LEOFF Plan 2 Retirement Board

Promoting Individual Savings for Retirement

Comprehensive Report

September 25, 2013

Issue

Members are not able to take advantage of a recent IRS ruling which provides new options for managing savings in retirement.

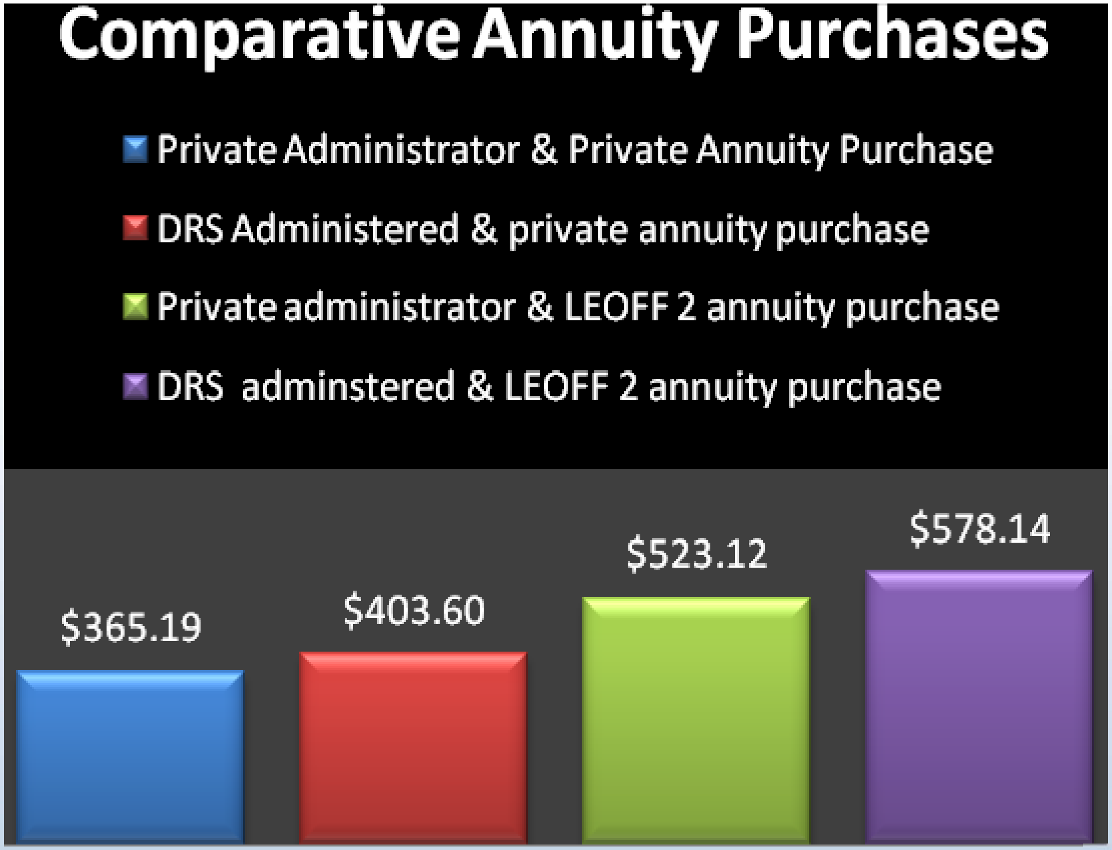
LEOFF Plan 2 Retirement Board

2012 IRS Ruling

- **Internal Revenue Bulletin 2012-8 issued February 21, 2012.**
  - Allows a member of a 401(a) defined benefit plan to annuitize tax deferred retirement savings.
  - Allow employees to maintain a “sidecar” savings account within defined benefit trust fund.

LEOFF Plan 2 Retirement Board

Different Administrator
Different Outcomes



LEOFF Plan 2 Retirement Board

Board Option 1

Authorize LEOFF Plan 2 to annuitize roll-overs of tax deferred savings.

