

## In Brief

### Issue

*Members of certain plans in the state's retirement systems currently have the option to purchase an expanded actuarially equivalent annuity benefit at retirement. Should an expanded annuity purchase option be extended to all members?*

### Member Impact

*Approximately 209,000 active PERS, SERS, PSERS, and WSPRS members in Plans 1, 2, and 3 do not have access to an additional annuity purchase option.*

*An annuity is a one-time, lump sum payment made by an employee in exchange for a guaranteed fixed monthly benefit payment for the rest of their life.*

Devon Nichols  
Policy Analyst  
(360) 786-6145  
devon.nichols@leg.wa.gov

# Annuity Purchase

## Issue

Members of certain plans in the state's retirement systems currently have the option to purchase an expanded actuarially equivalent annuity at retirement in order to supplement their normal retirement benefit.

The Washington State Patrol Troopers Association (WSPTA) has requested consideration of extending this expanded annuity purchase benefit to all members of the Washington State Patrol Retirement System (WSPRS) after legislation passed during the 2014 Legislative Session allowing members of the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF) Plan 2 to purchase an expanded annuity at retirement. The Select Committee on Pension Policy (SCPP) increased the scope of review to include all members of the state's retirement systems that do not currently have the option to purchase an expanded annuity benefit at retirement.

The following policy questions are currently before the SCPP:

- ❖ Are the existing annuity purchase options sufficient?
- ❖ Should an expanded annuity purchase option be extended to all members of the state's retirement systems?

## Background

### *What Is An Annuity?*

An annuity is a contract between an employee and the retirement plan where the employee makes an up-front lump sum payment in exchange for a set benefit payment for the rest of their lives.

Typically, annuities are discussed in relation to Defined Contribution (DC) accounts because outside of pensions, annuities are the only guaranteed, predictable income stream in retirement, regardless of investment performance. However, by purchasing an annuity with a DC account, a member is trading market risk and account growth for the guarantee of a steady stream of income for the remainder of their lives. While members will receive the security of a dependable monthly income, there is little to no flexibility with an annuity. If a member's living expenses fluctuate in

*There are currently multiple options to purchase various forms of annuities for certain members.*

retirement their annuity typically cannot adjust to meet changing needs.

This may be less of a concern for members of Washington's retirement systems because all plans contain a Defined Benefit (DB) component which guarantees a retirement benefit payment for life. If a DB member purchases an annuity they likely are doing so to supplement their pension and receive a higher guaranteed benefit payment for the rest of their lives.

There are options currently available to members of Washington's retirement systems as discussed below.

### ***Annuity Purchase On The Private Market***

All state retirement system members currently have the option of purchasing an annuity on the private market at the time of retirement. As discussed previously, purchasing an annuity allows members to increase their guaranteed monthly benefit for life. However, purchasing on the private market is more expensive than purchasing through the state. The cost of an annuity on the private market includes a built-in profit and typically a more expensive administrative fee.

For more discussion around the differences between private and public annuity purchase see the **Policy Analysis** section.

### ***Optional Plan 3 Member Annuity***

The hybrid Plan 3 benefit consists of a DB component and a DC component. Employer contributions are deposited into the employee's DB account while employee contributions are deposited into their DC account. All Plan 3 members currently have the option of purchasing an annuity with their DC account at the time of retirement. The amount of the annuity payment is calculated using many factors, including age and whether or not the member chooses to purchase a single life annuity, joint life annuity, or term certain annuity – each differing in how long the guaranteed benefit payment will be made.

Who provides the annuity for Plan 3 members varies based on whether the member chooses to self-direct their DC investments or to have the Washington State Investment Board (WSIB) invest their DC account in the Total Allocation Portfolio (TAP). With the former choice, ICMA-RC arranges annuity purchase through a private vendor and has distinctly different features and options than with the WSIB. The TAP is a diversified investment portfolio in Plan 3 that is designed for the long-term investor.

*All Plan 3 members have the option of purchasing an annuity with their DC account.*

According to the Department of Retirement Systems (DRS), approximately 10 percent of Plan 3 retirees took advantage of an annuity invested in the TAP during the last fiscal year.

