police and Fire Pension Fund in good shape and understanding how benefit changes, investment outcomes, and assumption switches are affecting things will make it easier for policymakers and plan administrators to keep the Pension Fund out of trouble.

It is our understanding that the Mediated Settlement Agreement did contain a provision for annual valuations and we would recommend that whatever reforms do occur in Jacksonville contain such a clause. There are also some additional disclosure recommendations that would make the valuation reports a more useful document.

First, actuarial assumptions and methods should be consistent from year to year and only be changed after an experience study or some other clear reason. Furthermore, once changed, the plan should use the new assumptions going forward rather than switching back and forth.

Second, each valuation should have a detailed list of actuarial gains and losses for that year, breaking it down between investment gains or losses, benefit changes, contributions, and other actuarial assumptions.

Third, each valuation should have projections of liabilities, assets, payroll, funded levels, benefit payments, and contributions going forward for at least the next 30 years.

Fourth, current and past actuarial valuations should be easily available on the City of Jacksonville website, along with investment reports and experience studies and key data should be directly available on the website so members of the public don't need to dig through actuarial valuations.

These steps will greatly increase the information available to policymakers, plan administrators, and the public which will improve policy decisions and help keep track of and possibly prevent future out of control increases in unfunded liabilities.

We are looking forward to continuing our analysis of Jacksonville's pension challenges. Beyond simply looking at the numbers, we intend to continue talking to stakeholders including elected officials, members of city government, plan administrators, public safety officials, members of the public and the press, and good government groups.

As part of this, we understand that the Task Force will be having an open meeting session next week where interested parties from throughout Jacksonville can suggest proposals and plans, offer comments, and state their key priorities on this issue. We would welcome a broad and representative set of ideas. We will be in attendance and will make ourselves available for questions but do not plan to offer any prepared remarks; this will be an opportunity for us to listen rather than speak.

We have seen a tremendous interest in smart reform in Jacksonville. Different groups will disagree on precisely what that means but we anticipate that an open, deliberative task force process will be able to take the best ideas and turn them into recommendations that all major stakeholders can support. Jacksonville's pension challenges—\$1.68 billion in pension debt and skyrocketing contributions—need a smart, comprehensive solution that will be fair to both workers and taxpayers. We are excited to work with the Task Force, the Mayor's Office, the City Council, and the Police and Fire Pension Fund to find that solution.

Thank you for this opportunity and I look forward to your questions.