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.)

BILL: CS/CS/SB 356

SPONSOR: Fiscal Policy Committee and Governmental Oversight and Productivity Committee

SUBJECT: Florida Retirement System/Optional Retirement Program

DATE: April 15, 1999 REVISED:

	ANALYST	STAFF DIRECTOR	REFERENCE	ACTION
1.	Wilson	Wilson	GO	Favorable/CS
2.	Hendon	Hadi	FP	Favorable/CS
3.				
4.				
5.				

I. Summary:

The committee substitute creates a fourth optional retirement program for public employees in the Regular Class of the multi-employer Florida Retirement System (FRS). Like the other three programs enacted for university and community college faculty and members of the Senior Management Service Class, this program is a personally owned, portable defined contribution (DC) plan. The employee begins vesting in the second year and is fully vested by year six. As is the practice with other state-sponsored pension arrangements, the employer makes all contributions, which are fixed at 8.21 percent of salary. Investment management is the personal responsibility of the employee, who bears all of the investment risk. The bill requires the state board of administration to provide an investment policy statement to guide the Division of Retirement's selection of investment providers for the defined compensation plan and states that the state's fiduciary responsibilities and investment duties will comply with standards under the Employee Retirement Income Security Act of 1974.

The bill also improves the existing defined benefit plan under FRS by adopting the same graded vesting schedule (employees begin vesting in the second year and are fully vested by year six). The bill also provides an increase in the payroll contribution rate structure to fund the bill in compliance with Art. X, s. 14, State Constitution. The bill requires that the salary figures for early terminators of the defined benefit plan used in the average final compensation calculation be indexed by 3 percent per year from the date of termination to retirement. The bill creates the Florida Retirement System Actuarial Assumption Conference to recommend contribution rates for the Florida Retirement System.

This committee substitute creates section 121.36, Florida Statutes. The committee substitute amends sections 112.363, 121.021, 121.0515, 121.052, 121.053, 121.055, 121.081, 121.091, 121.1115, 121.1122, 121.121, and 216.136, Florida Statutes.

The bill is effective July 1, 2001, except for sections 1 and 17 are effective July 1, 1999.

II. Present Situation:

The FRS is a multi-employer, defined benefit (DB) pension plan serving 791 state, local, and special district government agencies throughout the State of Florida. It is designed to provide a guaranteed pension benefit, expressed as a percentage of average final salary at retirement to all participating employees. Article X, s. 14, State Constitution, further requires that these promised benefits be prefunded in an actuarially sound manner so that there is no intergenerational transfer of liability. Benefit administration is performed by the relatively autonomous Division of Retirement in the Department of Management Services. Investment management is undertaken by the State Board of Administration (SBA), a constitutional agency headed by the Governor, Treasurer, and Comptroller.

The FRS provides for the payment of accrued and vested benefits through an annuity and members may choose among four different payment options to suit their retirement income, life expectancy, and survivor needs. Normal retirement for most classes is established at the earlier of thirty years of service or age 62; for public safety classes that period is age 55 or 25 years of service. The structure of benefits is coordinated with Social Security so that FRS payments are supplemental to these federal amounts. For most members vesting occurs at the completion of ten years of service. The remaining classes of elected and management positions have shorter vesting periods of eight and seven years, respectively. Public safety employment classes have ten-year vesting. Embedded within the plan structure is a death and disability benefit, a three percent cost-of-living allowance for retirees, and a retiree health insurance premium subsidy.

The FRS is a relatively young plan, having its origin less than thirty years ago. Its founding was the result of difficult financial circumstances faced by its predecessor Teachers' Retirement System. That system, long under-funded and facing a spurt of World War II-era retirees in the late 1960s, was combined with two other more solvent plans, and a third in 1972, to create the present-day FRS. But the stream of liabilities, some 80 percent of which were associated with the teacher plan, was not easily or quickly reduced. Over the succeeding twenty-eight years the unfunded pension liability climbed to nearly $16 billion. Only in 1998 was this debt officially retired and the plan able to achieve its first surplus of 3.8 percent in its asset base. To attenuate cyclical swings in valuation, the FRS recognizes its gains and losses over a rolling five-year averaging period. Experience gains and losses have been amortized over thirty years in separate funding bases.

Beginning in the 1980s and extending through the mid-1990s, the Legislature created three alternative optional annuity plans for university and community college faculty and management personnel. Discussions about the creation of a corporate-type 401(k) plan occurred in the mid-1980s but no official application to the Internal Revenue Service was forthcoming. Today about 11,000 state and higher education employees have voluntarily chosen to own their own pension plans. In such a DC arrangement the employee elects to invest the employer's pension contribution in a personally owned account administered by a financial institution. Such employees assume all of the investment risk and can take this account with them through subsequent employment changes in both the public and private sectors.

