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STATE OF WISCONSIN
DEPARTMENT OF EMPLOYEE TRUST FUNDS
801 West Badger Road
Madison, WI 53702

CORRESPONDENCE MEMORANDUM

DATE: May 23, 2003

TO: Employee Trust Funds Board
Teachers Retirement Board
Wisconsin Retirement Board

FROM: Julie Reneau, Administrator
Division of Retirement Services

SUBJECT: **Discussion of Administrative Rule to Establish Dividend Distribution Date under Wis. Admin. Code § ETF 20.25 (1) (a) and (2)**

In March 2003, the Employee Trust Funds Board, Wisconsin Retirement Board and the Teachers Retirement Board each passed a scope statement that would allow the Department of Employee Trust Funds to begin considering changes to the permanent rule under Wis. Admin. Code § ETF 20.25 (1) (a) and (2) that distributes annuitant dividends on March 1 (reflected in the April 1 annuity payment).

At the March meeting there was interest in further discussion before determining if a permanent rule change was warranted. In this memo, staff is providing information on possible options to consider, along with a recommendation for rule change. However, since it is important for all Boards to agree on a consistent approach before we proceed with the final rule process, we will have a discussion of this possible rule change at the Joint Informational Meeting of the Boards.

Staff is recommending that the Boards seriously consider two options. While we have included a draft of a potential rule in the agenda packets for possible action on one of those options, it does not require action if the Boards agree on another alternative. Since rules take months to promulgate, we wanted to be prepared to move forward if there was consensus among the various Boards to choose this option. No rule change would be needed if the Board chooses the other option.

History

In 2002 the rule was amended to change the annuitant dividend distribution date from April 1 (May 1 payment) to March 1 (April 1 payment). Annuitant groups had long requested that dividends be distributed as early as possible in a given year, and the purpose of the amendment was to get annual dividends to the annuitants one month sooner.

On October 1, 2002, the rule became effective to allow distribution of dividends to occur on March 1.

On February 24, 2003, the Boards each approved an emergency rule changing the date for 2002 dividend distributions (payable in 2003) back to April 1 (May 1 payment) from the permanent rule date of March 1. This change was made to avoid short-term harm that annuitants who were in the variable trust would have suffered by advancing the date. The variable adjustment for 2002 (applied on May 1, 2003) was –27%. This emergency rule was effective on February 28, 2003.

The emergency rule automatically expires after 150 days, or on July 28, 2003. After this time, the permanent rule is back in force, making the dividend distribution date March 1 again.

Issue
Should a permanent rule change be made to Wis. Admin. Code § ETF 20.25 (1) (a) and (2)? If so, on what date should dividends be distributed?

Factors for Consideration
Factors that must be given consideration include the potential economic impact on annuitants; the fiduciary and pension policy issues; any legal ramifications based on contractual rights; and the public relations, customer service and workload problems that an unpopular resolution would generate.

Options
Please note that there are five options listed below. Although all five are listed and have been analyzed, staff feels that the disadvantages of Options 3 through 5 make them difficult to support.

Recommendation: Staff recommends Option 2. However, Options 1 and 2 both have merit and should be given serious consideration.

Rationale: There is no perfect solution in choosing a dividend distribution date. Having given all of the options and factors consideration, this option seems the most logical from a policy perspective, has the most support among annuitants, and the least number of disadvantages.

Option I. Leave the rule as is, so that the dividends would be distributed effective March 1 (April 1 payment).

Advantages:

- If long-term investment performance assumptions are realized, this option would benefit annuitants since they would receive future increases earlier each year. It would fulfill the original objective for changing the rule, which was to get money to annuitants as quickly as possible after the close of the previous calendar year.

- Annuitant groups have long requested this change, although those requests were made before the economy and investment returns took a decided downturn.

- When calculating the dividend rates, the actuarial data on which the dividend is based assumes that the dividend is distributed on January 1. The difference between the assumed and actual distribution date results in a slight (positive or negative) carryover/adjustment in the following year.

Disadvantages:

- Based on the projections of fixed dividends in the near future, unless there are substantial improvements in equity valuations and an overall improvement in the economic climate during the remainder of the year, there is likely to be either a 0% or negative fixed dividend in 2004. It will take a State of Wisconsin Investment Board return of at least 8.3% in 2003 to avoid a negative dividend and a return of 24.2% to generate a dividend of 2%. There is also the potential for another variable decrease next year. If this occurs, annuitants will raise the same strong concerns about the harm that the earlier dividend distribution would cause them and the length of time it would take them to recover the monies lost by an earlier dividend payment.

