



December 16, 2015

# Retiree Annuity Purchase

## FINAL PROPOSAL

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## ISSUE STATEMENT

Current state law does not allow retirees to roll over tax deferred savings into LEOFF Plan 2 to purchase an annuity.

## PROPOSAL SUMMARY

Allow LEOFF Plan 2 retirees who retired before October 1, 2014, a six month window to purchase an annuity through LEOFF. The annuity would be offered under the same terms as the current option including built in COLA and a survivor option.

## OVERVIEW

At the time of retirement, members can roll their retirement savings from a tax qualified plan into LEOFF Plan 2. The Department of Retirement Systems (DRS) will convert this rollover into a monthly life annuity. Because members are rolling over from a tax qualified savings plan, they do not have to pay taxes at the time the annuity is purchased. Instead, the money will be included in their taxable income as they receive it.

Members receive their pension dollars as well as this annuity in one monthly check from DRS. If they were to pass away before receiving the initial cost to purchase the annuity, the designated beneficiary receives the balance.

Following passage of the 2014 legislation allowing purchase of annuity at the time of retirement, existing retirees inquired whether they could also roll over and purchase an annuity after retirement. The current law does not allow existing retirees to purchase an annuity. An annuity can only be purchased *at* the time of retirement.

## BACKGROUND & POLICY ISSUES

A 2012 IRS revenue ruling<sup>1</sup> allowed pension plan members to roll money from a deferred compensation account into the member's defined benefit plan to purchase an annuity if authorized by the plan document (i.e. the LEOFF Plan 2 statutes).

After studying the issue, the Board recommended legislation in 2014 which was passed unanimously by the Legislature. The legislation allows members of LEOFF Plan 2 who are retiring to purchase an optional actuarially equivalent life annuity from the LEOFF Plan 2 trust fund with a minimum payment of \$25,000. The payment may be made through an eligible or direct rollover, or trustee-to-trustee transfer from a tax-qualified plan offered by a governmental employer.

Existing retirees (retired before the 2014 Annuity Purchase legislation) began to raise questions about their ability to purchase an annuity. Neither the original revenue ruling nor the Board's legislation discussed whether existing retirees could also be given the opportunity to purchase an annuity.

Staff has since determined that federal tax law would allow retirees to purchase an annuity from the pension fund, if authorized in statute.

### Value of an Annuity Purchase

Purchasing an annuity increases a retiree's monthly benefit for the rest of their life. An "annuity" is an investment on which a retiree receives fixed payments for their lifetime. If an annuity is purchased, the retiree would continue to receive the annuity portion of their monthly benefit even if they returned to work, or returned to membership.

Similar to a monthly benefit, the annuity portion may also be passed along to a survivor if a survivor option is selected at the time of retirement. If a survivor option is not selected, any portion of the annuity remaining at the time of death will be paid to the designated beneficiary or the retiree's estate. If the retiree is eligible for an annual Cost-of-Living Adjustment (COLA) on their monthly benefit, they will receive the same COLA percentage on their purchased annuity.

Many private annuity companies offer their own versions of this benefit. However, LEOFF's higher interest rate assumption (7.5% - compared to around 4% for a private annuity company)

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<sup>1</sup> Internal Revenue Bulletin 2012-8; issued February 21, 2012.

translates into a larger annuity from the same lump sum. Additionally, administrative costs to the member are much lower.

Analysis supporting the Board's 2014 Annuity Purchase proposal is included from the December 18, 2013 Final Proposal as Appendix C.

### **Board Action**

At the June and September (2015) meetings, the Board discussed the possibility of opening a window allowing an annuity purchase by persons who retired prior to the 2014 legislation. Representatives of LEOFF Plan 1 retirees and WSPRS retirees expressed interest in being included in such a bill. The Board directed staff to draft legislation limited to LEOFF Plan 2 retirees, while leaving open the possibility of considering expansion.

The Select Committee on Pension Policy (SCPP) discussed allowing retirees from plans other than LEOFF Plan 2 a window to purchase an annuity. The SCPP decided to include that issue on its interim agenda. Given the SCPP action, it would be duplicative for the Board to consider the including WSPRS and LEOFF Plan 1 retirees.

