STATE OF WISCONSIN
Department of Employee Trust Funds
Eric O. Stanchfield
SECRETARY

801 W Badger Road
PO Box 7931
Madison WI 53707-7931

1-877-533-5020 (toll free)
Fax (608) 267-4549
TTY (608) 267-0676
http://etf.wi.gov

CORRESPONDENCE MEMORANDUM

DATE: November 23, 2004

TO: Employee Trust Fund Board

FROM: Employee Trust Fund Board Interest Crediting Subcommittee (Robert Niendorf, Nancy Thompson and Cindy Van Bogaert)

SUBJECT: Recommendation for Changing Interest Crediting for Wisconsin Retirement System Benefits

At the June 18, 2004, Employee Trust Funds Board meeting, this subcommittee was created to evaluate possible alternatives to how interest is currently credited to Wisconsin Retirement System (WRS) accounts for inclusion in lump sum benefits. The Department of Employee Trust Funds (the Department) staff provided a variety of alternatives for our review and participated in our October 21, 2004, meeting to evaluate the alternative options. At the meeting we discussed the merits and drawbacks of each alternative and whether each approach would be equitable to all WRS participants and would improve WRS benefit design.

Recommended Alternative

Upon careful consideration of the options, we recommend that the Employee Trust Funds Board (the Board) propose a statutory change to include effective rate interest in WRS benefits, including prorated effective rate interest for partial years. This seems the most equitable alternative because all participants would have interest credited at the actual annual effective rates, rather than prorated interest being credited at an artificial "assumed rate" (5%). It would also eliminate the potential for participants "gaming the system" by timing benefit applications to maximize interest crediting and avoid investment losses that their accounts actually incurred.

Since effective interest rates for a year are not available until approximately February of the following year, it would be necessary to pay lump sum benefits throughout the year without any prorated interest. Once the annual effective rates are known, the Department would have to issue a supplemental payment. Also, since effective rate interest can be a gain or loss, the Department feels it would need the authority and flexibility to withhold some portion of the account balance in the original payment to avoid potential overpayments. Any withheld portion could be included in the supplemental payment issued in the following year.

We consider this approach the best from a pure benefit design perspective, without full analysis of the administrative complexity and costs that would result and of whether the legislature would be likely to enact such changes. If the Board agrees with our recommendation, there are collateral issues that would also have to be explored (e.g. interest crediting on the supplemental payment) prior to the time the Board directs the Department to propose the statutory change.

Following are some of the pros and cons of this alternative:

Pros:

1. The interest rate (belatedly) included in the benefit would always be based on the fixed investment rate (and variable rate if applicable) actually credited to accounts for the year in

which the benefit is paid. While this would increase the total benefit for some participants and decrease it for others, depending on the effective rate vs. the assumed rate and whether the participant is in the variable fund, the total benefits paid would be consistent with the actual investment earnings and seems more equitable to all participants.

2. While participants would not have knowledge of what interest rate(s) they would receive for the partial year, the rate would be the same for a partial year and for full annual interest crediting. This would eliminate any benefit amount "cliffs" based on whether a payment is issued late in the year vs. at the beginning of the next year, and also eliminates gaming the system to avoid variable losses.

3. While significant additional programming would be necessary to generate the supplemental payments, this approach could be automated when lump sum benefits are implemented in the new payment system (which will occur several years in the future).

Cons:

1. Statutory changes would be needed to implement this alternative.

2. This would require double processing for all lump sum benefit payments that include prorated interest except for those paid in January. Over 5,000 lump sum benefits are paid annually. Significant additional staff resources would be needed.

3. Depending on when the original lump sum benefit was paid, the supplemental interest payments could be paid over a year after the original payment. The Department does not have an ongoing relationship with participants who have closed their accounts (like we do with annuitants), so in many cases the benefit recipients will no longer be at the same address. This would result in returned checks and additional location efforts.