- Allows members to leverage existing LEOFF Plan 2 infrastructure;
- Requires legislation;
- Requires consultation with Ice Miller.

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Board Option 2

Establish a 401(a) savings plan within LEOFF 2.

- Would likely have administrative costs similar to the DRS Deferred Compensation Program.
- Preliminary research indicates it may be more restricted than 457 plan – similar to the Plan 3 DC component.
- Requires consultation with Ice Miller.
- Requires legislation.

Board Option 3

Require LEOFF Employers to Offer DRS's Deferred Compensation Program to LEOFF Members.

- Combines 457 flexibility with low administrative fee;
- May need to account for existing local government contracts with private providers;
- Requires legislation.

Any Questions?

- **Contact:**

  Paul Neal

  Senior Legal Counsel

  360.586.2327

  paul.neal@leoff.wa.gov

September 25, 2013

PROMOTING INDIVIDUAL SAVINGS FOR RETIREMENT

COMPREHENSIVE REPORT

By Paul Neal
Senior Legal Counsel
360-586-2327
paul.neal@leoff.wa.gov

ISSUE

Members are not able to take advantage of a recent IRS ruling which provides new options for managing savings in retirement.

MEMBERS IMPACTED

New options encouraging member's retirement savings as part of LEOFF Plan 2 would be available to all 16,805 active LEOFF Plan 2 members[1].

OVERVIEW

The LEOFF Plan 2 defined benefit Plan, the first leg of the three-legged retirement stool, provides a defined lifetime payout that does not vary with investment return. Retirees must devise their own distribution strategy for the second leg of the stool, individual retirement savings. Members can reduce the risk of outliving their assets if they convert at least some of those assets into a lifetime annuity.

LEOFF Plan 2 members may purchase an additional monthly benefit through the LEOFF Plan 2 trust fund by buying up to 5 years of additional service credit at the time retirement. Under current law, only Plan 3 members (TRS, PERS & SERS[2]) can convert contributions to an annuity from their retirement system.

Leveraging the existing LEOFF Plan 2 infrastructure to authorize accumulation of savings and/or converting that account to a monthly benefit through the LEOFF Plan 2 trust fund would provide a cost-effective mechanism to encourage retirement savings. This can be particularly important for LEOFF Plan 2 members since many do not participate in social security through their employer.

This report examines federal laws encouraging retirement savings, the costs of savings for retirement, different mechanisms for annuitizing retirement savings, a recent IRS ruling authorizing annuitizing retirement savings through LEOFF Plan 2, and provides options for further action.

[1] Membership number as of June 30, 2011; Office of the State Actuary 2011 LEOFF Plan 2 Valuation Report.
[2] Teachers' Retirement System (TRS); Public Employees' Retirement System (PERS); School Employees' Retirement System (SERS).

BACKGROUND INFORMATION & POLICY ISSUES

The LEOFF Plan 2 Retirement Board began studying ways to encourage increased retirement savings during the 2004 Interim. The Board recommended legislation allowing purchase of up to five years of service credit at retirement. The Legislature passed that recommendation in 2005 (HB 1269). That same year the Department of Retirement Systems (DRS) began offering the annuities through the Plan 3 programs. The Purchase of Annuity topic was studied by the Board during the 2006, 2007, 2008 and 2009 Interims reaching the Final Proposal stage in 2006, 2008 and 2009, but no legislation was recommended. The topic was deferred for joint consideration with the Select Committee on Pension Policy (SCPP) for the 2009 Interim. No further action was taken.

