Annuitization of DROP balances in accordance with HB 3158

October 12, 2017

DALLAS
POLICE & FIRE
PENSION SYSTEM

HB 3158 Requirement

- The bill requires that all DROP accounts be annuitized over the account holder’s remaining expected life at a rate based upon a Treasury rate or other federal rate.

- The bill specifically tasks the Board with making the rules regarding this annuitization process.

- The bill provides that the annuity for current DROP members should start “as promptly as administratively feasible...” (6.14(e)).

Considerations

The following are specific issues the Board needs to address in order for staff to finalize a DROP Policy.

1. Monthly/Annual Election
2. Interest Rate
3. Interest for the period from September 1 to Annuitization Commencement
4. Mortality Table
5. Payments to Beneficiaries and Alternate Payees
6. Revised Annuity Upon Hardship Payment
7. De minimis Payment

Monthly/Annual Election

- The bill requires giving DROP holders the option of receiving their DROP annuity monthly or annually. Staff is recommending that the initial default election be monthly for the first payment but that notice be given that DROP holders may change that election to annual within 60 days of the date of the first payment.

- As there is no tax benefit in taking the annuity annually versus monthly and because staff believes that most DROP holders will want and elect monthly annuities, staff believes the monthly annuity default election is appropriate.

- Payments are made at the end period selected.

Interest Rate

- The bill requires the interest rate used for the annuitization be "…a rate as reasonably equivalent as practicable to the interest rate on a note issued by the Unites States Department of the Treasury or other federal treasury note with a duration that is reasonably comparable to the annuitization period applied to the account, as determined by the board." (6.14(e-2).

- Staff is recommending the interest rate be based upon the United State Department of Commerce Daily Treasury Yield Curve Rates. These relevant rates are available for 5,7,10,20 and 30 year US Treasury securities. All other years between 5 and 30 years would be calculated using a "straight-line interpolation" of these data points.

Interest Rate - continued

- For a life expectancy that occurs between the years for which rates are established, the rates are linearly interpolated.

- For example, if the 10-year rate is 2.20% and the 20-year rate is 2.60%. There is a difference of 40 basis points over the 10-year period, therefore with each year the rate increases by 4 basis points, i.e., 2.20%, 2.24%, 2.28%, etc.

Interest Rate - continued

- Rates would be set the first business day of each quarter (January, April, July and October) and would be based upon the average of the rates on the 15th day of the preceding three months (or the next day rates are published if the 15th day of any month is a date when rates are not published). The average rate is rounded to two decimals.

Published Rate	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
7/17/2017	1.86	2.12	2.31	2.65	2.89
8/15/2017	1.83	2.09	2.27	2.60	2.84
9/15/2017	1.81	2.04	2.20	2.52	2.77
Average	1.83	2.08	2.26	2.59	2.83

Interest Rate - continued

- US Treasury securities do not have maturities beyond 30 years therefore there are no US Treasury rates past 30 years. Segal and staff are recommending that the 30-year rate be used as the rate in annuitizing any DROP member's balance with a life expectancy of 30 years or longer.

Interest Rate - continued

- In determining the monthly annuity payment, the interest rate that is used is the annual interest rate divided by 12.
- The number of months of the annuity term are determined by multiplying the number of years of life expectancy, rounded to the nearest whole number, by 12.
- Interest on the DROP balance as of 9-1-17 is calculated for the period beginning on the last day of the month the member leaves active service and ends based on the applicable mortality table.

Interest for the period of 9/1/17 to Annuitization Commencement

- The bill provides that the annuity for current DROP members should start "as promptly as administratively feasible..." (6.14(e)).
- The bill also provides that the annuitization of a DROP account "…must reflect the accrual of interest on the amount in the DROP account as of September 1, 2017, over the annuitization period applied to the account under this section (6.14(e-2))."
- It is not clear from the bill if DROP accounts should be bear interest between September 1, 2017 and the date the DROP annuitization commences. Therefore, the Board has the right and duty to interpret the Plan and make a determination.

Interest for the period of 9/1/17 to Annuitization Commencement

- Staff is recommending that all DROP balances, except those of any member on Active Service, bear interest from September 1 to the date the DROP annuitization commences, taking into account their retirement date and any distributions out of DROP during such period. The interest credited would be at the interest rates used for the initial annuitization of these DROP balances.

