

SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

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

BILL: CS/SB 872

SPONSOR: Governmental Oversight and Productivity Committee and Senator Garcia

SUBJECT: Florida Retirement System

DATE: April 23, 2001 REVISED: _____

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Wilson	Wilson	GO	Favorable/CS
2.	_____	_____	AGG	_____
3.	_____	_____	AP	_____
4.	_____	_____	RC	_____
5.	_____	_____	_____	_____
6.	_____	_____	_____	_____

I. Summary:

The Committee Substitute recognizes that private sector providers of investment products and related administrative and advisory services, including those offering guaranteed accounts, shall be the principal means of implementing the Public Employees Optional Retirement Program, Chapter 2000-169, Laws of Florida.

The Committee Substitute also places designated state hospital, firefighters, assistant attorney general and aviation personnel in different retirement classes for benefit accrual purposes.

This bill amends sections 121.0515, 121.055, and 121.4501, Florida Statutes.

II. Present Situation:

The Florida Retirement System (FRS) is a defined benefit (DB), non-participatory, multi-employer pension plan covering the employees, survivors, and dependents of some 800 Florida state agency and local government employers. It offers a monthly benefit payable in the form of an annuity over a retiree's lifetime that is calculated as a percentage of the highest five years' of a member's average final pay. The FRS is composed of several sub-classes of membership with separate benefit accrual rates: Regular (1.60 percent-1.68 percent); Special Risk (3.00 percent); Special Risk, Administrative Support (1.6 percent); Senior Management (2.0 percent); Justices and Judges (3.33 percent); and Elected Officers (3.0 percent).¹ Normal, unreduced retirement occurs at the earlier completion of 30 years of service or age 62, or

¹Accrual rate is the pension value per year of creditable service. Accrual rate multiplied times total creditable service length in years multiplied times average final compensation (inclusive of up to 500 hours of annual leave) equals an Option 1 benefit for the life of the named retiree only. There are three other reduced payment options that incorporate survivors' benefits.

25 years of service and age 55 for the two special risk classes. Members must satisfy minimum service periods in order to qualify, or vest for benefits. Effective July 2001, the three separate vesting periods of 7, 8, and 10 years will be collapsed into one uniform 6-year period. Incorporated within the DB plan is a disability retirement provision that provides in-line-of-duty and non-duty retirement payments.

The FRS is a predominantly local government plan with state officers and employees comprising only about 25 percent of the total membership. The other principal employer categories are district school boards, counties, and community colleges. Membership is compulsory for state agencies and constitutional entities. Municipalities and independent special districts may participate as optional members upon resolution of their governing authorities. Withdrawal of optional membership can be affected only by statute and was last done in 1995 for public hospitals.

Benefit administration is the responsibility of a state agency, the Division of Retirement in the Department of Management Services. Investment activities are conducted by a constitutional agency, the State Board of Administration, headed by the Governor, Comptroller, and Treasurer in their collegial capacity as Trustees of the Florida Retirement System. Article X, s. 14, State Constitution, provides that all public pension plans in the State of Florida must fund promised benefits in advance in a sound actuarial manner.

The FRS was created in 1970 as the successor benefit plan to the separate Teachers' Retirement System, Highway Patrol retirement plan, and State and County Officers' and Employees Retirement System. The predecessor teachers' plan was approaching insolvency and its combination with the other solvent plans rescued it from collapse. In 1972 the FRS incorporated the last independent state retirement plan, the Judicial Retirement System. Today it covers about 600,000 active employees and nearly 200,000 retirees. Active members may choose to participate in a Deferred Retirement Option Program (DROP) during the last five years of their service.² Under its provisions participants have their monthly pension benefit paid into an interest bearing account. Upon termination of employment they receive the additional options of a full or partial lump sum payment of that amount plus its accrued 6.5 percent interest or they may transfer the account balance tax-free into a qualified retirement plan.

Retired members receive a 3 percent fixed cost-of-living allowance each July 1 on their monthly benefit. Members who have terminated employment with vested rights, that is, the right to receive a benefit, do not have these benefits indexed to inflation until commencement of pension payments. State of Florida employees have the option of maintaining their health insurance coverage at retirement at full cost less a monthly Health Insurance Subsidy payment equal to \$5 per month per year of service, not to exceed \$150.

