Retiree Life Insurance Initial Consideration

LEOFF Plan 2 Retirement Board

August 22, 2007

Overview

- Issue
- Background
- Comparison

Issue

- Survivor Option Actuarial Reduction

Background

- Purpose of Reduction
- Types of Life Insurance
  - Permanent
  - Term

Comparison – Defined Benefit

- Example:
  - Male member retires age 55
  - 50 year-old spouse
  - FAS is $66,000
  - 25 years of service.
  - Joint & 100% Survivor Option

- Monthly Benefit - $2,323.75

- Monthly Reduction - $426.25

Comparison – Term Life

- Pricing based on age 55 male member

Coverage Amount	**Monthly Premium**	**Health Class**
$450,000	$305 - $376 $437 - $500 $588 - $887	Best Lowest Smoker
$550,000	$371 - $433 $533 - $562	Best Lowest

Source: Intelliquote at https://intelliquote.com/

Comparison - Annuity

- Payment based on female beneficiary

Annuity Amount	Monthly Payment	Age
$450,000	$2,337.00 $2,625.00	50 60
$550,000	$3,208.00 $3,578.00	60 65

Source: http://totalreturnannuities.com/

Summary

- Defined Benefit
  - COLA
  - Can not be turned down

- Term Life Insurance
  - Age/health impacts cost/availability
  - Impact of inflation

Retiree Life Insurance

QUESTIONS?

Law Enforcement Officers' and Fire Fighters' Plan 2 Retirement Board

Retiree Life Insurance

Initial Consideration

August 22, 2007

1. Issue

How does the purchase of term life insurance compare to a survivor benefit option at the time of retirement?

2. Staff

Gregory M. Deam, Senior Research and Policy Manger
(360) 586-2325
greg.deam@leoff.wa.gov

3. Members Impacted

Any change to the existing LEOFF Plan 2 funding policies would impact all active members and employers. As of the most recent actuarial valuation September 30, 2005, there were 15,168 active LEOFF Plan 2 members and 481 employers.

4. Current Situation

At the time of retirement a member can choose either an unreduced retirement benefit that ceases upon the death of the member or they can choose a survivor option resulting in a reduced benefit. There are currently three options from which to choose: joint and 100% survivorship, joint and 66⅔% survivorship, and joint and 50% survivorship.

5. Background Information and Policy Issues

When a member retires they have the option of adding a survivor option. This allows the benefit to continue to be paid to the survivor after the member's death. However, if a survivor option is chosen, there is an actuarial reduction. The reason for the reduction is that the benefit is being paid over two lifetimes. The reduced benefit is the "actuarial equivalent" of a payment over two lifetimes instead of paying the benefit over a single lifetime. The amount of the reduction is based on the difference in age between the member and the survivor.

The survivor benefit is essentially a form of life insurance. How does it compare in terms of benefits and cost to standard life insurance options?

There are two basic types of life insurance; term life insurance and permanent life insurance. Term life insurance is the least expensive, at least initially. Coverage is for a fixed time period, normally between one to thirty years. Permanent life insurance provides for insurance that lasts as long as you live. There are several forms of permanent insurance; two of which are whole life and universal life.

For comparison purposes, we will be looking strictly at term life insurance because it is the simplest form of insurance to understand and has the fewer variables. Upon the death of the insured, a lump-sum payment is made to the survivor. The lump-sum can be converted into an annuity equivalent. Life insurance normally pays a lump-sum upon death and is paid for by monthly premiums. Alternately, the defined benefit with a survivor option reduces the monthly benefit amount, but pays over the combined lives of the member and survivor.

The following example shows the calculation for a member retiring with a joint and 100% survivorship, and then the cost of providing that same ongoing benefit to a survivor by converting a lump-sum payment into an annuity.

Example: Pension Calculation

Pat retires at age 55. Pat's spouse is 50 years old. Pat's final average salary (FAS) is $66,000 ($5,500.00/month), he has 25 years of service and he chooses a joint and 100% survivorship option.

<u>Monthly Benefit Calculation for 100% and Joint Survivorship</u>
2% x $5,500 x 25 x 0.845 = $2,323.75

<u>Monthly Reduction</u>
$426.25

In order to determine the value of the monthly reduction, the next step is to determine if the amount of life insurance that can be purchased for the monthly reduction can purchase an annuity of equal or greater value upon the member's death as the defined benefit would pay.

Example: Cost of Insurance Coverage Lump-sum purchase of an annuity

Monthly premium based on a male age 55 for $450,000 term life insurance policy. The monthly annuity amount is for his wife, age 50. The annuity amount in the case of these examples would be the face value of the term life insurance policy. The policy term is for 25 years, except for the smoker health class, which, in this example, could only be purchased for a 20-year term

Insurance Amount	Monthly Annuity	Monthly Premium	Health Class
$450,000.00	$2,337.00	$305 - $376	Best
		$437 - $500	Lowest
		$588 - $887	Smoker

At first glance it seems that the term life may be a less expensive alternative. However, there are a couple of things to consider. First, in this example, it assumes the member dies immediately upon retirement, age 55. Second, the term is fixed so if the member and spouse both live beyond 25 years and then the member dies, the spouse gets nothing. Third, this example is based on a fixed annuity, and continues to pay the same amount for the spouse's life span with no cost of living (COLA) increases.

To best illustrate the importance of the COLA factor, assuming in our previous example that the member dies at age 65, when his spouse is 60, let's see what happens to the monthly annuity.

Example: Lump-sum purchase of an annuity.

Monthly premium based on a male age 55 for $450,000 term policy. The monthly annuity amount is for his wife, age **60**.

Insurance Amount	Monthly Annuity
$450,000.00	$2,625.00

In comparison, the $2323.75 monthly defined benefit amount would have risen to approximately $3,120.00 (assuming the maximum 3% COLA increase each year for ten years). In order to purchase an annuity with a similar monthly benefit, you would need approximately $550,000. Depending upon your own life expectancy, you may need to purchase a greater term life policy. The cost of a $550,000 term life policy for a male at age 55 would cost between $371 and $433 per month in the best health class or between $533 and $562 in the lowest health class.

Finally, it is important to remember that in order to purchase term life there is typically some sort of exam required. Someone in poor health may not receive coverage at all from an insurance company. No matter what a person's health condition is, a joint survivor option can be chosen under the defined benefit.

Some retirement plans purchase life insurance for each member and name the company as the beneficiary. This is similar to what is known as Corporate-Owned Life Insurance

(COLI). COLI was originally purchased on the lives of key employees and executives. It was designed to be a hedge against the financial cost of losing key employees to unexpected death, recruiting and training highly-skilled personnel, or to fund corporate obligations to redeem stock upon death of an owner. However, the practice has been expanded to cover any employee, sometimes without the consent or knowledge of the employee. The Office of the Insurance Commissioner asked the Legislature to tighten restrictions on COLI in 2005 because of concerns about this type of insurance.

6. Supporting Information

- Endnotes:
  Term life quotes found at: https://www.intelliquote.com/
  Annuity quotes found at: http://www.totalreturnannuities.com/