A VARIABLE ANNUITY PROGRAM - IS IT FEASIBLE FOR IPERS?

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Introduction

Some interest has been expressed from time to time in the development of a Variable Annuity Program as an additional feature of the Iowa Public Employees Retirement System. This interest appears to have been generated because of the success achieved by the TIAA-CREF Annuity Program for Employees of colleges and universities. The logical question arises:

> "If it is a good program for the higher education people, why would it not also be a good program for all public employees in the State of Iowa; therefore, why not institute such a program as part of the IPERS System?"

The purpose of this report is to examine the foregoing question and give the Legislative Retirement Study Committee a basis for decision making on this question.

What Is TIAA-CREF?

TIAA (i.e. Teachers Insurance and Annuity Association) is a non-profit legal reserve life insurance and annuity company incorporated in the State of New York. The company was founded in 1918 by the Carnegie Foundation for the advancement of teaching. CREF (i.e. College Retirement Equities Fund) is a separate non-profit corporation, companion to TIAA, established in 1952 by a special act of the New York State Legislature. Eligibility for purchase of annuities from TIAA-CREF is limited to employees of colleges, universities, private schools and certain other non-profit research or educational organizations. The type of annuity provided by TIAA-CREF is technically known as a "money purchase" annuity — i.e. a person's contributions are accumulated to retirement age and then applied to provide a monthly annuity for life thereafter. The amount of the monthly annuity is whatever the accumulated contributions will buy.

The TIAA-CREF annuity is purchased in two pieces - one piece from TIAA and the other from CREF. The contributions used to purchase the TIAA annuity are invested in fixed dollar types of securities and the contributions are accumulated at a fixed rate of interest each year. At retirement the accumulated contributions in TIAA are applied to provide a fixed income annuity for lifetime.

The contributions used to purchase the CREF annuity are invested in stocks. The annuity value varies to reflect the growth or decline in value of the stocks. Technically, a member is purchasing a unit of annuity each year in CREF and then the annuity unit value varies in accordance with the performance of the stocks in the portfolio backing up the CREF unit annuities. At the time of a member's retirement the CREF accumulated annuity unit value is applied to provide a variable annuity under which the periodic payments to the retiree will continue to vary during the time of retirement in accordance with performance of the stocks backing up the CREF unit annuity.

The members (or policyholders) can invest their full annuity premium with TIAA or if they participate in CREF they may invest 1/4, 1/3 or 1/2 in CREF and the balance in TIAA. Contribution rates to TIAA-CREF in the State of Iowa for higher education personnel are 5% by the employees and 10% by the employer.

Probably the one most unique feature of the TIAA-CREF program is the variable annuity concept of CREF whereby the employee may choose to put a portion of his money into a stock market investment with the associated risks and prospects of growth.

Another important feature of this program is portability. The members of the program have ownership of their annuity policies which they take with them as they may move from one position to another within the qualifying fields of education to which membership in TIAA-CREF is available.

A Variable Annuity Feature In The IPERS Program - Is It Practical?

The Iowa Public Employees Retirement System was originally established in 1953 as a money purchase annuity program. This is the same type of program as TIAA; it differs from CREF mainly with respect to the type of investments backing up the annuity — i.e. the IPERS money purchase annuity program was always in fixed income securities with no investments in stocks.

In 1967 IPERS was revised in a major way by changing the type of benefit formula from "money purchase" to a defined benefit formula. This means that instead of having a member's annuity based directly on his accumulated contributions (and that of his employers), his retirement income from IPERS is now based on a formula related to a percentage of his salary and his years of service. Currently the IPERS formula provides a fixed annuity credit for each year of membership service equal to 1.57% of salary (up to $10,800) for that year.

Now to the question:

> "What is the problem with installing a variable annuity feature in the IPERS program?"

