SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based only on the provisions contained in the legislation as of the latest date listed below.)

Date: April 14, 1998 Revised:

Subject: Public Employee Retirement Systems

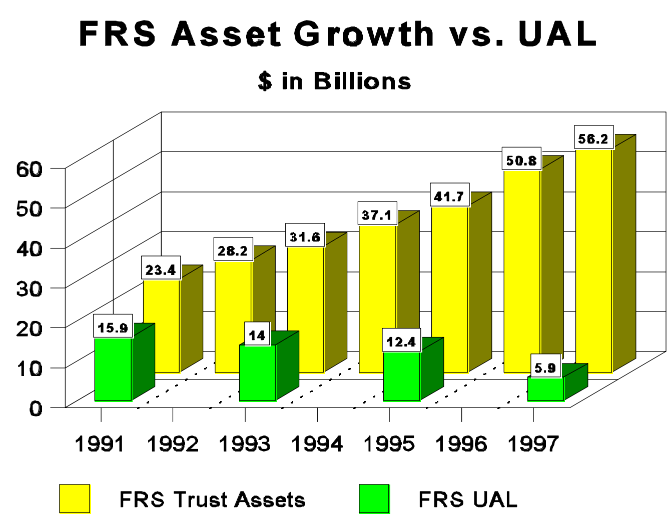
	Analyst	Staff Director	Reference	Action
1.	Lombardi	Wilson	GO	Favorable/CS
2.			WM	
3.				
4.				
5.				

I. Summary:

The committee substitute creates the Florida Retirement Benefit Study Commission. The commission will review and make recommendations regarding the implementation of a defined contribution plan as an option to the existing defined benefit plans for public employer members of the Florida Retirement System (FRS).

This act shall take effect upon becoming a law.

II. Present Situation:



The FRS was established in 1970 and encompassed formerly separate retirement plans covering state and local government employees and officers, teachers, the Highway Patrol, and the Judicial Branch. To provide actuarially funded benefits for all existing retirement plans, the FRS had to amortize the unfunded liabilities of prior generations of public employees through the assessment of a required contribution to pay off the unfunded accrued actuarial liability or UAL on its participating employer's payroll contributions. As of the July 1, 1997, valuation date, the FRS UAL stood at $5,943,190,000, a reduction of almost $10 billion from the same valuation date in 1991. The following example to the right depicts the correlation between growth in the FRS trust fund portfolio and its associated UAL.

In the 1997 report "Survey of State and Local Government Employee Retirement Systems," the Public Pension Coordinating Council ranked the FRS as the fourth largest state pension fund in terms of membership in the United States, behind California, New York, and Texas respectively. The report also indicated that FRS ranked first in the country for systems with 400,000 or more members as having the lowest administrative cost per member served ($18.34). By comparison California's administrative cost per member served is $88.67. Actual membership growth rates for the FRS as reported by the Division of Retirement are as follows:

FRS Growth of Active Members 1992-97

Year	# Members	Nominal Growth
1992	545,953	N/A
1993	552,581	1.2%
1994	572,390	3.6%
1995	586,625	2.5%
1996	586,796	.03%
1997	589,791	.51%

State employees, including University System employees, account for about 24 percent of the FRS membership. The remaining members are employed by local government employers, including counties, district school boards, community colleges, and some cities and special districts.

The FRS is designed to afford a measure of portability to Florida public employees allowing them to change jobs within the public sector without penalizing their vesting rights to FRS retirement benefits. A public employee who leaves the state to seek employment opportunities in the private sector may later return as a public employee of an agency or entity enrolled in the FRS and continue to earn credit toward his/her retirement benefits from the last date of service without penalty. However, not anytime may the employee take their FRS retirement benefit with them outside an employer enrolled in the FRS. The FRS enhances pension portability options by providing members the opportunity to obtain option service credit for various types of service as shown in the following table:

Service Credit Options

F.S. Cite	Service Option Availability	Description
s. 121.011(3)(e)	Periods of Suspension	Members reinstated without compensation following a period of suspension may claim credit for the suspension period.