At the November meeting, the Board direct staff to prepare and present a final proposal to create a window period allowing LEOFF Plan 2 retirees to purchase an annuity under the same terms as the original legislation. A bill draft and fiscal note is attached as Appendices A and B.

## **NEXT STEPS - OPTIONS**

Option 1: Vote to submit bill draft to Legislature for passage

Option 2: Take no further action

## **SUPPORTING INFORMATION**

Appendix A: Draft bill authorizing LEOFF Plan 2 retirees to purchase an annuity

Appendix B: Fiscal Note

Appendix C: Promoting Individual Savings for Retirement – Final Proposal, December 18, 2013

## APPENDIX A: DRAFT BILL AUTHORIZING WINDOW FOR RETIREE PURCHASE OF ANNUITY

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BILL REQUEST - CODE REVISER'S OFFICE

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BILL REQ. #: Z-0682.1/16

AN ACT Relating to allowing certain law enforcement officers' and firefighters' plan 2 retirees to purchase annuities; and adding a new section to chapter 41.26 RCW.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF WASHINGTON:

NEW SECTION. **Sec. 1.** A new section is added to chapter 41.26 RCW under the subchapter heading "plan 2" to read as follows, but because of its temporary nature is not codified:

(1) A plan 2 retiree whose retirement was effective before October 1, 2014, may purchase an annuity under subsection (2) of this section between January 1, 2017, and June 1, 2017.

(2) Plan 2 retirees who meet the requirements of subsection (1) of this section may purchase an optional actuarially equivalent life annuity benefit from the Washington law enforcement officers' and firefighters' retirement system plan 2 retirement fund established in RCW 41.50.075. A minimum payment of twenty-five thousand dollars is required.

(a) Subject to rules adopted by the department, a retiree purchasing an annuity under this section must pay all of the cost with an eligible rollover, direct rollover, or trustee-to-trustee transfer from an eligible retirement plan.

(b) The department shall adopt rules to ensure that all eligible rollovers and transfers comply with the requirements of the internal revenue code and regulations adopted by the internal revenue service. The rules adopted by the department may condition the acceptance of a rollover or transfer from another plan on the receipt of information necessary to enable the department to determine the eligibility of any transferred funds for tax-free rollover treatment or other treatment under federal income tax law.

(c) "Eligible retirement plan" means a tax qualified plan offered by a governmental employer.

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**APPENDIX B: FISCAL NOTE**

## APPENDIX B: PROMOTING INDIVIDUAL SAVINGS FOR RETIREMENT – FINAL PROPOSAL, DECEMBER 18, 2013



### DECEMBER 18, 2013 PROMOTING INDIVIDUAL SAVINGS FOR RETIREMENT

#### FINAL PROPOSAL

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#### ISSUE

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

#### PROPOSAL SUMMARY<sup>1</sup>

At the November 20<sup>th</sup> meeting the Board directed staff to prepare proposals on:

- Option 1: Authorize LEOFF Plan 2 to annuitize roll-overs of tax deferred savings;
- Option 3: Require LEOFF Employers to Offer DRS's Deferred Compensation Program to LEOFF Members; and
- Option 4: Encourage DRS to offer a Roth option as part of its 457 deferred compensation plan.

Those options are being presented for Board action at the December 18<sup>th</sup> meeting.

#### MEMBERS IMPACTED

New options encouraging member's retirement savings as part of LEOFF Plan 2 would be available to all 16,720 active LEOFF Plan 2 members<sup>2</sup>.

#### 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.

<sup>1</sup> The Board initially considered this issue at the August 28, 2013 Board meeting. At the September follow-up the Board looked at three options and requested additional information on: Annuitization of additional amounts rolled over into LEOFF Plan 2; and requiring LEOFF employers to participate in DRS's 457 plan. Staff also researched authorized "Roth" accumulations in governmental 457 plans.

<sup>2</sup> Membership number as of June 30, 2012; Office of the State Actuary 2011 LEOFF Plan 2 Valuation Report.

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<sup>3</sup>) 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.

## 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 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

<sup>3</sup> Teachers' Retirement System (TRS); Public Employees' Retirement System (PERS); School Employees' Retirement System (SERS).