At the same time the FRS had eliminated its unfunded pension liability, the Legislature created a working group of executive and legislative branch officials to examine the building blocks of the

FRS and to examine alternative, business sector pension systems for the public sector. Critical to the understanding of what an “ideal” pension system encompasses is an understanding of the values which the sponsoring organization is attempting to encourage. For the FRS the primary values have been stability, employment permanence, guaranteed income, efficiency of administration, and centralized organization. Implicit in these assumptions has also been an emphasis on benefit compensation. The ethic surrounding alternative, DC plans is quite different. They stress portability and individual, rather than employer responsibility for decision-making. Customarily they provide for shared costs and are usually embedded in organizations in which salary, not benefits, is the major component of compensation. A DB plan can be made as portable as a DC one through adjustment of vesting schedules although self-direction of contributions is not a customary feature.

The decade of the 1990s was one in which world-wide economic expansion reached unprecedented levels. Long known as a nation not enamored with personal saving, many Americans have used their pension accounts as the exclusive vehicle for their retirement income. During this same decade the State of Florida implemented policies which led nearly thirty percent of its operating budget to be contracted to the private sector. Many of these contractors are small to medium sized entities; few if any of them have developed large-scale pension systems like the FRS. A consequence of the “privatization”of government services has been the indirect fostering of DC pension plans, whether employer-sponsored or self-directed, which limit these contract vendor employer financial liabilities.

III. Effect of Proposed Changes:

Section 1. The committee substitute creates s. 121.36, F.S., and expands alternative pension plan enrollment eligibility to all members of the FRS. The Division of Retirement is directed to solicit proposals from vendors for the selection of as many as nine provider companies. Plan implementation is effective July 1, 2001.

The committee substitute tracks some, but not all, of the same features incorporated into prior optional retirement procurement plans, as follows:

> The optional program is available to members of the Regular Class of the FRS but not to members of the Special Risk and Special Risk Administrative Support Class. Members of the Senior Management and Elected Officer Class are already eligible for the annuity program offered these classes in current law.
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> Employer contributions are vested over a six year, proportional time frame after the first year of membership (graded vesting), with one or more of the selected provider companies; a separate section of the bill provides an identical FRS vesting upgrade to the DB plan.
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> The employee’s decision to participate is irrevocable once an election is made;
>
> There is no retroactive opening of the existing employee base for vesting improvements to the FRS DB plan - all changes are forward-looking. Employees may transfer from the DB to the DC plan and receive a present value discounted payout, in the form of securities or cash, of their FRS accounts for transfer to the successor provider company.

The public employer pays 100 percent of the contribution cost and the enrolling or transferring employee loses unvested but accrued credit in the FRS.

Up to nine provider companies will be selected, reflective of the principal financial industry groupings. At the discretion of the Board of Trustees the SBA is permitted to be one of the provider entities. Provider companies may serve all or a designated education-based segment of the Regular Class membership.

The process involves the Division of Retirement and the State Board of Administration acting as procuring and technical assistance authorities.

Each provider company must be rated in the highest of nationally recognized rating systems and demonstrate a capacity and fitness to undertake service responsibilities.

The process contemplates the hiring of a third-party information and education firm charged specifically with employee education on the DB/DC plans to met the standards of the Employee Retirement Income Security Act of 1974. In addition, the division or a third-party information and education firm would provide quarterly statements to participating employees. A separate firm would be hired if the SBA participates to avoid that agency being placed in the conflicting position of judging the sufficiency of its own submission.

Section 2. Section 112.363, F.S., is amended to delete senior management and optional retirement program recipients, and participants in the community college optional annuity program from eligibility for the health insurance subsidy provided FRS retirees.

Section 3. All solicitation materials provided optional retirement participants must presume an unsophisticated investor and must also conform to the policy readability provisions of s. 624.4145, F.S., notwithstanding the exemptions contained therein for annuity contracts. All provider companies will be subject to a due diligence inquiry, must demonstrate proven functional systems which are date calculation compliant, and must maintain an internal quality assurance system.

Section 4. Section 112.363, F.S., is amended to provide additional changes to the retiree or beneficiary health insurance subsidy in the year 2001 affected by the provisions of this act. The changes cap the monthly subsidy at $5 per year of creditable service, not to exceed $150.

Sections 5, 6, 7, 8 and 9. Sections 121.021, 121.0515, 121.052, 121.053, and 121.055, F.S., are amended to provide the same two- to six-year vesting schedule for the FRS as is provided enrolling members of the optional DC retirement plan. The improved vesting schedule applies across-the-board to all retirement classes in the FRS. Provides that members of the FRS that are mayors or former mayors of a consolidated local government that by charter is a municipality rather than a county can elect membership in the FRS for the time served as mayor at their own or the local government’s expense.