### ***Optional Expanded Annuity Purchase***

Since the early nineties, all members of the Teachers' Retirement System (TRS) have the option of purchasing an expanded annuity to increase their monthly retirement benefit

Similar to TRS members, members of LEOFF Plan 2 have the option of purchasing an expanded annuity at the time of retirement. For more information regarding the LEOFF Plan 2 annuity purchase benefit see the **Legislative History** section.

This expanded annuity purchase option is the same benefit that was before the SCPP at the September 2014 meeting.

*All TRS and LEOFF Plan 2 members already have the option of purchasing an expanded annuity to supplement their DB benefit at the time of retirement.*

### ***Optional Service Credit Purchase Up To Five Years***

All members of the state's retirement systems have the option of purchasing up to an additional five years of service credit in order to increase their monthly retirement benefit for the rest of their lives. A member may only purchase additional "air time", as it is often called, at the time of retirement and cannot use the additional credit to qualify for retirement. Purchasing additional service credit is essentially purchasing an additional annuity but, in this case, with a limit of five years imposed.

However, the limitations of purchasing optional service credit are different than purchasing an expanded annuity. Service credit is subject to some return-to-work rules. Should a retiree that has purchased additional service credit return to work, their normal retirement benefit and additional service credit benefit will be suspended until they fully separate from employment.

In order to calculate how much a member must pay to purchase additional service credit, DRS uses an annuity factor that the Office of the State Actuary (OSA) calculates. This annuity factor is based on a member's age and plan. See **Example** below.

According to DRS, approximately 5 percent of retirees during the last fiscal year purchased additional service credit. Those who did purchase additional service, on average, purchased just over 51 months with an average cost of just under \$80,000.

*All members of the state's retirement systems have the option of purchasing additional service credit at the time of retirement. Currently approximately 5 percent of all retirees take advantage of the optional benefit.*

## Example

Becky is a 65-year-old Public Employees' Retirement System (PERS) Plan 2 member who has 22 years (264 months) of service credit. Her Average Final Compensation (AFC) is \$3,000 per month. She wants to purchase the full five years of additional service credit (60 months).

Estimated Monthly Retirement Benefit	
Normal Benefit Without Purchase of Service Credit	Benefit With Purchase of Five Years Additional Service Credit
\$1,320	\$1,620

To calculate the cost of purchasing additional service, Becky will divide the amount of the benefit increase (\$300) by an annuity factor for her age and plan (in this case, 0.0069798). This calculation results in a cost of \$42,981 for the purchase of five years of service credit.

The above illustration is taken from DRS's webpage and shows the possible cost of purchasing service credit. The annuity factor used is for illustrative purposes only. See the [Administrative Factors page](#) on DRS's website for more information. For more detail on the example above see the [Purchasing Additional Service Credit](#) page.

*A bill passed in 2014 allowing LEOFF Plan 2 members to purchase an additional annuity from the LEOFF Plan 2 trust fund.*

## Legislative History

During the 2014 Legislative Session, a bill passed allowing members of the LEOFF Plan 2 to make an optional one-time lump sum annuity purchase through the LEOFF Plan 2 trust fund. The purchase must be made by rolling over funds from an eligible governmental plan at a minimum purchase amount of \$25,000. The resulting expanded annuity is actuarially equivalent to the additional amount contributed by the retiree.

If the retiree dies before the total monthly payments equal or exceed the purchase price of the annuity, the balance of the purchase price will be refunded to the selected beneficiary.

The annuity will also include: 1) an annual Cost-Of-Living-Adjustment (COLA), calculated the same as the COLA for LEOFF Plan 2 retirement benefits; and 2) the same survivor option as the retiree has chosen for his or her LEOFF Plan 2 retirement benefit.

Under this new law, retirees that choose this optional expanded annuity purchase may rescind or alter the contract within 15 days of DRS receiving the contract.