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<sup>4</sup> 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.
- The Small Business Jobs act of 2010 authorized governmental 457 plans to include a Roth option.

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<sup>5</sup>:

<sup>4</sup> Internal Revenue Bulletin 2012-8; issued February 21, 2012.

<sup>5</sup> 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.



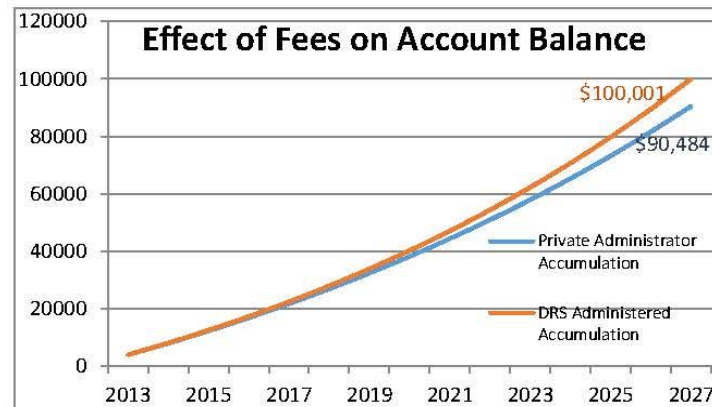


Figure 1

## 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<sup>6</sup>.

### **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.

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<sup>7</sup>, 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%.<sup>8</sup>

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<sup>6</sup> for \$100,000:

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<sup>6</sup> See Laws of 1991 c 278 § 2.]

<sup>7</sup> Age 56 with 17 years of service credit and a final average salary of \$5000 per month.

<sup>8</sup> 2010 State Actuary 2010 fiscal note on the Board's purchase of annuity proposal.

Insurance Company	Quote
American General	\$389
Aviva	\$402
Fidelity & Guaranty Life	\$421
Genworth Life Insurance	\$406
Integrity Life Insurance	\$400
<b>Average</b>	<b>\$404</b>

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<sup>9</sup>. That's a 43% increase over the average commercial quote, or \$174 more per month for life.

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.

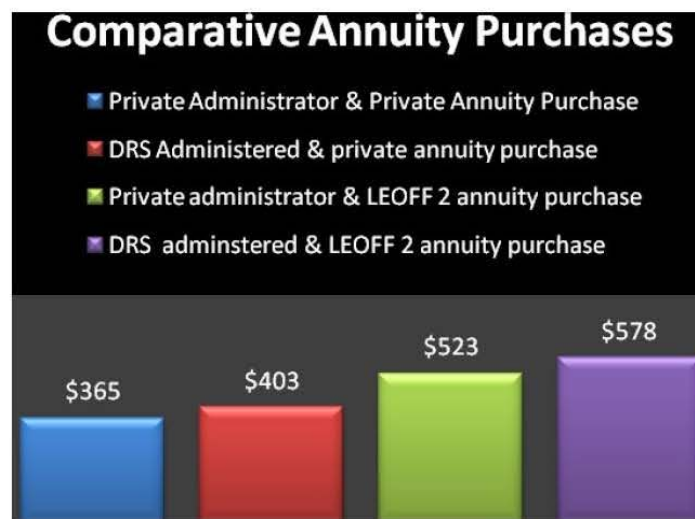


Figure 2

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.

<sup>9</sup> \$100,000 x .0057814 (conversion factor from DRS table for 56 year-old LEOFF member) = \$578.14 monthly life annuity



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## **NEWLY AVAILABLE ALTERNATIVES:**

### **Annuity 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.

### **Potential Risks**

The purchase of an annuity through the LEOFF Plan 2 trust fund would not have a cost to the system<sup>10</sup> 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<sup>9</sup>.

### **Roth Contributions**

The original 457 plan design allows employees to deduct contributions from their salary pre-tax. The amounts are taxed at the time of distribution. A Roth<sup>11</sup> plan reverses that system by taxing contributions, but then disbursing contributions and earnings tax free after retirement.

Governmental 457 plans were not originally allowed to offer a Roth option. The Small Business Jobs Act of 2010 authorizes government sponsored 457 plans to offer designated Roth accounts. Federal law now allows governmental 457 plans to permit participants to:

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<sup>10</sup> See OSA fiscal note on 2010 annuity purchase proposal, Appendix C.