Between 1984 and 1999 the Legislature created three other alternative pension arrangements to the FRS for covered employees. Administrators and faculty in the State University System and the Community College System and executives in the Senior Management Service may enroll in a defined contribution plan. About 12,000 employees among all three employer types have

²Participation in DROP requires the member to qualify for normal retirement. Retirees seeking early benefits must incur a 5 percent per year penalty measured from age 55/age 62 and are barred from participation.

selected this choice. A defined contribution (DC) plan offers the participant the choice of pension portability from employer to employer, 1-year instead of 6-year vesting, and personal ownership of, as well as personal responsibility for the investment choices. These plans are “front-loaded,” that is, they provide immediate ownership of pension dollars without any forfeiture should the participant terminate employment prior to vesting. Employer contributions are pre-tax and are roughly equivalent to the same DB contribution. Employees may make post-tax contributions to their DC accounts subject to federal earned income limitations. They stand in marked contrast to “back-loaded” DB plans which are structured to encourage career commitment and value the last five years as the most valuable. A DC plan assures only an employer payroll contribution, not a benefit result. The time-honored euphemisms of “thirty and out” and “high five” no longer apply: net asset value at the close of markets is all there is. The Florida DC plans, unlike many of their corporate 401(k)-type counterparts, are also structured as annuities and do not offer lump-sum features.³ Counties and school boards have the additional statutory authority to offer early retirement annuities to their departing members to compensate them for any penalties they may incur for non-normalized benefits.⁴

In 1999 the Florida Senate passed Senate Bill 356. It was designed to create a DC and DB pension choice for most members of the FRS.⁵ Participants would be able to enroll in the plan of their choice and receive an equivalent payroll contribution, then set at 9.21 percent of salary, by their employer. The choice would be unconstrained and would be accompanied by employee education and information on the elements and consequences of choice. The bill was patterned after the existing optional retirement plan choices for educators and managers and the state’s deferred compensation program. Employees would enroll with one or more of the several qualified investment and insurance providers that would offer whatever array of services, or the “bundle,” the participant believed valuable to purchase. The bill did not pass the House of Representatives but did precede the discussions undertaken during the 2000 Regular Legislative Session that resulted in passage of ch. 2000-169 (HB 2393/SB 1026), Laws of Florida.

Senate Committee Interim Report 2001-021, “Implementation of Pension Choice for Florida Public Employees”⁶ discussed in greater detail how public employee benefit programs are beginning to emulate the large-scale economic transformation from a job-based to a knowledge-based environment. The report traced the evolution of the Special Category appropriation and the increasingly greater role played by government contractors and their supplanting of direct service delivery by public employees. That shift from direct to indirect service delivery was accompanied implicitly by a shift from DB to DC pension management as contractors do not envision creating streams of unfunded employer liabilities in a competitive market where business infrequently exists for a lifetime.

³The numerical labels assigned plans derive from their respective sections of the Internal Revenue Code, Title 26 U.S.C. A 401(a) is a government plan; a 401(k) is a corporate pension plan; a 403(b) is a plan for non-profit research and education institutions; and a 457 plan is not a pension plan but a salary deferral plan. Each has unique and overlapping qualifications and coordination of benefit features.

⁴Similar provisions were enacted in prior years on an individual agency basis for departing employees of the Department of Education and the Department of Labor and Employment Security. There is, however, no general statutory provision for state agencies.

⁵The bill extended coverage to all members of the Regular Class, then some 91 percent of total plan membership.

⁶Senate Committee on Governmental Oversight and Productivity, Tallahassee, FL: November 2000.

