TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: S.F. 1160 (Senjem); H.F. 567 (Demmer): MSRS and PERA Plans: Eliminating the Sunset Date on Full Actuarial Value Military Service Credit Purchase Provisions

DATE: March 15, 2005

Summary of S.F. 1160 (Senjem); H.F. 567 (Demmer)

S.F. 1160 (Senjem); H.F. 567 (Demmer) would make permanent, rather than expiring on May 16, 2006, the full actuarial value military service credit purchase provisions in the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), the State Patrol Retirement Plan, the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General), the Public Employees Police and Fire Retirement Plan (PERA-P&F), and the Local Government Correctional Employees Retirement Plan of the Public Employees Retirement Association (PERA-Correctional).

Background Information on the Full Actuarial Value Provisions Proposed for Extension

S.F. 1160 (Senjem); H.F. 567 (Demmer) would make three provisions enacted by the 2000 Legislature permanent provisions. The three provisions are:

1. Minnesota Statutes, Section 352.275, a full actuarial value military service credit purchase provision for the MSRS-General Plan (which also applies for the MSRS-Correctional Plan);
2. Minnesota Statutes, Section 352B.01, a comparable provision in the State Patrol Retirement Plan; and
3. Minnesota Statutes, Section 353.01, Subdivision 16a, a comparable provision applying to PERA plans (PERA-General, PERA-Correctional, and PERA-P&F).

These three provisions allow certain military veterans to obtain service credit in the applicable Minnesota public pension plan. Eligible individuals are those who are active members of the applicable Minnesota plan; are vested in the plan (have at least three years of service credit); and who were in the United States armed forces before becoming a member of the applicable Minnesota plan; or who were eligible to obtain service credit in the Minnesota plan for the military service under the plan's military break in service provision, but failed to utilize that provision in a timely fashion. To purchase the service credit, individuals must pay the full actuarial value of the service being purchased.

Difference between Military Service Full Actuarial Value Provisions and Military Break in Service Provisions

Each of the pension plans previously mentioned has a military break in service provision in addition to these full actuarial value provisions. For most MSRS plans, the military break in service provision is Section 352.27, for the State Patrol it is Section 353B.01, Subdivision 3b, and for the PERA plans it is Section 353.01, Subdivision 16, clause (7). These military break in service provisions are permanent statutes and typically have been part of the plan's law for many decades. The last significant revision of these break in service provisions occurred in 2004, when the provisions were revised to make them consistent with Uniformed Services Employment and Reemployment Rights Act (USERRA) requirements.

The military break in service provisions apply to individuals who were Minnesota public employees before providing the military service and who returned to the same public employer after providing that service. Under these provisions, to receive service credit in the Minnesota plan for the period of military service the eligible individual must pay the employee contributions that would have been paid by the individual if the individual had not left to provide the military service. The employer pays the corresponding employer contribution plus 8.5 percent annual compound interest on the employee and employer contributions from the end of each fiscal year of the leave or break in service to the first of the month in which the employee and employer contributions are received by the plan. The individual is given a period of time in which to make the employee contribution before eligibility under the provision is forfeited. That period is three times the length of the military service that was provided, but not to be less than one year nor more than five years. The maximum service that can be purchased is five years unless a greater maximum is required under federal code. (Federal code does require that the individual be allowed to purchase more than five years if the minimum duration for the specific service is greater than five years. One example is service aboard a nuclear submarine, where the minimum period of service exceeds five years due to an extensive training period.)

In contrast, the full actuarial value military service credit purchase provisions can be used by individuals who provided military service *before* becoming a Minnesota public employee, and by those individuals who forfeited eligibility for the plan's military break in service provision by not making timely contributions. The payment requirements are not as generous as under the break in service provisions. Under the break-in service provision, the individual only needs to pay the contributions the individual would have made to the plan. Under the full actuarial value provision, the individual must make a payment equal to the *full additional liability that the pension fund is expected to have due to the additional service credit being purchased.* If the individual's retirement annuity is expected to increase by $60,000 due to the service credit purchase, the individual must pay $60,000 to receive the service credit. Full actuarial value service credit purchases are almost always considerably more expensive than the employee contribution required under the break in service provision. Another difference is that a service credit purchase under the full actuarial value section is limited to the initial period of enlistment, indication, or call to active duty, without any voluntary extension, while the break in service provision allows for an initial period plus voluntary extensions, but not to exceed five years in total.