<sup>11</sup> Named after Senator William Roth of Delaware, the chief legislative sponsor of the original legislation in the Taxpayer Relief Act of 1997 (Public Law 105-34).

- Designate a Roth elective deferral account within the plan; and/or
- Convert conventional pre-tax contributions into Roth contributions within the same plan. Participants wishing to convert existing contributions would have to pay taxes on amounts converted at the time of conversion.

Participants in DRS's 457(b) plans cannot take advantage of in-plan conversions/rollovers to designated Roth accounts unless DRS formally adopts those options in their plan document. DRS has the authority to do this under current law, though they are not required to.

### **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 than 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.

### 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 Plan 2 members can avail themselves of a plan with the lowest possible administrative fees.

### SUPPLEMENTAL POLICY OPTION INFORMATION

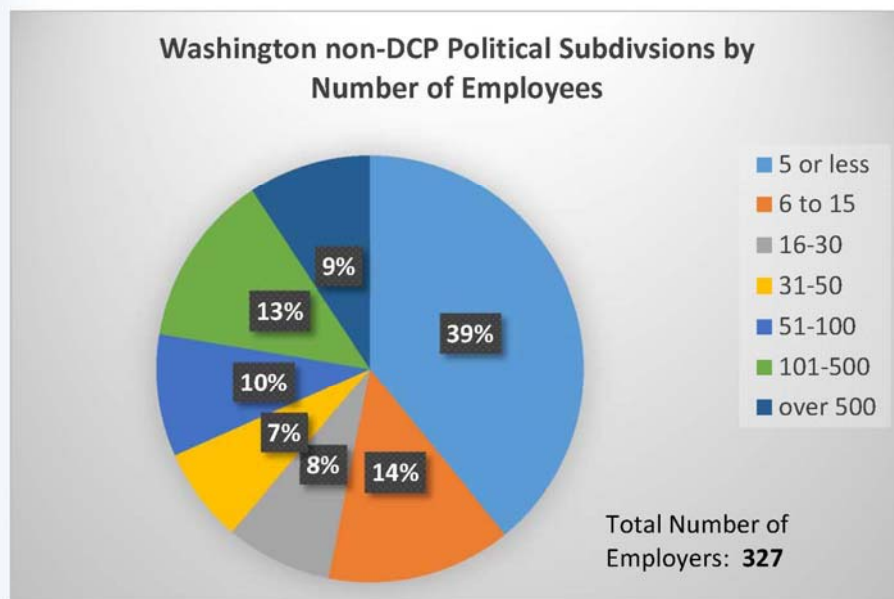
The Board requested additional consideration of options 1 and 3. A fourth option has been developed based on the additional information about Roth plans.

#### Option 1:

Staff has confirmed that the IRS will permit rollovers from any authorized tax-deferred savings plan (457, 403(b), 401(a)) into LEOFF 2 for purposes of purchasing an annuity. Further, there are no IRS limits on the amount that may be rolled over and annuitized, except that the total payout cannot exceed the IRS's section 415 limits on maximum allowable benefit.

#### Option 3:

Staff has drafted proposed legislation that is currently being reviewed by DRS for comments. DRS Director Marcy Frost has asked the Select Committee on Pension Policy to consider a similar directive for all Washington Public Employers. Additional data from DRS identifies Washington political subdivision that do not offer the State administered 457 plan:





**Option 4: Roth Contributions to Governmental 457 plan.**

The Board may wish to take action on the Roth option:

**Option 4(a): Amend Deferred Compensation Statute to Require Roth Option.**

Submit legislation requiring DRS to develop a Roth option as part of its deferred compensation plan. The Board may want to direct staff to work with DRS on bill language.

**Option 4(b): Ask DRS to Offer a Roth Option**

If the Board wished DRS to develop a Roth option without a bill, it may be sufficient to send a letter from the Board to DRS requesting them to take action.

**Option 4(c): Take No Action at this Time**

The Board could decline to take any action on the Roth option at this time.