Mortality Table

- Segal's Recommendation: The mortality table used is the same as the healthy annuitant tables as those used in the 1-1-2017 actuarial valuation, with the exception that for DROP Annuitization and the Joint & Survivor calculation the table is blended 85% male and 15% female.

- The table used in the annuitization is based on the RP-2014 Blue Collar Healthy Annuitant Mortality table, set forward two years for females, and projected generationally using Scale MP-2015.

Mortality Table - continued

- Staff is further recommending that the mortality table be reviewed upon the earlier of (i) the occurrence of any actuarial experience study or (ii) any change in mortality assumptions used in the annual actuarial valuation.

- For purposes of the annuitization, fractional ages which are equal to or greater than 0.5 years will be rounded up, fractional ages less than 0.5 years will be rounded down.

Payments to Beneficiaries and Alternate Payees

- If a holder of a DROP annuity should die prior to the end of the annuitization period, staff is recommending that the holder's designated beneficiary(ies) will continue to receive the same annuity for the period that remained for the deceased DROP annuitant.
- For spouses who through a divorce receive a portion of a DROP annuity that has commenced, staff is recommending that the annuity will be split as provided in the Qualified Domestic Relations Order.
- For spouses who through a divorce receive a portion of a DROP account while the member is still in Active Service, staff is recommending that the DROP annuity for the alternate payee (non-member spouse) not commence until the earlier of (i) the date the member's DROP annuity commences or (ii) the date the alternate payee reaches age 58. The annuity will be based the age of the alternate payee.

Revised Annuity Upon Hardship Payment

- Staff is recommending that upon any DROP hardship payment, the annuity of the DROP holder receiving the payment will be revised.

- The new annuity will be based upon the present value of the remaining annuity at the date of the hardship payment.

- The remaining term for such annuity will be used in calculating the revised annuity payment. The original interest rate will be used in calculating the revised annuity payment.

De minimis Payment

- Section 6.14(f)(2) allows the Board to adopt rules and policies regarding the annuitization of DROP accounts which are "…in the best interest of the pension system."

- Because of the administrative requirements that small amounts will create in the future when the DROP annuitants either pass away or beneficiaries are not able to be located, staff is recommending that accounts less than a certain dollar threshold be paid in total to DROP account holders.

- The de minimis payment will only apply at the time of the initial annuitization and not subsequent annuity revisions or beneficiary events, however this can be revisited by the Board at a later date.

De minimis Payment

- The chart below contains information about smaller retiree, beneficiary and alternate payee DROP balances:

Balances less than or equal to:	# of Accounts	% of Accounts	Total Dollars
$5,000	87	4.2%	$163,276
$10,000	136	6.5%	$521,236
$20,000	218	10.5%	$1,716,233
$30,000	285	13.7%	$3,379,174
$50,000	386	18.5%	$7,372,492

- Staff's recommendation is that the Board set the de minimis amount at $20,000. This amount will eliminate more than 10% of the accounts from being annuitized and managed for potentially 20 to 30 years. The dollar impact to the fund is approximately $1.7 million lump sum payment.

Next Steps

- Staff will develop a DROP Policy based on the direction received from the Board.

- If the policy is approved on November 1st at the Special Board meeting, the goal would be to stop the payments of the Minimum Annual Distribution as of October 31st and commence the annuitization payments on November 30th.

- If the policy is approved at the November Regular Board meeting, the goal would be to stop the payments of the Minimum Annual Distribution as of November 30th and commence the annuitization payments on December 29th.

DROP Election Revocation (Undo) in accordance with HB 3158

October 12, 2017

DALLAS POLICE & FIRE PENSION SYSTEM

Deferred Retirement Option Plan (DROP)

- A member may enter DROP when they are eligible to retire.
- When a member enters DROP they are choosing to set their benefit based on their average computation pay, their service time, and the multiplier applicable at the time they enter DROP.
- The benefit payments they would have received if they had retired at their DROP entry date are credited to a nominal account on their behalf while they are in active service.
- In addition, while in DROP, the member receives the same Annual Adjustment (COLA) and Benefit Supplement as if they had retired.
- When a member enters DROP, the decision is irrevocable.
  - However, in addition to this opportunity to revoke or “Undo”, there have been two other opportunities to Undo prior DROP elections as part of the Plan Amendment elections in 2011 and 2014.