Service Credit Options		
F.S. Cite	**Service Option Availability**	**Description**
s. 121.053	Postretirement service by an Elected Officer	Vested members of the Elected State and County Officers' Class may purchase elected officer credit if they had previously retired and then had postretirement service as an elected officer that was either uncredited or under credited.
s. 121.081(1)	Past Service	Members employed by a city or special district previous to the employer electing to participate in FRS, may purchase credit for service.
s. 121.081(2)	Prior Service	Members may purchase credit for service under the consolidated FRS for which contributions were previously refunded.
s. 121.021(20) & s. 121.111	Military Service	Members may purchase credit for actual "wartime service" or leave-of-absence military service.
s. 121.1115	Out-of-State Public Service	Members may purchase credit for periods of public employment in another state.
s. 121.115	Federal Service	Members may purchase credit for periods of public employment with the federal government.
s. 121.1122	In-state Public Service	Members may purchase credit for in-state public service.
s. 121.1122	Service in Certain Schools/Colleges	Members may purchase credit for periods employed in chartered schools or a nonpublic nonsectarian school or college accredited by the Southern Association of Colleges and Schools.
s. 121.121	Leaves of Absence	Members may purchase credit for authorized leaves of absence.
s. 121.122	Service as a Reemployed Retiree	Members may purchase renewed member credit for postretirement service as a reemployed retiree.

FRS Benefits Under the Retirement Plan

The FRS is an employer-funded pension plan which promises vested members a retirement benefit based on a formula determined by years of service, average final compensation, and member classification accrual rates. This type of pension plan is commonly known as a *defined benefit plan* and since 1975 FRS members have not been required to contribute to receive a pension benefit. The formula, in combination with up to 500 hours of annual leave, yields the base retirement benefit which is then adjusted annually for inflation at 3 percent. To receive the full retirement benefit, members must first reach their "normal retirement date" based on membership classification and age and/or length of service.

The FRS also provides disability and survivor benefits which are payable to joint annuitants and other beneficiaries under certain circumstances.

Existing Options to the FRS

While membership in the FRS is compulsory for most members, there are defined contribution options for those members who are eligible and choose to participate. These options are used as recruiting tools for those highly qualified employees who do not see a 10 year vesting period as advantageous. Consequently, these defined contribution options provide immediate vesting and portability and determine future retirement benefits based upon the value of the contribution made and the interest accumulated in the individual account. The following table depicts the defined contribution plan options to the FRS.

Defined Contribution Options to FRS

F.S. Cite	Plan Name	Who it effects
s. 121.35(4)	State University System Optional Retirement Program	A defined contribution plan which faculty and certain other employees of the State University System may participate.
s. 121.051(2)(c)	State Community College System Optional Retirement Program	A defined contribution plan provided by community college boards of trustees and available to faculty and certain other Regular Class members of the State Community College System.
s. 121.055(6)(d)	Senior Management Service Optional Annuity Program (SMS-OAP)	A defined contribution plan for state senior managers eligible for membership in the Senior Management Service Class. State and county elected officers may also elect to participate in the plan within 6 mos. of assuming office.
s. 121.055(1)(b)2.	Local government established annuity plans	A defined contribution plan for Senior Management Service Class employees electing not to participate in SMSC and elected officials of municipal and special district governing bodies who also elect not to participate in SMSC.

Public Employee Retirement Savings Plans

Existing tax code permits governmental and quasi-governmental employers to offer three main types of income-deferral arrangements to supplement retirement benefits. Sections 112.21 and 112.215, F.S., authorize the following deferred compensation arrangements:

* A **457 plan** under the internal revenue code permits an employee of the state, a local government, or certain other quasi-governmental entities to defer compensation for retirement. Currently, an employee may defer up to $8,000 or about 25 percent of gross salary annually, whichever is less. The cap will index in increments of $500 or more and adjusts with inflation. There exists a “catch-up” provision in the code for those individuals approaching normal retirement age who have contributed less than the maximum allowable amount.