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## **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 - 2009
- Appendix E: Bill Draft re: annuitization of savings
- Appendix F: Bill Draft re: Required participation in DRS 457 plan
- Appendix G: Letter to DRS re: offering Roth option
- Appendix H: OSA draft fiscal note -2013

## 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 MNDCCP – (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:

WSIB Investment Program Annuity Features and Options	
<b>Contract Provider</b>	Washington State
<b>Minimum Purchase Price</b>	\$25,000
<b>Annuity Payment Frequency</b>	Monthly
<b>Rescission Period</b>	15 calendar days from date of purchase
<b>Single Life Annuity</b>	<ul style="list-style-type: none"> <li>• Provides regular payment for as long as annuitant lives.</li> <li>• Automatic 3% Annual Cost of Living Adjustment (COLA)</li> <li>• Conversion option to Joint Life Annuity</li> <li>• Balance Refund</li> </ul>
<b>Joint Life Annuity</b>	<ul style="list-style-type: none"> <li>• Provides regular payment for as long as member or joint annuitant is alive.</li> <li>• Joint annuitant survivorship options: 100%, 66 2/3%, or 50%</li> <li>• Automatic 3% Annual COLA</li> <li>• Monthly payment pops-up to Single Life Annuity amount if joint annuitant predeceases member.</li> <li>• Balance Refund</li> </ul>
<p><b>Annuitant</b> – The member/owner who purchases the annuity; the payee who receives lifetime monthly payments.</p> <p><b>Balance Refund</b> – 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.</p> <p><b>Conversion Option</b> – 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.</p> <p><b>Joint Annuitant</b> – The person designated to receive an ongoing payment in the event of the annuitant's death.</p> <p><b>Pop-up</b> – An increase from a joint annuity payment amount to the full single life annuity amount if the annuitant outlives the joint annuitant.</p> <p><b>Rescission Period</b> – A period of time (typically 7 to 15 days) during which the terms of the contract may be canceled or altered</p>	

## APPENDIX C

### SERVICE CREDIT PURCHASE

Since the inception of the service credit purchase of “air time” benefit (2005), 214 service credit purchase billings have been requested from DRS and paid in full. The average cost of all billings was \$118,876.

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

## SUMMARY OF RESULTS

**BRIEF SUMMARY OF PROPOSAL:** This proposal allows certain retirees of LEOFF Plan 2 to purchase an additional annuity through the LEOFF Plan 2 trust fund during a temporary window.

**COST SUMMARY:** This annuity would be based on an actuarially equivalent purchase. As a result, this proposal is not expected to impact the actuarial funding of the system.

### HIGHLIGHTS OF ACTUARIAL ANALYSIS

This proposal does not have an expected cost because we assumed the member is paying the full actuarial value of the additional annuity. However, as the experience of the system emerges, if the purchase payment is more or less than the actual value of the annuity, then savings or costs would emerge and LEOFF Plan 2 contribution rates will decrease or increase accordingly.

For example, costs could emerge if retired members who purchase an annuity live longer than expected. Costs or savings could also emerge if investment returns are lower or higher than expected.

In addition, if the administrative factors adopted for this benefit are not based on actuarial equivalence, this proposal would result in either a cost or savings to the plan.

*See the remainder of this draft fiscal note for additional details on the summary and highlights presented here.*



## **WHAT IS THE PROPOSED CHANGE?**

### **Summary Of Proposal**

This proposal impacts the following systems:

- ❖ Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 2.

Members of the LEOFF Plan 2 who retired on or before October 1, 2014, may purchase an additional monthly annuity from the LEOFF Plan 2 trust fund between January 1, 2017 and June 1, 2017.

This annuity purchase must follow the provisions found in RCW 41.26.463 and are subject to rules adopted by the Department of Retirement Systems (DRS) as well as applicable Internal Revenue Service regulations (e.g. IRC Section 415(c)(1)).

To pay for the annuity, retirees must make a contribution from an eligible retirement plan of at least \$25,000 to the LEOFF Plan 2 trust fund. The resulting annuity will be actuarially equivalent to the additional amount contributed by the retiree.

Retirees may make the contribution through any combination of eligible rollovers or transfers from a tax qualified plan offered by a governmental employer.

Assumed Effective Date: 90 days after session.