> *The paradox is that investors recognize that their retirement savings will need to last longer than ever before but they aren't making plans to ensure they will actually have the money they need. There tends to be a false sense of security when it comes to Planning for retirement. We hope that the money will somehow be there when we need it but we're not taking the action required to ensure it is. This is a serious problem, and addressing it must become an urgent priority.*
>
> Noel Archard, Head of BlackRock Canada.
> July 2013

SAVING FOR RETIREMENT

Federal Law Encouraging Retirement Savings

The federal tax code encourages individuals to save for, and invest in, retirement:

- Qualified deferred compensation plans, such as the IRS §457 plan offered through the Department of Retirement Systems (DRS) deferred compensation program, permit an individual to authorize pre-tax salary deductions for deposit into a personal investment account. Many LEOFF Plan 2 employers offer these types of plans to employees. Upon separation from employment a member may leave the funds invested or select a distribution option.

- Members may transfer funds between government defined benefit pension Plans like LEOFF Plan 2 and deferred compensation accounts such as 457, 403(b), and 401(k) Plans. This helps members manage retirement savings as they change employers.

- Purchase of up to five years of service credit or “air-time” was authorized in the Federal Pension Protection Act.

- A recent IRS revenue ruling[3] allows members with funds in a deferred compensation account maintained by an employer to roll the funds over into their defined benefit plan and convert those funds to an annuity from the defined benefit Plan.

Using these federal provisions, some state and local government pension plans allow member fund transfers, including funds from tax-deferred accounts, into the primary defined benefit plans to purchase additional service credit or an annuity.

THE COST OF SAVING - DEFERRED COMPENSATION FEES

DRS operates a deferred compensation program under 26 U.S.C. §457, commonly called a "457 Plan". Washington's political subdivisions may participate in DRS's 457 Plan, or use another administrator, such as ICMA-RC. Administrative fees vary significantly. Comparing private administrator fees to DRS's annual .13% fee can be challenging since private administrators tend to use variable fee schedules rather than the flat fee charged by DRS, as demonstrated by the fee comparison table included as Appendix A.

The average net annual fee of the private 457 plan administrators examined in Appendix A is 1.29%, nearly 10 times the .13% charged by DRS. DRS's lower fees facilitate a larger accumulation from the same member contributions[4]:

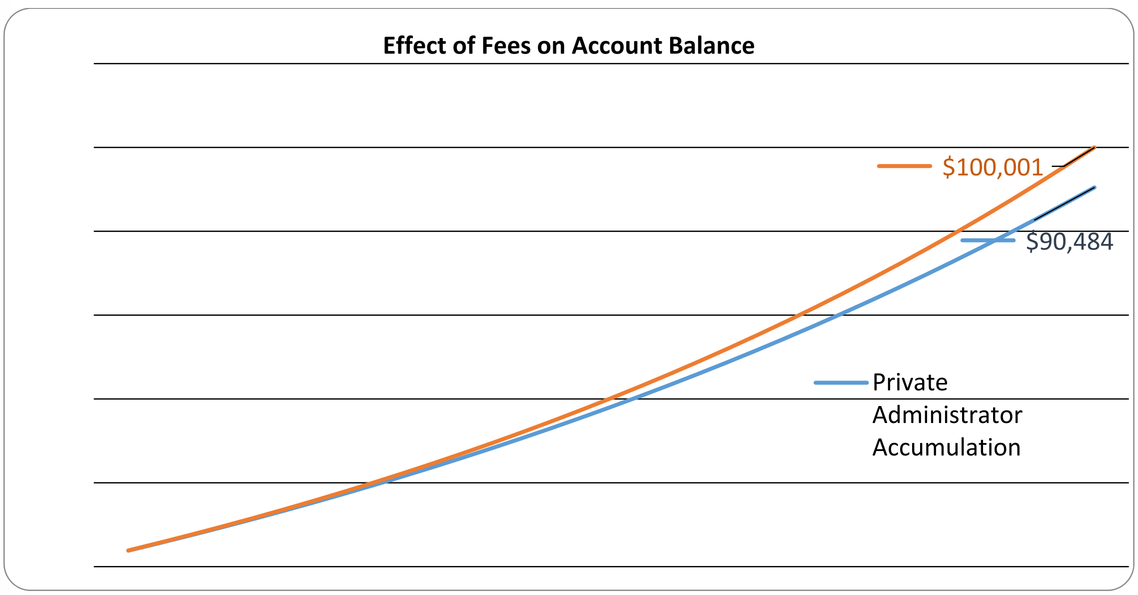

Figure 1

[3] Internal Revenue Bulletin 2012-8; issued February 21, 2012.
[4] The comparison assumes $3,602 per year contribution for 15 years, earning interest at LEOFF PLAN 2's assumed rate of 7.5%, less annual fees.

