

**SEP - 3 2003**

TO: Phillip Simard, Director
Division of Cost Allocation

FROM: Dennis J. Duquette 
Deputy Inspector General for Audit Services

SUBJECT: Audit of the Reasonableness of Florida Pension Charges to the Federal Government for State Agency Employees (A-04-02-00012)

As part of the Office of Inspector General's self-initiated audit work, we are alerting you to the issuance within 5 business days of our final audit report on the reasonableness of Florida pension charges to the Federal Government for State agency employees. Copies of the report are attached. This audit was undertaken to ascertain whether Florida complied with Federal cost principles designed to ensure that Federal awards bear their fair share of cost. Our audit covered the operation of the Florida Retirement System for the period July 1, 1999, through June 30, 2002.

Our audit was designed to assess whether Florida appropriately charged the Federal Government for the pension expenses of State agency employees. Specifically, our audit objectives were to determine whether: (1) funds, once designated as contributions to the Florida Retirement System, were used to pay pension expenses; and (2) retirement system contribution rates were reasonable based on actuarial projections.

With regard to our first objective, we found that Florida used funds designated as retirement contributions during the 3 years ended June 30, 2002, solely to pay pension-related expenses. With regard to our second objective, we found that these contributions were in excess of the amounts reasonable and necessary to fully fund benefit obligations. Florida has maintained a surplus relating to State-agency contributions totaling about \$3 billion (\$267 million Federal share).

Florida attributes the surplus primarily to exceptional investment performance and has taken steps to reduce the surplus. However, the rate stabilization mechanism established by Florida's State legislature prevents the entire surplus from being available for contribution rate reductions or benefit enhancements. We believe the long-term continuation of this surplus continues to violate the Federal cost principle contained in Section C.1.a. of Office of Management and Budget Circular A-87, Attachment A that requires costs: "Be necessary and reasonable for proper and efficient performance and administration of Federal awards."

We recommended that Florida reduce contribution rates to a level necessary to fully fund pension expenses over the long term, including amending as necessary its "rate

stabilization mechanism” contained in Florida Statute, section 121.031(3)(f). As an alternative, Florida may repay \$267,138,120 to the Federal Government. If the State repays this amount, it will also need to identify and pay the Federal share of excess contributions for participating employers who were not one of the 53 State agencies we reviewed (among others, this would include district school boards, community colleges, and cities).

State officials generally disagreed with our findings and recommendations in the draft report. At the State’s request we reviewed and agreed to use appropriations data in calculating the Federal share of surplus contributions to the Florida Retirement System. With regard to Florida’s position on the reasonableness of the rate stabilization mechanism in reducing the volatility of changes in contribution rates, we do not believe that a mechanism that retains surpluses within the retirement system for future years can be reconciled with the requirements of A-87. A detailed discussion of Florida’s comments and our rebuttal is included in the report.

If you have any questions or comments on any aspect of this report please do not hesitate to call Donald L. Dille, Assistant Inspector General for Grants and Internal Activities, at (202) 619-1175 or through e-mail at ddille@oig.hhs.gov. To facilitate identification, please refer to report number A-04-02-00012 in all correspondence.

Attachment



SEP - 5 2003

REGION IV
Room 3T41
61 Forsyth Street, S.W.
Atlanta, Georgia 30303-8909

Report Number: A-04-02-00012

Mr. Bill Simon, Secretary
Florida Department of Management Services
4050 Esplanade Way, Suite 250
Tallahassee, Florida 32399-0950

Dear Mr. Simon:

Enclosed are two copies of a United States Department of Health and Human Services (HHS), Office of Inspector General's (OIG) final report entitled, "***Audit of the Reasonableness of Florida Pension Charges to the Federal Government for State Agency Employees.***" A copy of this report will be forwarded to the action official noted on page 2 of this letter for his review and any action deemed necessary.

Our audit was designed to assess whether Florida appropriately charged the Federal Government for the pension expenses of State agency employees. Specifically, our audit objectives were to determine whether: (1) funds, once designated as contributions to the Florida Retirement System, were used to pay pension expenses; and (2) retirement system contribution rates were reasonable based on actuarial projections.

With regard to our first objective, we found that Florida used funds designated as retirement contributions during the 3 years ended June 30, 2002, solely to pay pension-related expenses. With regard to our second objective, we found that these contributions were in excess of the amounts reasonable and necessary to fully fund benefits. Florida has maintained a surplus relating to State-agency contributions totaling about \$3 billion (\$267 million Federal share).

Florida attributes the surplus primarily to exceptional investment performance and has taken several steps to reduce the surplus. However, the rate stabilization mechanism established by Florida's State legislature prevents the entire surplus from being available for contribution rate reductions or benefit enhancements. We believe the long-term continuation of this surplus continues to violate the Federal cost principle contained in Section C.1.a. of Office of Management and Budget Circular A-87, Attachment A that requires costs: "Be necessary and reasonable for proper and efficient performance and administration of Federal awards."

We recommend that Florida reduce contribution rates to a level necessary to fully fund pension expenses over the long term, including amending as necessary its "rate stabilization mechanism" contained in Florida Statute, section 121.031(3)(f). As an alternative, Florida may repay \$267,138,120 to the Federal Government. If the State repays this amount, it will also need to identify and pay the Federal share of excess contributions for participating

Page 2 – Mr. Bill Simon, Secretary

employers who were not one of the 53 State agencies we reviewed (among others, this would include district school boards, community colleges, and cities).

Final determinations as to actions taken on all matters reported will be made by the HHS action official named below. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 Code of Federal Regulations Part 5.)

To facilitate identification, please refer to report number A-04-02-00012 in all correspondence relating to this report.

Sincerely,



Charles J. Curtis
Regional Inspector General
for Audit Services, Region IV

Enclosures - as stated

Direct Reply to HHS Action Official:

Mr. William Logan
Director, Mid-Atlantic Office
Division of Cost Allocation
U.S. Department of Health and Human Services
Wilbur Cohen Building, Room 1067
330 Independence Ave. S.W.
Washington, D.C. 20201

Department of Health and Human Services

**OFFICE OF
INSPECTOR GENERAL**

**AUDIT OF THE REASONABLENESS OF
FLORIDA PENSION CHARGES TO THE
FEDERAL GOVERNMENT FOR STATE
AGENCY EMPLOYEES**



**SEPTEMBER 2003
A-04-02-00012**

Notices

THIS REPORT IS AVAILABLE TO THE PUBLIC
at <http://oig.hhs.gov>

In accordance with the principles of the Freedom of Information Act (5 U.S.C. 552, as amended by Public Law 104-231), Office of Inspector General, Office of Audit Services reports are made available to members of the public to the extent the information is not subject to exemptions in the act. (See 45 CFR Part 5.)