### **What Is The Current Situation?**

In 2014, the Legislature passed SB 6201 (Chapter 91, Laws of 2014), allowing members of LEOFF Plan 2 to purchase an additional annuity through the trust fund at the time of retirement. This bill did not include plan retirees.

At retirement, members of all state retirement plans can increase their monthly benefits by purchasing up to five years of additional service credit. The cost of service is based on the annuity factor for the member's age and plan.

Plan 3 members of the Public Employees' Retirement System, the Teachers' Retirement System, and the School Employees' Retirement System currently also have the option to purchase an annuity from the Total Allocation Portfolio at the time of retirement using funds in the defined contribution portion of the member's Plan 3 account.

For more information about the Plans 3 annuity options, please see Chapter 415-111-320 of the Washington Administrative Code.

## **Who Is Impacted And How?**

We estimate this proposal could affect all 3,055 LEOFF Plan 2 members who retired on or before October 1, 2014, with the option of improved benefits.

We estimate this proposal will increase the benefits for a typical retired member by providing the option to annuitize their qualified personal retirement savings. Annuitizing their money provides a member security against outliving their assets. Additionally, the purchase of an annuity through DRS will likely cost less than the purchase of the same annuity from a private insurer. A private insurer typically calculates annuities based on a lower interest rate to account for risk and profit.

For example, we estimate a private insurer will provide the annuity based on an interest rate of about 4.0 percent, whereas DRS would provide the annuity based on an interest rate of 7.5 percent. For an average retired member age 61 buying a \$10,000 annual life annuity (including the LEOFF Plan 2 Cost-of-Living Adjustment [COLA]), this means a private insurer would charge about \$216,000, whereas DRS would charge about \$144,000.

## **WHY THIS PROPOSAL DOES NOT HAVE AN EXPECTED COST**

### **Why This Proposal Does Not Have An Expected Cost**

This proposal does not have an expected cost since the retired member would pay the full actuarial value of their annuity purchase. However, if experience differs from the assumptions used to determine the full actuarial value, costs or savings to the plan could arise.

### **Who Will Pay For Any Costs/Savings If They Arise?**

As experience emerges, if the annuity purchase amount, on average, is less/more than the actual value of the annuity, then current LEOFF Plan 2 members and employers will pay for the costs/savings through an increase/decrease in contribution rates.

## **HOW WE VALUED THESE COSTS**

### **Assumptions We Made**

We assumed that the LEOFF Plan 2 Board would adopt annuity purchase administrative factors that maintain actuarial equivalence. In addition, other administrative factors may be required for converting the purchased annuity to the same payment form of the retired member's current benefit. It is unlikely, however, that these factors would need to be updated since the annuity purchase option under this proposal is only available for a six-month window.

To determine the purchase price of an annuity, we would need to make several assumptions, primarily:

- ❖ Expected rate of investment return.
- ❖ Expected rate of mortality for the annuitant.
- ❖ Expected rate of inflation.

As with any actuarial calculation that involves estimating future events, actual experience may differ from the underlying assumptions made. When actual experience differs from what we assumed would occur, the system experiences an actuarial gain or loss. An actuarial gain would decrease plan liabilities (or increase assets); whereas, an actuarial loss would increase plan liabilities (or decrease assets). Therefore, we cannot say with certainty that this proposal will not impact plan costs in the future.

If the retired members who purchase annuities, on average, live shorter/longer than assumed, the system will experience actuarial gains/losses in the future. If the actual rate of investment return is more/less than the assumed rate, the system will experience actuarial gains/losses. For these two assumptions, we will not know whether a gain or loss has occurred until DRS has made all payments under each annuity contract.

The annual COLA for LEOFF Plan 2 annuitant benefits is based in part on the rate of inflation and can be no greater than 3 percent. Thus, lower than expected inflation would result in smaller calculated COLAs on an annuitant's annual benefit and produce a savings for the plan.

Otherwise, we developed these costs using the same assumptions as disclosed in the [\*June 30, 2014, Actuarial Valuation Report\*](#) (AVR).

The analysis of this proposal does not consider any other proposed changes to the system. The combined effect of several changes to the system could exceed the sum of each proposed change considered individually.

