

# 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.)

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Prepared By: Ways and Means Committee

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BILL: CS/SB 1670

INTRODUCER: Governmental Oversight and Productivity Committee and Senator Garcia

SUBJECT: State Financial Matters

DATE: April 3, 2006

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>Favorable</u>
3.	_____	_____	_____	_____
4.	_____	_____	_____	_____
5.	_____	_____	_____	_____
6.	_____	_____	_____	_____

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## I. Summary:

The bill revises the interest calculation assumption on interest accrued in transfers between the Florida Retirement System (FRS) Pension Plan and Investment Plan; provides equivalent purchased military service credit for participants in the Investment Plan; provides procedures to be followed when a participant in the Investment Plan receives an invalid plan distribution; amends standards for investments made by the State Board of Administration; and makes cross-reference changes to separate investment authority provided to the Florida School for the Deaf and Blind.

This bill amends the following sections of the F.S.: 121.4501, 121.591, 215.47, and 1002.36.

## II. Present Situation:

### *Public Employee Optional Retirement Program*

In 2000, the Florida Legislature created the Public Employee Optional Retirement Program in part II of chapter 121, F.S. The State Board of Administration, which is responsible for establishing the program, calls this program the Florida Retirement System (FRS) Investment Plan in order to distinguish it from the FRS defined benefit program, the FRS Pension Plan. The FRS Investment Plan is a defined contribution retirement plan in which employer contributions, based on membership class, are made to an account established for the participant. The participant can then decide how to invest among a number of investment funds which “span the risk-return spectrum.”

New employees of FRS employers are automatically enrolled in the FRS Pension Plan on the first day of their employment.<sup>1</sup> Within five months following their month of hire, these new employees may elect to participate in the FRS Investment Plan instead of the FRS Pension Plan.<sup>2</sup> Employees of FRS employers also have a one-time option to change their retirement plan from the FRS Investment Plan to the FRS Pension Plan or from the FRS Pension Plan to the FRS Investment Plan.<sup>3</sup>

*Transfers from the FRS Pension Plan to the FRS Investment Plan*

Transfers from the FRS Pension Plan to the FRS Investment Plan are governed, in part, by s. 121.4501(3)(c), F.S. If a participant elects to transfer the present value of the employee's accumulated benefit obligation earned under the Pension Plan, the Division of Retirement must transfer the funds within 30 days of the employee beginning participation in the Investment Plan. With these time constraints, the Division must use estimates of the employee's creditable service and average final compensation. Within 60 days of the initial transfer, the Division must "true-up" the transfer - recomputing the amount transferred based on the participant's creditable service and average final compensation as of the date of FRS Investment Plan participation.<sup>4</sup> If the recomputed amount indicates that excess funds (\$10 or more) were transferred from the FRS Pension Plan, the Division of Retirement is required to transfer the excess funds from the participant's FRS Investment Plan to the FRS Pension Plan, based upon six percent effective annual interest, compounded annually, pro rata based on the participant's allocation plan.<sup>5</sup> If the recomputed amount indicates that insufficient funds (\$10 or more) were transferred from the FRS Pension Plan, the Division of Retirement is required to transfer the outstanding amount from the FRS Pension Plan to the participant's FRS Investment Plan account based upon eight percent annual interest, compounded annually.<sup>6</sup>

Prior to July 1, 2005, the actuarial investment return assumption used in the annual valuation was an eight-percent effective annual interest rate. Effective July 1, 2005, the actuarial investment return rate was reduced to 7.75% by the Florida Retirement System Actuarial Assumption Conference.

*Credit for Military Service and the FRS Investment Plan*

Part I of chapter 121, F.S., sets forth the general provisions for the FRS, including credit for military service in s. 121.111, F.S. This section allows military service to be creditable service<sup>7</sup> for FRS purposes if five criteria are met:<sup>8</sup>

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<sup>1</sup> Fla. Stat. § 121.4501(4)(a) (2005).

<sup>2</sup> *Id.*

<sup>3</sup> Fla. Stat. § 121.4501(4)(e) (2005).

<sup>4</sup> Fla. Stat. § 121.4501(3)(c)3. (2005).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> Fla. Stat. § 121.021(17)(a) (2005).

<sup>8</sup> These criteria are provided in subsection (1). Subsection (2) applies to employees whose initial date of employment was before January 1, 1987, and it allows those employees to receive four years of creditable service for military service upon payment of certain contributions and subject to certain limitations.