Chapter 2000-169, L.O.F., created a Public Employees Optional Retirement Program and provided all employee participants of the FRS the opportunity to enroll initially in a DC plan or to transfer with a discounted account balance from the DB plan. Each category of public employer – state, county, school board, and optional member – would be afforded a 90-day election window in which their employees could select the optional plan. Like SB 356 the choice was unconstrained – the failure to choose would maintain DB membership - and was to be accompanied by a broadly based information and education curriculum.⁷ Unlike that previous legislation, however, the plan would permit employees to transfer back to the DB plan once after their DC enrollment. It also would be organized on a wholesale, or “unbundled” basis in which the SBA would select the fund providers and slot them into predetermined asset classes. In this arrangement provider companies would compete on the basis of cost and performance of their individual investment offerings. They would not provide ancillary services to the participant such as estate planning, related investment products, or plan servicing as those elements became either non-existent or made the responsibility of an SBA retained third-party administrator. The disaggregation of services was a central feature of ch. 2000-169, L.O.F., as it contemplated overlaying the investment infrastructure of the SBA over the procured best-of-class funds to produce superior returns at minimal participant cost. The SBA believed itself to be in a commanding presence to produce this result, not only as a consequence of the stated objective of the law, but also by virtue of the procurement fitting into its own organizational deployment: it purchases on a wholesale basis as an institutional investor for the DB plan. Neither it nor the Division of Retirement engages in any ancillary activities outside the narrow scope of investment management and benefit administration thus keeping expenses low enough that the division reports itself as the national public pension plan leader in organizational efficiency as measured by cost per member.

The SBA has proceeded since the passage of ch. 2000-169, L.O.F., with the assembly of the implementing apparatus. In coordination with its own Investment Advisory Council and the separately created Public Employees Optional Retirement Plan Advisory Committee it has created four distinct work groups: an *Investment Services Implementation Group* (14 providers, 11 yet to be chosen) for the selection of investment products; a *Third Party Administrator Implementation Group* for the qualification and selection of a centralized financial services intermediary (CitiStreet); an *Education Services Provider Implementation Group* for initial and transfer education (Ernst and Young/Financial Engines/Ketchum); and an *Asset Transition Work Group* (Morgan Stanley) for the brokerage transactions incidental to the transfer of account balances from DB to DC. In the course of its public hearings, the SBA has published an Investment Policy Statement (IPS) in which it outlined the plan design and procurement objectives. The IPS has been promulgated additionally as a rule under the state’s Administrative Procedures Act, ch. 120, F.S. The statement and the rule have been legally challenged in administrative proceedings by employees and provider companies. Generally, the challenges suggest that the board’s interpretation of the statute fails to allow for the permitted inclusion of guaranteed products, or annuities, and conducts such a narrow reading of the statute text as to exclude provider companies with fully aggregated offerings. The advisory bodies have

⁷Title 29C.F.R. 2550.404c of the Employee Retirement Income Security Act (ERISA), imposes fiduciary standards on plan sponsors to provide information, education, broad investment options, and meaningful control over participant accounts. ERISA standards are generally not applicable to government plans. Florida law is perhaps unique in the nation in that both the DB and DC plans are required to be ERISA-compliant.

recommended alternations to the IPS and these have received the concurrence of the plan trustees.

Remaining changes not effected by rule must be effected by statute.

III. Effect of Proposed Changes:

Section 1. The bill amends s. 121.0515, F.S., to include in the special risk retirement class state agency or local government personnel with firefighting or supervisory responsibilities, those with fixed-wing aerial fire surveillance responsibilities, and those employees with direct, command supervision of emergency medical technicians or paramedics. Specifically enumerated unit treatment and rehabilitation employees in the state hospital system are also enrolled in the special risk class.

Section 2. The committee substitute amends s. 121.055, F.S., to add assistant attorneys general to the senior management retirement class which also permits them to select the optional retirement annuity in lieu of participation.

Section 3. The bill amends. s 121.4501(2), F.S., to provide that an “approved provider” for the public employee option retirement plan includes those entities offering fully “bundled” services. These services are described as inclusive of accounting and record-keeping; asset control; order execution; calculation of net asset values; account information and reporting; investment advice and guidance; distribution options; asset allocation; and retirement counseling and education.

Subsection (4) is amended to specify the methodology for computing the actuarial equivalent account balance transfer option for persons transferring back to the DB from the DC option. A person transferred from the DC to the DB plan using the one-time switch provision shall be required to transfer an amount equal to the contributions required for the same time period. If the DC account balance is in excess of the required amount, those funds shall remain in the DC account.