<u>Background Information on the Commission's Principles of Pension Policy</u>

The Commission has a statement of pension policy, and these group full actuarial value service credit purchase provisions are not consistent with that statement. The Commission's Principles of Pension Policy states in Principle II.C.10, as follows:

> 10. <u>Purchases of Prior Service Credit</u>
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> Purchases of public pension plan credit for periods of prior service should be permitted only if, on a case-by-case basis, it is determined that the period to be purchased is public employment or substantially akin to public employment, that the prior service period must have a significant connection to Minnesota, that the purchase payment from the member or from a combination of the member and the employer must equal the actuarial liability to be incurred by the pension plan for the benefit associated with the purchase, appropriately calculated, without the provision of a subsidy from the pension plan, and that the purchase must not violate notions of equity.

This principle has the following elements:

1. <u>Individual Review</u>. The Commission considers each service credit purchase request separately, whether the request is proposed legislation for a single person or is proposed legislation relating to a group of similarly situated individuals.
2. <u>Public Employment</u>. The period requested for purchase should be a period of public employment or service that is substantially akin to public employment.
3. <u>Minnesota Connection</u>. The employment period to be purchased should have a significant Minnesota connection.
4. <u>Presumption of Active Member Status at the Time of Purchase</u>. The principle states that contributions should be made by the member or in combination by the member and by the employer. It is presumed that the individual covered by the service purchase request is an active employee, because retirees generally are not considered to be "members" of a plan and these individuals no longer have a public employer.
5. <u>Presumption of Purchase in a Defined Benefit Plan</u>. The prior service credit purchase contributions in total should match the associated actuarial liability. The specific procedures in Minnesota Statutes and law for computing service credit purchase amounts, Minnesota Statutes, Sections 356.55 and 356.551, presume that the purchase is in a defined benefit plan with a benefit based on the individual's high-five average salary.
6. <u>Full Actuarial Value Purchase</u>. The pension fund should receive a payment from the employee, or from the employee and employer in combination, which equals the additional liability placed on the fund due to the purchase. This amount is referred to as the full actuarial value of the service credit purchase.
7. <u>No Violation of Equity Considerations</u>. Purchases of service credit should not violate equity considerations. Equity is a resort to general principles of fairness and justice whenever the existing law is inadequate. Persistent request to reconsider an action the Commission has taken can be considered a violation of equity. Another is a request to purchase service credit after the individual failed to take advantage of earlier laws that permitted the service credit purchase.

Overview of Generalized Service Credit Purchase Provisions Enacted After 1998

The Commission followed this policy statement rather faithfully for many years, through 1998. In 1999, the Commission began to depart from these policy statements, at least in certain cases involving groups of individuals. The Commission was persuaded to support several proposed generalized service credit purchase provisions applicable to the Teachers Retirement Association (TRA) and the first class city teacher retirement fund associations (the Duluth Teachers Retirement Fund Association, the Minneapolis Teachers Retirement Fund Association, and the St. Paul Teachers Retirement Fund Association). Under these provisions, classes of individuals (those with prior military service before becoming a Minnesota public employee, or with a break in service from the public employer but who failed to use the military break in service provision in a timely manner; out-of-state teaching service in a K-12 situation; individuals who taught in parochial schools, or in private schools; provided Peace Corps service; and various other categories) were permitted to purchase service credit in the applicable Minnesota plan for the specified service. These provisions, which were strongly supported by teacher groups, conflicted with the Commission's policy statement in several ways. All lacked any requirement of an individual review of the circumstance. Others allowed purchases for periods that were not public service or had no Minnesota connection.

In 2000, more service credit purchase provisions were added to law, this time for non-teacher plans (MSRS, the State Patrol Retirement Plan, and the PERA plans), providing a full actuarial value service credit provision for individuals who had military service prior to becoming a public employee, or who failed to pay contribution requirements in a timely manner under other military leave service credit purchase provisions. These provisions enacted in 2000 were comparable to the military service credit provisions added to teacher plan law a year earlier. In 2000, teacher plan law was also revised to permit full actuarial value service credit purchases for nonprofit community-based teaching service.