- (1) The employee is actively employed by an FRS employer immediately prior to service and leaves his or her employment for the purpose of induction into the Armed Forces of the United States or entry upon duty in the Armed Forces of the United States;<sup>9</sup>
- (2) The employee is entitled to reemployment under the provisions of the Veterans' Reemployment Rights Act;<sup>10</sup>
- (3) The employee applies for reemployment with the same FRS employer and is reemployed by that FRS employer within the applicable timeframes;<sup>11</sup>
- (4) The employee makes any required employee contributions and the employer makes the required employer contributions for the employee's membership class for each month of service credit during such period of military service;<sup>12</sup> and
- (5) The period of service claimed pursuant to this subsection does not exceed the applicable periods.<sup>13</sup>

Part II of chapter 121, F.S., relating to the Public Employee Optional Retirement Program/FRS Investment Plan, is silent regarding credit for military service.

*Invalid Distributions and the FRS Investment Plan*

Section 121.591, F.S., governs the payment of benefits under the Public Employee Optional Retirement Program/FRS Investment Plan.

FRS Investment Plan payments also are controlled by s.121.4501, F.S., which establishes the FRS Investment Plan, and s.121.091(9), F.S., which provides limitations on employment after retirement.

In order for benefits to be paid, an employee must have terminated employment<sup>14</sup> with the FRS employer, or be deceased, and have filed an application to receive benefits. Benefit payments are not made until the employee has been terminated for three calendar months.<sup>15</sup> The State Board of Administration may permit, by rule, distribution of up to 10 percent of the participant's account after being terminated for one calendar month if a participant has reached the normal retirement requirements of the defined benefit plan.<sup>16</sup> Benefits are payable in one of three ways:

1. A lump-sum distribution to the participant;

<sup>9</sup> Fla. Stat. § 121.111(1)(a) (2005) (An employee is construed to have left his or her employment for military purposes if he or she reported for active duty within 60 days after leaving such employment).

<sup>10</sup> Fla. Stat. § 121.111(1)(b) (2005) (specifically citing "38 U.S.C. ss. 2021 et seq.").

<sup>11</sup> Fla. Stat. § 121.111(1)(c) (2005) (specifically citing "the time set forth in s. 2021 or s. 2024 of the Veterans' Reemployment Rights Act, whichever is applicable").

<sup>12</sup> Fla. Stat. § 121.111(1)(d) (2005) (based upon the employee's rate of monthly compensation as of the date that the employee left his or her position, plus 6.5 percent interest compounded annually).

<sup>13</sup> Fla. Stat. § 121.111(1)(e) (2005) (specifically citing "the provisions of ss. 2021 and 2024 of the Veterans' Reemployment Rights Act which are applicable in the member's case").

<sup>14</sup> Fla. Stat. § 121.021(39) (2005).

<sup>15</sup> Fla. Stat. §§ 121.091(9)(c) and 121.591(1)(a)4. (2005) (created by ch. 2005-253, Laws of Florida.)

<sup>16</sup> Fla. Stat. § 121.591(1)(a)4. (2005).

2. A lump-sum direct rollover distribution in which all accrued benefits, plus interest and investment earnings, are paid from the participant's FRS Investment Account directly to the custodian of an eligible retirement plan; or
3. Periodic distributions, as authorized by the State Board of Administration.<sup>17</sup>

This section does not, however, have a provision which governs “invalid distributions.”

*Authorized Investments*

The State Board of Administration (SBA) acts as the principal investment manager for agencies of the State of Florida. Because the SBA administers funds on behalf of other entities it becomes a fiduciary operating for the exclusive benefit of these named funds and their parent agencies. The Legislature has delegated to the trustees of the SBA the authority to set the SBA’s operating budget. The approved operating budget is then submitted to the legislative branch for review and comment. The SBA imposes investment management charges on the funds it manages, and it is these charges which constitute the revenue stream for the funding of its operations.

