

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.)

Prepared By: Ways and Means Committee

BILL: CS/CS/SB 1446

SPONSOR: Ways and Means Committee, Governmental Oversight and Productivity Committee and Senator Argenziano

SUBJECT: State Financial Matters

DATE: April 14, 2005

REVISED: _____

| | ANALYST | STAFF DIRECTOR | REFERENCE | ACTION |
|----|----------------|----------------|-----------|---------------|
| 1. | <u>Wilson</u> | <u>Wilson</u> | <u>GO</u> | <u>Fav/CS</u> |
| 2. | <u>McVaney</u> | <u>Coburn</u> | <u>WM</u> | <u>Fav/CS</u> |
| 3. | _____ | _____ | _____ | _____ |
| 4. | _____ | _____ | _____ | _____ |
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| 6. | _____ | _____ | _____ | _____ |

I. Summary:

The bill makes changes to the administration of the Public Employees Optional Retirement Program (PEORP) in the Florida Retirement System administered by the State Board of Administration (SBA). The changes affect the manner in which benefits are paid and received, beneficiaries are designated, and uncashed checks on account balance transfers are processed. The bill places additional conditions on the reemployment of retired Investment Plan participants consistent with federal tax law and also expands the authority of the board to invest in additional forms of asset-backed securities.

This bill substantially amends the following sections of the Florida Statutes: ss. 121.021; 121.091; 121.35; 121.4501; 121.591, and 215.47.

II. Present Situation:

The Florida Retirement System (FRS) is a multi-employer, non-contributory pension plan providing retirement income security to the some 620,000 active and 210,000 retired public employee members of its 837 Florida state, county, municipal, educational, and special district government employers. The FRS is composed of a defined benefit, or percent-of-final-pay, Pension Plan and an alternative defined contribution, or equity-based, Investment Plan. In the former the plan sponsor guarantees an annuitized benefit result while in the latter the employee-participant takes personal ownership of the contribution amounts and allocates them among chosen fund classes. Employer payroll contribution rates are set annually following an annual valuation by an external actuary. Rates for the defined benefit plan vary annually with demographic changes in the membership, the structure of benefits, and investment gains or

losses. Rates in the Investment Plan are fixed in statute since the employer assures only a contribution to a participant account, not an investment result.

The Pension Plan rewards long-term employment as its benefits are calculated on the five best earning years, which for most employees are the last ones served. The Investment Plan is tailored for employees of shorter service length and its benefits are relatively more generous in the beginning of a limited career. Participants may switch between plans once in their lifetime in a manner which assures an actuarially equivalent result. Article X, Section 14, State Constitution and Part VII of ch. 112, F.S., require full funding of public sector pension benefits and prohibit the intergenerational transfer of unfunded liabilities.

The Division of Retirement in the Department of Management Services administers the Pension Plan and makes benefit payments. Investment management is the responsibility of the SBA for both plans. The SBA manages a number of other fiduciary funds for designated public purposes, chief among them catastrophic hurricane insurance, pre-paid college tuition, and the Florida Lottery. The SBA through its third party administrator, CitiStreet, administers the Investment Plan.

The state university system optional retirement program has five vendors with which eligible employees may contract for retirement benefits. Initially, the Department of Management Services was permitted to designate up to 4 companies to provide such services and benefits. In addition, one additional Florida domiciled company could be designated to participate in the program.

III. Effect of Proposed Changes:

Section 1 amends s. 121.021, F.S., to provide that the State Board of Administration (SBA) may require additional evidence of termination of employment prior to processing a distribution from an Investment Plan account.

Section 2 amends s. 121.091, F.S., to place restrictions on the reemployment of retirees who enter retirement status as members of the Investment Plan. Under the amended provisions, a retiree may not be reemployed by a covered FRS employer for three months unless the participant has otherwise reached the normal retirement limits of the defined benefit plan. Reemployment in violation of this provision subjects the subsequent employer to be jointly and severally liable for the repayment of benefits paid to the retiree, unless the employing agency has a statement from the employee indicating that a retirement action did not occur.

