TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: S.F. 620 (Betzold); H.F. 1758 (Smith): PERA Plans; Reduction in Deferred Annuities Augmentation Rate

DATE: March 15, 2005

Summary of S.F. 620 (Betzold); H.F. 1758 (Smith)

S.F. 620 (Betzold); H.F. 1758 (Smith) amends Minnesota Statutes, Section 353.71, Subdivision 2, by reducing the deferred annuities augmentation rates applicable to General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General) and Public Employees Police and Fire Plan (PERA-P&F) to 2.5 percent per year until age 55 with no augmentation thereafter, rather than the current rates of three percent per year until the first of the year after the individual attains age 55 and five percent per year thereafter, and is applicable for members who terminate service after December 31, 2005.

While there is some ambiguity in law, PERA probably interprets Section 353.71, Subdivision 2, as also applying to Local Government Correctional Service Retirement Plan (PERA-Correctional) employees.

Background Information on Deferred Annuities Augmentation

a. Definition. Deferred annuity augmentation refers to increasing the amount of a deferred retirement annuity by a percentage or dollar amount over time prior to receipt. This replaces all or part of any lost purchasing power in the unpaid retirement annuity due to inflation. Under current law, for members who terminate from PERA coverage after 1989 and who have a right to a deferred annuity due to their covered service, the deferred annuity increases (augments) by three percent annually until the first of the year after the individual turns age 55, and by five percent per year thereafter. Deferred annuity augmentation was added in 1971 to PERA plans, Minnesota State Retirement System (MSRS) plans, the Teachers Retirement Association (TRA), and was also added to first class city teacher plans in 1989, and is also found in the Minneapolis Employees Retirement Fund (MERF).

   Minnesota public pension plans are relatively unique among public and private defined benefit plans in providing deferred annuities augmentation. To the best knowledge of the Commission staff, only the Oregon statewide public employee defined benefit plans also provide deferred annuity augmentation.

   The Minnesota and Oregon plans that have deferred annuities augmentation are defined benefit plans. Defined benefit plans utilize a fixed formula to determine pension benefit amounts (typically years of service multiplied by a percentage benefit accrual rate amount and applied to a final salary or final average salary base). Since the benefit is fixed or specified in law from the individual's salary and service, the variable element is the contributions needed to fund those benefits. Defined benefit plans are distinguished from defined contribution plans, such as the Higher Education Individual Retirement Account Plan (IRAP), Individual Retirement Accounts (IRAs), or Section 401(k) plans, where the fixed element is the level of contributions funding the plan, and the variable element is the benefit to be derived, which is dependent on the investment earnings over time on the stream of contributions and the age of the individual at retirement. When an individual covered by a defined contribution plan changes employment and thus is no longer eligible for the employer's plan, the value of the account will continue to increase over time due to investment earnings on the account. Thus, the eventual retirement annuity that can be supported by the account's value will increase. Deferred annuity augmentation in a defined benefit plan provides a somewhat comparable effect. The individual's deferred retirement annuity is not locked in amount at the time the individual leaves covered service. It continues to grow over time by the percentages specified in law.

   Having deferred annuity augmentation in a defined benefit plans does add to plan cost. Because of the augmentation, the deferred annuitants receive higher benefits at the time of retirement than would be the case if the benefit were fixed at the time of termination of the covered employment.

b. Application in Service-in-More-Than-One-Plan Provisions. When deferred annuities augmentation was first added to various Minnesota plans in 1971, the record suggests that the Legislature wanted to add a tool to complement the service-in-more-than-one-retirement plan provisions (Minnesota Statutes, Section 352.72 (MSRS-General); Minnesota Statutes, Section 353.71 (PERA); and Minnesota Statutes, Section

354.60 (TRA)), to make that portability provision more adequate. However, the Legislature did not restrict its use solely to that provision. Deferred annuity augmentation applied to all deferred annuities, including those where the service-in-more-than-one-plan provisions do not apply.

