FEDERAL RETIREMENT THRIFT INVESTMENT BOARD

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THRIFT SAVINGS PLAN

July 7, 2015

MEMORANDUM FOR: BOARD MEMBERS KENNEDY, BILYEU, JONES, MCCRAY, AND JASIEN

FROM: Greg Long
Executive Director

SUBJECT: TSP Withdrawal Options

Summary:

This memo summarizes the recent project to review TSP withdrawal options and recommends increasing the flexibility related to these options. The recommendations are designed to increase the likelihood of improved financial outcomes for TSP participants.

What are the Issues with TSP's Withdrawal Options?

Last year, we examined TSP data and confirmed that many participants are transferring their balances from the TSP to other financial institutions at age 59½ and upon separation from federal employment. Virtually all of these transferred dollars are moving into accounts with higher expenses than are available within the TSP, a fact that appears to run counter to the participants' interest. Our mission is to administer the TSP solely in the interest of participants and beneficiaries, and as such, one of our primary goals is to help participants make smart choices that advance their ability to retire with dignity. All else equal, moving into a higher cost retail IRA from the low cost of the TSP would reduce a participant's net returns and negatively impact his/her retirement readiness.

TSP transactional data shows that in 2013, separated participants transferred $9 billion out of the TSP to other institutions. TSP survey data further shows that 27% of these participants cited a desire for additional withdrawal flexibility as a motivating factor behind these transactions. Participant actions and their feedback provide clear indications of meaningful dissatisfaction with our withdrawal options.

The TSP's Withdrawal Options Study Project

These facts caused me to assemble a cross-functional team to collect and analyze data, consider the issues, identify alternatives and, if appropriate, recommend modification to the TSP's withdrawal options. This memo summarizes the considerable work of the team.

To fully understand the issues and context, the team undertook various tasks, including:

1. Understanding the rationale behind the current TSP withdrawal options. This was done primarily through discussions with key personnel and a review of historical TSP documents.

2. Understanding what participants typically do when they become eligible for in-service or post-separation withdrawals. This was accomplished through a review of TSP transactional data.
3. Determining participant sentiment toward our current withdrawal options, the factors influencing their withdrawal decisions, and their level of demand for different features. This was done through discussions with call center and operational teams, and the administration and analysis of a survey of TSP participants that recently executed a withdrawal.
4. Understanding how TSP withdrawal offerings compare with those typically offered in the marketplace. This was accomplished through consideration of recent benchmarking analysis, a review of defined contribution industry research, and outreach to large public and private plan sponsors.

This work resulted in a significant amount of data and findings. However, these findings are distilled to the following:

1) The TSP initially had a withdrawal scheme that was designed to mimic a participant's eligibility for the OPM defined benefit annuity. Effectively, only participants that reached the age and service requirements that qualified them for a defined benefit payout could execute a TSP withdrawal that would result in a direct payment to the participant. All other separated participants were required to transfer their accounts to an IRA or another qualified plan. This structure proved confusing to participants and was modified several times through legislative changes in 1992, 1994, 1996, and 2003. Each change brought the TSP's withdrawal options more in-line with those commonly found in ERISA governed 401(k) plans. For example, the changes allowed the TSP to offer in-service hardship and age-based (59 ½) withdrawals and also allowed separated participants to maintain their account in the Plan, take a one-time partial withdrawal, or elect a combination of the TSP's full withdrawal options. Our researchers found no legislative language which indicated a Congressional intent to make TSP withdrawal options more restrictive than the ERISA plan marketplace.

2) Once separated, participants may choose to take no action until age 70 ½, or take a *one-time* partial withdrawal, or elect a full withdrawal. A full withdrawal can take the form of a single lump sum payment, a stream of monthly payments, an annuity purchase[1] or any combination of these options. To determine the propensity for participants to select any of these choices, we examined the group of participants who separated in 2012 and assessed what they had done with their TSP balances by the end of 2013. This data tells us that:

49% Took no action
2% Took only a one-time partial withdrawal
8% Received a cashout[2]
41% Took a full withdrawal, which included:

[1] FRTIB staff is currently examining additional annuity offerings. These offerings will be considered in a separate report.
[2] Vested account balances less than $200 are automatically disbursed to separated participants.

- 37% Received a lump sum
    - 11% Transferred the lump sum to another institution
    - 26% Took the lump sum as a cash payment
- 4% Initiated a monthly payment stream
- 1% Initiated an annuity purchase

It is important to highlight that although the majority of participants who selected a lump sum payout did so in the form of a cash payment, the cash payments only averaged $18,830 while the transferred amount averaged $126,557, resulting in 75% of assets from lump sums going to other financial institutions.