Section 10. Section 121.081, F.S., is amended to provide conforming vesting changes to that section of law prescribing conditions under which prior service credit may be recognized for retirement purposes.

Section 11. Section 121.091, F.S., is amended to provide conforming vesting changes for the receipt of disability retirement benefits.

Section 12. Section 121.1115, F.S., is amended to provide conforming vesting changes for the purchase of retirement credit for out-of-state and federal service.

Section 13. Section 121.1122, F.S., is amended to provide conforming vesting changes for the purchase of retirement credit for in-state public service and in-state accredited nonpublic school service.

Section 14. Section 121.121, F.S., is amended to provide conforming vesting changes for authorized leaves of absence.

Section 15. The bill increases payroll contribution rates by 1.36 percent for the Regular Class membership and by an unstated amount for the remaining FRS classes to fund the vesting improvements made in the bill.

Section 16. An important state interest clause is incorporated to address the provisions of Art. VII, s. 18, State Constitution, on local government costs of compliance.

Section 17. Implementation of the act is effective July 1, 2001, and is made contingent upon receipt of favorable approval of the plan changes by the Internal Revenue Service.

Section 18. Requires the terminating employees' average final compensation calculation to be indexed by 3% per year from the date of termination to retirement in the defined benefit plan.

Section 19. Creates the Florida Retirement System Actuarial Assumption Conference to recommend a consensus contribution rate for the programs under the Florida Retirement System. Defines the principals of the conference.

Section 20. The bill is effective July 1, 2001, except for sections 1 and 17 are effective July 1, 1999. Requires that the Optional Retirement Program, improved vesting, and indexing of deferred benefits created by the act shall not be implemented until legislation is enacted to properly fund such benefits as required by Article X, Section 14, of the State Constitution.

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

Because of likely contribution rate adjustments needed to compensate for the phenomenon of adverse selection, an important state interest clause is required prior to passing along any such costs to the participating local government employers. The committee substitute contains that clause.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

D. Other Constitutional Issues:

The Division of Retirement must solicit the opinion of the Internal Revenue Service on the adequacy of this plan relative to the federal tax code. Such opinions customarily take at least six months for completion.

Article X, s. 14, State Constitution, requires that all publicly funded pension plans be prefunded in an sound actuarial manner. Part VII of ch. 112, F.S., effects further compliance with this constitutional requirement.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

This issue has been discussed above relative to the increased payroll contribution rates which will be assessed due to the option cost.

B. Private Sector Impact:

Participating provider companies will incur expenses associated with the competitive procurement which they may recoup if they are selected. Such companies charge a variety of fees for their services, front- and back-end loads, deferred sales charges, account maintenance fees, among others, which will be passed along to their participants. These fees are customarily in excess of those charged by the State Board of Administration for its investment management service as they must allow for advertising, marketing, and their incorporation status. Generally, insurance company providers will have fees in excess of those charged by mutual fund companies and guaranteed products, such as annuities, will have fees in excess of those with variable, or market-based, products.

The bill provides for full fee and cost disclosure to the participant in readable language. The bill prohibits account balance transfers from the imposition of provider company commissions.

C. Government Sector Impact:

The FRS will likely have to increase its payroll contribution rate to accommodate the loss of forfeited contributions and vesting improvements for the FRS DB plan. The impact of these changes are stated in “basis points” where 100 basis points is the equivalent to one percent or $180 million in the current payroll.

The Unfunded Actuarial Working Group estimated the cost of the bill. They based their estimate on the assumption that one-half of all employees would select the plan that provides them with the greatest expected benefits at retirement. Under this and the other current actuarial scenarios the costs are estimated in the table below. The estimates do not however, take into account the surpluses provided when an employee in the DC plan leaves before vesting and forfeits contributions and when an employee in the DB plan who has not vested converts to the DC plan and forfeits prior contributions. These surpluses would lower the cost of the bill. The tentative figures below represent the increase in the cost of employer contributions.

Retirement Plan Component	First Year Cost (FY 2001-02)		Annual Long-Term Cost (Existing Employees Retire)	
	Basis Points	Dollars	Basis Points	Dollars
Defined Contribution Plan and Improved to Defined Benefit Regular Class	50	$90 million	180	$324 million
Improved Defined Benefit Plan for Other Classes	47	$84.6 million	47	$84.6 million
Wage Indexing for Defined Benefit Plan	103.2	$186 million	39	$70.2 million
Total	**200.2**	**$360.4 million**	**266**	**$478.8 million**

Source: Tentative Cost Estimates by the Unfunded Actuarial Working Group

Pursuant to Part VII of ch. 112, F.S., financial gains and losses to the FRS are amortized over a thirty year period. The Division of Retirement estimates it will require up to 1 basis point ($1.8 million) to fund its administrative capacity issues in advance of the effective date.