The largest single financial responsibility of the SBA is its investment management for the defined benefit (“Pension Plan”) and defined contribution (“Investment Plan”) programs of the Florida Retirement System.<sup>18</sup> More than three-quarters of the SBA funds under management are dedicated to this large multi-employer pension plan. The principal funds under management and their balances as of December 31, 2005, are as follows:

FRS Pension Plan (DB)	\$ 115,202,000,000
FRS Investment Plan (DC)	\$ 1,796,000,000
Local Gov’t. Pool	\$ 24,335,000,000
Chiles Endowment	\$ 1,988,000,000
Lottery	\$ 1,539,000,000
Hurricane Catastrophe	\$ 3,437,000,000
Debt Service Escrow	\$ 2,975,000,000
Other Funds (22)	\$ 1,797,000,000
<b>TOTAL</b>	<b>\$ 153,069,000,000</b>

Chapter 215, F.S., provides the statutory investment parameters for the SBA. Within these parameters the board and its Investment Advisory Council execute an investment policy statement and determine the allocation of funds to the specific asset classes. For the FRS, the allocation is based as well upon the plan’s principal economic assumptions that build its rate structure: assumed salary growth of 4 percent inclusive of 3 percent inflation, age adjusted; membership growth of 0 percent; post-retirement benefit increases of 3 percent; and an investment return of 7.75 percent. Two of these assumptions have a direct relationship: if salary growth exceeds the assumption it must be offset by a return greater than 7.75 percent for there to

<sup>17</sup> Fla. Stat. § 121.591(1)(c) (2005).

<sup>18</sup> As noted below, asset allocations for the defined contribution plan are participant-directed. Section 112.656, F.S., specifies the duties of named fiduciaries of public retirement plans.

be no payroll contribution rate consequence. Gains and losses are calculated annually and averaged over a running five-year period. The payroll contribution rate, like *ad valorem* taxation, is set in arrears by the Legislature following receipt of an annual plan valuation conducted by an external actuary. The Legislature annually procures a second opinion on the reasonableness of the valuation.<sup>19</sup>

For the defined benefit, or percent-of-final-pay pension plan, the distinct asset classes are equities - domestic, international, and global - fixed income; real estate; alternative investments;<sup>20</sup> and cash. Each fund contains its own unique asset allocation due to the underlying policy attributes of the fund. For example, the Local Government Investment Pool invests in debt securities of short maturity since it must maintain liquidity for its government agency participants who invest cash not needed for immediate operations. The SBA acts as the fiscal intermediary for the Department of the Lottery and purchases zero-coupon treasury strips for the largest Lotto payouts through an electronic auction. The single-payment prize amount is discounted to reflect the present value of the future benefit.

A large portion of the assets is managed internally and passively<sup>21</sup> by board staff with the remainder managed actively through contractual engagements with individual investment managers. As employer payroll contributions are received by the Department of Management Services' Division of Retirement, or other investment sources, these funds are electronically transferred to the SBA for investment. When funds are required for the payment of benefits to retirees, dependents, and survivors, the SBA redistributes the required amounts for payment through the Treasury. For the defined contribution plan, the individual participant makes such asset allocations with the SBA acting as both the contract manager and, in selected cases, investment provider.

About twenty percent of the FRS investment portfolio is invested in fixed income, most of which are obligations of the U.S. government and its agencies or debt issued by corporations. A portion of this investment lies with obligations of the Federal National Mortgage Association and the Government National Mortgage Association. These publicly traded entities purchase mortgages and repackage them into securities - mortgage backed securities - that are bought and sold on the secondary market. While Florida law restricts the SBA to state-mortgages on domestic real property, in practice it is not possible to package securities on such a basis and the language has become archaic over time. Originating lending institutions routinely sell their mortgage portfolios to generate capital for the issuance of additional mortgages. Mortgage expenses are "front-loaded," and the issuance expenses and initial interest payments charged the mortgagor are sound income sources for the lenders. Purchasers of these portfolios find them attractive as a stable source of income since any individual default or prepayment risk is spread over a large base and may carry its own default insurance.

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<sup>19</sup> Section 112.658, F.S.

<sup>20</sup> The alternative investment class includes equities outside of a recognized exchange system. It invests in relatively illiquid private equity through external managers and usually takes the form of the SBA as a limited partner in a general partnership. The engagement is a multi-year commitment and the limited partner must satisfy a capital call when one is issued by the general partner. This asset class has the highest level of risk but is also expected to produce the greatest level of return.

<sup>21</sup> Index funds are an example of a passive investment, in which the funds represent the daily value of a mathematically derived formula, or index, rather than direct ownership of the securities of the companies comprising it.