3) The Participant Service Representatives (PSRs) who respond to participants' telephonic inquiries via the TSP's Thriftline answer about 2 million phone calls a year. The most common reason participants call the Thriftline is to gain access to their money (i.e. loans and withdrawals). The operations teams also respond to thousands of letters and online secure messages. Through these contact channels, we gain insights into what participants like and dislike about the TSP's withdrawal options. These sources report significant participant dissatisfaction with the availability of only one partial withdrawal. Many participants view the TSP as overly restrictive and they want greater flexibility in accessing their TSP balances. In fact, feedback suggests that participants often withdraw funds in excess of their need when they realize they are permitted only "one trip to the well."

4) Participant survey data also reflected similar findings. A survey was conducted of over 40,000 participants who took either an in-service or post-separation withdrawal during the first six months of 2014. Among those participants who took a post-separation withdrawal and responded to the survey, the top reason for withdrawing money was to access funds for a major expenditure or life event (36%). Interest in withdrawal flexibility not currently offered by the TSP was mentioned as a reason by 27%.

5) Our benchmarking findings and outreach to plan sponsors made clear that both private and public sector plans typically offer greater withdrawal flexibility than the TSP. Specifically, the benchmarking report noted a gap vs. the marketplace in withdrawal flexibility and suggested that the TSP consider allowing participants to take partial distributions once separated. It further noted that participants who take an in-service, age-based withdrawal in most other defined contribution plans are typically still eligible to take a partial distribution once separated. This is not the policy at the TSP. The TSP's restrictions on how many and how often withdrawals can be made are areas where our restrictions clearly place us outside the norm of other plans and IRAs.

The team's examination of withdrawal behaviors and industry practices provided the foundation for the recommendations that are outlined below:

<u>Recommendations</u>

In consideration of the team's findings, I recommend changes as detailed in the tables below. These changes are responsive to participant feedback and bring us into alignment with other public and private sector plans. But most importantly, I believe the changes will lead to improved financial outcomes for participants.

In-Service Withdrawals			
Withdrawal Type	**Current Rules**	**Proposed Rules**	**Expected Outcome**
Age-based (59 ½)	Allow only one age-based withdrawal. If a participant takes this type of withdrawal, he/she is not allowed to take a partial withdrawal once separated.	Add flexibility by allowing multiple age-based withdrawals. Remove the restriction on post-separation partial withdrawals.	The average amount of age-based withdrawals will decline. Fewer age-based withdrawals will result in full-account liquidation.
Hardship	Allowed at any age and without limit on how many one can take if financial hardship is certified and contribution suspension period has ended. Contributions must stop for 6 months following the hardship withdrawal. We send a notice to the participant at the end of 6 months, but he/she must take action through the respective agency payroll to restart contributions.	No change to hardship approval rules. However, after the 6-month period expires, we will create a mechanism for the agency payroll to restart contributions unless the participant affirmatively declines to restart.	The number of active participants with a deferral rate of 0% 7+ months after a hardship withdrawal will decrease.

Post-Separation Withdrawals			
Withdrawal Type	**Current Rules**	**Proposed Rules**	**Expected Outcome**
Partial post-separation withdrawal	Allow only one partial post-separation withdrawal. After this is executed, only full-withdrawal options are available. A partial post-separation withdrawal is also not available if the participant previously executed an in-service age-based withdrawal.	Add flexibility by allowing multiple partial post-separation withdrawals.	Partial withdrawals will increase but more participants will elect to retain balances in the TSP, as withdrawals can be timed to their individual needs.
Full withdrawal via periodic payments	Currently, periodic payments can only be selected in monthly intervals. Additionally, the payment amount can only be adjusted once per year and this must occur just prior to the beginning of the next calendar year. These payments can be reduced to as low as $25/month. However, the recurring payments cannot be stopped unless a participant withdraws their entire remaining balance. Once a participant is in periodic-payments status, he/she cannot elect a partial withdrawal or annuity purchase.	Add flexibility to periodic payment withdrawals by allowing the election of quarterly or annual payments. Permit the payment amount to be changed at any time throughout the year. Permit stoppage of periodic payments while allowing the remaining balance to stay in the Plan. Permit flexibility to select a partial withdrawal or annuity purchase while in periodic payment status.	Periodic payments will increase as will long-term account retention. The additional flexibility will allow TSP withdrawal strategies that meet individual needs which may change over the course of retirement. Balances are more likely to be retained in the TSP. The added flexibility will increase communication challenges related to tax withholding rates and early withdrawal penalty rules.