OAS FINDINGS AND OPINIONS

The designation of financial or management practices as questionable or a recommendation for the disallowance of costs incurred or claimed, as well as other conclusions and recommendations in this report, represent the findings and opinions of the HHS/OIG/OAS. Authorized officials of the HHS divisions will make final determination on these matters.





REGION IV
Room 3T41
61 Forsyth Street, S.W.
Atlanta, Georgia 30303-8909

SEP - 5 2003

Report Number: A-04-02-00012

Mr. Bill Simon, Secretary
Florida Department of Management Services
4050 Esplanade Way, Suite 250
Tallahassee, Florida 32399-0950

Dear Mr. Simon:

This final report provides the results of our "*Audit of the Reasonableness of Florida Pension Charges to the Federal Government for State Agency Employees.*"

EXECUTIVE SUMMARY

OBJECTIVES

Our audit was designed to assess whether Florida appropriately charged the Federal Government for the pension expenses of State agency employees. Specifically, our audit objectives were to determine whether: (1) funds, once designated as contributions to the Florida Retirement System, were used to pay pension expenses; and (2) retirement system contribution rates were reasonable based on actuarial projections.

SUMMARY OF FINDINGS

With regard to our first objective, we found that Florida used funds designated as retirement contributions during the 3 years ended June 30, 2002, solely to pay pension-related expenses. With regard to our second objective, we found that these contributions were in excess of the amounts reasonable and necessary to fully fund benefits. Florida has maintained a surplus relating to State-agency contributions totaling about \$3 billion (\$267 million Federal share).

Florida attributes the surplus primarily to exceptional investment performance and has taken steps to reduce the surplus. However, the rate stabilization mechanism established by Florida's State legislature prevents the entire surplus from being available for contribution rate reductions or benefit enhancements. We believe the long-term continuation of this surplus continues to violate the Federal cost principle contained in Section C.1.a. of Office of Management and Budget (OMB) Circular A-87, Attachment A that requires costs: "Be necessary and reasonable for proper and efficient performance and administration of Federal awards."

RECOMMENDATION

We recommend that Florida reduce contribution rates to a level necessary to fully fund pension expenses over the long term, including amending as necessary its “rate stabilization mechanism” contained in Florida Statute, section 121.031(3)(f). As an alternative, Florida may repay \$267,138,120 to the Federal Government. If the State repays this amount, it will also need to identify and pay the Federal share of excess contributions for participating employers who were not one of the 53 State agencies we reviewed (among others, this would include district school boards, community colleges, and cities).

In written comments to the draft report, Florida officials generally disagreed with our findings and recommendations. Florida’s written comments and the Office of Inspector General’s (OIG) response to these comments are summarized after the **RECOMMENDATIONS** section of this report. The complete text of Florida’s comments is included in **Appendix A**.

INTRODUCTION

BACKGROUND

Federal Participation in Public Employee Retirement Systems

The Federal Government participates in and makes contributions to States’ public employee retirement systems through Statewide Cost Allocation Plans, which are submitted annually by States and approved by the U.S. Department of Health and Human Services, Division of Cost Allocation.

Both employees and their employing agencies may contribute to public employee retirement systems. The basis for these contributions can either be computed using a pay-as-you-go method or an acceptable actuarial cost method in accordance with established written policies of the governmental unit. Pension costs charged to Federal programs are subject to cost principles contained in Federal regulations. For State and local governments, the cost principles governing allowable costs to Federal programs are set forth in OMB Circular A-87. The current reporting and funding requirements for public employees retirement systems are set forth in Governmental Accounting Standards Board Statements 25 and 27.

Florida Retirement System

Title X, Chapter 121 of the Florida code governs the Florida Retirement System. This retirement system was created December 1, 1970, with the combination of the Teachers’ Retirement System, the State and County Officers and Employees’ Retirement System, and the Highway Patrol Pension Fund. In 1972, the Judicial Retirement System was also consolidated with the Florida Retirement System. The retirement system was created to provide a defined benefit retirement, disability, and survivor benefit program for participating public employees.

Membership is compulsory for all full-time 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. Elected officials may elect not to participate in the system.

The Florida Retirement System currently allows various classes of membership with various contribution percentages and benefit levels. Specifically, the retirement system now contains membership classes of: Regular, Special Risk, Special Risk Administrative Support, Elected Officers (subcategories for judges, certain elected State officials, and elected county officials), and Senior Management Service Class.

OBJECTIVES, SCOPE, AND METHODOLOGY

Objectives

Our audit was designed to assess whether Florida appropriately charged the Federal Government for the pension expenses of State agency employees. Specifically, our audit objectives were to determine whether: (1) funds, once designated as contributions to the Florida Retirement System, were used to pay pension expenses; and (2) retirement system contribution rates were reasonable based on actuarial projections.

Scope

Our audit covered the operation of the Florida Retirement System for the period July 1, 1999, through June 30, 2002. Fieldwork was performed at the offices of the Florida State Board of Administration, the Florida Office of Policy and Budget, the Florida Department of Management Services' Division of Retirement, and at the Tallahassee and Atlanta offices of the OIG.

We did not test the financial statements of the Florida Retirement System. To the extent possible, we relied on the work of the Florida Auditor General's Office. The 1999, 2000, and 2001 Comprehensive Annual Financial Reports for Florida, which were relied upon in this audit, were all audited by the Florida Auditor General's Office and given an unqualified opinion. We have used unaudited data where noted in this report for periods subsequent to June 30, 2002, in order to determine the current impact of any findings. In addition, we relied on the calculations of Florida's actuarial firm of Milliman USA f/k/a Milliman & Robertson, Inc., which attested to performing an actuarial valuation of the Florida Retirement System in accordance with the principles of practice prescribed by the American Academy of Actuaries.

We conducted our audit in accordance with generally accepted government auditing standards.

On March 14, 2003, we issued a draft report to Florida for comment. On April 14, 2003, we received the State's written comments to the draft report. On April 17, 2003, we held an exit conference with State officials.

Methodology

We met with State officials to:

- discuss the process by which payroll contributions are collected and forwarded to the Florida Retirement System;
- obtain actuarial reports, financial statements, correspondence, and other retirement system contribution related material;
- discuss the process by which retirement system contributions are collected and plan investments made, and to gather financial information regarding retirement system assets; and
- discuss the Federal participation percentage among State agencies participating in the retirement system.

We also held discussions with representatives from Milliman USA, the actuarial firm for the Florida Retirement System and with Buck Consultants, the consulting/peer review actuarial firm. Buck Consultants annually reviewed the assumptions Milliman USA used in its actuarial calculations.

FINDINGS AND RECOMMENDATION

With regard to our first objective, we found that Florida used funds designated as retirement contributions during the 3 years ended June 30, 2002, solely to pay pension-related expenses. With regard to our second objective, we found that these contributions were in excess of the amounts reasonable and necessary to fully fund benefits. Florida has maintained a surplus relating to State-agency contributions totaling about \$3 billion (\$267 million Federal share).