Section 3 amends s. 121.35, F.S., to allow the Florida domiciled company currently under contract with the department to continue to provide services until the expiration of its contract and to allow that company to assign its contract to an affiliated company.

Section 4 amends s. 121.4501(2)(f) and (h), F.S., respectively, to delete an obsolete cross-reference and to permit participants who have terminated from the Deferred Retirement Option Program (DROP) to be considered participants in the Public Employee Optional Retirement Program (PEORP) for the purpose of transferring a tax-free rollover distribution from their DROP account into the Investment Plan.

Subsection (4) is also amended to permit participant inter-plan transfers only if the person is earning service credit and has an employer-employee relationship. Further changes are made to create consistent enrollment requirements in the Investment Plan as they affect newly employed participants and those employees making a second election, or inter-plan transfer. Current law has the effect in some cases of preventing such transfers when the date of the change falls in a later month from one in which it is made, thus requiring manual correction.

Subsections (8) and (12) are further amended to delete three separate cross-references to an advisory committee established during the formation of PEORP that has since been abolished.

Subsection (20) is created to provide a parallel provision to that in the Pension Plan for the designation and change in beneficiary, especially when the change is precipitated by incapacitation or affects a minor child.

Subsection (21) is created to permit participants completing DROP an additional option to transfer, tax-free, their accumulated and deferred benefit to the Investment Plan at termination of employment. Current law permits a transfer to another tax-sheltered account, or a full or partial distribution less federal withholding tax.

Section 5 amends s. 121.591, F.S., to provide for a cancellation of uncashed benefit distribution checks after 180 days of issuance and their reversion to the PEORP Trust Fund after 10 years. These forfeitures are not subject to the provisions of ch. 717, F.S, relating to unclaimed property.

Subparagraph 4. is added to subsection (1) to provide that a partial benefit distribution of up to 10 percent of the account balance may be made prior to the participant's termination for three months.

Subsection (3) is amended to provide that s. 121.4501(20), F.S., as created by s. 4 of this bill, shall govern the payments of survivor benefits to beneficiaries in the case of a participant's death.

Section 6 amends s. 215.47, F.S., to provide an authorization for SBA investments in asset-backed securities, that is, bonds or financial instruments whose underlying value is based upon the pledge of accounts receivable. These instruments themselves may have their credit worthiness enhanced through the issuance of letters of bank credit or insurance.

The current statute permits investments in such instruments but only when issued by companies. More frequently, these asset-backed securities are being issued by limited liability entities that fall outside that incorporation definition.

Section 7 provides that the bill takes effect July 1, 2005.

IV. Constitutional Issues:**A. Municipality/County Mandates Restrictions:**

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

D. Other Constitutional Issues:

Depending on the resolution of the interplan transfer issue in s. 4 of the bill, there may be additional costs passed along to the Division of Retirement and the defined benefit Pension Plan. As discussed, below, both the SBA and the division have yet to reach consensus on this issue. Article X, Section 14, State Constitution, requires all public sector pension plans to be prefunded in a sound actuarial manner to avoid the intergenerational transfer of unfunded liabilities.

V. Economic Impact and Fiscal Note:**A. Tax/Fee Issues:**

None.

B. Private Sector Impact:

Since the inception of the Investment Plan there have been a number of participants who have amounts due them but who have not cashed distribution checks. Repeated attempts at contacting these individuals have not succeeded in making these amounts due them payable. As of February 28, 2005, there were a total of 10 people affected by these "stale, dated checks" who are owed a total of \$37,096.60. The largest single amount is \$18,970.34; the smallest is \$7.41.

The SBA pays an administrative fee to its third-party administrator for the maintenance of active accounts. As these stale dated checks become less frequent, that per-subscriber fee is eliminated.