HB 3158 Requirements

- The Bill provides that members who joined DROP prior to June 1, 2017 may revoke the DROP election prior to February 28, 2018 (6.14(j)(l)).
  - The Revocation only applies to members still in active service.

- A revocation is not permitted if money has been transferred out of the member's DROP account for any reason(6.14(o)).
  - Transfers may have been done to the City's 401(k) Plan or as result of a Qualified Domestic Relations Order in a divorce.

DROP Revocation

- The concept behind the revocation is to restore both parties (the member and DPFP) back to the position they would have been in had the member never entered DROP.

- The revocation is a full revocation, the member is put fully back to active service and the member continues to accrue service credit with no time in DROP.

- The member's DROP balance is eliminated. (6.14(m)(1)).

- The member's benefit will be set at the time they either reenter DROP or retire, whichever occurs first.
  - After a revocation, the member may choose to reenter DROP at any time in the future. It is likely that many members will complete an Undo and reenter DROP immediately.

Member’s Benefit Upon Revocation

- There are three parts to the member’s benefit calculation:
  - Average computation pay
  - Multiplier
  - Amount of service (time)

- With the Undo, the average computation pay and the multiplier are automatically revised to reflect the member’s average compensation, and age at the time the benefit is set again in the future.

- To receive credit for the additional service (time) the member had while in DROP, the member must pay any contributions which were not paid during their time in DROP.

Simplified Example

- Member entered DROP at age 48, with 24 years of service, and their average computation pay was $85,000 at the time of DROP entry. They have now been in DROP for 4 years.
  - Benefit: $85,000 x 24 yrs x 2.75% multiplier = $56,100 annually

- The member chooses to revoke their DROP election and re-enters DROP immediately. The member has received a 2% raise for each of the last 4 years. Average computation pay is now $92,007. (simplified calculation for illustration, assumes the Undo occurs on 9/1/17)
  - New Benefit: $92,007 x 24 yrs x 3.00% multiplier = $66,245 annually

- Same as above except the member pays the contributions they would have paid if they had not been in DROP and effectively "buys" the service credit for the period they were in DROP.
  - Benefit: $92,007 x 28 year x 3.00% multiplier = $77,286 annually

Revocation Considerations

To facilitate the preparation of the DROP revocation section of the draft DROP Policy, Board direction is requested on the following:

1. Service purchase: "all or a portion of"
2. Calculation of contributions due on a service purchase
    a. Unpaid contributions
    b. Interest
    c. Methodology for determining the cost to purchase a portion of service
3. Contribution payments: sources
4. Contribution payments: partial payments & timing
5. Revocation approval
6. Revocation effective date

HB 3158: Service Credit Purchase

- “The member shall receive pension service credited for <u>all or a portion</u> of the period of the revoked DROP participation on payment of the required contributions for the period of the revoked DROP participation in accordance with a uniform and nondiscriminatory procedure adopted by the board that results in the payment of the amount of member contributions that would have been made if the member had never participated in DROP.“ (6.14(m)(2))

Service Purchase: “all or a portion of”

- During prior DROP Undo opportunities, the member was required to pay for all or none of the contributions for the service period they were in DROP.

- HB 3158 provides that members may pay for <u>all or a portion of</u> the past service resulting from a DROP revocation.

- Due to the number of members interested in considering the DROP Undo, the number of possible scenarios for each member, and the complexity of the analysis for each member, staff is recommending members be allowed to buy either half or all of the past service, but no other percentage.

- Setting the portion to half would allow each member to buy all, half, or none of the service time they were in DROP. The member may buy the first half at one point and be allowed to buy the other half at any point prior to setting their benefit.

Calculation of Contributions due on a Service Purchase

Unpaid contributions

- Contributions due will be based on the actual salary records for the member from the City for the time the member was in DROP.
- The contribution percentage due will be the difference between the percentage the member contributed for the period in DROP and the percentage the member would have contributed had they not been in DROP.