ANNUITIZING ASSETS

Annuities can convert retirement savings into a guaranteed monthly income (this process is called annuitization) for a specified period of time. A life annuity provides that income for the member's lifespan in exchange for a lump-sum dollar amount paid up front. Deferred compensation plans do not normally allow for the distribution of assets in the form of an annuity directly from the fund. LEOFF Plan 2 members wishing to annuitize their retirement savings must purchase the annuity through an insurance company.

The price/value of the annuity depends in part upon the features selected by the purchaser. The terms and conditions of an annuity contract specify features such as whether the annuity will be for a single life or a joint annuity (like a survivor benefit feature), the payment frequency, adjustments for cost of living, and death provisions. Different methods for annuitizing assets are listed below, though not all are currently available to LEOFF Plan 2 members.

Trust Fund Annuity Purchase

TRS Plan 3, SERS Plan 3, and PERS Plan 3 members and survivors may convert some or all of the funds from their Plan 3 member account to a life annuity, RCW 41.50.088. The features and options of the Plan 3 annuities administered by DRS are detailed in Appendix B. This option is not available to LEOFF Plan 2 members.

DRS calculates the annuity that can be purchased for a given lump sum using an age based actuarial table to compute the monthly benefit per $1.00 of accumulation for defined benefits. There is no limit on the amount of funds in the member account that can be converted to an annuity.

RCW 41.32.067 also allows TRS Plan 1, 2 and 3 members to purchase additional benefits through a member reserve contribution which is actuarially converted to a monthly benefit at the time of retirement. The statute was passed to provide teachers with out-of-state service credit a mechanism for transferring contributions from a prior system into TRS[5].

Service Credit Purchase

LEOFF Plan 2 members can annuitize retirement savings by purchasing up to five years of additional service credit at the time of retirement. To purchase service credit under this option the member pays the actuarial present value of the resulting increase in the member's benefit. A member may pay all or part of the cost of the additional service credit with an eligible transfer from a qualified retirement plan. For more information on the history and methodology for calculating service credit purchases, see Appendix C.

[5] *See* Laws of 1991 c 278 § 2.]

The federal 5-year "air time" limit works out to a maximum of $86,484 that could be converted to a monthly benefit by the average LEOFF Plan 2 member[6], see Appendix C. This is a key difference between a Plan 3 annuity conversion and a service credit purchase: the Plan 3 conversion does not have a maximum amount limit.

Commercial Market Annuity

Retirement savings can be annuitized by purchasing an annuity policy through insurance agents, financial planners, banks and life insurance carriers. However, only life insurance companies issue policies. Generally, commercial market annuities do not offer all the same features as the Plan 3 trust fund annuity and do not provide as favorable a payout. A primary reason for the payout difference is the different interest rate used to calculate the value of the annuity. Private insurers use a lower interest rate, due in part to the inclusion of a reasonable profit:

> [A] private insurer will provide the annuity based on an interest rate of about 4 percent, whereas DRS will provide the annuity based on an interest rate of about 8%.[7].

The interest rate differential drives a significant difference in payout amounts between private annuity contracts and contributions annuitized through the trust fund. Five different insurance companies quoted the monthly annuity with a 3% annual COLA they would provide the average LEOFF Plan 2 retiree[6] for $100,000:

Insurance Company	Quote
American General	$389
Aviva	$402
Fidelity & Guaranty Life	$421
Genworth Life Insurance	$406
Integrity Life Insurance	$400
Average	**$404**

If that same average LEOFF Plan 2 member were able to leverage the institutional advantages of the retirement system by annuitizing $100,000 within the LEOFF Plan 2 system, the payout would be $578.14[8]. That's a 43% increase over the average commercial quote, or $174 more per month for life.