Subsection (8) is further amended to limit the activities of the retained third-party administrator to participant enrollment and collection and disbursement of contributions. The remaining functions shall be assigned or subcontracted to one or more of the approved provider companies. The services of the retained third-party administrator must not duplicate services provided by the DMS’s Division of Retirement. The definition of administrative services is expanded to include enrollment, contribution collections and disbursement functions. Provider companies may provide their own set of services including more particular asset purchase and control, calculation of account values, and periodic account reporting.

Subsection (9) is amended to provide that the SBA shall contract with one or more provider companies. Each provider company may offer a diversified mix of products, one of which may be guaranteed annuities. The optional retirement program shall offer also a guaranteed account to provide lifetime income similar in structure to the DB feature of the FRS. Reasonable fees may be charged for accounts emphasizing liquidity.

Investment offerings shall give participants the option of committing their contributions for extended periods of time. This is designed to create a parallel relationship between time and demand deposits in commercial banking in which the full liquidity of a demand deposit is accompanied by a lower rate of return.

Existing restrictions on the imposition of provider fees are modified to permit liquidity risk management fees imposed on lump-sum distributions and reasonable mortality and expense risk charges on insurance features.

All provider companies must maintain compliance with federal, state and industry regulations and guidelines for the ethical marketing of investment products. There must be an internal compliance monitoring system and provider representatives must provide unbiased determinations of suitability for product recommendations. No provider may represent itself as an exclusive vendor of services or products nor may it sell or distribute any customer list or participant identification outside of the procurement.

Section 4. The act takes effect upon becoming a law.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

The committee substitute contemplates that there would be a trustee-to-trustee electronic transfer of funds from the FRS Trust Fund to provider companies. In such a case there would be limited need for the creation of a trust fund to act as a plan intermediary, as is contemplated by SB 436. The Internal Revenue Code requires such intermediaries to preserve the integrity of participant funds. The trust account would be required if the SBA is directed by the trustees to offer its own fund selections or if funds are placed in a suspense account pending the execution of investment choices by the participant changing plans.

On February 13, 2001, the SBA received a preliminary response from the Internal Revenue Service on its November 4, 2000, request for a determination letter for the Public Employees Optional Retirement Program. The letter requested additional information on how employees will be notified and informed of their contribution and distribution options. In an attached internal memorandum dated February 19, 2001, legal counsel to the SBA indicated a technical revision to the statute would be indicated should there exist some concern about clear statutory authority to promulgate plan guidelines fully compliant with the federal tax code.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

Because the *public employer* owns the DB plan and its promise to pay, it bears the administrative cost. Individual participants bear the incidence of plan administrative costs in the DC alternative as *they* own the contract.

In its most recent annual report the SBA reported its investment service charge at 1.75 basis points for the first ten months of the fiscal year ending June 30, 2000.⁸ For the last two months the charge was waived. The board also lowered its outside manager fees from an average of .25 to .22 percent of assets.

The Division of Retirement reports an administrative cost per member of \$21.68, exclusive of its automation reengineering project.

It is difficult to project what charges provider companies will charge participants in the absence of the procurement having selected approved providers. Should the SBA become an approved provider entity, the lower end of its fee range is already known. A survey conducted by board staff of provider fee ranges in the university optional annuity program, itself organized in a bundled fashion, reported wide variations in investment service or plan charges. See *Private Sector Impact*, below.

Fee charges reduce investment return requiring a compensating change in performance for an equivalent economic offset. Participants may also select funds with a higher risk potential to compensate them for higher administrative costs.

B. Private Sector Impact:

The SBA has engaged in a wide-ranging analysis and qualification of provider companies in the execution of ch. 2000-169, L.O.F.⁹ Its staff has compared the investment charges for plans within the university optional retirement program and the deferred compensation program and produced the following analysis. For every 1 percent of additional plan costs, participant account balances are 10 percent lower after 20 years and 15 percent lower after 30 years (p. 27). Using a benchmark of \$35,000 for average employee salary and a 10 percent employer payroll contribution rate, a terminal account balance at 30 years would be \$100,000 lower.