### **How We Applied These Assumptions**

We developed these costs using the same methods, assets, and data as disclosed in the AVR.

## **ACTUARIAL RESULTS**

### **No Expected Impact To Liabilities Or Present Value Of Future Salaries (PVFS)**

This proposal is not expected to change the present value of future benefits payable or the PVFS, so there is no impact on the actuarial funding of the affected plan due to liability or PVFS changes.

## No Expected Impact To The Contribution Rates Or Budgets

This proposal is not expected to change the contribution rates for members and employers, so there is no expected impact on the actuarial funding of the affected plan due to contribution rate changes.

## HOW THE RESULTS CHANGE WHEN THE ASSUMPTIONS CHANGE

To determine the sensitivity of the actuarial results to the best-estimate assumptions selected for this pricing, we varied the following assumptions:

- ❖ **Mortality Rate** – We determined the cost to the system if the annuity amount was calculated based on higher mortality rates than what actually occurs over time. In other words, retired members purchasing these annuities live longer than expected. For this sensitivity run we decreased the assumed age offsets as disclosed in the 2014 AVR. A decrease to the age offsets implies the mortality experience of an individual at a certain age is consistent with mortality experience of a younger individual.
- ❖ **Investment Returns** – We determined the cost to the system if the annuity amount was calculated based on higher/lower investment returns than what actually occurs over time (investments pay less/more than assumed). For this sensitivity run we used a 7.0/8.0 percent investment return rather than the assumed 7.5 percent.
- ❖ **All Of The Above** – We determined the cost to the system if lower than assumed mortality experience occurred in combination with both 7.0/8.0 percent investment returns. The combination of these two sensitivity variations produces an interactive effect.

The table below shows the expected results compared to the three sensitivity runs outlined above. The example shows the financial impact of an average retired member, currently age 61, who purchases an annuity under this proposal with \$100,000. When multiple scenarios occur at once, the cost to the plan is different than the sum of each of the two scenarios individually due to interaction between the assumptions. Note that this analysis illustrates how the costs to the plan could change under the different assumption scenarios above.

Financial impacts to the plan could also arise if inflation is less than expected or retired members purchasing benefits under this proposal have a shorter life span than expected. Under both of these situations, savings would arise and LEOFF Plan 2 contribution rates would decrease accordingly.

<b>Sensitivity Example – 61-Year-Old Purchases Retirement Annuity with \$100,000</b>			
<b>Scenario</b>	<b>Cash Paid From Member to Plan</b>	<b>Present Value of Plan Annuity</b>	<b>Cost to the Plan</b>
1) Expected	\$100,000	\$100,000	\$0
2) Lower Mortality Than Expected (purchasers live longer)	\$100,000	\$105,884	\$5,884
3) Lower Asset Returns Than Expected	\$100,000	\$104,917	\$4,917
4) Higher Asset Returns Than Expected	\$100,000	\$95,508	(\$4,492)
5) Scenarios 2 and 3	\$100,000	\$111,489	\$11,489
6) Scenarios 2 and 4	\$100,000	\$100,789	\$789

*Note: Assumes annuity calculation based on 3% COLA and 90%/10% male/female mortality blend.*

Another consideration with actuarially equivalent purchases pertains to the concept of anti-selection. This is defined as a risk where members with above-average costs make a choice (in this case, to purchase an annuity) resulting in higher costs for the plan. For example, retired members in poor health may be less likely to annuitize their savings, while members in relatively good health may be more likely to do so. Under the provisions of current law, only active members at retirement may purchase an annuity of this kind. While the possibility of anti-selection still exists under current law, the likelihood of anti-selection may be greater under this proposal since prospective purchasers of an annuity would likely be older and perhaps in a better position to assess their expected future lifetime.

Since the assumptions used to develop administrative factors include life expectancy, the LEOFF Plan 2 Board could adopt administrative factors that include mortality assumptions to address expected anti-selection, and limit that risk to the plan.

The Board may also want to consider an alternate investment return. Current retirees purchasing an annuity under this proposal have a shorter time horizon than active members so an assumed investment return that matches this shorter time horizon may be more appropriate to maintain actuarial equivalence.

