

# Research Report

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## Using Multiple Bundled Providers Adds Competition and Needed Choice to Florida's New Optional Retirement Program

The State of Florida is in the process of implementing a new retirement program for government employees. The Public Employee Optional Retirement Program (PEORP) will begin accepting state employees on June 1, 2002. It is a defined contribution plan, and employees may choose between it and the current defined benefit plan which is being retained. Currently, the State Board of Administration (SBA) is in the process of selecting a third-party administrator, an education provider and investment providers.

There has been considerable debate regarding the issue of the proposed mix of investment providers, products and services, specifically between state-maintained institutional funds and investments offered by private "bundled providers." These are companies that offer a group of investment products as well as administrative and customer services, including education and advice. Florida TaxWatch has been following this debate and concludes that offering multiple bundled providers in concert with institutional funds will afford participants with ample choice and a true opportunity to take control of their own retirement planning, if so desired. Such an arrangement will result in the benefits of enhanced options, competition, portability and a low level of risk to the state while creating an attractive public employee benefit.

This is the fourth in a series of Florida TaxWatch reports on optional retirement. The first two reports (released in April 1999 and April 2000) had 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. The 2000 Legislature achieved this goal when it created the Public Employee Optional Retirement Program (PEORP). A January 2001 report warned of the problems associated with limiting choice in the plan. (*For more information on PEORP and the difference between defined benefits and defined contribution plans see our previous reports at [www.floridataxwatch.org](http://www.floridataxwatch.org).*)

This report focuses on the inclusion of bundled providers in PEORP. It examines whether they will add value to the program and looks at issues including cost considerations and fiduciary exposure. Florida TaxWatch offers some recommendations to ensure that meaningful choice along with appropriate safeguards is provided.

## **Bundled Providers Do Add Value**

The State Board of Administration (SBA), which is responsible for implementing and administering PEORP, originally proposed that only state maintained institutional investment products would be offered and provided "unbundled" from the provision of education and administration services. After allowing for public input and the review of an advisory committee, some flexibility in allowing bundled providers was added.

The criteria developed by the SBA to evaluate bundled providers helps spell out the benefits of using a bundled approach, including such "value-added" factors as : (1) additional products or services that are not otherwise available to the participants within the program; (2) the type and quality of investment products offered; (3) the type and quality of non-investment services offered including trust services, education advice, financial and retirement planning; (4) protection provided to the participants and plan sponsor; (5) nationally recognized provider and investments with established expertise and performance; and (6) availability of personal services. A prospective bundled provider is required to fully specify and quantify the "value afforded," and document the supporting rationale.

Choice and responsibility are underlying principals behind defined contribution plans. You must arm participants with the tools and the knowledge to take control of their retirement planning.

Participants' life circumstances are likely to change, therefore, their retirement planning options need to be flexible. 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 provide a level of satisfaction for many investors. Many participants may already have existing relationships with these providers.

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. There are significant risks with permitting investment providers who have an inherent conflict of interest to educate participants. Without appropriate controls, providers may sell (as opposed to educate) participants on the merits of a defined contribution plan over a defined benefit plan and their bundled products over the institutional options. This is an important consideration in determining the need for a third party educator.

However, 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 state's existing defined benefit 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 PEORP is not for them.

## **Fiduciary Responsibility and Exposure**

One of the principles behind PEORP is that, by giving employees choice and control over their retirement assets, the state would be relieved of some fiduciary liability. The law does, however, mandate that the program comply with the fiduciary standards set forth in the Federal Employee Retirement Income Security Act of 1974 (ERISA.)

The issue of the impact that limiting choice would have on the fiduciary liability has been raised before, including by Florida TaxWatch in our January 2001 report. We reported therein that liability in a DC plan should be placed on the participants, not the state and the taxpayers of Florida. Also, if participants have the liability, the state cannot overly control and limit the options and products available to them. The self-directed nature of a defined contribution must be protected.

Recently, one of the potential providers to PEORP had its outside counsel examine the SBA's potential exposure to fiduciary liability under the plan. Florida TaxWatch has reviewed the findings and concludes that the fiduciary liability of the SBA would be significantly reduced by a multiple bundled provider approach.

The counsel's analysis contends that the SBA is protected by the Florida's sovereign immunity provisions with respect to discretionary planning and design functions but could be liable for up to \$200,000 per occurrence for operational decisions. The distinction is made between exercising operational decision-making in operating state-maintained investment funds and the purely planning or design functions involved in selecting bundled providers. Moreover, the fiduciary duties the PEORP law incorporated from ERISA will apply to the SBA to the extent that it is responsible for investment of assets.

The analysis further concludes that, in addition to increasing the state's liability exposure, limiting choice could also have the effect of reducing the remedies available to PEORP participants. With state-maintained funds, if a participant is injured by an act or omission, their right of recourse is limited by the sovereign immunity laws and the lack of any direct contractual contact with independent investment managers. With bundled providers, participants would have the full range of rights to recover as well as being protected by their regulation under federal and state law.