* A **403(b)** plan is a tax sheltered annuity program offering a deferred compensation arrangement and is limited to employees of public educational systems and other tax exempt

organizations like hospitals and nonprofit groups. Employees may defer up to $10,000 annually and the cap is indexed for inflation. "Catch-up" provisions also exist in the code.

* A **401(k)** plan is only available as a qualified plan to public sector employees if the public employer adopted the plan prior to May 6, 1986. The State of Florida did not adopt this plan, thus state employees are now foreclosed from this option. However, for the few governmental entities which did adopt such a plan in the State of Florida, employees hired after the May 6, 1986 date may be added to the plan. Employees under such a plan are allowed to defer up to $10,000 annually with separate limits applying to employer contributions.

Comparing and Contrasting DB and DC Plans

Defined contribution plans generally give an employer greater control over employee retirement costs. The following table summarizes the advantages and disadvantages of defined benefit and defined contribution plans from an *employer* perspective.

Objective	Defined Benefit	Defined Contribution
Funding Certainty	Plan liabilities are influenced by future salary increases, investment earnings, and employee turnover.	Employer liability is funded annually as contributions are made to employee accounts.
Predictable Costs	Change in actuarial projections can vary annual cash expenditure from year to year.	Expected cash expenditures are basically influenced by employee salaries.
Recruitment Tool	Benefits are not portable outside the plan system and less appealing to a mobile workforce.	Benefits are portable and are appealing to a mobile workforce.
Reward Long Service Employees	Benefits are based upon length of service and average final years of compensation.	Benefits are based upon accumulated contributions and earnings.
Administrative Expenses	Generally more expensive because of actuarial valuation in addition to record keeping and investment management.	Generally less expensive because no actuarial valuation is needed and can be administered by a third party.
Investment Risk	Investment risk is assumed by the employer.	Investment risk is assumed by the employee.

Source: Bureau of Labor Statistics: Employee Benefits in State and Local Government.

1991 data from the Bureau of Labor Statistics indicated that tenure for the total workforce was approximately 7.2 years in comparison to 9.3 years for public administration. Defined contribution plans work best in situations characterized by career mobility. The following table summarizes the advantages and disadvantages of defined benefit and defined contribution plans from an *employee* perspective.

Objective	Defined Benefit	Defined Contribution
Ultimate Benefit Potential	Benefits are predetermined at retirement.	There is greater potential to earn greater benefits through superior investment results. Thus benefits at retirement are not constrained by formula.
Easily Understandable	Benefits are based on variables that are difficult to calculate; e.g., future earnings and years of service at retirement.	Participant is presented with a monthly statement of accumulated contributions and earnings.
Access to Benefits While Employed	Benefits are not available for withdrawal under any circumstances while actively employed.	Benefits are available for withdrawal under the provisions of IRS guidelines.
Reward Long Service Employees	Benefits are based upon length of service and average final years of compensation.	Benefits are based upon accumulated contributions and earnings.
Recruitment Tool	Benefits are not portable and less appealing to a mobile workforce	Benefits are portable and are appealing to a mobile workforce.
Investment Risk	Investment risk is assumed by the employer.	Investment risk is assumed by the employee.

Source: Bureau of Labor Statistics: Employee Benefits in State and Local Government.

Who Actually Wins and Who Loses

Classification	Determination	DB or DC
Healthy Retirees	Defined benefit plans pay benefits to retirees for life.	DB
Savvy Investors	Those who direct investment in a superior fashion will receive higher benefits than those who are less successful investors.	DC
Retirees in Times of High Inflation	Inflation can erode the value of a defined contribution account while those enrolled in defined benefit plans will likely experience cost of living adjustments after retirement.	DB
Death & Disability Beneficiaries	In the event of death or disability, a defined contribution member's account balance may be inadequate due to short service.	DB
Career Mobile Members	DC plans can be left to be credited with future investment earnings or rolled over into another qualified or IRA.	DC
Early Retirees	Retirees prior to normal retirement receive a benefit of higher value than those who leave later.	DB
Older Members	The value of benefits earned by older members under a DB plan is significantly higher than those earned by younger members of either plan because the investment has longer to work.	DB

