The Florida Senate

Interim Project Report 2008-127 *October 2007*

Committee on Governmental Operations

REDUCING INVESTMENT MANAGEMENT EXPENSES IN THE STATE OF FLORIDA DEFERRED COMPENSATION PROGRAM

SUMMARY

Governments at all levels tend to compensate their employees with an emphasis upon benefits rather than salary. This shifts the responsibility to the employer to develop longer term stability as this emphasis obligates the public treasury generations into the future. The State of Florida maintains a diverse portfolio of automatic and voluntary benefits but does so with simultaneous involvement of multiple organizations. Its legacy pension plan choices along with its voluntary salary deferral program operate in similar benefit cultures but with widely different investment management expenses for like asset classes. The report recommends a reprocurement or consolidation of fund classes to achieve the greatest economies of scale possible. This will lower direct investment management expense paid by participants in the voluntary benefit programs, an objective promised and realized by the inception of the defined contribution program in 2001.

BACKGROUND

Salary and benefits consume roughly three-quarters or more of an organization's resources. It is the allocation of that division in public organizations which makes them markedly different from their incorporated peers. Incorporated entities operate on a business cycle in which many transactions are voluntary and market specific. Competition is intense and successful organizations are those which adapt to changing business cycles, consumer demand, and the transformation of an industrial economy to one that is service based. Government operates on an involuntary basis since the nature of its transactions - public safety, education, health and welfare - are impervious or counter cyclical to the overall economy and represent durable commitments to basic public policy.[1] Economic recoveries tend to bolster public treasuries as taxable receipts increase while recessions tend to deplete them as service demands abound.

There are three principal state agencies involved in the delivery of state employee benefits. The **Board of Administration** manages twenty-eight separate financial accounts for state and local government agencies, the largest single one of which is the multi-employer Florida Retirement System (FRS). It also directly manages a separate Defined Contribution Program for employees making this retirement choice. The **Department of Management Services** (DMS) has two separate divisions - State Group Insurance and Retirement - that provide related services in health care, dental, and supplemental benefits and the payment of pension benefits for FRS system retirees and their dependents. The third agency, the **Bureau of Deferred Compensation in the Department of Financial Services**, manages a federally tax-qualified salary deferral program under Title 26, Section 457 of the United States Internal Revenue Code.

The book of business here is considerable. The FRS has system assets of more than $135 billion and is the nation's fourth largest plan. Its defined contribution plan assets crossed the $4 billion threshold in September 2007. Revenues in state health insurance programs exceed $1 billion annually and the Deferred Compensation Plan has assets in excess of $1.4 billion. In its 2005 annual publication on the state employee workforce, the DMS reports that employee benefits as a percent of salary range from forty-five to sixty-two percent. Dollar equivalent benefits for lower salaried workers raise the percentage amount.[2]

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[1] A landmark publication on the relationship between mental health indicators and the economy was authored by M. Harvey Brenner, *Mental Illness and the Economy*, Cambridge, MA: Harvard University Press, 1973.

[2] Department of Management Services, *Annual Workforce*

Financial markets are intensely competitive. Increasing transparency produces easily accessible price and performance benchmarks which distinguish the leaders from the laggards. The result allows investors to access timely and accurate data to make informed choices. Successive changes to federal law, beginning with the landmark Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940, have given institutional and retail investors alike tools that allow them to make intelligent comparisons among a variety of fund classes in markets that subscribe to basic trading and regulatory standards. Over the intervening years it has become axiomatic that scale and transparency tend to reduce costs even when contemporaneous events can suggest otherwise.[3] The same is true in the benefit market although less so given the more customized nature of the employers. Still, many governments are offering non-traditional legacy programs, including managed health or consumer driven health care choices, as well as salary deferral and medical reimbursement accounts shielded from taxation as current income.

Several states are exploring augmenting their total compensation policies to encourage workplace savings by providing employer matching payments to their employee-based plans.[4] At the national level, the Comptroller of the Governmental Accountability Office, an arm of Congress, urged federal employers to take the lead in developing financial literacy among their workforces. Congress legislated to this issue in the passage of amendments to the Fair and Accurate Credit Transactions Act of 2003.[5]

METHODOLOGY

The report reviews trends and conditions generally in the management of employee benefit programs, identifies opportunities to reduce administrative expenses, and presents alternatives to consider in the encouragement of additional savings opportunities for state employees that do not present undue employer, employee or organizational risk. The report reviews an informal review undertaken five years earlier on the administrative and provider cost components of the Deferred Compensation Program and compares those components with similar ones today. The report also provides results of an additional survey taken of many local governments on their use of salary deferral programs for their workforces.