The service-in-more-than-one-plan provisions were early portability provisions, preceding the Combined Service Annuity provision, Minnesota Statutes, Section 356.30, which was enacted in 1975. The service-in-more-than-one-plan provisions, which still exist in law, allow service with one of the plans covered by these provisions to be used for purposes of vesting in another covered plan. This was an important feature back in the 1970s and early 1980s because vesting normally required ten years of service. Without the service-in-more-than-one-plan provisions, individuals who were job mobile, moving to various positions covered by various Minnesota public plans within different systems, might fail to vest in some of the plans due to the long vesting requirement. By allowing service in one fund to be used for purposes of vesting in another, the service-in-more-than-one-plan provisions helped job mobile individuals to vest in the applicable plan or plans and made them eligible to receive benefits.

While this helped job mobile individuals to vest, these individuals still faced a problem. The value of the benefit from the early plans would erode considerably in value over time if the benefit was fixed at the time the individual left that service. Deferred annuities augmentation addressed that problem by allowing the annuity from the early plan or plans that provided coverage to increase over time, providing a benefit at retirement that was at least somewhat similar to what would have occurred if coverage had been provided by a single plan for the individual's entire public service.

To demonstrate, the following compares the total retirement annuity of a public employee with 30 years of public service under three different scenarios. Scenario A shows coverage by three different plans and without deferred annuity augmentation. Scenario B shows coverage by three different plans with deferred annuity augmentation. Scenario C shows coverage by one plan for all service. The individual is assumed to begin service in 1970 with TRA coverage, and the individual leaves that service after ten years with a high-five average salary of $22,500. The individual then moves to PERA-covered employment, having that coverage until 1990, with a high-five from that service of $33,100. The individual then moves to MSRS-covered employment, retiring in 2000 with a high-five of $46,660. Without deferred annuities augmentation, Scenario A, the sum of the three retirement annuities is $13,492 per year. Under Scenario B, deferred annuities augmentation is applied and it boosts the value of the TRA and PERA pensions, creating a total from the three plans of $17,117 per year. Under Scenario C, the individual spends all 30 years of employment under a single plan, the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General). The individual's pension is $23,796 per year. While deferred annuities augmentation does help, in this example it falls short of providing the same pension that would have occurred if all service had been under a single plan.

Scenario A	
Coverage by TRA, 1970-1980	
Final Average Salary	$22,500
Annual Deferred Retirement Annuity	$2,250
Coverage by PERA, 1980-1990	
Final Average Salary	$33,100
Annual Deferred Retirement Annuity	$3,310
Coverage by MSRS, 1990-2000	
Final Average Salary	$46,660
Annual Retirement Annuity	$7,932
Total Annual Annuity	
TRA Annuity	$2,250.00
PERA Annuity	$3,310.00
MSRS Annuity	$7,932.00
Total	$13,492.00

Scenario B	
Coverage by TRA, 1970-1980	
Final Average Salary	$22,500
Initial Annual Deferred Retirement Annuity	$2,250
Augmented Deferred Retirement Annuity	$4,503.60
Coverage by PERA, 1980-1990	
Final Average Salary	$33,100
Initial Annual Deferred Retirement Annuity	$3,310
Augmented Deferred Retirement Annuity	$4,682.00
Coverage by MSRS, 1990-2000	
Final Average Salary	$46,660
Annual Retirement Annuity	$7,932
Total Annual Annuity	
TRA Annuity	$4,503.60
PERA Annuity	$4,682.00
MSRS Annuity	$7,932.00
Total	$17,117.60

Scenario C	
Coverage by MSRS, 1970-2000	
Final Average Salary	$46,660
Annual Retirement Annuity	$23,796.60

c. Combined Service Annuity Provision. Service-in-more-than-one-fund provisions are less used now than in the distant past. In 1975, the Legislature enacted the Combined Service Annuities law, Section 356.30, which was an improvement in many cases over the service-in-more-than-one-fund provisions. The Combined Service Annuities law applies to those Minnesota public defined benefit plans which base annuities on the high-five average salary. Local police or paid fire plans are not included under the Combined Service Annuities provision because those plans base their annuities on the salary of a certain position, usually a top grade patrol officer or firefighter. The Combined Service Annuities calculation begins by determining the high-five average salary of the individual, which could include service under more than one employer, and that common high-five average salary is then used to compute the annuities from all the plans included in the calculation. Thus, the salary used to compute the annuities from the earlier plan or plans may be much higher than the salary the individual was receiving before terminating that earlier employment. The benefit computed from each of the applicable plans is determined using the most recent version of law, thus allowing the individual to access any benefit improvements that occurred in the earlier plans after the individual left service covered by the applicable plan. The individual must begin drawing annuities from all the plans included in the person's Combined Service Annuities benefit calculation within a one-year period. The use of Combined Service Annuities is in lieu of deferred annuities augmentation from the earlier covered plans.