In 2001, several other service credit purchase provisions were enacted. An out-of-country teaching service credit purchase provision was created in teacher plan law, and also one for Development Achievement Center teaching. These new provisions included sections of law permitting purchase of service credit, not to exceed ten years, in the teacher plans for service while teaching at the University of Minnesota which was not covered by a pension plan at the University. These provisions stemmed from a legislative request for the executive director of the Minneapolis Employees Retirement Fund MERF), who many years earlier taught some accounting courses at the University while employed in a position that was excluded from pension plan coverage. The final generalized service credit provision enacted was a family leave provision permitting individuals who may be covered by a teacher plan, or any of several other general employee and public safety plans, to purchase service credit for the past family leaves or family-related breaks in service.

Justification of Legislative Support – 1998 through 2001 Provisions

There are a few reasons why the Commission and Legislature may have supported the above provisions. First, the provisions were intended to be temporary. Each was set to expire a few years after enactment. The departure from policy may have been viewed as a short-term departure from established policy to address short-term market conditions for teachers. Second, the Legislature was given assurances that the provisions created no financial harm to the pension funds because the purchases would be at full actuarial value. The methodology to compute full actuarial value purchase prices had been revised in 1998, and the teacher unions and the administrators of the teacher pension funds expressed confidence that the procedures would produce accurate price estimates, thereby shielding other fund contributors from subsidizing these purchases.

When the revised methodology was enacted in 1998 as Section 356.55, the section included a provision requiring data to be retained and analyzed on every service credit purchase made using the procedure, and the section included an expiration date. If legislative review of these purchases suggested that the procedure was not accurate and was causing subsidies to occur, the section would be permitted to expire. If it expired, a previous procedure used to estimate full actuarial value, coded as Section 356.551, would again become effective. That prior procedure in Section 356.551 tended to produce higher cost estimates than the revised procedure. Teacher unions and other constituent groups favored continuing the revised procedure in Section 356.55, because it tends to produce lower prices. From a policy standpoint, the Section 356.55 procedure is better if it is more accurate than the prior procedure. If the lower prices are resulting in subsidies, its use harms the pension funds.

2003 Commission Study

The various group full actuarial value service credit purchase provisions enacted in the 1998 to 2001 period, and the method to compute the full actuarial value prices to be charged under Section 356.55, were all temporary provisions, subject to expire a few years after initial enactment. As the repeal date for these provisions approached, the repeal dates were extended by the Legislature without much study of the issues, due to strong support for these provisions from the teacher unions and other constituent groups. Most of the provisions were extended more than once.

During the 2003 Interim, the Commission studied the impact of these general law service credit purchase provisions and the full actuarial value methodology over the course of three meetings, hearing testimony from fund directors, teacher union representatives and other interested parties, and considered the three Commission staff memos provided for those meetings. The first meeting was on September 9, 2003, and the staff memo provided a general overview. The second meeting was on October 7, 2003, and the staff memo reviewed each generalized service credit purchase provision enacted after 1998, noted conflicts with the Commission's policy document and other policy concerns, and reviewed the accuracy of the service credit purchase methodology. To review that methodology, Commission staff examined the purchase price produced by the procedure and paid by the individual to the pension plan, and compared that to the additional liability created in the next actuarial valuation due to the specific purchase. The plans and the actuary were required by law to retain and report that information to permit study of the procedure. In reviewing several hundred purchases, in no case did the purchase price match the liability due to that purchase as reflected in the plan actuarial valuation following the purchase. Differences tended to be large, generally several thousands of dollars, and in many cases tens of thousands of dollars. This raised concerns that the pricing method was not accurately estimating the full actuarial value of the service credit purchases, resulting in considerable subsidies in many cases, and possible overcharges in others.

The review of results from the full actuarial pricing methodology concerned Commission members. Commission members were aware that the various full actuarial value service credit purchase provisions enacted in 1999 and later conflicted with the Commission's policy statement, by including purchases for periods of private or nonprofit employment rather than public employment, and in other cases by lack of any Minnesota connection. But these policy departures were believed to create no burden on the pension funds. The Commission's review of results of those purchases raised considerable doubt about the accuracy of the current pricing method, and also whether any system could be devised that can be consistently accurate, because any method must use assumptions about future events. If the Commission cannot be confident in the pricing mechanism, it cannot be confident that the pension funds are not being harmed. Departures from policy, which were assumed to cause no financial harm, may have monetary consequences.