*The issue raises the key policy question of whether the current annuity options available to members are sufficient.*

## Policy Analysis

This issue raises the following key policy questions:

- ❖ Are the existing annuity purchase options sufficient?
- ❖ Should an expanded annuity purchase option be extended to all members of the state's retirement systems?

In responding to this issue, policy makers may wish to consider whether or not existing annuity purchase options are sufficient for members of the state's retirement systems. Additionally, policy makers may consider the value of the optional benefit to members, benefit consistency, expected costs, and potential risks to the system and member.

### ***Annuities Increase A Retiree's Income For Life, May Be Cost Prohibitive For Some***

*Optional annuities are a valuable benefit to members who can afford to purchase them. However, it may be cost prohibitive for many.*

A member who chooses to purchase an optional annuity at the time of retirement will increase their retirement benefit payment for the remainder of their life; or a survivor's life should they choose to purchase a survivor option. If a member has the means to purchase an expanded annuity, it could be a valuable benefit to them in retirement.

As mentioned above, there are existing options which all members of the state's retirement systems currently have access to. All members of the state's retirement systems have the option of purchasing up to five years of additional service credit as a means to increase their retirement benefit for the rest of their lives. However, with this option, a member is limited to the size of the annuity purchase.

Without an option to purchase an expanded annuity through the state, a member who takes advantage of the state's Deferred Compensation Program must either purchase an annuity on the private market or take a lump sum payment.

As shown in the table below, a LEOFF 2 member purchasing an annuity through the state will likely save a sizeable amount of money when compared to purchasing on the private market.

However, only a limited number of retirees are currently taking advantage of this optional benefit and purchasing additional service credit.

	Interest Rate	Cost of Annuity To Member
Private Insurer	4.0%	\$236,000
DRS	7.5%	\$157,000

*Based on a LEOFF Plan 2 member aged 56, buying a \$10,000 life annuity, including a 3% COLA.*

*Used for illustrative purposes only.*

*Source: House Bill 2577 (2014) Actuarial Fiscal Note.*

*The only mechanism available to members who can afford to purchase above the existing five year limit is in the private market, which is more expensive than the state.*

It is possible that employees will find the cost of purchasing an expanded annuity cost prohibitive. Whereas some may be able to take advantage of the existing options – purchasing up to an additional five years of service credit – it is possible that members may not be able to purchase more than what is already offered. In that case, it is possible members who would take advantage of an expanded annuity purchase option would likely be higher-paid employees.

A policy maker may wish to extend the option for all members of the state's retirement systems to purchase an expanded annuity if they feel there is a demand for expanded annuity purchases above what is already offered to all members. However, if a policy maker feels the current options available are sufficient or being underutilized, they may wish to not extend the expanded annuity purchase option at all.

Policy makers will likely wish to weigh the benefits of extending an optional annuity purchase to all or some members of the state's retirement systems against the existing benefit options and the potential risks to the system.

### ***Allowing All Members To Purchase An Optional Expanded Annuity Would Create Benefit Consistency***

Over 90 percent of active members do not currently have an option of purchasing an expanded annuity through the state. TRS members gained the ability to purchase an expanded annuity in the early nineties, likely due to teacher shortages and the need to recruit out-of-state teachers. LEOFF Plan 2 members were granted the option of purchasing an additional annuity during the 2014 Legislative Session as a means to take advantage of the WSIB investment performance and lower administrative fees.

If a policy maker is primarily concerned with benefit consistency, they may wish to extend the optional annuity

purchase benefit to all members of the state's retirement systems. However, some policy makers may wish to only extend the optional benefit to systems that have similar career paths and requirements of the systems that currently have access to an optional additional annuity for recruitment and retention purposes.

*The cost of an actuarially equivalent purchase of annuity is expected to be borne by the purchaser.*

### ***There Are No Expected Costs If All Assumptions Are Realized***

Currently, most annuity purchase options are priced on an actuarial equivalence. In other words, the cost of the annuity purchase is calculated so that the member bears all the expected cost. However, if the expectations are not realized, the purchase payment made by the member may be more or less than the actual value of the annuity, resulting in a gain or loss to the system.