Some individuals have service in more than one of the plans covered by the Combined Service Annuities law, but choose not to use that provision. In these cases, deferred annuity augmentation would apply if the plan has an applicable provision. This can occur in cases where the normal retirement ages in the plans that provided coverage to the individual are very different. If an individual age 55 had prior Public Employees Police and Fire Plan (PERA-P&F) coverage (a plan with normal retirement age of 55), and the individual is now covered by the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) (which has an age of 65 or 66 normal retirement age), the individual may be reluctant to leave current employment in order to use the Combined Service Annuities provision. He would face a stiff early retirement penalty from the MSRS plan if he begins drawing an MSRS annuity at age 55. Instead, the individual may choose to draw the PERA-P&F annuity, including any deferred annuity augmentation on that benefit, and continue working in MSRS-General covered employment.

Thus, at the current time, deferred annuities augmentation is used by individuals who could be covered by the Combined Service Annuities but choose not to use that provision, by individuals moving among Minnesota public plans not all of which are included in the Combined Service Annuities law, and by individuals who move from public to private sector employment.

Actuary Commentary from 1978, on Augmentation Provisions

Attached is a brief memo from Franklin C. Smith, an actuary who provided advice to the Legislative Commission on Pensions and Retirement during the 1970s. In the memo written in 1978, he notes that following the addition of the Combined Service Annuities provision in 1975, deferred annuities augmentation provisions were no longer of much use to individuals who move to different positions within the public sector. Its main value is to assist those who move to non-public employment. Since protecting that group had not been stated as a priority by the Legislature, he suggested that the Legislature consider repealing augmentation provisions. The Legislature did not act on the suggestion.

Deferred Annuities Augmentation Provisions, as Amended Over Time

The 1971 Legislature created deferred annuities augmentation. The 1971 legislation specified that deferred annuities will augment at the same rate as the investment earnings assumption used by the plan. The level of deferred annuities augmentation therefore changed as the investment return assumption was revised. That assumption was 3.5 percent in 1971, but was revised in 1973 (Laws 1973, Chapter 653, Section 45), to five percent. Deferred annuity augmentation provisions were revised again by the 1978 Legislature, which amended the deferred annuity augmentation provisions by removing the tying of the augmentation rate to the investment return assumption, and instead set the augmentation rate at three percent per year after January 1, 1981. By using a January 1, 1981 effective date on the deferred annuities augmentation provision, the 1978 Legislature provided a few years of lead time on the benefit reduction. The 1989 Legislature again revised the provisions, this time enhancing the deferred augmentation provisions by increasing augmentation after age 55. As revised in 1989, the provisions provided three percent per year augmentation until the first of the year after the individual turns age 55, and five percent annually thereafter. The 1989 revisions were part of a major benefit increase bill which in part increased the accrual rates in

many plans, created subsidized joint-and-survivor annuities, and enhanced the deferred annuity augmentation provisions.

Plans with Deferred Annuity Augmentation Provisions

The PERA/PERA-P&F deferred annuity provision currently provides three percent augmentation to the first of the year following the individual's 55th birth date, and five percent per year augmentation thereafter. As noted below, numerous general employee plans have provisions using the same rates as that of PERA/PERA-P&F. The Minneapolis Employees Retirement Fund (MERF) differs, providing three percent augmentation per year.

The MSRS State Patrol Plan and the PERA-P&F Plan, which are nearly identical plans, have slightly different deferred annuity augmentation treatments specified in law. The State Patrol Plan provides three percent annual augmentation to age 55, but no augmentation after that age. This may cause no difference in practice, though, because the normal retirement age for this plan and for PERA-P&F is age 55.