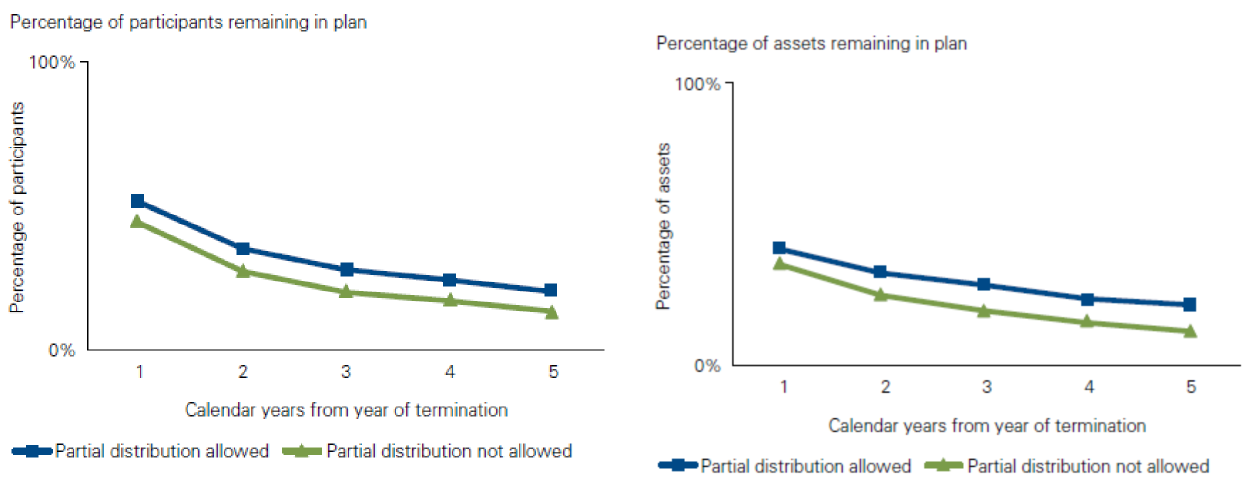
Withdrawal-Related Provisions			
Provision	**Current Rules**	**Proposed Rules**	**Expected Outcome**
Withdrawal Election Deadline	TSP participants are required to make a post-separation withdrawal election by April 1st of the year following the year in which they turn 70½ and are separated from Federal service. This withdrawal election deadline is independent of the IRS requirement to begin distributing required minimum distributions (RMDs) annually by April 1st of the year following the year in which they are 70½ and separated from Federal service.	Eliminate the withdrawal election deadline. The deadline does not impact the need to pay RMDs as we once thought it would. Participants often conflate the withdrawal election deadline and the RMD requirement. It is also easy for them to confuse the requirement to make a withdrawal election as a requirement to withdraw their entire account balance.	Full account cash-outs at age 70+ will decline. Participants will not feel compelled to withdraw balances in excess of the Required Minimum Distribution because of the deadline to make a post-separation withdrawal election of some type.

Does More Flexibility Equate to Giving People All the Rope They Need?

The proposed changes described above all provide additional flexibility for the participant. The natural concern with these proposed actions is over whether we are enabling a participant to exhaust his/her retirement savings earlier than he/she otherwise would. In other words, just because people want more flexibility, does not by itself mean it is prudent for the TSP's fiduciaries to provide that flexibility. Although it may appear counter-intuitive, the research on this issue demonstrates that additional withdrawal flexibility leads to more participants keeping money inside the employer-based qualified plan system longer.

Vanguard's December 2013 study on *Retirement distribution decisions among DC participants* finds that while only 10% of DC plans allow separated participants to take "ad hoc" partial withdrawals, the DC plans that did so experienced an increase in retention of their participants and assets. The below charts from Vanguard's study illustrate the critical difference that additional flexibility can bring.

In-plan behavior and plan rules
Participants age 60 and older by 2008 year of termination cohort



Note: The participant analysis includes the following participant categories: combination, installment, and remain in plan. The assets analysis represents the December 31, 2012 value for assets remaining in the plan plus actual transaction value for assets distributed from plan for all five participant categories.
Source: Vanguard, 2013.

The 2013 Vanguard study indicates that DC plans that allow multiple partial withdrawals for separated participants actually retain more participants and assets than those plans that do not offer multiple partial withdrawals.

The team also reviewed a similar study from Aon-Hewitt[3] which drew a comparable conclusion; providing greater withdrawal flexibility to participants who are nearing retirement actually reduces leakage from the plan.

Hurdles to Implementation

The proposed changes presented in this paper will require changes to statute, regulations, systems, business processes, forms, and communications material. There will also be multiple areas where this work is dependent on 3rd party cooperation or dependent on progress made in other TSP projects and initiatives. In short, changes to the TSP's withdrawal options will be complex, require substantial planning, and demand significant time to fully implement.

If the Board is supportive of these changes, we will initiate the planning to request the necessary legislative and regulatory changes and start the additional work to prioritize, cost, and rationalize this effort within the broader framework of the Agency's projects and initiatives.

Conclusion

The proposed changes to our withdrawal program are designed to yield improved financial outcomes for TSP participants. These changes, when implemented, will result in more participants retaining balances in the TSP, thereby continuing to benefit from the advantages of high quality investments and low fees that cannot be matched in the IRA marketplace. Additionally, the retention of assets will contribute to lower overall plan administration costs for all participants. Simultaneously, these changes will allow us to favorably respond to participant demand and move closer to typical plan design found in private and public sector plans. This set of changes will be a win for participants, and I recommend support of all the recommendations.

[3] Leakage of Participants' DC Assets: How Loans, Withdrawals, and Cashouts are Eroding Retirement Income, Aon Hewitt, 2011