When a member elects to purchase an optional annuity at the time of retirement, DRS calculates the cost using an administrative factor that is calculated by OSA. This administrative factor is one of many that are updated periodically to account for updated assumptions and gains or losses to the system.

When a member purchases an annuity at retirement, DRS calculates their payment using annuity factors which incorporate assumptions about the future. There are three primary assumptions that impact the cost calculation:

- ❖ Expected rate of investment return.
- ❖ Expected rate of mortality.
- ❖ Expected rate of inflation.

These demographic and economic actuarial assumptions are updated periodically. However, as with any actuarial calculation that involves estimating future events, actual experience may differ from the underlying assumptions made. In instances where this happens the entire system will experience an actuarial gain or loss. When this happens, any impacts from potential gains or losses are borne by employers and members, not the annuity purchaser.

*If actual experience differs from the actuarial assumptions that went into pricing the cost of a member's annuity, there will be an impact to the system.*

If, for example, members who purchase annuities, on average, live longer than assumed, the system will experience a loss in the future. However, if actual investment returns are greater than assumed at the time of the annuity purchase, the system will experience a gain.

## ***Risks To The System Could Emerge Over Time***

As mentioned above, there is a possibility that experience over time may not align with the assumptions made at the time a member purchases their annuity.

*Costs to the system can arise if members live longer than expected or investment returns aren't as high as expected.*

Costs to the system can arise if members who elect to purchase an annuity at the time of retirement live longer than expected. For example, mortality assumptions are updated every six years in the Demographic Experience Study, conducted by OSA. During the most recent update, the mortality assumption was updated to reflect a sizable increase in life expectancy. Because the mortality assumption is only updated every six years, some members who purchased an annuity in recent years may have paid less than the expected value under the updated assumptions.

*Anti-selection can also impact system costs.*

There may also be a risk 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, members in poor health may be less likely to annuitize their savings, while members in relatively good health may be more inclined to do so.

In addition, if long-term investment returns are lower than assumed, there would also be a cost to the system.

For both of the assumptions mentioned above, any potential gains or losses to the system would not be known for decades — until DRS has made all payments under the annuity contract.

*If actual inflation is less than assumed, the member bears the cost.*

In contrast, if the actual inflation over a member's lifetime is lower than expected, they may end up paying more than required to fully fund their annuity. However, the guarantee of a fixed benefit payment for the rest of their life may outweigh the potential for slightly overpaying.

A policy maker may wish to leave the existing annuity options unaltered if the potential risks to the system outweigh the potential benefit of extending the additional annuity option. Additionally, if policy makers feel that the existing options available to members of all retirement system are sufficient, they may wish to make no changes at this time.

## ***There Are Potential Ways To Manage The Risk Of Annuity Purchases***

At this time, potential ways to manage risk have not been analyzed and are, therefore, not included in the discussion of this paper. However, there may be further opportunity should

*Direction from the SCPP will likely inform any future discussions around ways to manage potential risks.*

*Policy makers will likely wish to weigh the benefits of extending an optional annuity purchase to all or some members of the state's retirement systems against the existing benefit options and potential risks.*

the SCPP wish to continue the study of extending an expanded annuity purchase option to all or some members of the state's retirement system.

For example, the committee may wish to discuss the implications of using a different set of assumptions to manage specific risks of annuity purchase.

## Conclusion

Currently, all members of the state's retirement system have access to some type of annuity purchase option at the time of retirement as a means to increase their fixed monthly benefit payment for life. All members have the option of purchasing up to an additional five years of service credit and Plan 3 members may also purchase an annuity with their DC account. Only TRS members and LEOFF Plan 2 members have the option of purchasing an expanded annuity at the time of retirement.

The different options available to members vary in their limitations and some may be perceived as being better than others.

In responding to this issue, policy makers may wish to consider the value of the optional benefit to members, benefit consistency, expected costs, and potential risks to the system and member.

Policy makers will likely wish to weigh the benefits of extending an optional annuity purchase to all or some members of the state's retirement systems against the existing benefit options and the potential risks to the system.

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