

The Thrift Savings Plan (TSP):

The US Experience with Complementary Pension Funds for Federal Civil Servants

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Outline of the Presentation

- ◆ The Old Federal Civil Servant System and the 1983 Reform
- ◆ The New Civil Servant System and the Role of TSP
- ◆ TSP's Legal Framework and Governance Structures
- ◆ The Design of TSP's Pension Plan
 - The accumulation phase
 - The payout/benefit phase
- ◆ TSP's Performance
- ◆ Conclusions and Possible Lessons

Part I. The Old Civil Servant Pension Scheme

Key Features of the Old Scheme

- ◆ Traditional salary based Defined Benefit system
- ◆ Accrual rate: 1 ½ % first 5 years, 1 ¾% years 5 to 10, 2% years above 10 (56 ¼% for 30 years)
- ◆ Maximum replacement rate of 80%
- ◆ Reference Wage – Highest Three Years Earnings
- ◆ Exempt from Public Social Security System
- ◆ Employee Contribution - 7% of wage with no tax deduction
- ◆ Eligibility for full retirement at age 55 with 30 years service, age 60 with 20 years, 62 with 5 years
- ◆ Full price indexing of benefits after retirement

Reasons for Federal Pension Reform

- ◆ Part of Social Security reforms in 1983. Needed to include federal workers to enhance solvency
- ◆ Cost of old system was perceived as too high in the context of record fiscal deficits in the early 1980's
- ◆ System was viewed as limiting civil servants' mobility and impediment to downsizing of staffing levels
- ◆ Public pensions were seen as more generous than average pension in the private sector
- ◆ Emergence of defined contribution (DC) plans as an alternative model

Part II. The New Civil Servant Pension Scheme

Contributions to the New Scheme

- ◆ Employee contributions
 - 0.8% of pay to downsized defined benefit component
 - 4.2% of applicable wage base to Social Security
- ◆ Employer contributions
 - 11.4% of employee's pay
 - 10.4% of applicable wage base to Social Security
 - Required contributions to the TSP
- ◆ Contribution amounts increase in 2013 to ???

Civil Servant Benefits under the New Scheme

- ◆ Participation mandatory for all workers beginning service on or after Jan 1, 1984
- ◆ Three part retirement benefit:
 - Defined Benefit at 1% annual accrual rate
 - Mandatory enrollment in Social Security
 - Voluntary participation in new Defined Contribution plan (TSP)
- ◆ Survivor and disability benefits remained in defined benefit plan
- ◆ “Old” workers remain in CSRS but with option to switch to FERS

New System Benefits (cont'd)

- ◆ Five year vesting period
- ◆ Normal retirement age for both men and women at age 55 with 30 years but gradually being raised to 57
- ◆ Or age 60 with 20 years or 62 with 5 years
- ◆ Social Security benefits – average of 40% with progressive replacement
- ◆ Normal Social Security retirement at age 65 for both men and women with increase to 67 in future years
- ◆ Most civil servants retire later because benefit is less generous at 55

New Scheme Defined Benefit Compared to Old Scheme

- ◆ Much lower accrual rate (about half)
- ◆ Raised minimum retirement age from 55 to 57
- ◆ No price indexing of benefits for retirees until age 62
 - Indexing rate less generous
- ◆ Average replacement after full career:
 - 40% under new DB plus 40% under Social Security (80% under old DB, no Social Security)
 - Higher income workers get less than 80% under new system due to Social Security “tilt” towards lower paid workers
 - TSP makes up the difference for higher income workers

The Role of the Thrift Savings Plan (TSP) in the New Scheme

- ◆ Provides complementary income, especially for higher income workers
- ◆ Provides tax-favored defined contribution individual accounts
- ◆ Designed to operate on a defined contribution (DC) basis, like US private sector “401(k) plans”

TSP Legal Framework and Governance Structures

- ◆ Law establishing TSP provided basis for independence from political influence
- ◆ Independent Board of Directors that governs separate administrative body staffed by civil servants
- ◆ Full asset segregation
 - Amounts belong to participants – held “in trust” in individual accounts
 - Participants have legal ownership under U.S. law and Constitution