The plan will likely have its cost components significantly affected through adverse selection, or option cost. Forfeited and unvested contributions made on behalf of FRS employees accrue to the trust fund and act as a suppressant of total plan costs. As members migrant to alternative plans with different vesting schedules, and the other three plans in law, these forfeiture losses expose the FRS to higher future costs.

This fiscal impact can be minimized either by adjustment downward of the 8.21 percent payroll contribution rate for the DC option, or by manipulation of the defined benefit plan assumptions to reduce this option cost risk. There are three operating assumptions in effect this year: 1) an assumed investment return of 8 percent, 2) payroll growth at 5.5 percent, and 3) salary increases at 7.25 percent. Pending legislation before both legislative chambers, SB 2530 and HB 1883, make further changes to these assumptions indirectly through downward adjustments in payroll contribution rates. That tentative change presumes a lowering in the assumed, prospective salary increases, inclusive of promotions, for all FRS employers to 6.25 percent. Further downward adjustment in the salary assumptions or a raising in the investment return can produce sizeable savings, or costs, and are quite sensitive to underlying changes in world financial markets and the actual salary policy of the 791 FRS employers.

VI. Technical Deficiencies:

The bill still requires inclusion of additional payroll contribution rates for other classes of the FRS to fund the revised vesting schedule for FRS. These amounts were unavailable from the Division of Retirement at the time of the reporting of the bill.

VII. Related Issues:

A number of issues present themselves in any alternative form of choice in a benefit environment. *First*, respective DB and DC plan types can be designed to be more neutral in terms of cost. This becomes a difficult exercise for the FRS given its current steep, ten-year gradient of vesting affecting more than 90 percent of its active members. Adverse selection sets in rapidly and can drive the costs of alternative plan choice up sharply. The bill could be made more cost neutral through further lowering of the fixed contribution rate of 8.21 percent in the bill. The result, however, may yield a number which is so low as to act as a financial disincentive to the risk associated with the choice. Maintenance of the existing ten-year vesting schedule would assist in reaching that cost neutrality although it would establish a preference for the DC choice for participants motivated solely by the short-term nature of the vesting benefit.

Second, the current defined benefit plan under the FRS includes an age bias because it does not inflation-adjust the calculation of the highest five annual salary. This negatively impacts those vested employees who leave the DB plan and retire many years later. The calculation of these employees benefit is based on salaries levels that, due to inflation, are much lower than an employee who worked a similar number of years but at the end of his or her career. The bill addresses age-bias, a feature which would add additional basis points to the option cost but tends to equalize the risk associated with choice.

Third, portability of pension benefits is improved through quicker vesting cycles, although at some sacrifice to cost. Wage indexing however, has an even greater effect on increasing portability. Both quicker vesting cycles and wage indexing are contained in the bill

Fourth, self-determination, investment risk, and personal accountability are the principal characteristics of a DC plan. The present DB plan in FRS does accommodate these considerations since its design favors the employer’s needs, not those of the employee.

Fifth, the transition from one plan type to another can be a difficult experience; a large number of FRS members are not sophisticated investors. Such a change can be appealing to some who value its ethic and are comfortable with the choice, but it can prove troubling to others who do not, or cannot, bring the same skill sets to that critical and irrevocable purchasing decision. In such circumstances there may be social costs resulting from retirees who made bad, though informed, choices or who experienced adverse circumstances due to normal cyclical swings in economic markets immediately prior to retirement. A recourse available to them would be an investment option with a guaranteed result, such as an annuity. That product is, however, less financially satisfactory than the annuity offered through participation in the FRS under present law.

Advanced funding to the Division of Retirement is necessary for the following reasons:

First, the division in the midst of a multi-year reengineering of its customer service and data base systems. A DC plan option must be integrated within these changing infrastructure elements.

Second, the transition will occur concurrently with assessment of Year 2000 (Y2K) date calculation compliance. The division believes its systems are compliant but any externally-directed change to its existing systems must be accommodated.

Third, the proposal contemplates division responsibility for DC administration with the latitude for the delegation of such responsibilities to the participant's employer. Nonetheless, many FRS member employers are small units of government with limited administrative service familiarity with direct pension information.

Fourth, the Internal Revenue Service requires at least six months to review applications for changes to existing federally tax-qualified plans such as the FRS. As that date will cross the Y2K compliance period, additional time needs to be factored for this review.

VIII. Amendments:

None.