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[6] Age 56 with 17 years of service credit and a final average salary of $5000 per month.
[7] 2010 State Actuary 2010 fiscal note on the Board's purchase of annuity proposal.
[8] $100,000 x .0057814 (conversion factor from DRS table for 56 year-old LEOFF member) = $578.14 monthly life annuity

The chart below uses the 15 year accumulations calculated in figure 1 and estimates the annuity those accumulations would purchase from either an insurance company or the LEOFF Plan 2 trust fund.

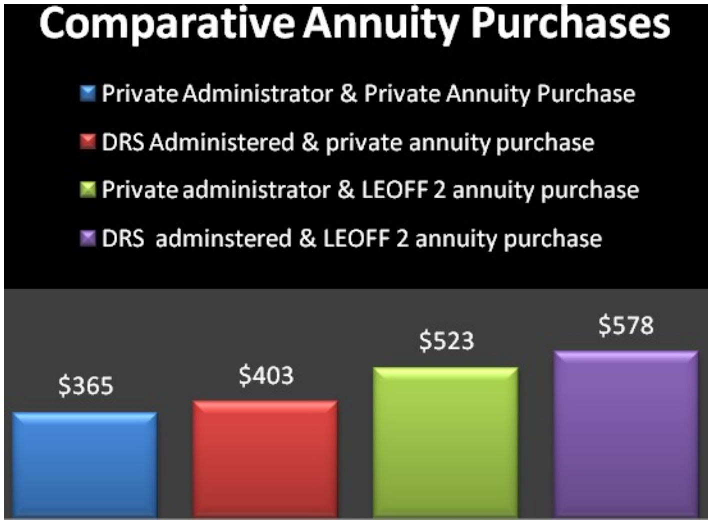

Figure 2

Current state law does not allow annuitization of retirement savings through the LEOFF Plan 2 trust fund. A recent IRS ruling gives the green light to such a program.

NEWLY AVAILABLE ALTERNATIVE: ANNUITIZATION THROUGH 401(A) PLAN

Federal tax law allows public defined benefit plans to add a member savings account within the plan, sometimes referred to as a companion account or "sidecar". Contributions to the employee savings account may be made by the employer or the employee and may be either pre-tax or after tax depending on plan design.

Under the recent IRS ruling cited above, a retirement savings account can be annuitized within the 401(a) defined benefit plan to obtain an additional monthly benefit paid through the trust fund. This can be done either through a employee savings account administered within the 401(a) plan or by rolling over retirement savings from another plan such as a 457 plan.

A "sidecar" plan administered through LEOFF Plan 2 could leverage the institutional advantages available to active members as participants in an existing state-administered Plan. Those advantages include the lower fees charged by DRS to administer the savings plan, and the more favorable annuity payout when purchased through the existing LEOFF Plan 2 trust fund.

LEOFF Plan 2 Retirement Board

Potential Risks

The purchase of an annuity through the LEOFF Plan 2 trust fund would not have a cost to the system[9] under current actuarial assumptions. There is, however, a potential risk to the fund if those assumptions change or actual experience falls below assumed levels. When an annuity is purchased, the member locks in the actuarial assumptions in place at that time. A subsequent change in assumptions may knock the annuity out of actuarial equivalency.

For instance, the Actuary's 2010 fiscal note assumed a trust fund annuity would be calculated using the fund's 8% interest assumption. The Board has since reduced that assumption to 7.5%. An annuity locked in with an 8% interest assumption would be "too high" under a 7.5% assumption, causing a $12,980 actuarial loss to the fund[9].