Who Actually Wins and Who Loses		
Classification	**Determination**	**DB or DC**
Career Members	DB members in a few instances make no contribution and always assume no risk under the promised benefit.	DB
Employers	Employer assumes more risk in a DB plan and exposes himself to more variables which influence employer contribution costs.	DC
Taxpayers	The financial predictability and control offered by DC plans can result in lower tax burdens.	DC
Women	Woman typically outlive men by an average of 7 or more years. A DB plan pays benefits to retirees for life.	DB

Source: EFI Actuaries, Public Sector Employee Benefits Consultants.

Pension Fund Actions by Other States

Michigan: Michigan is the newest state to offer both a defined benefit plan and a defined contribution plan to state employees, excepting law enforcement and school system employees. The new program establishes a second tier in the plan. All new employees, effective March 1, 1997, are automatically enrolled in Tier II of the plan. Employees hired prior to the March 1, 1997, have the option of transferring to the new plan or may remain in the old.

Tier II of the plan is a defined contribution plan which requires the employer to contribute 4 percent of gross payroll. Employees have the option of contributing another 3 percent which the employer is required to match. Employees may make additional contribution beyond 3 percent, up to the IRS allowable cap. Vesting in the program is immediate and the employee incrementally vests 25 percent of the employer’s contribution for each year of completed service. After four years of completed service the employee is entitled to 100 percent of all contributions made thereafter by the employer. The program is completely portable.

Washington State: Washington State has cultivated a three tier retirement plan. The Tier 1 plan is the original defined benefit plan and was closed in 1978. This plan gave employees access to *full retirement benefits* at any age provided they accumulated 30 years of service. Full benefits were also awarded to those age 55 with 25 years of service, or age 60 with a minimum of five years of service. The minimum vesting period for employees in this plan is five years.

The Tier II defined benefit plan began after the closure of the Tier 1 plan in 1978 and effectively increased the normal retirement age from age 60 to age 65. On July 1, 1996 Tier III of the plan went into effect which provides two independent plans: an employer-funded defined benefit plan and an employee-funded defined contribution plan. When added together, these two plans will comprise the employee’s total retirement benefit.

One of the provisions in the plan provides flexibility to the mobile employee by allowing a member terminating before retirement eligibility to withdraw all member contributions, plus interest earned at market rate, without destroying eligibility to receive the employer-funded defined benefit portion when retirement eligibility criteria has been met.

West Virginia: The original retirement plan, now closed to new members, gave employees access to *full retirement benefits* at any age provided they accumulated 35 years of service. Full benefits were also awarded to those age 50 with 30 years of service, or age 60 with a minimum of five years of service. The minimum vesting period for employees in this plan is five years. Under the program employees contributed 6 percent of their salary with the employer contributing $2.50 for every dollar contributed by the employee.

On July 1, 1991, West Virginia adopted a new defined contribution plan where the employee contributes 4.5 percent of gross salary while employer contributes 7.5 percent. To provide flexibility to the mobile employee, a member terminating service before reaching retirement eligibility is permitted to withdraw all member contributions, plus interest earned at market rate. In addition, the employee is permitted to withdraw a portion of the employer's contribution with interest specifically: one-third after 6 years, two-thirds after 9 years, and 100 percent after 12 years of completed service.

Colorado: On July 1, 1995, Colorado adopted a new hybrid plan which added a matching employer contribution to refunds and provided a lump-sum payment option at retirement. Employees pay 8 percent of their gross salary and the employer contributes another 11.6 percent of payroll. The employer cost includes an amount for a health care subsidy for retired employees.

Under the program the employer "match" is either 25 percent of the member contribution account balance for refunds made before retirement age or 50 percent for payments made after retirement eligibility. The money purchase refunds and lump-sum options theoretically provide portability to an employee seeking an alternative plan. However, experience shows that lump-sum payment plans have major negative tax consequences if not rolled over into another qualified plan and often the money is spent quickly and is seldom used for retirement purposes.