The deferred annuity augmentation provisions in law are:

- Section 3A.02, Subdivision 4. Applies to the Legislators' Plan and is substantively identical to the PERA/PERA-P&F provision.

- Section 352.72, Subdivision 2. Applies to MSRS General and MSRS-Correctional Plan, and is substantively identical to the PERA/PERA-P&F provision.

- Section 352B.30, Subdivision 2. Applies to the MSRS State Patrol Plan, and provides three percent augmentation per year until age 55, which is the normal retirement age for the plan.

- Section 352C.033. This provision is substantively identical to that found in PERA law and applies to the Elected State Officers Plan.

- Section 353.71, Subdivision 2. This is the PERA/PERA-P&F provision, which provides three percent augmentation per year until the year in which the individual turns age 55, and five percent per year thereafter. The provision was probably also meant to apply to PERA Local Government Correctional Plan members, although the applicable law is somewhat unclear.

- Section 354.55, Subdivision 11. This is the TRA provision, which is substantively identical to the PERA/PERA-P&F provision.

- Section 354A.37, Subdivision 2. This is the first class city teacher provision, which is substantively identical to the PERA/PERA-P&F provision.

- Section 422A.16, Subdivision 10. This is the MERF provision, providing three percent augmentation per year.

MSRS Plan with No Apparent Augmentation Provision

The MSRS Judges Plan has no deferred annuities augmentation provision. That may reflect an assumption that Judges will continue in office until retirement.

Motivation for Proposing to Reduce Deferred Annuity Augmentation

Deferred annuity augmentation under PERA's Section 353.71, Subdivision 2, is of considerable value to plan members who become deferred annuitants. The proposed reduction would harm existing members who terminate as deferred annuitants after calendar year 2005. This is not an action that PERA would take lightly. The probable reason for the proposal is that PERA seeks to reduce plan costs, to help with the contribution deficiencies occurring in PERA-General and in PERA-P&F. PERA has bills introduced on its behalf to increase PERA and PERA-P&F employee and employer contribution rates (S.F. 286 (Betzold, by request); H.F. 1755 (Smith): PERA Employee and Employer Contribution Rate Increases; and S.F. 621 (Betzold, by request); H.F. 1756 (Smith): PERA-P&F, Employee and Employer Contribution Rate Increase).

Attached are copies of PERA-General and PERA-P&F actuarial presentations from 1998 through 2004, and the PERA Local Government Correctional Plan from 1999 (the first year for which data are available for that plan) to 2004. The PERA Local Government Correctional Plan is a fairly new plan.

PERA-General's funding ratio has generally drifted downward since 1999, from a high of 89.9 percent funded to the current 76.7 percent funded. In 1998 and 1999, the fund had a very slight contribution sufficiency, meaning that although the plan had a funding ratio slightly under 90 percent, the plan contributions were believed to be sufficient to fully fund the plan by the full funding date, 2020. The actuarial work for the next year shows a large increase in normal cost, from 7.49 percent of payroll in 1999 to 9.33 percent of payroll in 2000. This was the predominant cause for the plan's shift from a slight sufficiency to a 1.96 percent contribution deficiency. It is unclear what full range of factors caused the jump in normal cost, but one factor which contributed was that the age of new entrants to the plan was increasing. Older employees have a higher normal cost than young employees, so if new entrants were tending to be older, this would raise the plan normal cost. In the 2001 legislative session, the employee and employer contributions were increased, effective January 1, 2002, and the full funding date was extended to 2031. The increased contributions were intended to reduce the gap between the required contributions as indicated by the actuary and the contributions being made to the plan under law, while the extended amortization date would lower the annual amortization requirement. Despite these efforts, little if any progress has been made on the contribution deficiency and the funding ratio. During the early 2000s, investment markets were weak. These low and in some cases negative returns are continuing to impact the actuarial value of assets (referred to as "current assets" in the actuarial work). The unfunded liability has been growing, leading to a 4.25 percent of payroll amortization requirement in 2004, more than twice the amortization requirement as a percent of payroll that was needed in 1998 or 1999.