TSP Governance (cont'd)

- ◆ Fiduciary responsibilities – Enforceable in the courts
 - Must act prudently and solely in the interest of the participants and beneficiaries
 - Executive Director and five Board members are accountable for all actions
- ◆ Independence of Board
 - Five Board members appointed by the President (two upon recommendation of Congress) to 4-year fixed, staggered terms
 - Cannot be easily removed (Do not serve “at the pleasure of” the President or Congress)
 - Board members appoint the Executive Director

TSP Governance (cont'd)

- ◆ Budgetary independence
 - Independent budget authority (not subject to White House control)
 - Administrative charges to TSP account balances for all expenses
 - No Congressional appropriations (except for small start-up appropriation)
- ◆ Investment structure
 - Index (passive) investment funds
 - No voting shares in portfolio
 - External asset management

TSP Regulatory Oversight

- ◆ Private pensions supervisory agency (Department of Labor) oversees TSP
 - Performs annual series of audits and issues findings and recommendations
 - Reports to the Board
- ◆ Congressional oversight
 - Hearings
 - Government Accountability Office audits

TSP Administration

- ◆ Approximately 250 TSP employees
 - Policy
 - Legal
 - Accounting
 - Oversee operations and IT system
- ◆ Other key functions outsourced through contracts
 - Investment management
 - Record keeping
 - Call centers
 - Computer center

TSP Administration (cont'd)

- ◆ Payroll function
 - Essential to control data, prevent mistakes
 - Contribution records must balance
- ◆ Accounting controls
 - Individual account plan, need to balance every day
- ◆ Audit
 - Have annual internal audit as required by law under US GAAP, certify books and records
 - Auditors report directly to Board
- ◆ Computer system
 - Robust computer system essential to proper functioning
 - Run system every night
 - Capacity of IT system poses biggest challenge

TSP Communications

- ◆ Website is now primary communications vehicle
 - Transactions on-line: Investment decisions, some loans, withdrawals. Over 90% of investment transactions online
 - Account balances and statements
- ◆ Voice response system (ThriftLine)
 - Automated account information
 - Some automated transactions
 - Opt out to call centers
- ◆ TSP Publications
 - Available for download on the website
 - Agency reps may order forms and publications to provide directly to employees
- ◆ Agency responsibilities to communicate enrollment and retirement information

Part III. TSP Pension Plan Accumulation Phase

TSP Contribution Rules

- ◆ Since August 2010, automatic enrollment with 3% contribution rate
- ◆ Immediate agency automatic contribution equal to 1% of salary
- ◆ For FERS employees, government immediately matches first 5% of employee contributions
 - 100% match on first 3%
 - 50% match on next 2%
- ◆ All employees can voluntarily contribute up to IRS limit annually, \$17,500 in 2013. Over age 50, can contribute an additional \$5,500 annually
- ◆ Employees can “roll-in” money from other eligible DC or IRA plans

TSP Investment Structure

- ◆ Participants choose how to invest their accounts
- ◆ Law requires use of index funds for equity
 - Index funds are designed to follow entire markets
 - Ensures investment management is “passive”
 - “Active” decisions could be based on politics
 - Index funds are low cost
- ◆ Board decided to use indexing for fixed income also
- ◆ Prohibition on active public agency involvement in corporate governance
 - Prohibits direct voting of shares (proxies)
 - Avoids voting shares for political reasons
- ◆ Funds and accounts valued each business day

Current TSP Investment Options

- ◆ **G Fund** – Specially issued government securities
- ◆ **F Fund** – U.S. corporate and government bond index fund. Tracks the Barclays U.S. Aggregate Bond index
- ◆ **C Fund** – Large capitalization U.S. stocks. Tracks the S&P 500 index
- ◆ **S Fund** – Small to medium capitalization U.S. stocks. Tracks the Dow Jones U.S. Total Stock Market index, minus the S&P 500
- ◆ **I Fund** – International stocks. Tracks the EAFE index
- ◆ **L Funds** – Introduced in 2005