FINDINGS

The Bureau of Deferred Compensation administers the deferred compensation program authorized under s. 112.215, F.S. The organization procures provider companies by competitive selection and contracts with a third-party administrator for the maintenance and servicing of participant account balances. By law, providers represent insurance companies and mutual funds licensed to business in the state. While the administrative costs of the bureau are funded by provider companies, costs may be recouped from the participant-employees. The SBA reviews fund choices

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Report, Tallahassee, FL: 2006, p. 14.

[3] The derivative investment scandals of the 1990s as well as the mutual fund scandals of 2003 produced a number of statutory reforms in large part based upon the opaqueness of the instruments themselves and the lack of sophistication of the parties to the transactions. These are reflected in ch. 95-194, Laws of Florida, as well as other federal statutes. See also the Employee Retirement Income Security Act of 1974, P. L. 93-406, 88 Stat. 829; the Sarbanes-Oxley Act of 2002, P. L. 107-0204, 116 Stat. 745; and the Pension Protection Act of 2006, P.L. 109-280, 120 Stat. 780. The latter scandals also produced their own spirited debate about fees and expenses charged to investor accounts. The chief protagonists in this exchange have been two university academics and the investment trade organization. See John P. Freeman and Stuart L. Brown, "Mutual Fund Advisory Fees: The Cost of Conflict of Interest," *Journal of Corporation Law*," 26(3), Spring 2001, pp. 609-673. A rejoinder to this publication was published by the Investment Company Institute. Sean Collins, "The Expenses of Defined Benefit Pension Plans and Mutual Funds," Investment Company Institute *Perspective*, 9(6), December 2003. Concurrent analysis of this debate by the Securities and Exchange Commission indicated the significant methodological hurdles involved in making a definitive case for each side. United States Securities and Exchange Commission Division of Investment Management, "Report on Mutual Fund Fees and Expenses," Washington, DC: December 2000.

[4] The states of Oklahoma, Maryland, Minnesota, Louisiana, and Colorado are among those with active or proposed employer matching programs.

[5] Governmental Accountability Office, *The Federal Government's Role in Improving Financial Literacy*, Washington, DC: November 2004. Among private organizations the Employee Benefit Research Institute has taken a leading role in the development of its *Choose to Save Program*; www.choosetosave.org. See also Financial Literacy & Education Commission, *Taking Ownership of the Future: the National Strategy for Financial Literacy*, Washington, DC: 2006, 139 pp.

presented to it by the bureau. The 457 deferred compensation plan allows participants to choose among nearly seven dozen different provider funds in several different asset classes. In 2000, the SBA provided an analysis of the effect of investment management expenses upon participant accounts in its development of the Public Employees Optional Retirement Program (PEORP). The analysis showed the effect of investment management fees and expenses and their drain on participant account value.[6] More than $ 87 billion in excess fees were identified among the existing providers at the time.

In 2002, a staff survey compared the investment management expenses of the deferred compensation plan with the other tax-sheltered retirement programs offered to state employees by SBA. The first two tables report the results of that review at two points in time, 2003 and 2007.

Table 1

Employee Investment Management Expenses/Fees for State of Florida Employee-Managed Pension (DC) and Deferred Compensation (457) Accounts		
Asset Class	**DC**	**457**
Bond	2 - 85	23 - 122
Large Cap Growth	18 - 57	68 - 155
Large Cap Value	21 - 64	67 - 100
Mid-Cap Growth	49 - 84	89 - 143
Inter/Global/World/For	20 - 103	116 - 125
Lifecycle/Balanced	12 - 17	88 - 90
Total Funds	**$ 344 MM**	**$ 1.37 B**

Even within like asset categories it is clear that the institutionally procured funds in the DC plan are accompanied by lower fee ranges at both the high and low ends. In the case of the bond funds this difference is tenfold higher. These are fees paid directly by participants and can be offset only when the total return in the fund exceeds the extra fee imposed. The table suggests another anomaly: that a plan one-fourth the size can generate fees that are dramatically lower. There are some caveats to be reported with this data set but even making allowances for the legitimate reporting differences noted above in footnote three, these would not explain the wide margins of difference.