ERISA also requires that plan participants and beneficiaries be provided an opportunity to exercise control over their assets. To do this, investors need to have the opportunity to obtain sufficient information to make informed decisions. With unbundled arrangements, enhanced education is only made available to those willing to pay for it. This is not consistent with legislative emphasis on participant education. A bundled arrangement would be consistent with that direction.

## **Cost Considerations**

The SBA staff has argued that bundled providers will increase the fees for plan participants and that the institutional offerings are the best way to keep costs down. Keeping fees low is very important because, other things being equal, higher fees can significantly decrease someone's retirement benefit over time.

However, cost is not the only consideration and may not be the most important one. The quality of the investment vehicles used and the quality of the advice that leads to investments decisions will also impact the growth of a participant's retirement portfolio.

Section 121.4501(9)(a), *Florida Statutes*, states the SBA "shall select one or more providers who offer multiple investment products when such an approach is determined by the board to afford value to the participants otherwise not available through individual products." When multiple investment options and other services are coupled in a bundled arrangement, the whole package must be considered. Fees may be higher if a participant wants to avail themselves to educational services offered through a bundled provider, but the benefit derived from a good mix of products and sound education and advice has the potential to far outweigh that cost.

The education vendor will provide basic educational services and supplemental "low-cost" investment advice that is to be paid for by the participants who choose these services. If enhanced educational services are provided only to those who pay individually for them, this creates a disincentive for participants to get the kind of education and advice called for in the Statute. Bundled providers would most likely provide these types of services as part of their package. The lowest-cost educational option is not the best for everyone; instead cost-effectiveness should be stressed.

The U.S. Department of Labor has stated in the context of ERISA compliance plan fiduciaries can review bundled arrangements comprehensively, rather than evaluating bundled products and services separately, including cost. It also holds that the value of "one-stop shopping" may also be considered.

Allowing multiple bundled providers will also inject a valuable cost-containment measure into the PEORP program competition. Letting the free market system work helps ensure that the providers who offer the best combination of products, service and cost will be available to participants.

Of course, part of the added cost associated with bundled providers may be to compensate aggressive sales professionals for their efforts in capturing assets. Care must be taken in evaluating providers that added cost equals added value. Among bundled providers, costs will be scrutinized in the selection process. The current methodology to be used by SBA and its consultants to evaluate bundled providers places considerable importance on fees and expenses. Along with factors such as organizational qualities, operational capabilities, investment management personnel and investment performance, cost are weighted highly. For bundled providers offering no services, costs make up 35% of the evaluation. For those providing some services, costs are weighted at 40.5%.

Again, it is about choice. Care must be taken that fees are readily identifiable. Low-cost options should

be available for those who want them. Similarly, higher-cost (but potentially more cost-effective) options should be as well.

## **Pending Legislation Could Require Multiple Bundled Providers**

House Bill 347, being considered by the 2001 Legislature, makes several changes to the PEORP law passed last year, including some relating to bundled providers. The bill (as amended) would provide for the SBA to contract with five or more bundled providers that offer nine investment products and related services, while still allowing the SBA to offer institutional products. It also mandates that providers can only give advice and guidance on the investments they provide. These changes would help ensure that ample, appropriate choice is afforded to participants in the new retirement plan.

FEA-United, the state teachers union, supports the legislation. This is important because Florida's higher education employees already have a defined contribution plan that uses a multiple bundled provider approach. Other state education employees will be included in the PEORP program as of September 1, 2002. The union says that the approach envisioned in the legislation would provide the features its members want. It should be noted that AFSCME, the government employees union, has been critical of the bill.

## **Florida TaxWatch Recommendations**

Florida TaxWatch recommends that at least five providers be provided to empower participants with appropriate choice. Each provider must show a compelling value-added benefit through its differentiating brand and/or incremental services. Each bundled provider may appeal to segmented bases of employee demographics.

Appropriate safeguards should include the requirement that each investment option offered by bundled providers must be a "best of class" investment option as defined by the investment consultant.

Further, bundled providers should not communicate or educate participants until and unless the participant has reviewed their options with the third party educator.

The third party educator should initially advise participants concerning the merits of the DB/DC conversion and the relative benefits of each tier of investment (including each bundled tier). Bundled providers should not be involved in this type of education. Once a participant selects a bundled tier, that bundled provider may in a reactive manner educate the participant concerning the investment options offered in their bundle.

Bundled providers can bring some real benefits to the state new optional retirement plan. These included: a diversified array of options; additional choices creating competition; personalized, hands-on education, advice and service; brand recognition and continuing existing relationships; additional protection

afforded by federal securities laws; and decreased liability to the state and its taxpayers.

The state should strive to make sure that PEORP incorporates meaningful choice within the context of added value and best of class products.

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