4. Some participants will die between the date that the original payment is issued and the date the supplemental payment is made. Per Department staff, this would result in the supplemental payment being due to the decedent's estate (rather than to the beneficiaries), which means that we would be dealing with personal representatives, affidavits for transfer of assets to heirs of the decedent, and other issues similar to those experienced with the Special Investment Performance Dividend (SIPD) distribution project.

5. The participant would not have knowledge of what interest rate(s) would be paid for the partial year when applying for a lump sum benefit.

6. If there is a significant variable loss for the year, applying the negative variable rate even for a partial year could more than offset the partial year's fixed rate gains. In other words, the lump sum benefit amount paid with no interest included could actually be higher than the final calculated benefit amount that includes the prorated variable loss, resulting in an overpayment. To avoid this, the Department indicates it would need the authority and flexibility to withhold some portion of the account balance in the original payment, thereby avoiding overpayments that would be very difficult to recover. Any withheld portion could be included in the supplemental payment issued in the following year.

7. There is currently a pending court case regarding whether the Department should be paying additional interest on supplemental benefit payments for the time period between the issuance of the original payment and the supplemental payment date. This recommendation also includes a statutory change that provides interest on supplemental lump sum benefits.

8. Actuarial assumptions are currently based on the prorated 5% interest for partial years as provided under current law. Since the recommended change would result in different benefit amounts, staff advises that there would need to be an actuarial evaluation on the potential effects on funding and contribution rates.

General Background Issues

Following is some general background information provided by staff that warranted consideration when considering the alternatives:

- Staff advises that any changes in how interest is credited to a WRS account for benefit payment purposes will require changes in Wisconsin statutes. While the Department can draft proposed language, the changes are dependent on legislative action.

- Statute and/or rule changes must be applied consistently to all benefit applicants. Depending on each participant's individual situation, any change will have the effect of increasing benefit amounts for some participants and decreasing amounts for others.

- Any interest crediting changes that would result in delaying the issuance of lump sum payments will harm participants who apply for lump sums because they urgently need the money. The Department routinely receives requests to speed up the payment process for hardship reasons.

- When the Department receives a lump sum benefit application, delays in application processing are normally the result of missing termination data from the employer. A lump sum benefit cannot be paid until the Department receives the final termination date plus service, earnings and contribution data. Other application processing delays can result from additional and/or clarified data needed from the applicant (e.g. spousal consent, Social Security number verification, etc.) Delays are only rarely due to Department backlogs.

  Note: Separation benefit applications are currently being processed within about one week of receipt; payments are then "approved" on Mondays and checks issued on Fridays. (The Department does not have check-writing authority; the actual checks are issued through the State Treasury.)

- Under the current statutes there is no prorated monthly interest applied to separation benefits. Only annual interest is included in separation benefits.

- Current statutes require effective rate interest crediting every December 31, applied to that year's January 1 balance. Any interest crediting changes that do not include that annual effective rate interest (positive or negative) in the lump sum benefit could face legislative obstacles, as could any changes that could be perceived as a benefit improvement.

- It is the Department's practice to pay all lump sum benefits as soon as possible; lump sum benefit applications are not put "on hold" over the end of a calendar year to increase (or decrease) the benefit through annual interest crediting.

- When a participant has chosen to participate in the variable fund, that individual's variable account is actually invested in the variable fund either until the participant withdraws the money or until a variable cancellation becomes effective. Since the actual effective annual interest rates cannot be determined until after the end of a calendar year, the statutes provide for some partial interest crediting (prorated 5% interest) when an account is closed during the year.

Under the current statutes and rules, when a lump sum benefit is approved after the end of the year, the benefit includes annual effective rate interest. When that effective rate is a variable loss, the participant will understandably not be pleased to accept that loss. However, when the benefit is approved before the end of the year, the benefit by law includes prorated 5% interest, *even though the account may have actually lost money during the year.*

Under current law participants have some ability to "game the system." To avoid a variable fund loss they can withdraw their contributions in a lump sum before the end of the year, as long as they apply early enough and the Department has all the necessary information from the employer and participant. A basic issue for consideration, however, is whether it is appropriate to give participants even further means to avoid an investment loss when doing so results in other participants absorbing that loss.