Table 2 updates the 2003 report to 2007 across the same asset classes using information published by the SBA and the bureau.

Table 2

Employee Investment Management Expenses/Fees for State of Florida Employee-Managed Pension and Deferred Compensation (457) Accounts		
Asset Class	**DC**	**457**
Bond	5 - 56	23 - 72
Large Cap Growth	45	23 - 94
Large Cap Value	85	57 - 82
Mid-Cap Growth	35	74 - 126
Int/Globe/World/For	2 - 53	82 - 120
Lifecycle/Balanced	5 - 11	56 - 90
Total Funds	**$ 4.0 B**	**$ 1.4 B**

Several points of comparison present themselves. *First*, there has been an eleven fold increase in DC asset growth while the 457 plan has remained flat. This may be due to the retirement of employees and their distribution of account balances to cash or other tax sheltered vehicles. It may reflect also the difficulty of encouraging voluntary contributions for younger hires when a DC plan provides an equity contribution without employee match. The DC asset growth reflects the increased visibility of this product to new hires as well as reemployed retirees who believe this option suits their employment time horizon. And, *second*, there has been a general reduction in 457 and DC provider fees during this same period, primarily at the higher end.

In electronic correspondence dated August 8, 2007, the Chief Financial Officer's Office indicated its desire to work with the SBA to add its low cost providers to the 457 plan, a request favorably agreed to by the executive director of the SBA.[7]

The Legislative Commission on Intergovernmental Relations (LCIR), a joint legislative committee, was requested to commission an informal survey of county, city, and school district employers to determine their use of salary deferral programs and the extent of employer participation. Table 3 represents those results through September 20, 2007.

[6] *Overview of Proposed Investment Policy Statement for the Public Employees Optional Retirement Program*, Presentation to PEORPAC, Tallahassee, FL: September 14, 2000, pp. 37-38. See also, Government Accountability Office, *Federal Retirement Thrift Investment Board: Due Diligence Over Administrative Expenses Should Continue and be Broadened*, GAO-07-541, May 2007, and *Financial Product Sales: Actions Needed to Better Protect Military Members*, GAO-06-23, November 2005.

[7] Correspondence of August 8, 2007, between Jim Cassady and Coleman Stipanovich.

Table 3

Survey Responses from Counties and School Boards on Deferred Compensation Plans

	Responding	Existing Plan	Employer[8] Contribution
Counties	43	41	2 (5)
School Boards	38	31	3 (4)

Not surprisingly, a large number of reporting units had established such a plan although only a handful indicated any sort of employer contribution across the board. A number of large private employers and states do have a formalized employer contribution mechanism in place to enable their workforces to supplement their retirement income. This makes fewer demands on their pension funding requirements while fostering a culture of savings in the workplace. Investor owned companies use such programs, along with dividend reinvestment programs, to moderate their reliance on external financial markets for the generation of future investment capital.

RECOMMENDATIONS

1. The Department of Financial Services should reprocure the entire array of investment offerings for its deferred compensation program participants. While investment management expenses are less than retail customers would pay they are nowhere near what an institutional provider would pay. The result is a loss in value to the individual participant for equivalent investment performance. Section 110.215, F.S., should be amended to provide that the deferred compensation program providers offer products at an institutional rate, that is, the best rate offered to its wholesale customers.
2. The reprocurement should consolidate the 83 different mutual fund or target date choices provided by six different providers into fewer funds represented by fewer providers. Too many overlapping selections only complicate informed choices and add expense when fewer funds representing the major asset classes would be sufficient. A subsequent reprocurement should provide also an expectation of a multi-year contract so the provider entity can establish a longer business relationship. The reprocurement should also consider consolidating the separate back-office administrative servicing components of the SBA and the Bureau.
3. The Legislature, after receiving the recommendations of the Chief Financial Officer, should consider amending s. 110.215, F.S., to permit units of local government to join the state plan when such local governments find it financially advantageous to do so. Multiple cost centers with overlapping fund choices only add expense at the cost of participant value.

[8] Several units reported limited contributions by the employer in the case of employment termination or designated positions.