South Dakota: In South Dakota, the need for pension system reform attracted political attention when the university system began having trouble recruiting new professors. Consequently, the state has recently implemented a cost-neutral choice plan with a unique portable retirement option (PRO). The employee may elect an employer administered defined contribution plan instead of the standard defined benefit plan. The defined contribution plan becomes the vehicle for maintaining the employee benefit values if the employee moves to a new employer. If the employee does not change employers, the employee can elect at the time of retirement to go back to the standard defined benefit plan computation. The choice is kept cost neutral by not including the standard survivor and disability benefits in the defined contribution plan. However, the employee can still receive these benefits by paying the additional premium.

III. Effect of Proposed Changes:

The committee substitute creates the Florida Retirement Benefit Study Commission. The commission will review and make recommendations regarding the implementation of a defined contribution plan as an option to the existing defined benefit plans for public employer members of the FRS.

The commission will consist of 19 members:

* Two members appointed by the President of the Senate, one representing the majority party, and one representing the minority party;
* Two members appointed by the Speaker of the House of Representatives, one representing the majority party, and one representing the minority party.

The Governor shall appoint the following commission members based upon the recommendations of each of the respective employer or employee member organizations:

* One member representing the Division of Retirement;
* One member representing the State Board of Administration;
* One member representing the Department of Management Services;
* Two members representing the financial services industry;
* Two members representing municipality members of the FRS, one representing the employer, and one representing nonmanagerial, nonsupervisory employees;
* Two members representing counties, one representing the employer and one representing nonmanagerial, nonsupervisory employees;
* Two members representing special district members of the FRS, one representing the employer and one representing nonmanagerial, nonsupervisory employees;
* Two representatives of school boards, one representing the employer and one representing non managerial, non supervisory employees; and
* Two representative of state employees, one representing managerial/supervisory employees, and one representing nonmanagerial, nonsupervisory employee.

The commission will be responsible for reviewing defined benefit and defined contribution plans in order to establish the proper balance of employer and employee contributions in establishing the new plan. Consideration will be given to the impact on existing retirement plans resulting from the implementation of a new retirement plan, including, but not limited to: demographic factors, geographic factors, vesting rights and portability options, and any other factors influencing the demand for either a defined benefit or defined contribution plan in a co-existing, retirement plan environment.

The commission will recommend and address an employer’s obligation, if any, to educate employees regarding the differences in optional plans and their investment choices. The commission will also recommend and address program administration and its cost to the employee and the offering of employer plans independently, or as a group.

Members will serve on the commission without pay but will be entitled to per diem expenses as provided by s. 112.061, F.S., while carrying out official business of the commission. The Division of Retirement shall provide staff for the commission.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

None.

C. Government Sector Impact:

Expenses of the commission will be paid from the Florida Retirement System Trust Fund. There is no additional fiscal impact.

VI. Technical Deficiencies:

None.

VII. Related Issues:

Defined contribution (DC) plans shift the responsibility from the employer to the employee in assuring that adequate funds are available at the time of retirement. However, the success of a defined contribution plan depends upon the investment skills of the employee who may or may not be trained or educated in this area. Additionally, DC plans have other subtleties which can create problems in assuring adequate funds are available at retirement:

* DC plans allow members to borrow against his/her retirement account during the accumulation period. If the funds are not replaced then the amount available at retirement is significantly diminished;

* DC plans allow lump-sum distribution of the entire accumulated benefit amount at job termination and at retirement. As noted earlier in the Colorado Retirement Plan, experience shows that lump-sum payment plans have major negative tax consequences if not rolled over into another qualified plan and often the money is spent quickly and is seldom used for retirement purposes;

* DC plans do not protect against inflation;

* Defined contribution members are more likely to retire with inadequate benefits and/or outlive their benefits, especially woman who live an average of seven years longer than men. The future social costs may be high if a significant number of Floridians are without adequate resources for retirement.

VIII. Amendments:

None.