TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director

RE: S.F. 1865 (Kelley); H.F. xxx: TRA; School Administrator Defined Contribution Plan Coverage or Interstate Portability Agreements

DATE: March 29, 2005

Summary of S.F. 1865 (Kelley); H.F. xxx

S.F. 1865 (Kelley); H.F. xxx amends Minnesota Statutes, Chapters 354 and 354B, the governing laws for the Teachers Retirement Association (TRA) and the Individual Retirement Account Plan of the Minnesota State Colleges and Universities System (MnSCU), by adding Minnesota Statutes, Section 354.415 and 354B.215, authorizing public school administrators upon beginning Minnesota public school service to elect to be excluded from TRA and to be covered by IRAP for all subsequent school administrator service, gaining portability through a defined contribution plan and by adding Minnesota Statutes, Section 354.511, authorizing TRA to enter into a cooperative portability agreement with the Wisconsin Retirement System or any other qualified public retirement plan to provide defined benefit pension portability without the transfer of service credit or plan assets, akin to the intrastate Minnesota Combined Service Annuity.

Background Information on Pension Portability

Pension portability refers to mechanisms that allow a person with two or more different employments ultimately to gain pension coverage for the person's entire working career that reflects the totality of that career and provides an adequate benefit.

Portability can be provided in a number of different ways, which include the use of multiple employer retirement plans, the use of defined contribution retirement plans, the consolidation of one retirement plan with one or more other retirement plans, the purchase of prior service credit authorizations, the transfer of assets representing the value of retirement plan coverage, or combined service portability mechanisms between plans.

The use of a multiple employer retirement plan, especially a defined benefit plan, will provide full portability. Social Security is a defined benefit plan that covers the bulk of private sector and public sector employees in the United States and the ultimate Social Security benefit is portable no matter how many different employments a person has. Within Minnesota, the major statewide retirement plans (the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General), and the Teachers Retirement Association (TRA), function similarly.

The use of defined contribution plans will also provide full portability, because the benefit provided by a defined contribution plan is an asset accumulation and money is fungible. This portability concern is the likely significant factor in the prevalence of the Teachers Insurance and Annuity Association – College Retirement Equity Fund (TIAA-CREF) for private sector and public sector colleges and universities.

Consolidations of pension plans, with prior service credit in one plan becoming allowable service credit in a successor retirement plan, will also provide portability. Consolidations within the public sector sometimes occur within states, but rarely or never occur across state boundaries. Consolidations are not usually prompted by portability concerns, but more usually are part of an initiative attempting to address the adequacy of benefit coverage for a type of employee or to address financial difficulties.

Purchases of prior service credit can provide pension portability, but if it is the selected mechanism, suffers from the fragmented nature in which it will be implemented. Service credit purchases can be implemented by one retirement plan without any consultation with or agreement by other retirement plans and has been the focus of groups seeking greater portability, such as the National Council of Teacher Retirement. Service credit purchases only arise with defined benefit retirement plans, where the non-fungible item of value, allowable service credit, is translated into a fungible item, an additional payment of money. Virtually every teacher retirement plan which is a member of the National Council of Teacher Retirement permits the purchase of prior service for teaching service rendered in another state.

Asset transfers also can provide pension portability and represent a more systematic version of the prior service credit approach. Some jurisdictions (i.e., Louisiana, Missouri, New York and Rhode Island) have authority to enter into interstate pension reciprocity agreements where assets related to a member's accrued retirement benefit would be transferred from one plan to another plan and translated into retirement benefit coverage in the subsequent retirement plan. The four-state authority has led to the development of a model interstate portability transfer legislation by the National Council of Teacher Retirement.

In Minnesota, which boasts a large number of both statewide and local retirement plans, intrastate portability has been developed through the "service in more than one plan" combination vesting provision (see Minnesota Statutes, Section 354.60, for an example) or through the "combined service annuity" portability provision. The "service in more than one plan" provisions allow portability of service credit for purposes of vesting for an eventual benefit. The "combined service annuity" provision provides for full portability, with recognition of past service credit for vesting purposes and with the utilization of a common final average salary for all benefit calculations.

Discussion and Analysis

S.F. 1865 (Kelley); H.F. xxx would permit various school administrators to elect retirement coverage by the Minnesota State Colleges and Universities System (MnSCU) Individual Retirement Account Plan, a defined contribution plan, rather than the Teachers Retirement Association (TRA), a defined benefit plan, for future retirement coverage and would allow TRA to enter into a interstate portability agreement with the Wisconsin Retirement System, or any other state retirement plan similar to TRA, that essentially replicates the Combined Service Annuity provision.