Contribution Rate History	Active Members	Active Members in DROP
1-1-1993 to 9-30-2011	8.5%	0.0%
10-1-2011 to 9-30-2012	8.5%	3.0%
10-1-2012 to 9-30-2013	8.5%	6.0%
10-1-2013 to 12-31-2014	8.5%	8.5%
1-1-2015 to 8-31-17	8.5%	4.0%

Calculation of Contributions due on a Service Purchase

Interest

- In prior Undo opportunities, a member was not required to pay interest on the contributions to buy service. Prior Undo opportunities had less of a benefit to members so few exercised the option.
- Currently, for members who make contribution payments for past service such as those who had a portion of their contributions paid to a divorcing spouse, such repayments bear interest at the actuarial assumed rate of return applicable to the period of time that relates to such repayments.
- The Board must determine whether contribution payments to purchase service will bear interest.

Calculation of Contributions due on a Service Purchase

Interest

- One option is that interest be charged for the period of time associated with the service until paid by the member.
- Another option is to charge interest from the time of the effective date of the revocation (or 2-28-18) until the contributions are paid.
- Possible interest rates:
  - The actuarial assumed rate of return for the Plan, 8.5% until 1-1-2015 and then 7.25% beginning 1-1-2015.
  - Some other rate.
  - It is not recommended that the *actual* Plan return be used due to significant valuation adjustments which were made in 2013-2015 related to prior years. Also, using the actual return is complex because active members' time in DROP ranges from 4 months to > 24 years. The benefit structure in the Plan was based on achieving the assumed rate of return, not the actual return.

Calculation of Contributions due on a Service Purchase

Determination of the cost to purchase a portion of service

- If a portion of the service is purchased by the member, the cost of that purchase could be significantly different depending on what portion of service time is being purchased.
- The goal of the member and DPFP are likely not aligned in determining what portion of service is purchased. The following are different for different service periods:
  - The member's computation pay
  - The contribution rate already contributed by the member
  - The impact of interest if the Board assesses interest
- Staff recommends that the total cost for the member to buy DROP service be determined, including the interest component if the Board determines that is appropriate, and then an equal dollar amount be applied to each portion of the service, rather then identify costs related to specific portions of service.

Contribution Payments: sources

- Staff is recommending that, to the extent permitted by law, members be allowed to transfer funds from any tax-deferred account to the extent permitted by the Internal Revenue Code rules and regulations to pay for past contributions, in addition to payments of cash.

Contribution Payments: partial payments & timing

- In prior Undo opportunities, a member was not required to pay the contributions associated with the Undo until the time of re-entering DROP or retirement. The member could make minimum payments of $500 towards their required contributions if they chose to do so. If the total amount was not paid in full prior to resetting their benefit, any amount paid was refunded with no interest and no additional service was credited. No interest was charged on the contributions due.
- Staff recommends that if past contributions bear interest, the member be allowed to make partial payments at a determined minimum amount at any time prior to reentering DROP or retiring. If past contributions do not bear interest, the ability to make partial payments and the timing of the payments should be limited.

Revocation Approval

- In prior Undo opportunities, the Board approved the member revocations on the consent agenda. However, staff is recommending that Board approval not be required.

Revocation Effective Date

- The Bill requires an end date for the revocation opportunity of February 27, 2018
  - If Board approval is not required for the revocation, the election should be effective upon receipt by DPFP of a revocation form which is in proper order as determined by DPFP.
  - If Board approval is required for the DROP revocation, the final date to make a revocation will need to be determined to meet the deadline mandated by the bill.

Next Steps

- Staff will develop a draft DROP Policy based on the direction received from the Board.

- The DROP revocation process will begin immediately upon Board approval of the DROP Policy.

Hardship Distributions in accordance with HB 3158

October 12, 2017

DALLAS POLICE & FIRE PENSION SYSTEM

HB 3158: Hardship Provisions

- HB 3158 allows that in the event of a financial hardship that was not reasonably foreseeable, a lump-sum distribution can be made to the DROP account holder.
- HB 3158 states that if a lump sum distribution is made, a corresponding reduction will be made in the total number or in the amount of annuity payments.
- HB 3158 requires that the Board adopt rules necessary to implement the hardship provisions, including what constitutes a financial hardship that was not reasonably foreseeable. In adopting the rules, the Board shall provide flexibility to members.
- A hardship distribution is not available to a member in active service.

Hardship Considerations

- Circumstances eligible for hardship distribution
- Hardship administration
- Flexibility
- Revised annuity upon hardship distribution

Circumstances eligible for hardship distribution: <u>current policy</u>

The Board adopted a policy for hardship distributions (DROP Unforeseeable Emergency Policy) in January 2017. The Policy is similar to the IRS rules for 457 plans.