Florida attributes the surplus primarily to exceptional investment performance and has taken several steps to reduce the surplus. However, the rate stabilization mechanism established by Florida's State legislature prevents the entire surplus from being available for contribution rate reductions or benefit enhancements. We believe the long-term continuation of this surplus continues to violate the Federal cost principle contained in Section C.1.a. of OMB Circular A-87, Attachment A that requires costs: "Be necessary and reasonable for proper and efficient performance and administration of Federal awards."

ACTUARIAL SURPLUS OF \$12.9 BILLION

At July 1, 2002, the actuarial value of assets in the Florida Retirement System exceeded actuarial accrued liabilities by \$12.9 billion.

The actuarial liability is that portion of the actuarial present value of projected benefits that will not be paid by future employer normal costs or member contributions. The difference between this liability and funds accumulated as of the same date is referred to as the unfunded actuarial accrued liability. If the difference is negative, the excess of the funds accumulated over the liabilities is referred to as the surplus. The table below shows that the Florida Retirement System had a surplus starting in 1998, and the surplus increased in percentage amount for the next 2 years and in dollar amount for each of the next 3 years.

**Schedule of Florida Retirement
System Surplus 1998 - 2002**

(Dollars in Thousands)

	<u>7/1/1998</u>	<u>7/1/1999</u>	<u>7/1/2000</u>	<u>7/1/2001</u>	<u>7/1/2002</u>
Actuarial Accrued Liability	\$63,205,829	\$68,575,249	\$74,948,950	\$80,993,718	\$86,469,774
Actuarial Value of Assets	\$66,997,227	\$77,795,313	\$88,503,838	\$95,517,948	\$99,405,677
Unfunded Actuarial Accrued Liability	(\$3,791,398)	(\$9,220,064)	(\$13,554,888)	(\$14,524,230)	(\$12,935,903)
Funded Ratio	106.00%	113.45%	118.09%	117.93%	114.96%

Any funded ratio above 100 percent represents a surplus of assets over liabilities. Variations between actuarial expectations and actual experience occur constantly in retirement systems, and in the case of the Florida Retirement System’s positive experience (actuarial gains) occurred consistently throughout the 1990s.

Exceptional Investment Performance – Primary Cause of Initial Surplus

Exceptional investment performance was the primary cause of the initial surplus. During the 1990s, the Florida Retirement System benefited from experience that exceeded actuarial expectations. For the period of our audit, the retirement system used an expected rate of return on investments of 8 percent. However, for the 10-year period ending June 30, 2001, the annualized total fund investment performance was 12.2 percent, over 50 percent higher than actuarial expectations for a decade.

The assumptions used in the actuarial calculations by Florida’s primary actuary were reviewed annually by a separate consulting actuary, and have generally been found to be reasonable. The data we reviewed during our audit revealed that the investment returns the State experienced in the 1990s were generally unanticipated. State officials described this as an extraordinary event that is unlikely to recur. Note that the market return on investments for the years ended July 1, 2001, and July 1, 2002 were a negative 6.93 and 7.62 percent, respectively.

What Florida Has Done to Address the Surplus

Florida has taken steps to address the surplus. The first step was to improve benefits among various categories of participants and beneficiaries. The State offset a portion of the surplus by increasing benefits. For example, in Fiscal Year 2000, the State granted a 12 percent benefit

increase for certain Special Risk retirees and beneficiaries. This change reduced the surplus by approximately \$283 million.

Second, Florida reduced employer contribution rates. For example, the contribution rate as a percent of salary for the “regular” class of participants dropped from 15.51 percent for the year ended June 30, 1999, to 6.09 percent for the year ended June 30, 2002. The current contribution rate for the “regular” class of participants in the retirement system is 4.5 percent of salary.¹

The increase in benefits had the effect of reducing the surplus and the reduction in the contribution rate helped limit the growth of the surplus. Both of these actions did not result in the Federal Government overpaying for pension expenses for State employees. However, the third step, the establishment of a rate stabilization mechanism, has resulted in Federal programs contributing on a year-to-year basis more than necessary to fully fund the pension costs of State agency employees.

Rate Stabilization Mechanism

Florida implemented a rate stabilization mechanism that has the effect of retaining the actuarial surplus in the Florida Retirement System over time.

The rate stabilization mechanism was created when Florida House Bill 2393 was enacted by the 2000 Legislature and signed into law by the Governor. This mechanism has been codified into Title X, Section 121.031 of Florida Statutes.

Section 121.031 actually has two mechanisms that would serve the purpose of stabilizing contribution rates. The first mechanism is contained in 121.031(3)(a), which requires the valuation of assets to be based on a 5-year averaging methodology such as that specified in the United States Department of Treasury Regulations, 26 Code of Federal Regulations 1.412(c)(2)-1, or a similar accepted approach designed to reduce fluctuations in asset values.

To see the effect of this mechanism, note that the actuarial value of assets (as shown in the Table on page 5) continued to rise over the last 2 years while the rates of return on investments have been negative. By minimizing the variation in asset values from year-to-year, the 5-year market smoothing process results in less variation in required contribution rates. This is a commonly used and accepted method of rate stabilization.

The second stabilization mechanism, described in Section 121.031(3)(f), requires a modification of the actuarial model used to determine the adequate level of funding for the Florida Retirement System. In various printed material, the State described this mechanism as “similar in principle to the State’s Rainy Day Fund”, with goals of “providing contribution rate stability in the face of unexpected economic stress”. The rate stabilization mechanism establishes a tiered approach to utilizing the actuarial surplus within the Florida Retirement System. Under the rate stabilization

¹ These numbers represent contributions only for the “regular” class of participant. Contribution rates vary considerably from class to class.

mechanism all actuarial surpluses in excess of 15 percent over actuarial liabilities are available for rate reduction. To the extent that actuarial surpluses are less than 15 percent over actuarial liabilities, the mechanism explicitly restricts a portion of the surplus, making it unavailable for rate reductions.

In developing the rate stabilization mechanism, two of the policy issues addressed by Florida were how large the reserve should be allowed to grow, and how quickly the reserves should be used up through contribution rate reductions. While the “reserves” referred to in the State’s printed material clearly refer to Florida Retirement System assets, and remain within the retirement system until used, they represent a pre-funding of benefits that have not yet accrued to retirement system participants (See Florida’s Response and OIG Comment section below for further discussion). The specific operation of the rate stabilization mechanism is described in the Florida statute as shown in **Appendix B**.

In our opinion, the restriction on the use of the actuarial surplus that is imposed by the rate stabilization mechanism is not reasonable. OMB Circular A-87, Attachment A, Section C.1 prohibits States from charging the Federal Government for costs that are not reasonable and necessary. Specifically, Section C.1.a. states that to be allowable under Federal awards, costs must be necessary and reasonable for the proper and efficient performance and administration of Federal awards. Subsequent to the implementation of the rate stabilization mechanism, the Florida Retirement System has not set its contribution rates at a level that is reasonable and necessary.