The TSP Lifecycle (L) Funds

- ◆ “Lifecycle” or target date asset allocation funds
- ◆ Using combinations of underlying TSP funds chosen by expert consultant
- ◆ Participant decides when they need the money
- ◆ Farther out time horizon dates – more aggressive (i.e. risky) investments, with more equity
- ◆ As horizon date approaches, automatically change to more conservative investments, with more fixed income
- ◆ Provide investment allocations designed to give optimal returns for the amount of risk taken

The L Funds (cont'd)

- ◆ Five funds selected
 - Income Fund
 - For those already withdrawing their accounts
 - 2020 Fund
 - 2030 Fund
 - 2040 Fund
 - 2050 Fund
- ◆ As a Lifecycle Fund reaches its maturity date and is retired, the TSP will introduce a new fund for the next generation of workers

Selection of External Investment Managers

- ◆ Board selects appropriate indexes
- ◆ Board chooses selection criteria
 - Based on staff recommendations (with expert advice)
 - “Minimum criteria” used to limit competition to firms that have necessary size, experience
- ◆ Board chooses weight to give to technical factors vs. cost. As criteria become more objective, cost weighting can be greater.

Part IV. TSP Payout/Benefit Phase

TSP Post-Employment Withdrawals

- ◆ Three options:
 - Lump-sum payment without restriction
 - Monthly payments from TSP account (participant decides payment rule)
 - Life annuity
- ◆ Can choose more than one option
- ◆ Can transfer certain payments to IRAs or other plans
- ◆ Can leave account in until age 70 ½

TSP Life Annuities

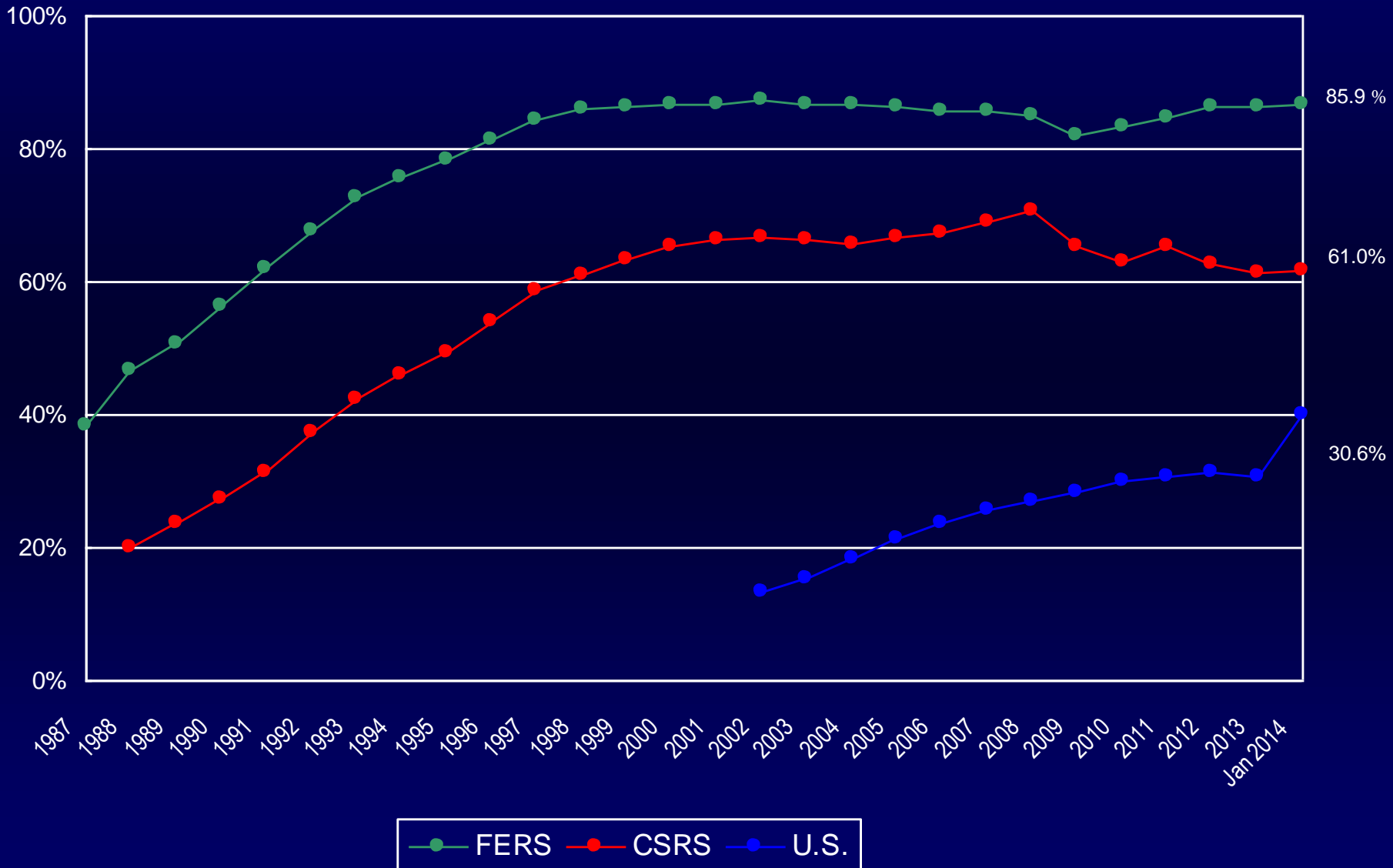
- ◆ Only an option (not required unless spouse insists)
- ◆ 18 different annuity types (single life, joint and survivor, etc.) – Possibly too many
- ◆ TSP selects vendor and monitors performance. No liability once annuity is purchased
- ◆ Annuity provider competitively procured
- ◆ Insurance companies compete on price
- ◆ Provides participant with lifetime source of income; with or without a survivor benefit
- ◆ Not currently a popular option, given low interest rate environment