To qualify for a hardship distribution from DROP, a holder of a DROP account must currently demonstrate that:

- a severe financial hardship exists at the time of the application (i.e., not one that may occur sometime in the future);
- the hardship cannot be relieved through any other financial means (i.e., compensation from insurance or other sources, monthly annuity benefits, or liquidation of personal assets) unless using those other sources would also cause a severe financial hardship; and
- the amount requested in the application is reasonably related to and no greater than necessary to relieve the financial emergency

Circumstances eligible for hardship distribution: current policy

Like the IRS rules for 457 plans, the following circumstances are currently eligible for a hardship distribution:

- the need to repair damage to the primary residence not covered by insurance as the result of a natural disaster (i.e., flood, etc.);
- the need to make significant changes to the principal residence not covered by insurance because of medical necessity;
- the imminent foreclosure or eviction from a primary residence;
- the need to pay for medical expenses of the DROP account holder, a DROP account holder's spouse or a dependent child or relative as described under IRC section 152(c) and (d), including non-refundable deductibles, as well as for the cost of prescription drug medication;
- expenses related to an automobile accident involving a DROP account holder not covered by insurance; and
- the need to pay for the funeral expenses of a spouse or a dependent child or relative as described under IRC section 152(c) and (d)

Circumstances eligible for hardship distribution: consideration of eligible circumstances

Our experience since January has included requests in the following categories that were not deemed to be within the Policy:

- Home related: replace hot water heaters, air conditioners, furnaces, deferred maintenance repairs including roofs, doors and windows. New primary residence construction contract. Additional primary residence replacement costs.
- Debts: credit cards and other loans
- Taxes: income and property taxes, penalties & interest
- Tuition: college, private school K-12
- Transportation: car replacement and repairs, airfare
- Medical: transportation and hotel for the patient and others, medical costs of non-qualifying people, elective surgery
- Funeral: funeral for non-qualifying people, travel and hotel for other non-dependent family
- Legal: attorney costs and child support

Eligible circumstances: suggested expansion

Tuition

- Postsecondary education below the graduate level.
- Education for the account holder, spouse or child who is, or was, a dependent of the member or member's spouse.
- An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.
- Amount is limited to the FASFA determined Expected Contribution Amount (ECA). The ECA is provided on the Student Aid Report after completing a FASFA application.

Eligible circumstances: suggested expansion

Funeral expenses

- Clarify and broaden the rules to allow funeral expenses for a parent, child or a grandchild regardless of dependency.

- Include travel and reasonable hotel costs for the account holder, spouse, parents, child or grandchild to attend the funeral of account holder, spouse, parent, child or grandchild. Dependency is not a requirement.

Hardship administration: current administration

- A notarized application is required to apply for a hardship distribution.
- Documentation is required to be submitted to support the request – types of documentation include medical/dental explanations of benefits, property insurance claim documentation, repair bills, funeral bills, etc.
- The applicant attests that they do not have sufficient assets available or any other financial means to otherwise pay for the expenses detailed in the request.
- The applicant also attests that the distribution will be used to pay the expenses detailed or obligations resulting from a prior payment of the expenses detailed in the request.
- Applicant may submit a request every 90 days.

Hardship administration: considerations

- Documentation is received to understand/quantify the circumstances that lead to the hardship.

- Staff is relying on the applicant's attestation that the hardship can not be relieved through any other means. Staff is not reviewing financial information to determine if they have the ability to pay.

- Unless specifically noted, beneficiaries other than spouse would not be eligible to receive a hardship distribution.

- Staff requests Board direction on whether proof of financial need is required.

Flexibility

HB 3158 states “In adopting the rules, the Board shall provide flexibility to members.”

The Bill does not specify the nature or extent of flexibility, therefore the Board must determine if the rules provide flexibility to the members.

Revised annuity after a hardship distribution

- Staff is recommending that upon any hardship payment, the annuity of the DROP holder receiving the payment will be revised.

- The new annuity will be based upon the present value of the remaining annuity at the date of the hardship payment.

- The remaining term for such annuity will be used in calculating the revised annuity payment. The original interest rate will be used in calculating the revised annuity payment.

Next steps

- Staff will develop a draft DROP Policy based on the direction received from the Board.

- The DROP hardship process will be revised immediately upon Board approval of the revised Policy.