The trustees, the SBA, and the Department of Management Services are all named fiduciaries of the Florida Retirement System and must discharge their duties exclusively for the best interests of the participants. By statute, the FRS adheres to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. s. 1104, notwithstanding the exemption provided under federal law for government plans.<sup>22</sup>

Chapter 2005-253, Laws of Florida, provided the board with additional enforcement authority on permitted distributions from the Investment Plan. The board has advised that on infrequent occasions participants would terminate employment, take a distribution from the account, and then become reemployed in a covered position prior to the expiration of the suspense period set by statute. That 2005 legislation authorized the board to notify participants when their actions violated the statute as these actions constituted a *non bona fide* retirement. Complicating a resolution of this circumstance is the passage of funds from the FRS Trust Fund to a participant-directed account. Once the funds leave the State Treasury, the ability of recoupment short of litigation becomes quite problematic. For small accounts that are subsequently depleted or liquidated in their entirety, the expense associated with a recovery may exceed the amounts realized.

### III. Effect of Proposed Changes:

**Section 1** amends s. 121.4501(3), F.S., to change the effective rate of interest charge on final participant plan transfers from defined benefit to defined contribution from the nominal eight percent to the amount then in effect and assumed as part of the actuarial assumptions used for that plan year. This amount is currently set at 7.75 percent and is incorporated into the financial assumptions that underpin the funding procedures of the Pension Plan.

The bill further amends subsection (22) of that same section to provide equivalent recognition of prior United States Armed Services credit under the terms provided in s. 121.111, F.S.

**Section 2** amends s. 121.591, F.S., to provide sanctions against a current or former Investment Plan participant who receives an invalid distribution from a defined contribution account. If such a participant fails to repay the invalidated distribution within ninety days of final notification the person shall be deemed retired and no further gains on subsequent payroll contributions shall be recognized.

**Section 3** amends s. 215.47, F.S., to delete an investment threshold for time deposits, bankers' acceptances, and certificates of deposits based upon an institution's financial net worth. Substituted is an investment standard based upon a rating system set by one of the major national services.<sup>23</sup>

A similar change is made in authorized investments comprising debt and group annuity contracts.<sup>24</sup> Deleted is a rating by one of two rating services in any one of the three highest

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<sup>22</sup> Section 215.47(9), F.S. An additional citation to the duties of fiduciaries is contained in s. 518.11, F.S.

<sup>23</sup> The analysis discusses, below, the major rating systems.

<sup>24</sup> An annuity is a contract for the payment of a specified sum over a defined period of time. The payments may be immediate or deferred and the underlying investment may be fixed or variable. An annuity requires the exchange of a principal amount between the insured party and the carrier/issuer.

ratings. Substituted is a rating of investment grade by any one rating service or, with respect to annuities, a concentration greater than three percent with any one insurer.

Deleted as an approved investment is reference to investments in Florida-specific first mortgages in single family residences.

This section creates a new subsection (17) that authorizes the board to sell short any of its securities or authorized investments.

**Section 4** amends s. 1002.36, F.S., to provide a cross-reference correction for the separate investment authority granted the Florida School for the Deaf and Blind. The amended text eliminates the investment authorization in s. 215.47(2)(c), F.S., regarding Florida-specific first mortgages.

**Section 5** provides that the bill takes effect July 1, 2006.

#### **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:

Additional fee and expense income will be distributed to the financial intermediaries that market or process these securities transactions. It is not possible to estimate this income with precision as they are dependent upon the nature and scale of the transactions themselves.

C. Government Sector Impact:

This is a considerable expansion of permitted investment authority for the board. Because of the reach of the bill it is more appropriate to discuss its impact in terms of directional change rather than its precise magnitude.

The change from twenty to twenty-five percent authorization for foreign investments will not produce any necessary change in investment allocation. It is an upper limit on this asset class; specific changes will be made by the board, its retained advisors, and its Investment Advisory Council in consultation with the Trustees and will occur incrementally rather than upon passage of the act. The board already has global equity investments of \$4.9 billion and international equities of \$18 billion. As of December 31, 2005, this comprised fifteen percent of its total funds under management for the FRS. This percent declines slightly when international equities assigned to the Chiles Endowment are included.

There are two different ratings systems for cash-like instruments and debt discussed in the revised language. The first of these is a “prime” rating system in which a rating entity assigns a risk value to the underlying security, usually short-term deposits, with P-1 being the highest.