Even though Florida does not expect a repeat of extraordinary returns on investment that occurred in the 1990s, and has taken steps described above to reduce the surplus, we believe that the continuing surplus, and the rate stabilization mechanism that was enacted to perpetuate the surplus, have resulted in Federal programs being overcharged for pension costs for State employees. Further actions are needed to insure that Federal programs do not continue to be overcharged for pension costs.

Calculation of Federal Participation Rate

We determined the relative portion of the Florida Retirement System that State agencies comprise. The retirement system had 811 participating employers as of June 30, 2001, only 53 of which were State agencies. Participating employers also included district school boards, community colleges, county agencies, and cities, among others. While these other employers may have received some Federal monies, review of their participation was outside the scope of this audit.

For the year beginning July 1, 2002, the most current year, State agency contributions were expected to make up 23.4861 percent of all contributions to the Florida Retirement System. The surplus in the retirement system as of July 1, 2002, was \$12,935,903,000. Multiplying these figures gives an approximate State agency-related portion of the surplus of \$3,038,139,114.

During the course of our audit we tried to obtain actual salary expenditure data for employees working on Federal programs. However, Florida did not maintain records documenting the Federal portion of salary expenditures. Therefore, in our draft report, we based our calculation on a weighted average of Federal expenditures to total expenditures for selected contributing agencies to the Florida Retirement System. In its response to our draft report, the State proposed an alternative calculation based on appropriated salary data rather than on total expenditures. See page 10 of this report for a discussion of the State’s comments and this revised approach.

We developed an estimated Federal participation rate of 8.79 percent using the methodology that the State suggested. Based on this Federal participation rate, we estimate that the Federal portion of the Florida Retirement System surplus relating only to State agency contributions is \$267,138,120.

RECOMMENDATION

We recommend that Florida reduce contribution rates to a level necessary to, on a long-term basis, fully fund pension expenses, including amending as necessary its “rate stabilization mechanism” contained in Florida Statute, section 121.031(3)(f). As an alternative, Florida may repay \$267,138,120 to the Federal Government. If the State repays this amount, it will also need to identify and pay the Federal share of excess contributions for participating employers who were not one of the 53 State agencies we reviewed (among others, this would include district school boards, community colleges, and cities).

Florida’s Response – OIG Incorrectly Interpreted OMB Circular A-87

In written comments to the draft report, State officials generally disagreed with our findings and recommendations. State officials contended that the:

- (1) OIG misinterpreted OMB Circular A-87 in that A-87 excludes pension reserves that are computed using acceptable actuarial cost methods. State officials reasoned that since there are no contributions made separately for a reserve, nor is any portion of the pension reserve segregated from the pension system, Florida’s reserve does not fall within the definition of a contingency reserve;
- (2) draft report proposes an enforcement action that would impose immediate and full recognition of all net actuarial gains in contravention of generally accepted accounting principles, actuarial practice and OMB rules;
- (3) rate stabilization method approved by the Legislature to gradually use some of the surplus to maintain a stable contribution rate seems reasonable and is used by other pension systems; and
- (4) Florida Retirement System is not currently over funded. At this point in time there are not sufficient assets to pay all promised benefits for current participants when future benefit

accruals are recognized. The reserve only means that retirement system is ahead of its previously established funding schedule.

OIG Comments – OIG Incorrectly Interpreted OMB Circular A-87

- (1) Rather than relying on the allowability of contingency reserves or the rules concerning pension costs, we have clarified in the report that Florida’s treatment of the surplus is not in accordance with the general principles of reasonableness and necessity contained in the Attachment A of the Circular. The rate stabilization mechanism that was enacted has resulted in Federal programs contributing on a year-to-year basis more than necessary to fully fund the pension costs of State agency employees. In response to Florida’s comments, we have revised our references to OMB Circular A-87.

To restate our position, the assets that are set aside and are not available for current rate reduction or benefit enhancement as a result of the rate stabilization mechanism, remain within the Florida Retirement System. We have not implied that there were separate contributions to a reserve. We have also noted that the surplus originated primarily as the result of investment performance exceeding expectations, not due to excessive contributions to fund a “reserve.”

Among other things, the State's annual actuarial reports spell out how much of the surplus is available for rate reduction, one example of which is cited in **Appendix B** of this report. Contribution rates for the Florida retirement System are set by statute and consist of a normal cost contribution and an unfunded liability contribution. Since the retirement system has a negative unfunded liability, the contribution rates have reflected a reduction from the normal cost contribution in recent years. The modification in the contribution rate calculation methodology enacted by the 2000 Legislature prevents the use of the entire surplus for purposes of this reduction.

- (2) The OIG recommendations provide the State with alternative methods of compliance. The State can either reduce future contributions or refund the Federal portion of overpayments. The OIG does not propose that the State recognize all actuarial gains immediately.
- (3) With respect to the reasonableness of the rate stabilization mechanism, we acknowledge the benefit that such a mechanism has provided for State budgeting purposes by reducing contribution rate volatility. However, we do not believe that a mechanism that retains surpluses within the Florida Retirement System for future years can be reconciled with the requirements of A-87, and thus disagree with the State that the mechanism is reasonable from a Federal cost perspective.
- (4) We agree that the Florida Retirement System does not have enough funds to pay for all retirement benefits that current employees will accrue during the remaining course of their employment. We would not expect the State to have funded these additional pension benefits that have not yet accrued. The term “fully funded” is often applied to a system where contributions at the normal cost rate are completely adequate to pay for the benefits of

all existing employees. More often than not, systems are not fully funded, either because benefit improvements in the past have not been fully paid for, or because actuarial deficiencies have occurred due to experience that has not been as favorable as anticipated. Under these circumstances, an unfunded actuarial liability exists. For the Florida Retirement System, no unfunded actuarial liability has existed for the past five years, and the retirement system is “fully funded”. It is our position that under A-87, it is not reasonable or necessary to fund benefits that will accrue in future years during the current year.

Florida’s Comments and OIG Response – Federal Participation Rate

Florida cannot readily break down the amount of salary and benefit expenditures between Federal and non-Federal sources. Therefore, we based our draft report calculation of the Federal participation rate on total expenditures. Subsequent to our issuing the draft report, the State developed a Federal participation rate based on the ratio of Federal funds appropriated for salaries and benefits for State employees for a given fiscal year to total appropriated funds. The State requested we consider this alternative methodology.

We noted that the State used appropriated amounts in computing its estimate of Federal participation, and that differences in appropriated amounts versus actual expenditures may have an impact on the Federal participation rate. As part of our review of the State’s calculation, we determined that the Federal participation rate that resulted from the State’s methodology remained relatively consistent for all 3 years of our audit period (9.33 percent, 8.73 percent, and 8.79 percent for the years ended June 30, 2000, through June 30, 2002, respectively). These percentages are slightly less than the percentages for Federal participation originally calculated by the State (9.39 percent, 8.80 percent, and 8.87 percent for the same 3 years respectively). The difference is due to revised data provided by the State with respect to actual agency contributions to the Florida Retirement System for the years in question.