POLICY OPTIONS

The specifics of options available to the Board are in many ways a function of federal tax laws. DRS has received some guidance from the law firm of Ice Miller as of this writing. The LEOFF Plan 2 Board staff had additional questions which are still pending at this time. The options presented below, while accurate in broad strokes, may have to be modified in subsequent presentations depending on future tax law guidance. Additionally, option 1 could be combined with either option 2 or option 3.

Option 1: Propose Legislation authorizing LEOFF Plan 2 to accept roll-overs of tax deferred savings and annuitize those amounts through the plan upon retirement.

Under this option the Board would direct staff to develop legislation authorizing DRS to accept roll-overs from LEOFF Plan 2 members for annuitization at the time of retirement. Further guidance is required to determine what types of roll-overs are allowable under federal tax laws and what limitations, if any, there are on annuitization of rolled over amounts.

Option 2: Propose Legislation establishing a 410(a) savings plan within LEOFF 2 to accept contributions from LEOFF Plan 2 members.

Under this option the Board would direct staff to develop legislation establishing a "sidecar" savings plan within LEOFF Plan 2 that could accept member contributions for distribution following retirement. Preliminary research indicates that this vehicle would be less flexible that a 457 plan such as that administered by DRS's Deferred Compensation Program. Member contributions may be required to follow the same rules as Plan 3 contributions. A member could be required to select a rate upon enrollment. Like the Plan 3 contribution rates, once selected the rate could not be changed except upon change of employment. Voluntary member contributions, which could apparently fluctuate, would be after-tax.

[9] *See* OSA fiscal note on 2010 annuity purchase proposal, Appendix C.

Option 3: Require LEOFF Employers to Offer DRS's Deferred Compensation Program to LEOFF Members.

This option provides a more flexible plan than the 401(a) option. The Board would propose legislation requiring all LEOFF Plan 2 employers to offer the state administered 457 plan. This would ensure that LEOFF 2 members can avail themselves of a plan with the lowest possible administrative fees.

SUPPORTING INFORMATION

Appendix A: Deferred Compensation Fee Comparison

Appendix B: Plan 3 annuity purchase option features

Appendix C: Service Credit Purchase history and example

Appendix D: OSA draft fiscal note

Appendix A

DEFERRED COMPENSATION FEE ANALYSIS

An approximation of annual fees for private administration of a 457 deferred compensation plan was derived by working from a table developed by The City of Duluth in 2013 to allow employees to compare costs of 4 different 457 Plan administrator. Fees were highly variable. Board staff averaged the fees of each provider and then averaged those to derive a net average estimated annual fee. Given the small sample and the assumptions that had to be made in averaging, this is a “ball park” figure provided solely for purposes of comparison.

	Hartford Life Deferred Compensation Plan		**ICMA Retirement Corporation Deferred Compensation Plan**		**Minnesota State Deferred Compensation Plan MNDCP – (Great West)**		**NationwideDeferred Compensation Program**	
	Original data	**Average fee**	**Original data**	**Average fee**	**Original data**	**Average fee**	**Original data**	**Average fee**
Annual Account Fees	No	0 %	No.	0%	No	0%	No.	0%
Daily Asset-Based Charges	75 - 90 bps	.825 %	0.55% administration fees on all assets; additional 0.15% fee on assets in non-proprietary funds.	.55%	0.10% annual administrative fee, charged only on the first $100,000 in an individual account.	.1%	0.50% annual administrative fee on all variable fund assets. 0.25% annual administrative fee on fixed account option.	.375%
Fund Operating Expenses	Varies by investment option, from 0.0% to 2.42%	1.21%	Fund expenses range from 0.46% to 1.40%	.93%	Fund expenses range from 0.01% to 0.93%.	.47%	Fund expenses range from 0.00% to 1.40%.	.7%
Net fee estimate	**2.035%**		**1.48%**		**.57%**		**1.075%**	
Average for all plans	**1.29%**							