Death and Disability

- ◆ Death and disability benefits under defined benefit
- ◆ Upon death, designated beneficiaries receive TSP account balance
- ◆ If no designated beneficiary, use order of precedence under law
- ◆ Widow/er establishes own TSP account with same investment and withdrawal options as active participants
- ◆ All other beneficiaries receive direct payment with option to transfer to inherited IRA, if applicable
- ◆ Additional optional insurance for death or disability possible, but paid by employee

Part V. TSP Performance

Thrift Savings Plan Participation Rates

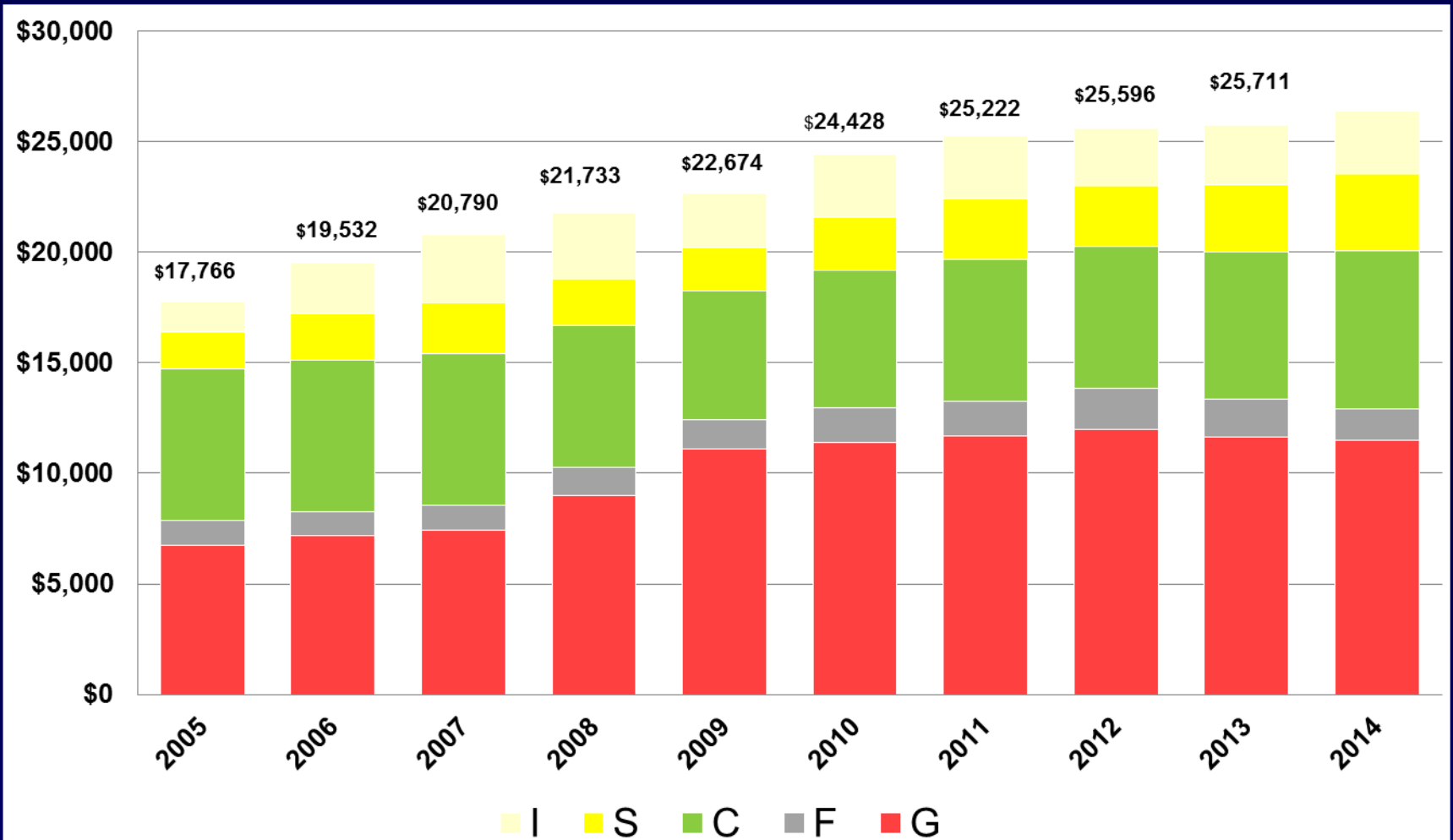


Annual data as of September of the respective year.