The report extended the analysis to expense ratios and account fees (p. 2), which is summarized below:

⁸Florida State Board of Administration, *1999-2000 Investment Report*. Tallahassee, FL: January 1, 2001, p.8.

⁹Florida States Board of Administration, *Overview of Proposed Investment Policy Statement for the Public Employees Optional Retirement Program*, Presentation to PEORPAC. Tallahassee, FL: September 14, 2000.

<u>Fund Categories</u>	<u>DC Retail Mutuals</u>	<u>Institutional Mutuals</u>	<u>Separate Account</u>
Indexed U.S. Stocks	.27%	.35%	.13%
Active Large Stocks	.83%	.91%	.63%
Active Small Stocks	1.06%	1.01%	.95%
Foreign Stocks	1.33%	1.15%	.75%
Active U.S. Bonds	NA	.69%	.37%

The SBA report applied the known fees assessed on participants in the state university system Optional Retirement Program and displayed the loss (pp.36-37) in terminal wealth and cumulative provider fees, as follows:

Participant/Provider Fees and Their Effect on Accumulated Wealth and Costs, 30-Year Career, 10% Contribution, Entry Salary of \$35,000

Loss in Participant Terminal Wealth

ORP Vendor A	-\$ 29,000
ORP Vendor B	-\$126,000
ORP Vendor C	-\$132,000
ORP Vendor D	-\$163,000
SBA	-\$ 11,000

Cumulative Vendor Fees

ORP Vendor A	\$ 19.6 B
ORP Vendor B	\$ 76.3 B
ORP Vendor C	\$ 79.4 B
ORP Vendor D	\$ 94.9 B
SBA	\$ 7.6 B

C. Government Sector Impact:

The FRS uses the *entry age normal* method for valuing the assets and liabilities of the FRS.¹⁰ This methodology produces a level amortization that tends to overstate costs in early years and understate costs in later years. The SBA estimates that asset transfers of employees from the DB to the DC plan will result in a range of asset movement between \$8 billion and \$13 billion. This will produce two effects: first, with a constant level of staffing, the board’s administrative costs as a percentage of remaining assets will increase; and second, should it be directed by the trustees to offer its own funds as a provider entity, it will have to assemble an infrastructure to undertake these activities. No cost estimates on this latter consequence are available.

¹⁰ Entry age normal is the predominant valuation method for government plans. Corporate plans use the *projected unit credit* method that provides lower funding levels in earlier years and higher ones in later years.

Chapter 517, F.S., governs the registration and selling of securities in the State of Florida. Sections 517.021, 512.051 and 517.061, F.S., provide a list of definitions of covered parties, circumstances and securities exempt from the “Florida Securities and Investor Protection Act.” It is likely that employees of the SBA engaged in activities as a “provider company” may require registration as securities personnel under appropriate state and federal law absent a state use exemption not readily discernible from a reading of the chapter.

The retirement upgrade for assistant attorneys general affects slightly more than 350 positions in the Department of Legal Affairs. On a per position basis the increase is about \$1000 on an annual basis. The bill provides a January 1, 2002, effective date for this upgrade so the partial year financial effect is about \$190,000.

The retirement upgrade to special risk for emergency medical technician and paramedic supervisory personnel is based upon Senate Bill 894. That fiscal impact is confined exclusively to local government employees, principally fire rescue districts. The cumulative employer payroll impact is about \$245,000 in extra contributions to the FRS Trust Fund.

No data are presently available on the magnitude of the impact of the retirement upgrade for state hospital employees. The direction of impact suggests a nearly 11 percent employer contribution rate increase on total gross wages per person, representing the difference between regular class and special risk class payroll rates.

The retirement upgrade for aviation personnel is limited to the local governments with firefighting, fixed wing aircraft personnel and comparable positions in the Division of Forestry in the Department of Agriculture and Consumer Services. The fiscal impact is believed to be negligible.

The bill provides no overall retirement rate contribution increase to fund the benefits. Each participating employer will be responsible for remitting the necessary payroll amounts on the respective effective dates.

VI. Technical Deficiencies:

None.

VII. Related Issues:

None.

VIII. Amendments:

None.