The PERA-P&F plan is unusual in having a normal cost considerably in excess of its total contributions, yet is 101 percent funded, although its funding ratio has been trending downward for several years. In 1998, the plan had a funding ratio of 134 percent. Under law, that excess of assets over liabilities is used to reduce the funding requirement through negative amortization (computed over rolling 30-year periods), using a portion of the excess assets to reduce the contribution requirement below what it would otherwise be. Weak markets have impacted the plan. Assets have not increased much at all from 2002 to 2004 while liabilities have increased by $800 million, in part due to extensive use of the plan's generous disability provision. Normal cost has also increased in 2003 and 2004. The fund has gone from a payroll *sufficiency* of 7.6 percent in 1998 to a 6.55 percent of payroll contribution *deficiency* in 2004, a swing of over 14 percent of payroll.

The PERA Local Government Correctional Plan went from being 109 percent funded in 1999 to 88.6 percent funded in 2004. Again, the investment markets played a role in reducing the funding ratio. That plan, however, continues to have a contribution sufficiency.

Privatizations: Deferred Annuities Augmentation Treatment Under Chapter 353F, PERA Privatized Hospital

Several years ago, the Legislature enacted what became Minnesota Statutes, Chapter 353F, PERA Privatized Hospital, to deal with public employer privatizations, either through a sale or lease to a private sector company or nonprofit corporation, or due to reorganization that changes a public employer into a 501(c)(3) nonprofit corporation. The original model for the public retirement plan treatment under these situations was the Fairview/University Hospital merger, which privatized many employees who previously were state employees covered under MSRS-General. The new MSRS treatment was coded in 1996 as Chapter 352F, University Hospital Employee Retirement. A few years later in 1999, some PERA privatizations occurred and the same policies were adopted and coded as Chapter 353F. To date, the PERA privatization chapter has been used for the following privatizations:

- Fair Oaks Lodge in Wadena
- the Glencoe Area Health Center
- Kanabec Hospital
- Luverne Public Hospital
- RenVilla Nursing Home
- Renville County Hospital in Olivia
- Saint Peter Community Healthcare Center
- Waconia-Ridgeview Medical Center, Metro II (a joint power organization formed under Section 4761.59)
- Saint Paul Civic Center authority

Several bills have been introduced during the 2005 session which request that employees in certain new public hospital privatizations be included under Chapter 353F.

When a privatization occurs, the privatized employees are no longer eligible for continued PERA or MSRS coverage as active employees, because the employees are no longer public employees. For purposes of the

pension plan, they are terminated employees although many of them may continue in the same employment, although now under a privatized employer.

Privatized employees who are included under Chapters 352F or 353F are extended certain benefits that other terminated employees do not receive. One justification for this different treatment is that the privatized employees did not choose to leave public service and to end public retirement plan coverage. Their employee status changed from public to nonpublic due to an action by the employer that transferred ownership of the facility rather than by an exercise of free will on the part of the employee.

Under a privatization that is included under Chapter 352F or 353F, the following special coverage provisions are extended to the privatized employees:

1. Vested Benefit with Any Service Length. The normal three-year PERA vesting period is waived, so a privatized employee with less than three years of PERA-covered service would be entitled to receive a PERA retirement annuity, notwithstanding general law.

2. Increased Deferred Annuity Augmentation Rate. For the period between the date of privatization and the date of eventual retirement, the privatized employee's deferred PERA retirement annuity will increase at the rate of 5.5 percent rather than three percent until age 55 and at the rate of 7.5 percent rather than five percent after age 54.

3. "Rule of 90" Eligibility with Post-Privatization Service. For privatized employees with actual or potential long service who could have retired early with an unreduced retirement annuity from PERA under the "Rule of 90" (combination of age and total service credit totals 90), the employee will be able to count future privatized service with the hospital for eligibility purposes, but not for benefit computation purposes.