Permitting employees who have finished their DROP enrollment and terminated employment to transfer their accumulated account balances to the Investment Plan will provide them with the same investment choices they could receive in the open market, or through the state's Deferred Compensation Program, but at significantly lower cost. A 2003 staff review comparing several like asset classes among the Investment Plan, the Deferred Compensation Plan, and the State University System Optional Retirement Program (SUSORP) revealed the following expense ranges:

**Employee Investment Management Expenses/Total Fees
for State of Florida Employee-Managed Accounts,
Third Quarter Ending 2003, In Basis Points (bps, .0001 or .01%)**

| | Fund Type | Investment Plan | Deferred Compensation | SUSORP |
|---|--------------------|------------------------|------------------------------|----------------|
| 1 | Bond | 2 - 85 bps | 23 - 122 bps | 44.5 - 190 bps |
| 2 | Large Cap Growth | 18 - 57 | 68 - 155 | 50.5 - 205 |
| 3 | Large Cap Value | 21 - 64 | 67- 100 | 167 |
| 4 | Mid-Cap Growth | 49 - 84 | 89 - 143 | 249 |
| 5 | International/G/W | 20 - 103 | 116 - 125 | 53.5 - 248 |
| 6 | Lifecycle/Balanced | 12 - 17 | 88 - 90 | 44.5 - 210 |

The above amounts should be read as ranges within the asset classes. Annuitization of an SUSORP account is accompanied by significant mortality and expense charges as well as disintermediation, or account surrender fees, payable by the participant. These alone are about 100 basis points. Fees and investment management expenses lower overall returns and can cause a fund selection to underperform even if its performance compares favorably to its peers.

C. Government Sector Impact:

The Division of Retirement and the SBA have not reached a consensus position on any fiscal impact associated with the provisions in s. 4 relating to the effective date of inter-plan transfers. The SBA takes the position there is no fiscal impact while the division has not yet concurred. The amount in disagreement is not believed to be substantial and will be subject to confirmation by the division’s external actuary.

Increased participation in the Investment Plan by participants making tax-free, roll-over transfers can result in a lowering of fees as business volume increases. Savings accrue to the benefit of participants and to the SBA as it may negotiate greater investment management expense discounts, a term that includes participant fees, as the volume of business increases.

Correspondingly, there can be competitive cost pressures on the legacy providers of such post-employment retirement accounts due to the loss of business or the fact that those selling retail products in the post-employment market must adjust their expenses to meet additional providers of institutional products marketed on a lower, wholesale level.

VI. Technical Deficiencies:

None.

VII. Related Issues:

On January 13, 2005, the SBA received a legal opinion from its tax counsel on its federally tax qualified status relative to certain distribution actions taken by participants in the Investment

Plan. The Investment Plan is required to maintain compliance with the Internal Revenue Code, Title 26, United States Code, pursuant to s. 121.4501, F.S. The tax opinion referenced a situation in which FRS employees have been reemployed in a covered FRS position following transfer from the Pension Plan to the Investment Plan. Under such an arrangement the employer would offer the participant resumption of the same or similar position after the participant transfers the assets out of state custody and into a private retail account sponsored by one or more commercial insurance and annuity companies. The participant then retires and waits thirty days prior to resumption of employment, the required time to be removed from all payrolls and to have vested leave benefits redeemed. The asset transfer occurs outside of the treasury thus preventing any state agency from suspending the benefit by invoking the current law's twelve month suspension of benefit provision. The result, according to the tax counsel, could result in a non-bona fide retirement and an in-service distribution of pension benefits to a retiree, actions prohibited by federal tax law. The SBA has identified as many as 50 cases that appear to be engaged in this behavior with most of them centered on the Special Risk Retirement Class and affecting sheriffs' offices and the Florida Department of Corrections.

Such employer and employee actions can violate the United State Internal Revenue Code as impermissible distributions and, unless sanctioned by the SBA as the plan sponsor and fiduciary, could jeopardize the tax-qualified status of the Investment Plan. Corrective actions are being implemented by the SBA and its third-party administrator to advise Investment Plan participants and FRS employers of the jeopardy attached to such circumstances.

VIII. Summary of Amendments:

None.

This Senate staff analysis does not reflect the intent or official position of the bill's sponsor or the Florida Senate.