The proposed legislation raises several pension and related public policy issues that may merit Commission consideration and discussion, as follows:

1. Actual Need for Out-of-State Teaching Personnel Recruitment. The policy issue is whether or not there is a compelling need for Minnesota school districts to enter a national market to obtain school superintendents and other teaching personnel. Although there are suggestions that Minnesota needs to recruit non-Minnesota teaching personnel and thereby cause an interstate portability problem, it is not clear that there is any discontinuity between the supply of teachers and educational administrators in Minnesota and the need for teaching personnel by Minnesota school districts. With over 60,000 teachers and over 700 school districts and other educational entities, there may be a sufficient pool in the state of potential educational administrators and other teaching specialists that exists without going to extraordinary means to attract out-of-state talent. The experience of current Minnesota teachers and school administrators should be quantified to determine how successful and how valuable educational administrative personnel coming from out-of-state have been. While Minnesota school districts clearly do seek out-of-state talent for some teaching and administrative positions and may gain prestige from hiring from a national talent pool, it is not clear that there is any dispassionate research available that rigorously evaluates the need or discusses the past experience with out-of-state school administrator recruiting and what conclusions can be drawn from that research.

2. Appropriateness of an Interstate Combined Service Annuity Solution. The policy issue is the appropriateness of an interstate combined service annuity as a solution to a mobile teacher pension credit portability problem. The proposed legislation allows the Teachers Retirement Association (TRA) to implement on an interstate basis the same portability mechanism that Minnesota uses to provide intrastate portability between the state's numerous public pension plans. The proposed legislation would provide a mobile teacher with essentially the same benefit in combination from all applicable plans that the person would have had if the person had been covered by one plan for the duration of teaching service and would allow for TRA to collect from other plans if portability causes more liability in TRA than it does on other state plans. The proposed legislation, however, must be implemented by agreement between retirement plans, rather than by individual member election, so the lone school administrator with prior Wyoming or Alaska teaching service may never gain an opportunity to use the portability mechanism. The proposed legislation also will increase the actuarial cost of all applicable plans, even though it includes a mechanism for recovering any disproportionate level of additional cost, and that cost will be borne by the general teacher retirement plan membership, many of whom lack out-of-state teaching service, and all participating employers.

3. Appropriateness of the Optional Defined Contribution Plan Approach. The policy issue is the appropriateness of creating an option for school administrators to be excluded from Teachers Retirement Association (TRA) coverage in favor of defined contribution pension plan coverage. Portability concerns are not new in public employment and portability is the least well-adapted aspect of the current structure of teacher retirement plans. To gain portability, the proposed legislation uses a defined contribution retirement plan. Among city managers, who function in a national market, and

among college professors, who also function in a national market, both have gained portability by utilizing defined contribution pension plans. City managers, under Minnesota Statutes, Section 353.028, have the option to be excluded from coverage by the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) in favor of the International City Management Association defined contribution retirement plan. Minnesota State Colleges and Universities System (MnSCU) faculty members, under Minnesota Statutes, Section 354B.21, have the option to be excluded from coverage by TRA in favor of the Individual Retirement Account Plan (IRAP), a defined contribution plan. University of Minnesota faculty also are covered by a defined contribution retirement plan. Defined contribution plans are very well equipped to provide portability, but are less well equipped to provide a very specific level of benefits at the end of a school administrator's career. Defined contribution plans work best when contributions are as sizeable as possible as early as is possible, so investment returns can be maximized, and plan investments need to avoid sizeable immediate pre-retirement losses in value and benefits. It is unclear that this option would be useful for existing school administrators who are well into their careers, but could be of advantage to those school administrators who plan to enter the national educational administration market at a relatively early time in their career.

4. Appropriateness of Restricting the Defined Contribution Plan Coverage to School Administrators. The policy issue is the appropriateness of restricting the proposed defined contribution plan coverage to school administrators and not including regular teachers. The logic for the differential treatment is probably because school administrators are more likely to be in a national market than regular teachers and are more like city managers or college professors in this regard. Similarly, Minnesota teachers were covered by a defined contribution plan until 1969 and sought to shift to defined benefit plan coverage as a major initiative for the 1969 Legislature. However, there is some interest by some legislators in replacing the current defined benefit plan coverage for all general employees with defined contribution coverage and creating this coverage option would begin the implementation of this type of change.