- Even if there is a positive variable dividend, there is likely to be either a flat or negative fixed dividend (as accumulated losses are recognized through the Market Recognition Account). Only about 25% of annuitants receive variable dividends, while all annuitants receive a fixed annuity. Consequently, a fixed decrease and a variable increase will hurt at least 75% of annuitants, and possibly 100%, depending on the size of the fixed and variable dividends.

- Given the potential for little or no dividend next year, and some annuitants' belief that they are contractually entitled to have a dividend paid for a full 12-month period, if the dividends are not both positive next year there is again the potential for lawsuits, annuitants seeking legislative intervention, etc.

- The complaints generated by an earlier distribution of a negative dividend would result in significant additional workload for the Department and erode the feeling of goodwill among the annuitant population.

Option 2. Amend the rule to return to the April 1 effective date (May 1 payment).
(favored by staff)

Advantages:

- Amending the rule would continue the practice that is familiar to annuitants and would require no special explanation. Given the possibility of a 0% or negative fixed dividend in the next few years, there will be significant potential for confusion and distress for annuitants. An earlier distribution date, resulting in even less money flowing to annuitants, would amplify their distress.

- Since there would be no change in the distribution date, annuitants would continue to receive monthly payment amounts based on the previous year's dividends for a full 12 months. This should preclude any possible legal question of contractual rights to continue the existing annuity amount for a full 12 months.

- This option would be extremely easy to administer. It is what we have done in the past and no additional resources would be required to implement the change.

Disadvantages:

- Since the actuarial data used to calculate the dividend rates assumes that the dividend will be distributed on January 1, the difference between the assumed and actual distribution dates is slightly greater than what the effect would be for an April 1 date. This results in slightly less (positive or negative) carryover/adjustment in the following year.

- When the dividends are positive once again, annuitants may again press for an earlier distribution date that they know is technically possible.

The following options were researched by staff at the request of Board members. However, after analyzing the advantages and disadvantages of these options, staff is not recommending them for further consideration.

Option 3. Amend the rule to specify a conditional effective date.* This would most likely be in the form of returning the date to April 1 (May 1 payment), and include a provision permanently changing the date back to March 1 (April 1 payment) in the first year when there is a positive dividend in both the fixed and variable funds, or a positive dividend of at least a certain percentage in both funds for that year.

Advantages:

- Since the distribution date would only change to one month earlier in a year when both the positive and negative dividend are both positive, it is unlikely that annuitants would complain because they would get more money sooner.

Disadvantages:

- There would be uncertainty and confusion among annuitants as to when they would receive their dividends, and there could be a significant workload impact each year from annuitant inquiries until the condition is met and the earlier distribution occurs. There might also be confusion about whether the distribution date could change each year versus being permanently changed to the earlier date.

- There could be small fixed and variable annuity increases in a year that would trigger the earlier effective date, but a significant decrease in variable annuities in the following year, which would then be distributed on the earlier date. The decrease in the following year could more than offset the increase from the earlier, "trigger" year, which could result in harm to annuitants when the two years are considered in total. Therefore, while there might not be complaints and other issues raised in the "trigger" year, those same issues could be raised in the later year.

Option 4. Keep the administrative rule flexible, which would give the ETF Board discretionary authority to decide on a distribution date each year.

Advantages:

- The ETF Board would have the flexibility to decide on a distribution date each year in a manner that could help preclude financial harm to annuitants.

Disadvantages:

- Annuitants would pressure board members to have a later distribution date in "down" years and earlier in good years, which raises a number of pension policy, actuarial and possibly fiduciary issues.

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* Rob Weber, Chief Legal Counsel, has opined that a rule with a conditional effective date is possible, as long as the conditions that will trigger a change in the dividend distribution effective date are clearly specified in the amended rule.

- This could result in the Board members expending considerable time on the decision each year.

- The Legislature may be reluctant to give the Board discretionary authority.

- There could be considerable anticipation and confusion among annuitants each year, wondering when they would receive their dividends.

- The volume of questions that this approach is likely to raise could create significant workload and customer service problems.

Option 5. Leave the rule as is, and promulgate an emergency rule each year that we do not want the dividend to be distributed until the May 1 payment.

This approach was investigated but is not being offered as a feasible option. Rob Weber, Chief Legal Counsel, has opined that the legal definition of an emergency for rule promulgation would not be met each year.

We look forward to a thorough discussion of this matter. If you would like to discuss this in advance of the meeting, please call me at (608) 266-0222.