Osborn, Carreiro & Associates, Inc.

ACTUARIES ● CONSULTANTS ● ANALYSTS

One Union National Plaza, Suite 1690
124 West Capitol Avenue
Little Rock, Arkansas 72201
(501)376-8043 fax (501)376-7847

House Bill 1204

Actuarial Cost Study prepared for
Joint Committee on Public Retirement and Social Security Programs
of the Arkansas 90th General Assembly

Provisions of the Bill

House Bill 1204 affects the Local Police and Fire Retirement System (LOPFI).

LOPFI has a Deferred Retirement Option Plan (DROP). Upon election of deferred retirement, a participant's benefit accruals are frozen, and seventy-five percent of the monthly benefit he or she would have received is instead credited to a DROP account; this account balance earns 6% annually; then this account balance is distributable to the participant upon termination of employment, as a qualified rollover, cash lump sum, monthly annuity, or a combination of these options. The maximum participation period for DROP is seven years. The account balance may not be left on account with LOPFI upon termination of employment.

House Bill 1204 would allow employees to defer the withdrawal of all or part of their DROP accounts upon termination of employment. Instead of the 6% annual interest credit granted to DROP account balances during the DROP period, participants who leave their balances on account would be credited interest at a rate of 2% less than the plan's annual investment return, with a floor of 0%. In order to comply with minimum required distribution regulations, the account balance is required to be annuitized or distributed by December 31 of the year a member reaches age seventy-and-one-half.

Fiscal Impact

The fiscal impact to LOPFI would depend on the variance of the LOPFI investment returns. In particular, the impact to LOPFI is the value to participants of the 0% interest rate floor less the offsetting experience gains. LOPFI would have experience gains during years in which investment returns are positive; otherwise, there would be experience losses. The valuation of this option is not straightforward—however, we can get an idea of the value by analyzing LOPFI's historical returns.

For example, assume that ten (10) years ago DROP balances left on account totaled $1,000,000. LOPFI's annualized return over the period (1/1/05 to 12/31/14) was approximately 5.81%; the $1 million would have accumulated to approximately $1.76 million. However, the annualized return owed to DROP accounts resulting from the protection afforded by House Bill 1204 would have been approximately 7.45%; the DROP liabilities would have accumulated to approximately $2.05 million—the $290,000 difference would have been a cost borne by LOPFI.

There are also scenarios in which the provision could end up reducing LOPFI costs—in particular during periods of sustained positive investment results. If we looked at just the last 5 years, the provision would have been a net benefit to LOPFI (as the earnings retained by the 2% interest differential would have outweighed the protection provided by the 0% floor).

As of December 31, 2013, LOPFI reported DROP accounts totaling $33 million; as LOPFI is a relatively young system, we would expect this number to increase in the coming years as more participants become eligible for DROP. If House Bill 1204 were to become law, we would expect the total DROP accounts to increase even more significantly due to participants electing to leave their balances on account with LOPFI.

There can be other long term effects to consider. If more bells and whistles are added to the DROP plan, it can become attractive enough to change the retirement pattern of the system as a whole. If participants begin to elect DROP earlier than assumed, the cost of the system would increase.

Other

The interest crediting method in House Bill 1204 is different from the set 6% paid during the DROP period. The change in interest crediting methods at the end of the seven year period would likely be difficult for the participants to understand and would increase administrative work.

Current law does not preclude a DROP participant from making a transfer to an IRA or other tax deferred vehicle for future distribution. House Bill 1204 would ask LOPFI to become another tax deferred option. In fact, the LOPFI option would share in the management and returns of the LOPFI system, without sharing in the losses. The closed, Local Plans has provisions similar to those found in House Bill 1204 and they have been used by many participants. Total DROP balances in several Local Plans became substantial enough that the asset allocation strategy was altered, and the member focus often shifted from the primary benefit of the plan to DROP balances.

There are references in House Bill 1204 to participating in the plan. Although participation is not a defined term in this subchapter, it appears to denote participation in the DROP plan which has a maximum duration of seven years.

The IRS has issued commentary and issued and withdrawn various regulations concerning DROP since 2009. Although the regulatory environment continues to develop, we can discern the IRS viewpoint. DROP balances are not individual accounts that are segregated from plan assets, that is, they remain a part of plan assets until distribution. The preferred or suggested interest crediting method is a flat interest rate or a rate tied to an index (typically government bonds). These concepts deal with keeping the DROP a definable benefit addition to a defined benefit plan for the purpose of Internal Revenue Code 415 limits.

The previous discussion serves to point out two concerns that we have. First, we would prefer references to individual accounts to be modified to reference account balances or individual account balances. It is a small change, but could prove helpful if ever reviewed by the IRS. Second, the interest crediting method meets the IRS definition used in recent communications, but it is not one of the illustrated methods.

Sincerely,

Jody Carreiro

Jody Carreiro, EA, ASA, MAAA
Actuary