2004 Commission Action

In 2004, bills had been introduced to either extend the various general law service credit purchase provisions or to make them permanent. Similarly, the method used to estimate the full actuarial purchase prices, Section 356.55, was to be made permanent. After reviewing these bills and in light of the 2003 interim study, the Commission and the Legislature decided to allow Section 356.55 to expire. In its place, an alternative procedure for computing the full actuarial value became effective, coded as Section 356.551. This procedure, which actually is the procedure the Commission used before Section 356.55 was enacted, tends to produce higher estimates of price. The Commission also recommended that all the general law full actuarial value service credit purchase provisions, except for the provisions to purchase service credit in the plans for military service periods, should be allowed to expire. Thus, Section 356.55 and most of the full actuarial value service credit purchase procedures expired in 2004, while the Commission and Legislature chose to extend the military service provisions for two more years, to 2006.

Current Situation: Various Full Actuarial Value Service Credit Purchase Provisions

Given actions taken by the 2004 Legislature, only five of the numerous full actuarial value service credit purchase provisions enacted since 1998 remain, those dealing with military service periods. These provisions are the three provisions covered by the current bill (the MSRS, State Patrol Retirement Plan, and PERA plan provisions) and the two provisions not covered by this bill that were enacted for TRA (Section 354.533) and for the first class city teacher plans (Section 354A.097). Under current law, all five of these provisions are set to expire in 2006.

In deciding what to do with some or all of the remaining full actuarial value military service purchase provisions, the Commission may wish to consider that Minnesota public employees who are currently providing military service in Iraq, Afghanistan, or elsewhere, do not need these provisions to receive service credit in the Minnesota plan for the period of military service. They can receive that service credit using the military break in service provisions in the plan, which provide the service credit at a highly subsidized price. The individual would pay only the employee contribution that the individual would have made if they had remained on the job in Minnesota. This is actually better treatment than would have occurred if there had been no break in service, because the individual is charged no interest for the delay in making the contribution. In part, the full actuarial value military service purchase provisions would be used by some who were not Minnesota public employees before providing the military service, but who later became Minnesota public employees. These individuals, however, may have pension rights for the military service period under a military pension, or from their previous employer, due to requirements of USERRA which mandates that the employer extend the employer's pension plan to those who return to the same employer, providing contributions are made. Thus, some of those who might use the full actuarial value service credit purchase provision would be creating double coverage for the military period. Another group who might use the full actuarial value military service credit purchase provisions consists of those Minnesota public employees who failed to make timely payments under the military break in service provisions. Providing a full actuarial value service credit purchase to individuals who fall into either of these categories raises equity concerns which may be viewed as conflicting with the Commission's policy statement.

<u>Discussion of S.F. 1160 (Senjem); H.F. 567 (Demmer)</u>

S.F. 1160 (Senjem); H.F. 567 (Demmer) would make permanent, rather than expiring on May 16, 2006, the full actuarial value military service credit purchase provisions in the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), the State Patrol Retirement Plan, the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General), the Public Employees Police and Fire Retirement Plan (PERA-P&F), and the Local Government Correctional Employees Retirement Plan of the Public Employees Retirement Association (PERA-Correctional).

The bill raises the following pension and related public policy issues:

1. <u>Need for Consideration</u>. The issue is whether there is sufficient need to consider this legislation, at least at this time. The provisions covered by this bill are currently set to expire on May 16, 2006. The Commission could chose to take no action at this time and delay any debate on the bill until the 2006 Session. A related issue is whether there is sufficient need to consider this bill given that Minnesota public employees who return to their current employer after providing military service can receive service credit in the applicable plan under the far more generous terms of the military break in service provision of the plan. For that group, these full actuarial value service credit purchase provisions serve no purpose unless these individuals fail to make timely payments under the break in service provision.

2. <u>Risk Imposed on the Pension Fund</u>. The issue is whether full actuarial value service credit purchases should remain in law, given that these purchase provisions impose risks on the pension plan. This is one reason why the Commission's policy statement advises individual review of the cases, to keep service credit purchases limited to those specific cases which have sufficient merit to warrant imposing risk on the plan. One source of risk is that the methodology used to compute the full actuarial value purchase prices may be faulty. A method that undercharges leads to subsidized purchases, with the cost of the subsidy borne by other employees and by the employers. Given the repeal of Section 356.55 in 2004, that risk should be reduced, but it can not be removed completely.