- Board members have expressed concern that a participant's voluntary additional contributions to the WRS do not begin to earn interest until the January 1 after the Deparatment receives the contributions. This is a statutory restriction and is consistent with interest crediting on required contributions. The Department advises participants about this restriction, and many participants submit their additional contributions directly to the Department just before the end of the year. Steps are being taken to make this interest crediting information more prominent in our informational literature.

Consideration of Other Alternatives
We gave serious consideration to two other alternatives:

Secondary Alternative 1: Make no change to how interest is credited for benefit purposes.

Pros:
1. No legislation or rule changes are necessary.
2. Interest continues to accrue until the benefit approval month.
3. The current laws are well understood by staff and fairly easy to communicate to participants.
4. The current system will be relatively easy to automate as the new payment system is developed and implemented.
5. Despite the uncertainty of this approach, very few participants believe this approach has unfairly harmed them. In the past seven years, only two appeals concerning this interest crediting methodology were brought to the Board,

Cons:
1. In cases where interest crediting is based on the benefit approval date (most lump sums), the participant will not be able to determine in advance exactly what interest will be included in the benefit, due to uncertainty about when the payment will be approved. Delays can result from waiting for termination data from the employer, additional information needed from the participant, and even slower-than-expected delivery of the application by the post office.* This is most significant at the end of the calendar year, when application processing delays (for any reason) will make a difference in whether the benefit includes annual interest (vs. prorated 5% interest).

   **Note: the new fax and e-mail rule will allow instant delivery, as does hand delivery.*

2. Participants can generally "game the system" by submitting an application near the end of the year in which a variable loss is anticipated. Unless the benefit cannot be paid until after the first of the year due to missing data, the participants can avoid the investment losses

that the funds in their accounts have actually experienced. Other fund participants must essentially absorb those losses.

3. When an application is received too late in the year to pay the benefit before January, the Department must delay paying the benefit until the annual effective rate(s) are known (normally late January, and early February for variable).

Secondary Alternative 2: If the Department receives the application prior to December 1, pay prorated 5% interest for each full month prior to the benefit approval date. If the application is received on or after December 1, pay the benefit after the first of the year and include annual effective rate interest for the year plus prorated 5% interest for each full month elapsed in following year until the benefit approval date. In exception hardship cases when the application is received on or after December 1, allow for immediate payment (if termination data is available) of a benefit based on the January 1 account balance, while giving the Department the flexibility to withhold a discretionary portion of the January 1 balance to cover for potential fixed and variable fund losses for the year. A supplementary payment would be issued in the following year after effective rates for year are determined, which would consist of any amount due from prorated effective rate interest and any amount payable that had been held back.

Pros:

1. Participants have a date certain by which to submit an application and lock in prorated 5% interest if the Department receives the application prior to December 1. This gives the participant certainty and control over the interest rate that will be credited and included in the benefit.

Cons:

1. Statutory changes would be needed before this change could be implemented.

2. Participants can "game the system" by submitting an application prior to December 1 in a year in which a variable loss is anticipated, thereby avoiding the investment losses that the funds in their accounts have actually experienced. Other fund participants must essentially absorb those losses. Also, if there was an unexpected reversal in the investment experience before the end of the year and the actual investment experience is higher than the assumed rate, participants could further game the system by canceling their applications before payment is issued, receive annual effective rate interest on their account, and then take advantage of the higher annual interest rate by reapplying for the benefit.

3. When an application is received on or after December 1, the Department would need to delay paying the benefit until the annual effective rate(s) are known.

Except for applications received during roughly the first couple of weeks in December, there is effectively very little difference between the two secondary options. Considering that a statutory change would be necessary for the second alternative and there would be an administrative burden associated with the change, our secondary recommendation is to leave the current interest crediting laws as they are without change.