Annual Contributions

G, F, C, S and I Funds

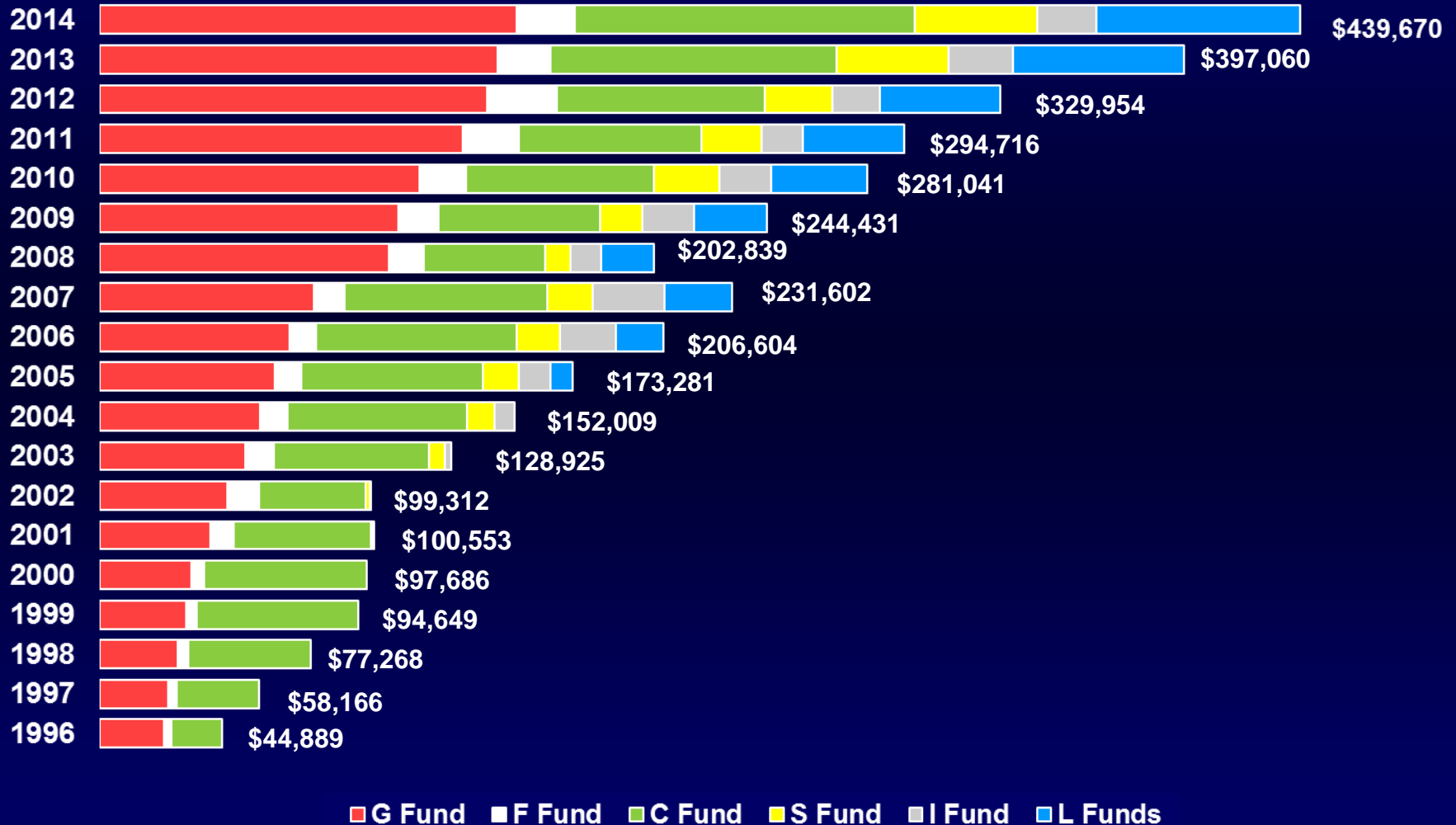
(\$millions)



Annual Year-End Balances

G, F, C, S, I, and L Funds

(\$ millions)