   The major risk imposed on the pension plans is that the assumptions used in the full actuarial value computation will prove to be inaccurate over time. Any methodology used to compute purchase prices is only as good as the assumptions used in the computation. The computation method must make assumptions about future events such as salary increases over time, mortality during retirement, the age at which the person will retire, and investment earnings. For example, when an employee purchases service credit, it is necessary to estimate the change in the annuity at the time of retirement due to the service credit purchase. In part, the predicted value of that annuity depends on salary increases that will occur between the current date and the date the individual is expected to retire, because the annuity will be based on the individual's high-five average salary. If the individual's salary increases over time are greater than the salary increase assumption used in the computation, the service credit purchase will be subsidized, assuming other assumptions are accurate. Similarly, low pension fund investment returns may create a subsidy. In computing a purchase price, the method assumes that the pension plan will earn 8.5 percent per year on the money received by the fund due to the purchase. If the pension fund can not earn 8.5 percent because of weak investment markets, the price is subsidized. Individuals who purchased service credit a few years prior to retirement, just as the pension funds entered the period in the early 2000s that created negative pension returns, received a subsidized purchase. Whenever individuals purchase service credit in a plan, they are shifting investment and mortality risk from the individual to the pension plan.

3. <u>Conflict with the Commission's Policy Statement</u>. The policy statement indicates that the period being purchased should have a Minnesota connection. The Commission may wish to decide if there is a sufficient Minnesota connection, although the Commission may choose to give little weight to that issue given the value of the service which our military personnel are providing to the country. In cases where the individual was a Minnesota public employee before and after the military service, the Commission may wish to also consider the equity issue of allowing a second chance to individuals who failed to take advantage of far more generous purchase terms, under other provisions of these plans applying to military break in service situations. The Commission may feel this is not a concern, because of the far less generous terms offered under full actuarial value service credit purchase provisions.

4. <u>Matching the Policy Tool to the Objective.</u> The Commission and Legislature may wish to consider the objective, and whether the tool is well designed to meet the objective. If the Legislature desires to honor military personnel through special privileges in recognition of the service they are providing to their country, the Commission and Legislature may wish to consider whether this tool is well designed, or if is too limited in scope to warrant retaining it. The tool causes pension policy conflicts, will provide no actual financial gain to the individual if the computation method and assumptions are accurate, and is unnecessary for most Minnesota public employees who provide military service because they have better purchase terms under another provision of the plan's law. Another matter is that the provisions apply only to a small subgroup of veterans, those who are Minnesota public employees or become Minnesota public employees after providing the military service. The Commission might choose to decide to let these provisions expire and to concentrate efforts on providing some meaningful benefit to all Minnesota veterans, or to all Minnesotans who provided military service in recent conflicts.

5. <u>Scope.</u> If the Commission chooses to retain these provisions, an issue is the proper scope. The MSRS, State Patrol Retirement Plan, and PERA full actuarial value military service credit provisions would be made permanent under these bills, but TRA and the first class city teacher plans have similar provisions which, without legislative action, will expire in 2006. The Commission may want to address the full actuarial value military service credit provisions in all of these plans rather than for only a few of the plans.

6. <u>Permanent versus an Extension</u>. The Commission may wish to decide whether to make these provisions permanent or whether to continue some or all of them as temporary provisions by extending the expiration date from May 16, 2006, to a date to be set by the Commission.

<u>Potential Amendments for Commission Consideration</u>

LCPR05-069 would make the provisions expire on a date to be set by the Commission, rather than being made permanent.

LCPR05-070 would add the teacher plans (TRA and the first class city teacher retirement plans) full actuarial value military service credit purchase provisions to the bills. All of the full actuarial value military service credit purchase provisions would be permanent.

LCPR05-071 would add the teacher plans (TRA and the first class city teacher retirement plans) full actuarial value military service credit purchase provisions to the bills. All of the full actuarial value military service credit purchase provisions would be temporary, expiring on a date to be set by the Commission.