## **WHAT THE READER SHOULD KNOW**

The Office of the State Actuary (“we”) prepared this draft fiscal note based on our understanding of the proposal as of the date shown in the footer. We intend this draft fiscal note to be used by the LEOFF 2 Board during the 2015 Interim only.

We advise readers of this draft fiscal note to seek professional guidance as to its content and interpretation, and not to rely upon this communication without such guidance. Please read the analysis shown in this draft fiscal note as a whole. Distribution of, or reliance on, only parts of this draft fiscal note could result in its misuse, and may mislead others.

## ACTUARY'S CERTIFICATION

The undersigned hereby certifies that:

1. The actuarial cost methods are appropriate for the purposes of this pricing exercise.
2. The actuarial assumptions used are appropriate for the purposes of this pricing exercise.
3. The data on which this draft fiscal note is based are sufficient and reliable for the purposes of this pricing exercise.
4. Use of another set of methods and assumptions may also be reasonable, and might produce different results.
5. We prepared this draft fiscal note for the LEOFF 2 Board during the 2015 Interim.
6. We prepared this draft fiscal note and provided opinions in accordance with Washington State law and accepted actuarial standards of practice as of the date shown in the footer of this draft fiscal note.

The undersigned, with actuarial credentials, meets the Qualification Standards of the American Academy of Actuaries to render the actuarial opinions contained herein.

While this draft fiscal note is meant to be complete, the undersigned is available to provide extra advice and explanations as needed.



Lisa A. Won, ASA, FCA, MAAA  
Deputy State Actuary

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## GLOSSARY OF ACTUARIAL TERMS

**Actuarial Accrued Liability:** Computed differently under different funding methods, the actuarial accrued liability generally represents the portion of the present value of fully projected benefits attributable to service credit that has been earned (or accrued) as of the valuation date.

**Actuarial Present Value:** The value of an amount or series of amounts payable or receivable at various times, determined as of a given date by the application of a particular set of actuarial assumptions (i.e. interest rate, rate of salary increases, mortality, etc.).

**Aggregate Funding Method:** The Aggregate Funding Method is a standard actuarial funding method. The annual cost of benefits under the Aggregate Method is equal to the normal cost. Under this method, all plan costs (for past and future service credit) are included under the normal cost. Therefore, the method does not produce an unfunded actuarial accrued liability outside the normal cost. It is most common for the normal cost to be determined for the entire group rather than on an individual basis for this method.

**Entry Age Normal Cost Method (EANC):** The EANC method is a standard actuarial funding method. The annual cost of benefits under EANC is comprised of two components:

- ❖ Normal cost.
- ❖ Amortization of the unfunded actuarial accrued liability.

The normal cost is most commonly determined on an individual basis, from a member's age at plan entry, and is designed to be a level percentage of pay throughout a member's career.

**Normal Cost:** Computed differently under different funding methods, the normal cost generally represents the portion of the cost of projected benefits allocated to the current plan year.

**Projected Unit Credit (PUC) Liability:** The portion of the Actuarial Present Value of future benefits attributable to service credit that has been earned to date (past service) based on the PUC method.

**Projected Benefits:** Pension benefit amounts that are expected to be paid in the future taking into account such items as the effect of advancement in age as well as past and anticipated future compensation and service credits.

**Unfunded Actuarial Accrued Liability (UAAL):** The excess, if any, of the actuarial accrued liability over the actuarial value of assets. In other words, the present value of benefits earned to date that are not covered by plan assets.

**Unfunded PUC Liability:** The excess, if any, of the Present Value of Benefits calculated under the PUC cost method over the Valuation Assets. This is the portion of all benefits earned to date that are not covered by plan assets.



# Retiree Annuity Purchase

Final Proposal  
December 16, 2015

# Issue

**Current state law does not allow retirees to roll over tax deferred savings into LEOFF Plan 2 to purchase an annuity.**

# Final Proposal Summary

- **Draft Bill**

- Window for LEOFF Plan 2 retirees to purchase annuity: January 1 to June 30, 2016
- Available only to those retired prior to October 1, 2014
- Same terms as current law

- **Fiscal Note**

# Options

- 1. Recommend bill to Legislature**
- 2. Take no further action**

# Questions?

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