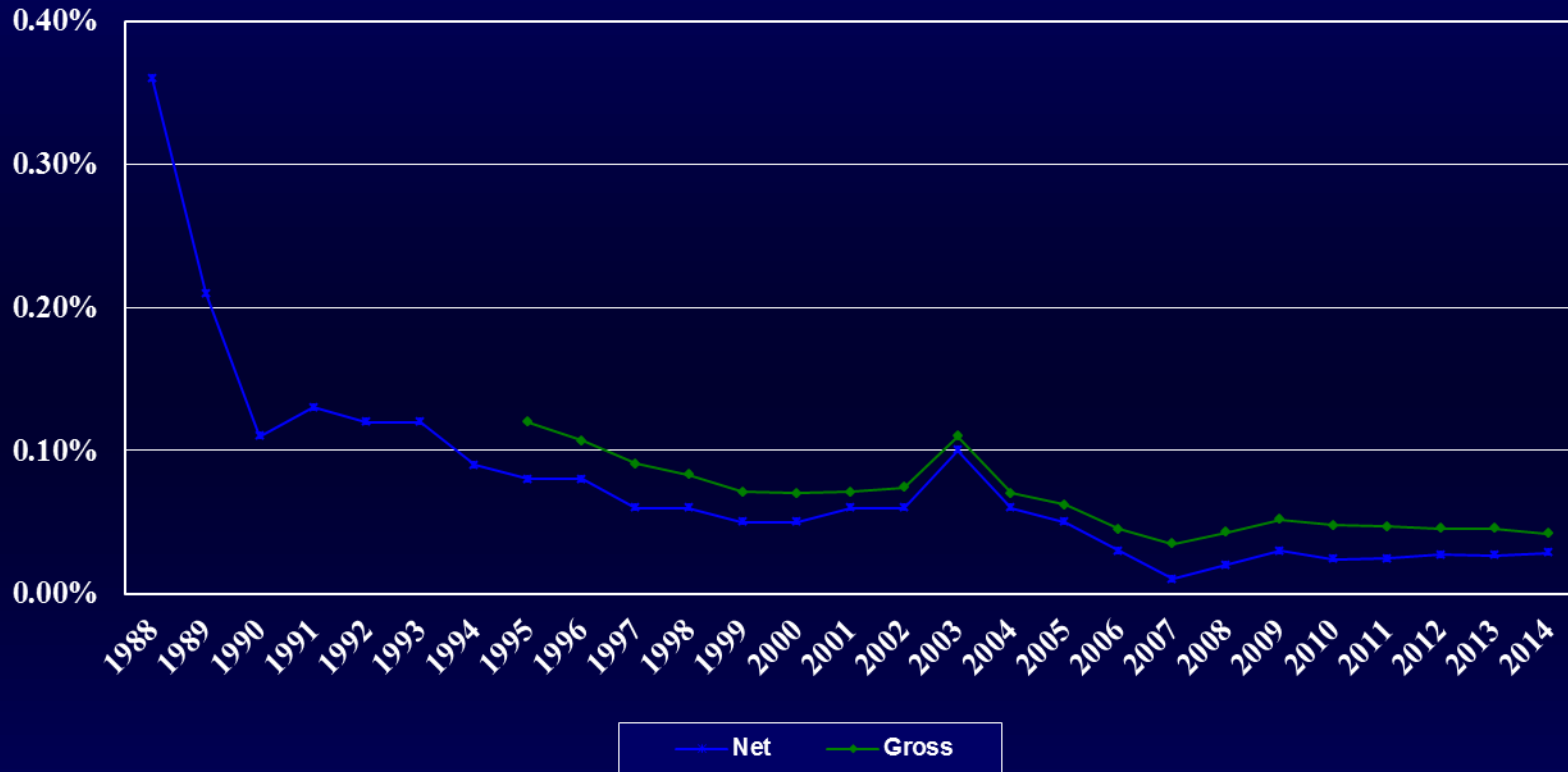


TSP Costs

- ◆ Total TSP expenses were \$168 million in 2014
- ◆ Includes both administrative and investment management costs
- ◆ Employing agencies provide some free services
- ◆ Expense ratio was 4.2 basis points (.042% or 42 cents per \$1,000 of account balance)

TSP Annual Expense Ratios

1988-2014



The gross expense ratio is the annual amount of accrued TSP administrative expenses expressed as a percentage of average assets. The TSP net expense ratio is the annual amount of those administrative expenses charged to participant accounts, after offsets for forfeitures and loan fees. Both represent a blended ratio for all TSP funds.

Expense ratios may also be expressed in basis points. One basis point is 1/100th of one percent, or .01%. Therefore, the 2014 net expense ratio of .0285% is "2.85 basis points." Expressed either way, this means that net expenses charged to each TSP account in 2014 were approximately less than 29 cents per \$1,000 of investment. This is an average net administrative expense of each of the 5 core TSP Funds. Individual fund expense ratios may differ.

Why Are TSP Administrative Expenses So Low?

- ◆ Use of low-cost index funds
- ◆ Simple plan structure (only 5 investment funds)
- ◆ Huge economies of scale
- ◆ Use of investment manager instead of mutual funds for investing
 - Only invest one amount per fund each day – investment manager maintains only one TSP account; not 4.37 million accounts
 - Individual accounts are maintained in TSP record keeping system
- ◆ Competitive procurement of all functions

Part VI. Lessons Learned

25 years of TSP

Key Lessons

- ◆ Independent structure has proven resilient
- ◆ Independence is essential for a civil servant fund
- ◆ Passive investing has provided attractive returns at low cost with less political risk
- ◆ Payout phase needs more study and possible revisions



Questions?

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