

Florida's New Retirement Program Should Offer More, Not Fewer, Informed Choices for Employees

The 2000 Legislature created a valuable option for government employees' retirement planning when it created the Public Employee Optional Retirement Program (PEORP). This program allows employees to choose between the current defined benefit (DB) plan or the newly established defined contribution (DC) plan (see box on this page for details of the plans.)

So far, the state has done a good job of beginning to implement the optional retirement program. However, one aspect of this plan may undermine the very fundamentals of a defined contribution retirement plan by unduly limiting the options available to the member/investor employee.

DB vs. DC: What's the Difference Between a Defined Benefit and Defined Contribution Plan?

A ***defined benefit plan (DB)*** is a contract between an employee and his/her employer which entitles the employee to a certain level of retirement income based upon earnings and length of service, as determined by the employer in the plan provisions. A defined benefit system entitles an employee to a certain level of retirement income based upon earnings and length of service, as determined by the employer in the plan provisions. That income is a variable cost, borne entirely by the employer (and in this case, the state and local taxpayers of Florida). The variability in employer costs (contribution rates) is caused by such factors as: employee earnings, length of service and investment return. Through employer contributions and investment income and appreciation, at the end of a covered employee's employment, sufficient funds may be available to meet that obligation. In effect, the benefit amount controls the employer's cost (variable), with investment return (positive or negative), reducing or increasing that cost.

In a ***defined contribution (DC)*** retirement plan, the employee retirement benefit amount is variable and not pre-determined, with the employer's cost being known (a percentage of covered employees' earnings). While there are many variations of DC plans, in general, the employer assumes no "risk" since there is no stated benefit amount. The amount of an employee's retirement income is still a function of length of employment and earnings, but investment return assumes a larger importance in the total benefit. While investment return (positive or negative) can reduce or increase an employer's cost in a DB plan, the employee's retirement benefit remains "fixed." In a DC plan, the employee's

retirement benefit is variable, dependent upon investment return, the individual employee's level of investment risk and reward and the asset is fully portable/transferable and can be passed to heirs and future generations.

Public Employee Optional Retirement Program (PEORP)

Due to a surplus of more than \$9 billion in the state employee retirement system -- the Florida Retirement System (FRS) -- the 2000 Legislature debated ways to enhance that system. Two main options were considered: increasing benefits and reducing contributions in the current defined benefit system or adding an optional defined contribution plan.

Florida TaxWatch released two reports -- in April 1999 and April 2000 -- on optional retirement with the goal of providing a strategy to enhance Florida's public employers' competitive position to attract and retain a high quality workforce without adding billions of dollars in current and long-term taxpayer costs and liabilities. Florida TaxWatch championed the effort to create an optional defined contribution plan for public employees. The 2000 Legislature passed HB 2393 that creates the Public Employee Optional Retirement Program (PEORP). The law:

- ▼ Establishes a defined contribution plan alternative, effective July 1, 2002.
- ▼ Changes the vesting period for all active FRS members from 10 to 6 years, effective July 1, 2001.
- ▼ Upgrades Special Risk Class service from 1978 through 1992 to 3%, effective July 1, 2000.*
- ▼ Increases the minimum number of employees local agencies may designate for Senior Management Service Class membership, effective July 1, 2000.
- ▼ Adds assistant state attorneys, assistant statewide prosecutors, assistant public defenders, and assistant capital collateral regional counsels to the Senior Management Service Class, effective January 1, 2001.
- ▼ Adds community-based correctional probation officers and certain professional health care bargaining unit or non-unit members who are employed by the Department of corrections or the Department of Children and Family Services to the Special Risk Class, effective January 1, 2001.
- ▼ Reduces FRS employer contribution rates, effective July 1, 2000 to:**

- ◆ Regular Class - 8.21%
- ◆ Special Risk Class - 19.35%
- ◆ Special Risk Administrative Support Class - 10.74%
- ◆ Judges - 19.48%
- ◆ Legislators, Governor, Lt. Governor, Cabinet, State Attorneys, Public Defenders - 13.31%
- ◆ County, City, Special District Elected Officials - 16.05%
- ◆ Senior Management Service Class - 10.19%

* Special Risk members who retire effective July 1, 2000 **will** be eligible for the upgrade. Retired Special Risk Class members, including DROP participants, with service between 1978 and 1992 are **not** eligible for this upgrade.