5. Appropriateness of Restricting the Defined Contribution Plan Coverage Option to School Administrators Outside the First Class Cities. The policy issue is the appropriateness of extending the defined contribution plan coverage option only to statewide school administrators and not school administrators in cities of the first class. If the defined contribution plan coverage option appropriately addresses the needs of personnel in a national market, the first class city school districts are more likely to be in a national market than many school districts outside the first class city school districts.

6. Extent of Interest by the Wisconsin Retirement System in the Interstate Portability Agreement. The policy issue is the extent of interest that the Wisconsin Retirement System may have in the interstate portability authority provision. Because of the similarity of the retirement plans and proximity, the Teachers Retirement Association (TRA) and the Wisconsin Retirement System are the most likely plans to enter into this type of agreement, although it is not clear that Wisconsin is the predominant out-of-state source of school administrators or teachers. Since the proposed legislation has been developed rather recently and has not been circulated and reviewed extensively, the Wisconsin Retirement System likely has no notice that the proposed legislation exists and consequently has no current interest in it. The provision, if enacted, will be a work in progress over time, since no predecessor agreement scheme or structure exists on which to base the proposal, and the provision can be expected to be revisited frequently by TRA and the Legislature as practical problems develop.

7. Appropriateness of Service Credit Purchases as an Alternative Interstate Portability Solution. The policy issue is the appropriateness of authorizing the purchase of out-of-state teaching service as an alternative solution to demands for interstate defined benefit retirement portability. Out-of-state teaching service credit purchase authorization has been the apparent preferred method for addressing the interstate teaching service portability need for the National Conference on Teacher Retirement, but that preference may be because service credit purchases are simpler to implement and have been more frequently utilized rather than because they are well adapted as a solution to the portability problem. Service credit purchases are problematic because they are sparsely utilized, inherently involve an "election against the fund" situation, are costly either to the member, the employer, the retirement plan, or all three, are potentially time-consuming administratively for both the member and the retirement fund, and potentially permit unintended enrichment. Analyzing the experience with Minnesota Statutes 2002, section 354.534, of the average of 72,000 Teachers Retirement Association (TRA) members who could potentially purchase out-of-state service credit between 1999 and 2004, only six-tenths of one percent of the membership utilized the authority, even given that there should have been a considerable backlog of pent-up demand for the purchase authority, only 10.5 percent of

those purchases involved school administrators, the length of service credit purchased was very short in most cases (i.e., more than one-third less than one year), and did not increase in number as expected in the two years immediately prior to the expiration of the authority. The service credit purchase phenomenon is an individual election scenario, breaking the group average/pooled experience upon which defined benefit plan pension funding depends, and skewing the utilizers to those most benefited. The service credit approach is very costly, analogous to allowing individuals to purchase fire insurance on their houses during or after the fire, when the occurrence of a loss is certain and when there is a need for someone to pay a very large premium in order to maintain the funding health of the pension plan. Assembling and processing the documentation required for a service credit purchase can also be considerable. Since teachers are almost always covered by a retirement plan for all service, and may be able to reinstate that service credit in the prior state after the purchase occurred, out-of-state service credit purchase provisions inherently risk permitting individuals to gain coverage for the same period of teaching in more than one retirement plan. Also, it is unclear that an out-of-state teaching service credit purchase provision is a good solution for individual school administrators at large. Generally, school administrators arise out of the ranks of classroom teachers, meaning that school administrators are likely to have a pre-administrator teaching career and concomitant potentially lengthy pension coverage. Before an administrator enters a national market, the administrator likely will need to gain experience in a state and have additional teacher retirement plan service credit. If the administrator is in a national market and is likely to be in more than two states, the administrator can optimize retirement coverage only when the person takes an administrative position in the final state, since prior state teaching service credit generally may only be purchased once. Also, once an administrator has entered a national market, the person will likely have a more significant salary than the person had early in their teaching career and will be older, which are both factors that will drive up the actuarial cost of any service credit purchase. The service credit purchase, averaging over $20,000 per year of service credit and typically limited to either accrued service credit in the particular pension plan or to ten years of service credit, will be very expensive, may not cover an entire career, and requires considerable preplanning in order to amass the necessary purchase resources.