We also compared total agency expenditures with agency appropriations for the same time periods and determined that expenditures did not vary significantly from appropriations. We could not compare appropriated Federal salaries and benefits with actual Federal salaries and benefits on an agency-by-agency basis, because the State does not maintain records that show actual Federal salaries and benefits on an agency-by-agency basis.

After reviewing the State's calculated federal participation rate and determining that it appears to be supportable, consistent, and reasonable, we modified the federal participation rate based on the State's calculation. Accordingly, we have made appropriate changes to the final report.

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Final determinations as to actions taken on all matters reported will be made by the Department of Health and Human Services (HHS) action official named below. We request that you respond to the HHS action official within 30 days from the date of this letter. Your response should present any comments or additional information that you believe may have a bearing on the final determination.

Page 11 –Mr. Bill Simon, Secretary

In accordance with the principles of the Freedom of Information Act (Public Law 90-23), OIG reports issued to the Department's grantees and contractors are made available, if requested, to members of the press and general public to the extent information contained therein is not subject to exemptions in the Act which the Department chooses to exercise. (See 45 Code of Federal Regulations part 5.)

To facilitate identification, please refer to report number A-04-02-00012 in all correspondence relating to this report.

Sincerely,

A handwritten signature in black ink, appearing to read "Charles J. Curtis". The signature is written in a cursive style with a large initial "C".

Charles J. Curtis
Regional Inspector General
for Audit Services, Region IV

Direct Reply to HHS Action Official:

William G. Logan
Director, Mid-Atlantic Office
Division of Cost Allocation
U.S. Department of Health and Human Services
Wilbur Cohen Building, Room 1067
330 Independence Avenue, S.W.
Washington, D.C. 20201

A P P E N D I C E S



**FLORIDA
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APR 14 2003

Office of Audit Svcs.

April 11, 2003

Appendix A
Page 1 of 15

Mr. Charles J. Curtis
Regional Inspector General for Audit Services, Region IV
Department of Health and Human Services
Room 3T41
61 Forsyth Street, SW
Atlanta, Georgia 30303-8909

Dear Mr. Curtis:

As discussed with Mr. John Drake, Audit Manager, enclosed is the revised response to your draft report number A-04-02-00012, *Audit of the Reasonableness of Florida Pension Charges to the Federal Government for State Agency Employees*, dated March 14, 2003.

We apologize for any inconvenience this may have caused.

If you have any questions, please feel free to contact me at (850) 488-5285.

Sincerely,

Steve Rumph
Acting Inspector General

SR/taw

Enclosure

STATE OF FLORIDA
DEPARTMENT OF MANAGEMENT SERVICES

FORMAL RESPONSE TO
DRAFT AUDIT OF THE REASONABLENESS OF FLORIDA PENSION CHARGES
TO THE FEDERAL GOVERNMENT FOR STATE AGENCY EMPLOYEES
(HHS Report Number: A-04-02-00012)

Executive Summary

The State of Florida, Department of Management Services ("Department"), has reviewed the findings and recommendations in the draft audit report and has determined the following. First, the draft report incorrectly classifies a portion of the reserves in the Florida Retirement System ("FRS") as "contingency reserve" rather than "pension reserve." This classification is inconsistent with the plain language of OMB Circular A-87. Second, the report incorrectly characterizes the rate stabilization mechanism ("RSM") as an unacceptable actuarial method. This is in contradiction to the opinions of two national actuarial firms who have performed actuarial valuations on the FRS. Third, the draft report estimates a 17% federal contribution to, or participation rate in the FRS. The Department presents an alternative calculation method that yields a more accurate estimated participation rate of 8.87% for the relevant period. Finally, contribution rates for employers who participate in the FRS, including the Federal Government, have declined steadily and significantly since 1999. Contribution rates have been and are reasonable. As such, the Department submits that neither repayment of FRS pension reserve funds nor further reduction of future contributions is justified.

- FRS Pension Reserve

The audit covers the operation of the FRS for the period July 1, 1999, through June 30, 2002. It finds, i.e., that the RSM enacted by the Florida Legislature created a contingency reserve in the FRS trust fund. Specifically, the draft audit report states:

Exceptional investment performance was the primary cause of the initial surplus. The state has taken several steps to address the surplus. One of the steps created a contingency reserve, the FRS rate stabilization mechanism. This contingency reserve is not in accordance with federal cost principles and resulted in federal programs being overcharged for the pension costs of state agency employees. (Draft Report, p. 4)

This conclusion is based on an incomplete, and therefore incorrect, reading of OMB Circular A-87, Section 12, and is inconsistent with subsequent analysis of the RSM.

Section 12 provides:

Contributions to a contingency reserve or any similar provision made for events the occurrence of which cannot be foretold with certainty as to time, or intensity, or with an assurance of their happening, are unallowable.

However, Section 12 goes on to state:

The term contingency reserve excludes pension reserves (see subsection 11.e) computed using acceptable actuarial cost methods. (Emphasis added.)

In concluding that the FRS reserve is a contingency reserve, the draft report focuses solely on "various printed material" describing the RSM and reasons for its use. However, the RSM utilized by the State of Florida to compute the reserve is, in fact, an acceptable actuarial cost method. Florida's "reserve" is a net actuarial gain and results from the FRS being ahead of schedule to pay future benefits that are not yet funded, and as such, falls within the definition of a "pension reserve." Since there are no contributions made separately for a reserve, nor is any portion of the pension reserve segregated from the pension system, Florida's "reserve" does not fall within the definition of a contingency reserve.

An actuarial valuation of the FRS is performed annually by a nationally recognized actuarial firm selected through the State's competitive procurement process. A subsequent independent consulting/peer review of that firm's actuarial methodology is performed by a second actuarial firm chosen by the Florida Legislature under the auspices of the Office of Program Policy Analysis and Government Accountability (OPPAGA). During the period reviewed by the audit, Milliman, USA performed the FRS valuation for the Department, and Buck Consultants, Inc., reviewed Milliman's calculations and report on behalf of the Legislature. Both of these actuarial firms have concluded that the FRS is funded using an acceptable actuarial method and reasonable actuarial assumptions in accordance with federal cost principles and generally accepted accounting and actuarial practices. In Appendix A, page 17, item 7 of the March 2002 OPPAGA actuarial valuation, report number 02-20, Recommended Florida Retirement System Contribution Rates Are Reasonable, Buck Consultant's, Inc. reported that:

The method approved by the Legislature to gradually use some of the surplus of the separate experience gain base to maintain a stable contribution rate seems reasonable and, in fact, is used by other systems of which we are aware.