** These rates do not include the Health Insurance Subsidy rate of 0.94%.

The Current Investment Policy Statement Does Not Allow for Adequate Choice

The State Board of Administration (SBA), which is responsible for implementing and administering PEORP, drafted an Investment Policy Statement (IPS) which will serve as a blueprint for the plan. SBA will be selecting vendors to provide investment products, education and administrative services. Under the IPS, initially drafted by SBA, these services would be provided in an "unbundled" environment; institutional investment products would be provided "unbundled" from the provision of education and administration services. This seemed to be contrary to the intent of the law and the wishes of the legislative sponsors which called for "bundled" providers or vendors providing a wide range of investment products and services.

After allowing for public input and the review of an advisory committee, the IPS was amended to include a single bundled provider. While this is an improvement, it does still not provide the flexibility and options necessary when participants take more responsibility for their retirement planning.

There are important reasons why the state must ensure that participants have ample options in the new retirement system:

- 1) It is mandated by the law (HB 2393) and is the intent of the founders of the this plan. Both the Governor and legislators called for a defined contribution plan that provides ample choice and portability;
- 2) it's the underlying principal behind defined contribution plans, arming participants with the tool and the knowledge to take control of their retirement planning; and
- 3) participants' life circumstances are likely to change, and therefore their retirement planning options need to be flexible. And of course, no one knows a person's unique retirements needs better than that person.

Moreover, the House of Representatives did a survey of over 8000 potential participants, and the respondents indicated that choice was the most important feature of a defined contribution plan. It is clearly the wishes of those for which the plan was created to benefit.

The SBA contends that in order to meet the mandate of low cost investments, the limited approach is best. Under the initial plan, each investment class would be served by a single investment option. A "third party administrator" would handle all the

administration, and the education provider would provide all the information about the program and investment advice as well.

Institutional investments are generally of lower cost than the typical investment offered by a bundled provider. This is because the institutional product does not include on-going investment counseling and education. But, not offering bundled options precludes the participant from making the decision to try to achieve better return with the attendant higher costs. Institutional products should certainly be an option, but a program should allow different levels of investment, education and cost for different levels of investors.

Not only will different participants have different investment needs, but different education needs as well. Many people will need hands-on, person-to-person, investment advice as they chart their retirement course. At the other end of the spectrum, the sophisticated investor with a high level of knowledge will want technology-driven products and services. Offering a broad array of products, including nationally known brand names, will offer a level of satisfaction for many investors.

Florida's Public Employee Retirement System Guiding Principals

A good retirement system must:

- | | |
|---|---|
| ◆be market-driven (competitive) | ◆be affordable |
| ◆be funded in an actuarially sound manner | ◆be independent of political manipulation |
| ◆be portable | ◆be easily understood (clarity) |
| ◆be easily administered | ◆be flexible |
| ◆be equitable | ◆be predictable (costs and benefits) |

While the SBA is certainly correct in wanting to make sure that no provider of investment products has a hand in the basic education of helping participants decide between defined benefits and defined contribution plans, no one is better to offer investment advice within the range of products offered than the provider of the products.

If an employee feels that he or she can beat the return offered by the DB plan by making their own investment choices, then they should be given as many tools as practical to be successful. If they are not comfortable with managing their own investments and the associated risks and costs of doing so, then perhaps a DC plan is not for them.

The issue of legal liability also has been raised. It has been suggested that if the investment options chosen by the state under-perform, legal action by participants is a possibility. Liability in a DC plan should be placed on the participants, not the state and the taxpayers of Florida. And if participants have the liability, the state cannot control and limit the options and products available to them, or the self-directed nature of a DC plan is an illusion. Therefore, while costs are important in a DC plan, choice and education are paramount considerations.

It should be noted that Florida's optional retirement program for higher education employees utilizes a multiple bundled provider approach.

The SBA should be commended for its work in implementing this new optional retirement program and for recognizing the need for some form of bundling. However, the current IPS does not go far enough in allowing for adequate options for both current and future employees who may opt for the defined contribution plan. The IPS was approved by the SBA Trustees on September 26, 2000. But there are still opportunities to add the needed element of choice to the plan. The IPS now goes through the rule-making process and will be up for final approval. The Trustees may also amend the IPS at any time.

Florida's implementation of the new public employee optional retirement system will be watched closely and could help serve as a model for other government retirement plans. Allowing multiple bundled providers will "let the market work" and provide a wide array of investment options and services. As a result, the benefits of competition, portability, low level of risk to the state and true choice and responsibility for plan participants will be realized.

This report was researched and written by
Kurt R. Wenner, Senior Research Analyst, under the direction of
Keith G. Baker, Ph.D., Senior Vice President and Chief Operating Officer.
T. O'Neal Douglas, Chairman; Dominic M. Calabro, President and Publisher

© Copyright Florida TaxWatch, January 2001