APPENDIX B
CURRENT ANNUITY PURCHASE FEATURES

The purchase of annuity currently administered by DRS through the Plan 3 programs includes the following features:

<table>
<tr><th colspan="2">WSIB Investment Program Annuity Features and Options</th></tr>
<tr><td>Contract Provider</td><td>Washington State</td></tr>
<tr><td>Minimum Purchase Price</td><td>$25,000</td></tr>
<tr><td>Annuity Payment Frequency</td><td>Monthly</td></tr>
<tr><td>Rescission Period</td><td>15 calendar days from date of purchase</td></tr>
<tr><td>Single Life Annuity</td><td>• Provides regular payment for as long as annuitant lives.
• Automatic 3% Annual Cost of Living Adjustment (COLA)
• Conversion option to Joint Life Annuity
• Balance Refund</td></tr>
<tr><td>Joint Life Annuity</td><td>• Provides regular payment for as long as member or joint annuitant is alive.
• Joint annuitant survivorship options: 100%, 66 2/3%, or 50%
• Automatic 3% Annual COLA
• Monthly payment pops-up to Single Life Annuity amount if joint annuitant predeceases member.
• Balance Refund</td></tr>
<tr><td colspan="2">Annuitant – The member/owner who purchases the annuity; the payee who receives lifetime monthly payments.

Balance Refund – Any remaining balance equal to the original purchase price minus the total of all annuity payments made to the single or joint annuitants, may be refunded to the specified beneficiary.

Conversion Option – If a single life annuity is purchased and then a subsequent marriage occurs, a one-time opportunity is available to convert to a joint life annuity with the new spouse as the joint annuitant. If a joint annuity is purchased with someone other than a spouse named as the joint annuitant, the annuity may be converted to a single life annuity after payments have begun.

Joint Annuitant – The person designated to receive an ongoing payment in the event of the annuitant's death.

Pop-up – An increase from a joint annuity payment amount to the full single life annuity amount if the annuitant outlives the joint annuitant.

Rescission Period – A period of time (typically 7 to 15 days) during which the terms of the contract may be canceled or altered</td></tr>
</table>

APPENDIX C
SERVICE CREDIT PURCHASE

Since 2005 the inception of the service credit purchase of "air time" benefit through August of 2007, 15 service credit purchase billings have been requested from DRS and paid in full. The average cost of all fifteen billings was $103,045. The average benefit increase from the fifteen billings was $597 per month. The average break-even point is just over 14 years, or age 69.

LEOFF Plan 2 SC Purchases at Time of Retirement

Year Paid	2006	2007	2008	2009	2010	2011	2012	2013	Grand Total
Number of PSC Bills Paid	6	10	11	15	30	42	57	43	214
Average Cost of PSC Bill	$106,853	$102,102	$85,391	$99,161	$119,527	$123,924	$120,245	$132,699	$118,876
Average SC Months of PSC Bill	55	53	44	48.5	54.6	51.8	48.4	54.3	51.3

A five year service credit purchase by an average LEOFF Plan 2 retiree who, at the time of retirement, is 56 with 17 years of service, and a monthly final average salary of $5,000 is detailed below:

<u>Service Credit Purchase Calculation</u>

1. Calculate Base Benefit: 2% × 17 YOS × $5,000 = $1,700 per month

2. Add 5 Years Of "Air Time": 2% × 22 YOS × $5,000 = $2,200 per month

3. Calculate Increase in Monthly Benefit from Additional Service Credit:

$2,200 - $1,700 = $500 increase per month

4. Calculate Service Credit Purchase Cost: $500 ÷ 0. 0057814 [10] = $86,484

[10] The factor for the "Monthly benefit per $1.00 of accumulation for defined benefit Plans" for an age 56 LEOFF Plan 2 member from WAC 415-02-340.

APPENDIX D
OSA FISCAL NOTE OF 2010 ANNUITY PURCHASE PROPOSAL

Attached Separately