Accordingly, under the plain language of OMB Circular A-87, Section 12, the rate stabilization amount under the FRS is not a prohibited contingency reserve. Rather, it is a pension reserve wholly allowable under Section 12.

- **Rate Stabilization Mechanism**

Although the draft audit report concludes that the RSM is not actuarially sound, notably the report does not directly address this point nor discuss the auditors' rationale for this technical determination. This assumption can only follow from the report's incorrect interpretation of Section 12 of OMB Circular A-87.

The RSM enacted into Florida law in 2000 was the culmination of a two-year process of study and evaluation that involved members of the Florida Legislature, FRS employers, legislative and executive branch policy staff, professionals from the Florida State Board of Administration (SBA) and the Division of Retirement, two independent actuary firms, as well as the SBA Trustees. The process encompassed a wide-ranging evaluation of virtually every facet of the actuarial methodology employed by the FRS, possible alternatives, and their likely fiscal consequences under a wide variety of possible future conditions. This evaluation resulted in a report (Report of the Unfunded Actuarial Liability Working Group) containing 12 recommendations.

One of the report's recommendations was for the Legislature to explore additional options for stabilizing contribution rates and consider a mechanism to ease the burden of contribution volatility on FRS employers. During the next year, the SBA continued to work with the two actuary firms to evaluate alternative ways to implement this recommendation. The result was a set of 13 alternative models that were presented to the SBA trustees. During an extensive public meeting discussing these alternatives, the Trustees, acting pursuant to their fiduciary obligation to members of the FRS and their beneficiaries, endorsed one of the alternatives and forwarded that recommendation to the Legislature for consideration during the 2000 legislative session. It was subsequently enacted into law as the rate stabilization mechanism.

The current FRS pension reserve amount arises through established and widely recognized actuarial and accounting methodology. The amount is never accumulated or funded through explicit contributions or methodologies separate

from the generally accepted accounting principles and actuarial practice that are used to finance the benefits provided under the plan. The amount is never formally segregated from the pension fund itself. Indeed, the amount constitutes what is commonly known under generally accepted accounting principles and actuarial practice as a net actuarial gain, arising not from any contingency reserving practice that is subject to Section 12, but from the commonly recognized difference between reasonable actuarial assumptions and actual experience.

The actuarially sound RSM ensures that the FRS has sufficient assets on hand to pay benefits for all participants. The mechanism is structured to provide for predictable and level contributions (measured as a percent of payroll). It also prevents the burden from shifting between tax-paying generations. The mechanism was developed and adopted as a compromise between risk and return -- using the probability that experience will cause an unfunded actuarial liability to reemerge and create contribution rates in excess of normal cost.

The Department notes, particularly, that FRS is not currently over funded. At this point in time there are not sufficient assets to pay all promised benefits for current participants when future benefit accruals are recognized. The reserve only means that FRS is ahead of its previously established funding schedule. The investment return will gradually bring the FRS back to the previously established funding schedule.

- **Calculation of Federal Contributions to FRS**

As set forth in detail above, the draft report's conclusion that a contingency reserve exists in the FRS fund is incorrect. Accordingly, the recommendation that the Department either repay excess funds or reduce future contributions is not justified.

The Department notes, however, the report concludes that the federal participation rate for the most current year data is available (as of July 1, 2002) was an estimated 17.0234%. The 17.0234% was multiplied by \$3,038,139,114 (estimated state agency-related portion of the total FRS surplus) to arrive at a figure of \$517,194,574 in federal surplus contributions. The Department proposes an alternative calculation that results in a more accurate estimated federal participation rate during the period (FY 2001-2002) of 8.87% (see Attachment 1). This figure was determined using actual figures for total salaries and benefits for all State of Florida agencies (employers), the federally funded portion of that total, and total actual retirement contributions paid by the agencies. Accordingly, the Department believes the amount of FRS pension

reserve for FY 2001-2002 relating to federal contribution could be no more than \$269,482,939, (\$3,038,139,114 x 8.87%).

The Department also notes that the draft report proposes an enforcement action that would impose immediate and full recognition of all net actuarial gains, in contravention of generally accepted accounting principles, actuarial practice and of the OMB rules themselves. The immediate and full recognition of actuarial gains is commonly applied only upon full settlement of all risks and obligations relating to pension benefits, such as in full termination of the pension plan or upon fully covering all obligations through the purchase of annuity contracts. Obviously, no such settlement has taken place with the FRS.

The recommendation contained in the draft report would force settlement treatment that would completely mischaracterize the pension arrangement and jeopardize the proper financing of the plan as well as the stability of future contributions for all employers in the system. Under generally accepted accounting principals promulgated by the Governmental Accounting Standards Board, such immediate recognition of net gains would not be appropriate for the determination of the annual required contribution. Thus, compliance with the corrective action suggested would force the FRS to carry and amortize a liability for the amount paid under that action, clearly reflecting the unacceptability of the basis used for the suggested corrective action.

- **Actual Decline in Federal Contributions to FRS**

The following table shows the decline in the regular class contribution rates as the FRS surplus increased during the period audited.

**CONTRIBUTION RATES
REGULAR CLASS EMPLOYEES**

	FY98-99	FY99-00	FY00-01	FY01-02	FY02-03
Normal Cost Rate	10.64%	9.21%	9.49%	9.91%	9.94%
Actual Cost Rate	15.51%	9.21%	8.11%	6.09%	4.50%

In summary, the federal government, as well as all other participating employers in FRS, is paying an employer contribution rate that is lower than the normal cost rate because of the positive investment experience of the retirement system.

We have included with this response position papers from Milliman, USA and Ennis Knupp and Associates. These papers discuss the issues raised in the draft audit report.

Mr. Charles J. Curtis
April 10, 2003
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As the position papers point out, the FRS is funded using an acceptable actuarial method and reasonable actuarial assumption in accordance with federal cost principles, generally accepted accounting principles and actuarial practice.

The State of Florida plans to continue making adjustments to future contribution rates based on the results of the latest actuarial valuation, in accordance with state law and as has been the FRS's standard practice.

OIG Note:

State officials provided additional information relative to their calculation of federal contributions to the FRS. In view of this additional information, state officials requested that we delete from their response, the schedule showing the state's computation of the estimated federal participation rate.



A MILLIMAN GLOBAL FIRM

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April 9, 2003

Via Overnight Delivery

Ms. Erin B. Sjoström
State Retirement Director
Division of Retirement
Cedars Executive Center, Building C
2639 North Monroe Street
Tallahassee, FL 32399-1560

Re: HHS Audit Position Paper

Dear Erin:

Attached is a position paper regarding the draft audit of the FRS by the Federal Department of Health and Human Services.

Please call with any questions.