The second rating system encompasses debt and other commercial issuances. Each of these rating systems uses a different combination of alphabetic and numerical characters to evaluate the risk tolerance of the underlying security. The ratings services, while not named specifically in the bill, are generally assumed to be Standard & Poor, Moody’s, and Fitch. Because of differences in valuation techniques and assumptions, there may be a lag among all three of the ratings results, even on the same security at the same time. The bill permits the board to exercise its judgment and choose from the one that has the highest, or least risky alpha-numeric rating. Return is a direct function of risk and an investor trades off the possibility of a higher nominal return for the stability and predictability of a more stable result. This difference, or spread, is meticulously measured and is itself the product of the world-wide market system in which the securities are traded. Moody’s uses a financial rating system with a leading upper case and trailing lower case letter, such as “Aa.” A numerical suffix denotes standing within that grade from one to three. Fitch employs a similar system, which it claims to have pioneered, of upper case letters ranging from the highest of “AAA” to “DDD.” Standard & Poor employs a system similar to Fitch’s with alphabetic differences on lower-rated securities. All ratings systems combine qualitative and quantitative factors to arrive at security rating estimates. These take into consideration financial assets and liabilities, estimates of managerial ability and performance, and the market climate for the product or service.

Ratings systems may vary with the industry under analysis as, for example, corporate debt versus insurance. Two additional firms, AM Best and Weiss Research, provide ratings on insurers and incorporate separate rating systems on claims paying ability and financial performance specific to that industry.

Many institutional investors, such as pension plans, are limited to investments that are investment grade, that is, they must be rated at a level of BBB, its equivalent, or higher unless they maintain an alternative investment class that permits speculative investments. When such investments fall below this standard the investor may have to dispose of the security with an accompanying probability of financial loss. Conversely, an investor may profit from an investment in a lower rated security whose issuer improves its

performance: the security undergoes a capital appreciation and the borrowing ability of its issuer improves.

Pension plans are institutional investors: they invest for the long-term based upon the morbidity and mortality of their underlying workforce demographics and the structure of promised benefits. Generally, their investment time horizon is measured in generations, not weeks or months. As such, they invest “long” and command the lowest fees and costs due to the institutional scale of their purchasing power. Increasingly, such investors are examining investments in short-term strategies. “Shorting” a security is borrowing it at a certain price in anticipation of its decline. It is a bet on failure and, as such, it is a strategy for well-capitalized, sophisticated investors only. Fundamentally, shorting a security implies an altered investment philosophy and time horizon: the investor is seeking to profit in the short-term by the demise of the issuer or of the overvalued nature of the security itself. Short sales of stock along with the repricing of stock options to a lower strike price are two benchmark indicators of potential corporate financial and managerial stress outside of a balance sheet or income analysis, especially when the trading activity occurs through insider transactions by officers or directors.

The Florida School for the Deaf and Blind maintains its own investment operations and is statutorily authorized to participate in the \$34 billion Common Fund,<sup>25</sup> a large multi-member investor for institutions of higher education and their endowments. The change contemplated in this bill is a technical cross-reference only.

#### **VI. Technical Deficiencies:**

None.

#### **VII. Related Issues:**

There is robust discussion in financial markets about the entry of institutional investors into more aggressive investment techniques that traditionally were the province of a smaller group of highly leveraged seasoned investors. Mutual funds and pension plans have to accommodate the growing benefit payment requirements of mature western economies that are experiencing a large departure of their workforces into retirement. The shifting bases of these western economies - from industrial to service, from on-shore to off-shore, and production to consumption - mean more speculative ventures and global positioning of capital will begin to characterize the investment policy of such institutional investors for the foreseeable future. This transformation has been mutual. As institutional investors are taking on the attributes of speculative investors, such funds are themselves taking more aggressive steps to act as tools of improved corporate governance. There have been many recent examples<sup>26</sup> of highly leveraged firms taking corporate management to task for underperforming operations, assets, or

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<sup>25</sup> The Common Fund is a different entity from the New York Common Retirement Fund, the principal retirement fund for the public employee retirement system of the State of New York.

<sup>26</sup> Wendy’s International and Triam Partners/Pershing Square Capital Management; McDonalds Corporation and Pershing Square Capital Management; General Motors and Tracinda Corporation; and Sovereign Bank/Relational Investors, to name but a few recent examples.

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management. 2005 was a poor year for such speculative undertakings which themselves seem to prosper when the economy does not.

Investment Plan participants seeking to file a grievance, such as a recoupment of an invalid distribution, can use a complaint resolution process developed by the SBA. The administrative process is provided by board rule and can lead to either a formal (request for hearing) or informal adjudication (request for intervention) on the substance of the claim. The specific statutory authority for this process is contained in s. 121.4501 (9)(f)3., F.S.

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

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## **VIII. Summary of Amendments:**

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