We feel that the defined benefit formula method of determining a person's annuity at retirement is not compatible with the variable annuity concept — i.e. the "money purchase" method is <u>essential</u> to the efficient operation of a variable annuity as with the CREF program. It is our opinion that it would not be practical to attempt a variable annuity feature under the defined benefit formula concept of the IPERS program. There would be a number of problems, both from the standpoint of equity among participants and of administration, but one of the most significant problems would be in establishing how much of the benefit would ultimately be provided under the defined benefit portion of the program so that proper funding could be maintained with some degree of certainty. Therefore, we feel that the installation of a variable annuity feature in the IPERS program would require establishment of a new segment to the program separate from the defined benefit formula. This separate segment would be designed similar to CREF – i.e. a money purchase annuity backed by investments in stocks with the variation in stock values being reflected in each participant's variable unit annuity values. This segment of the program could be supported solely by employee contributions or a combination of employee and employer contributions which would be in addition to the basic defined benefit formula IPERS program to which all employees and employers would be required to contribute. Participation in the variable annuity segment of IPERS could be made optional with the employees and the extent of the employee participation as to his contributions could be on a varying basis – i.e. employees be permitted each year to elect a certain percentage of contribution to be made into the variable annuity segment of IPERS during that year.

Major Advantages and Disadvantages

Three major advantages to the TIAA-CREF annuity system are

(1) Growth prospects in the CREF variable annuity, and

(2) Portability made possible by the fact that each participant in TIAA-CREF has individual annuity policies issued in his own name, and

(3) The high level of contributions to the TIAA-CREF program – i.e. 5% of salary by employees and 10% by employers.

The major disadvantage to TIAA-CREF is its basic structure – i.e. "money purchase" type of benefit. Any money purchase annuity system is always faced with the battle against rising salaries and inflation – i.e. increasing wage or salary levels tend to erode the money purchase annuities when compared to a person's salary level at time of retirement.

Conclusions

We believe that the appropriate direction for the basic IPERS program is the defined benefit formula which was established in 1967 to replace the money purchase system. We further believe it appropriate to change the defined formula benefit from the career average salary approach (i.e. the unit of annuity earned each year is computed on the employee's salary for that year) to the final average salary approach (i.e. the total annuity is computed on the basis of the employee's final average salary). This is the direction in which the Legislative Retirement Study Committee's efforts are being directed in studies which have been made up to this time.

If the variable annuity concept is considered to be sufficiently desirable for IPERS, then we strongly recommend that it be established on a "separate segment basis" using the money purchase concept and a separate fund account invested in stocks to support the variable annuity program, like CREF. We can visualize this being an optional feature supported by optional employee contributions only in addition to the contributions re-quired for the basic IPERS defined formula benefit program.

However, we also wish to point out that a program of this type is already available, individually, to Iowa Public Employees – i.e. a deferred compensation program whereby employees may elect a reduction in wages and have the amount of such reduction set aside for retirement. This program is set out in Section 12 of Chapter 509A of the Iowa Code which reads as follows:

509A.12 **Deferred compensation program for governmental employees.** At the request of an employee the governing body shall by contractual agreement acquire an individual or group life insurance contract, annuity contract, security or any other deferred payment contract for the purpose of funding a deferred compensation program for an employee, from any company the employee may choose that is authorized to do business in this state and from any life underwriter duly licensed by this state or from any securities dealer or salesman registered in this state to contract business in this state. The deferred compensation program shall be administered so that the state comptroller or his designees may remit one sum for the entire program according to a single billing.

The provisions of this section shall be in addition to any benefit program provided by law for any employees of the state or any of its political subdivisions. [64GA, ch 1112,§1]

Finally, we conclude that a variable annuity program is feasible for IPERS on a "separate segment basis" as described above. However, we believe that in the Committee's decision regarding a variable annuity segment for IPERS, it should take into consideration the question of whether or not Section 509A.12 of the Iowa Code will adequately serve the needs of Iowa Public Employees desiring to avail themselves of variable annuities through private funding mediums.

Respectfully submitted,

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