Sincerely,

Milliman USA

Robert S. Dezube, FSA
Consulting Actuary

Enclosure

cc: Adrien LaBombarde

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MILLIMAN USA

POSITION PAPER REGARDING THE DRAFT AUDIT OF THE REASONABLENESS OF FLORIDA PENSION CHARGES TO THE FEDERAL GOVERNMENT FOR STATE AGENCY EMPLOYEES (HHS Report Number: A-04-02-00012)

Milliman USA has reviewed the draft audit report of HHS Report Number A-04-02-00012 regarding an audit of the reasonableness of pension charges by the State of Florida (the "State") to the federal government for state agency employees and submits this position paper in response at the request of the State. The draft audit report mischaracterizes a portion of the pension reserve for the Florida Retirement System ("FRS"), incorrectly classifying that amount as a contingency reserve. The draft audit report incorrectly judges the FRS's rate stabilization mechanism ("RSM") as an unacceptable actuarial method and fails to provide any justification for doing so. Seriously compounding those errors, the draft audit report proposes an enforcement action that would impose full and immediate recognition of all net actuarial gains, in direct contravention of generally accepted accounting principles and actuarial practice and of the OMB rules themselves.

1. The amount covered under the RSM is a net actuarial gain both accumulated and treated in accordance with generally accepted accounting principles and actuarial practice. As a net actuarial gain accumulated in accordance with an acceptable actuarial cost method, the RSM amount constitutes a pension reserve as identified in the second sentence of §12 of OMB Circular No. A-87, Attachment B. Accordingly, by the specific definition provided in that section, the RSM amount is not a contingency reserve subject to the restrictions stated in the first sentence of §12.
 - a. *The rate stabilization amount is a pension reserve, exempt from treatment as a contingency reserve.* Notwithstanding any specific terminology given in materials relating to the accumulation and objectives for treatment of the RSM, the amount arises directly and entirely through established and widely recognized actuarial and accounting methodology as a pension reserve. The amount is never accumulated nor funded through explicit contributions or methodologies separate from the generally accepted accounting principles and actuarial practice that are used to finance the benefits provided under the plan. The amount is never formally segregated from the pension fund itself. Indeed, the amount constitutes what is commonly known under generally accepted accounting principles and actuarial practice as a net actuarial gain, arising not from any contingency reserving practice that is subject to §12, but rather from the commonly recognized difference between reasonable actuarial assumptions and actual experience.

The draft audit report centers its analysis and conclusions upon an incomplete appraisal of §12 that fails to recognize the important exemption provided for pension reserves. Indeed, the draft audit report conveniently

quotes only the first sentence of §12, recognizing the critical second sentence with a mere ellipsis and at most a glancing reference. The draft report provides no explanation or substantiation for denial of the exemption provided under the second sentence of §12; rather, the draft audit report simply ignores that crucial exemption aside as though it were inapplicable, without providing any justification for doing so.

- b. *The draft audit report fails to distinguish between past actuarial funding methods and future treatment of the pension reserves accumulated using those methods.* The rate stabilization amount arose from generally accepted accounting principles and actuarial practice used to accumulate the pension reserve for the Florida Retirement System. Even if a question were to arise concerning the acceptability of actuarial practice with respect to the treatment of the RSM amount (and even that point is never directly addressed under the draft audit report), at most the only amounts open to question should be the portions of future pension financing that would be based on those questioned components, not the past pension reserve itself as accumulated through prior periods using generally accepted accounting principles and actuarial practice. Essentially, the draft audit report draws an implied and unsubstantiated conclusion regarding the actuarial acceptability of future pension reserving methodology, then retroactively applies that conclusion against the past reserving methodology without any explanation or justification for doing so. Indeed, the draft actuarial report appears to be premised on the faulted belief that the mere presence of an actuarial surplus is in and of itself evidence of excess contributions, although universally accepted actuarial practice openly disputes that claim. Such a belief and the conclusion reached from that belief demonstrate a very severe misunderstanding of generally accepted accounting principles and actuarial practice relating to pension reserves, and is not consistent with the spirit and the letter of the rules provided under §12.
 - c. *The draft audit report fails to acknowledge any segregation of source of net gain or loss by source.* That approach for financing the pension benefits would have the effect of a failure to recognize as a legitimate pension reserve the accumulation of net mortality gains, net turnover gains, and all other experience for which generally accepted accounting principles and actuarial practice clearly recognize pension reserve methods that are exempt under the second sentence of §12.
2. The draft audit report fails to provide justification that the amounts under the RSM have been accumulated using other than an acceptable actuarial method.

Essentially, the draft audit report turns §12 on its head. Under that section, as discussed above, if a pension reserve has been accumulated under an acceptable actuarial method, then it is not defined as a contingency reserve. Completely reversing the logic, the draft audit report claims that if an amount has been characterized as a contingency reserve, then it accordingly fails to constitute a pension reserve accumulated under an acceptable actuarial method. Beyond that inexplicable reversal of the definition, the draft audit report provides

no concrete basis for judging the actuarial cost method used to accumulate the pension reserve to have been unacceptable.

Indeed, §11e calls upon the State to have "established written policies" of the acceptable actuarial cost method by which its pension reserve is to be computed. The State has done so, both in establishing the written policy relating to the RSM and in regards other pension reserving practices.

- a. *FRS's actuarial cost method prior to introduction of its rate stabilization mechanism, which ought be the proper focus of any focus on the development of the current actuarial surplus, constituted an acceptable actuarial cost method in compliance with §11e and therefore eligible for exemption under the second sentence of §12.* The draft actuarial report completely ignores this issue, effectively conveying its conclusions regarding the RSM indiscriminately to all actuarial cost methods used under the plan and to all reserves accumulated under the plan, whether or not pre-dating the RSM, and without any regard to generally accepted accounting principles and actuarial practice.
 - b. *Florida's RSM is a method for future treatment of accumulated net actuarial gains that complies with the terms of §11e.* The draft audit report fails to provide any substantive analysis or concrete argument for maintaining that the RSM fails to constitute an acceptable actuarial cost method. At most, the report seems to suggest that the mere presence of an actuarial surplus is de facto evidence of excess contributions, although such a conclusion is in very sharp contrast with generally accepted accounting principles and actuarial practice relating to pension reserves.
3. The draft audit report proposes a severe corrective action that would have the effect of immediate and full recognition of all actuarial gains, regardless of source, in direct contravention of generally accepted accounting principles and actuarial practice.

Under generally accepted accounting principles and actuarial practice, immediate and full recognition of actuarial gains is commonly applied only upon full settlement of all risks and obligations relating to pension benefits, such as in full termination of the pension plan or upon fully covering all obligations through the purchase of annuity contracts. Obviously, no such settlement has taken place nor is anticipated with Florida. Hence, forcing settlement treatment would completely mischaracterize the pension arrangement and jeopardize proper financing of the plan. Indeed, under generally accepted accounting principals promulgated by the Governmental Accounting Standards Board, since such immediate recognition of net gains would not be appropriate for the determination of the annual required contribution, compliance with the corrective action suggested by the draft audit report would force Florida to carry and amortize a liability for the amount paid under that action, clearly reflecting the unacceptability of the basis used for the suggested corrective action.

MEMORANDUM

To: Ms. Simone Marsteller, Interim Secretary
Florida Department of Management Services
Mr. Coleman Stipanovich, Executive Director
State Board of Administration of Florida

From: Rowland M. Davis

Date: April 10, 2003

Re: Rate Stabilization Mechanism

This letter offers, and provides support for, my view that the "rate stabilization mechanism" for the Florida Retirement System (FRS), as implemented pursuant to Florida law, is an inherent part of an acceptable actuarial cost method used to determine annual contributions to the FRS pension plan.

An expanded set of actuarial standards of practice in the area of pension cost determination is now in the final stage of development by the actuarial profession. The most current document is an Exposure Draft approved by the Actuarial Standards Board in December, 2002 with the title "Measuring Pension Obligations and Determining Pension Plan Costs." In reviewing the FRS rate stabilization mechanism, the most pertinent sections of the Exposure Draft are Sections 3.10 and 3.11, which state the following:

3.10 Funding Policy—The funding policy typically brings together the normal cost under an actuarial cost method and the amortization of the difference between the actuarial accrued liability and the actuarial value of assets, if any, to determine the plan contribution or cost for the period. When giving advice on selecting a funding policy, the actuary should take into account factors such as the following:

3.10.1 Plan Sponsor Goals—Examples of plan sponsor goals include some desired pattern of costs or contributions and the desire to achieve or maintain some level of benefit security.

3.10.2 Amortization—A funding policy typically provides for the amortization of the difference, if any, between the actuarial accrued liability and the actuarial value of assets. When giving advice on selecting the amortization period or range of periods, the actuary should consider such factors as input provided by the plan administrator or plan sponsor regarding limitations on the availability of future contributions and progress towards meeting a desired funding goal.

3.11 Reasonableness of Resulting Contributions or Costs— A funding policy may not necessarily produce a reasonable contribution or cost pattern even if a combination of reasonable assumptions, a reasonable cost method, and a reasonable asset valuation method is used. A contribution or cost pattern is reasonable if it is expected to be sufficient to satisfy the plan's projected cash flow obligations if all actuarial assumptions are realized. When assigning costs to time periods, the actuary should determine whether the resulting contribution or cost pattern is, in the actuary's judgment, reasonable for an appropriate time period. If the resulting contribution or cost pattern is not reasonable, the actuary should make appropriate recommendations to the plan administrator or plan sponsor that, if implemented, are expected to produce a contribution or cost pattern sufficient to satisfy the plan's projected cash flow obligations."

In 1998 and 1999, a detailed review was made of all aspects of the FRS actuarial process and method of determining pension contributions. As a result of this review, certain changes were recommended in the way that unfunded actuarial liabilities, or surplus asset amounts, were recognized in the annual cost calculations. These recommendations ultimately led to the legislation that adopted the rate stabilization mechanism. I was one of the actuaries involved in reviewing alternatives and advising FRS and SBA staff on how well these alternatives met FRS objectives. These objectives were to ensure adequate funding to provide benefit security, to provide stability in the required rate of contribution, to provide a fair distribution of future cost among the current and future generations of Florida taxpayers (as required under law -- Section 112.61 Legislative Intent: "... it is the intent of this act to prohibit the use of any procedure, methodology, or assumptions the effect of which is to transfer to future taxpayers any portion of the costs which may reasonably have been expected to be paid by the current taxpayers."), and to have transparency in the calculations so that they provide a realistic picture of the true long-term cost of the plan.

In this advisory role, I made projections of future contribution requirements for each alternative under review, using a variety of scenarios for future economic and investment return outcomes. In reviewing these projections, it was clear that the amortization policy then in effect was not producing a pattern of expected contributions that met the stated FRS objectives. Rates were not stable, and long-term trends showed that future taxpayers could be exposed to rates that were unreasonably high, in comparison with rates that were likely for the current generation of taxpayers. Several changes were recommended, including a revision in certain actuarial assumptions, a new amortization policy, and the rate stabilization mechanism. The cost projections indicated that without a rate stabilization mechanism, contribution rates were exposed to much larger changes across different generations of taxpayers than was reasonable. The rate stabilization mechanism was recommended to solve this problem, so that the pattern of expected future contribution rates was more aligned with the stated FRS goals. The recognition of these goals is consistent with the requirements of the Exposure Draft language quoted above.

By way of general background, I am a consulting pension actuary with over 30 years of experience. I am a Fellow in the Society of Actuaries, and an Enrolled Actuary under ERISA provisions for pension actuaries. I work with Ennis, Knupp & Associates through an exclusive consulting agreement.

Operation of the Rate Stabilization Mechanism as Described in Florida Statute Section 121.031(3)(f)

...(f) The actuarial model used to determine the adequate level of funding for the Florida Retirement System shall include a specific rate stabilization mechanism, as prescribed herein. It is the intent of the Legislature to maintain as a reserve a specific portion of any actuarial surplus, and to use such reserve for the purpose of offsetting future unfunded liabilities caused by experience losses, thereby minimizing the risk of future increases in contribution rates. It is further the intent of the Legislature that the use of any excess above the reserve to offset retirement system normal costs shall be in a manner that will allow system employers to plan appropriately for resulting cost reductions and subsequent cost increases. The rate stabilization mechanism shall operate as follows:

- 1. The actuarial surplus shall be the value of actuarial assets over actuarial liabilities, as is determined on the preceding June 30 or as may be estimated on the preceding December 31*
- 2. The full amount of any experience loss shall be offset, to the extent possible, by any actuarial surplus.*
- 3. If the actuarial surplus exceeds 5 percent of actuarial liabilities, one-half of the excess may be used to offset total retirement system costs. In addition, if the actuarial surplus exceeds 10 percent of actuarial liabilities, an additional one-fourth of the excess above 10 percent may be used to offset total retirement system costs. In addition, if the actuarial surplus exceeds 15 percent of actuarial liabilities, an additional one-fourth of the excess above 15 percent may be used to offset total retirement system costs.*
- 4. Any surplus amounts available to offset total retirement system costs pursuant to subparagraph 3. should be amortized each year over a 10-year rolling period on a level-dollar basis...*

As an example of the operation of this mechanism for the current year, note that the Florida Retirement System funded percentage as of July 1, 2002, is 114.96 percent (See Table on page 5). As stated in the actuarial valuation of the retirement system as of July 1, 2002, "After the rate stabilization mechanism is applied to the \$12.9 billion surplus, approximately \$5.4 billion is available for contribution rate reduction, or other retirement system uses. The surplus pursuant to Florida law is amortized over 10 years...." The remaining \$7.5 billion also stays in the retirement system, but is not available in the current year for these same purposes.

ACKNOWLEDGMENTS

This report was prepared under the direction of Charles J. Curtis, Regional Inspector General for Audit Services. Other principal Office of Audit Services staff that contributed included:

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