Of importance for the current bill is the enhanced deferred annuity augmentation treatment under privatizations. PERA is proposing to considerably reduce the deferred annuity augmentation received by PERA terminated employees in situations other than privatizations. That upsets the relationship between the terminated employee and privatized employee augmentation rates. The Commission may wish to review the privatization treatment. If the current bill were enacted, the gap between the augmentation rates for privatized employees under Chapters 352F and 353F and those of other terminated employees will widen considerably. If the differential between these two treatments was deemed appropriate before, then the Commission would need to downsize the treatment under privatizations, through an amendment, to keep a semblance of the same differential. Under the current bill, terminated employees would receive no augmentation after age 55, while privatized employees will continue to receive much higher augmentation to age 55, and 7.5 percent per year annually thereafter.

Policy Issues

S.F. 620 (Betzold); H.F. 1758 (Smith) amends Minnesota Statutes, Section 353.71, Subdivision 2, by reducing the deferred annuities augmentation rates applicable to PERA-General and PERA-P&F to 2.5 percent per year until age 55 with no augmentation thereafter, rather than the current rates of three percent per year until the first of the year after the individual attains age 55 and five percent per year thereafter, and is applicable for members who terminate after December 31, 2005. Policy issues are:

1. Policy for PERA Deferred Annuitants. The bill requires the Commission and the Legislature to reconsider treatment of individuals who leave PERA for private sector employment, or in some cases, other public sector employment. The current policy is to provide fairly generous augmentation, helping to keep the deferred benefit whole in real terms. This feature adds a defined contribution notion to the defined benefit plan, allowing the reserves for the annuity to increase over time, somewhat similar to what would occur to an individual's defined contribution account value after leaving the given plan, but prior to drawing an annuity. The proposal would reduce deferred annuities augmentation to 2.5 percent per year, terminating at age 55.

2. Inconsistency Between Terminated Employee Treatment and Privatization Treatment. The issue is the gap between deferred annuity augmentation treatment for terminated employees and those under PERA or MSRS privatization laws. PERA is proposing to considerably downsize the augmentation for terminated employees but is not proposing any revision in the augmentation under a privatization. The Commission may wish to consider an amendment to keep reasonably similar differentials between the terminated employee and privatized employee treatments.

3. PERA and PERA-P&F Current Actuarial Condition. The current proposal is presumably part of an effort to reduce cost in PERA-P&F and PERA-General to help reduce the contribution deficiency in these plans. The Commission may wish to review the current actuarial condition including the

contribution sufficiencies of PERA-General and PERA-P&F. An actuarial presentation of these pension funds covering several years is attached. Any revision in deferred annuity augmentation can at most play a minor role in correcting any contribution deficiencies. The Commission may wish to consider whether that tool should be used at all to address the funding problem. The significant problem in PERA-P&F is that the total contributions are far less than the plan's normal cost (the cost of operating the fund for another year, given the benefit package provided and the additional service credit the members will accrue for the year in the plan). The PERA-P&F actuarial information suggests that use of negative amortization may deserve Commission study. In past years, negative amortization masked the persistent shortfall between the normal cost and the contributions. In 2004 the normal cost was 22.37 percent of payroll, while the total contributions were only 15.5 percent. Bad markets and negative amortization have nearly eliminated all surplus assets, so there will be no excess assets to cover the difference going forward. Unless the future provides extraordinary investment returns, large contribution deficiencies will persist and this fund will become less than fully funded next year. The Commission may also wish to recall that last year, PERA made an initial attempt to revise PERA-P&F disability procedures, to limit abuses of those provisions. It might be productive to do more work in that area.

Regarding PERA-General, the immediate problem is the growing amortization requirement, currently 4.25 percent of payroll. A key cause of that problem is several years of poor investment markets. The Commission and the Legislature might choose to take a wait-and-see attitude. It is possible that much of PERA-General's problem could go away if there are a few years of good investment returns.

4. Interaction with Other Bills. The Commission may wish to consider that bills have been introduced to increase PERA-General and PERA-P&F contribution rates. These bills are S.F. 286 (Betzold), by request); H.F. 1755 (Smith): PERA Employee and Employer Contribution Rate Increases; and S.F. 621 (Betzold, by request); H.F. 1756 (Smith): PERA-P&F, Employee and Employer Contribution Rate Increase. The Commission may wish to consider the current bill in conjunction with those bills, and to take no action on the current bill if there is no action to revise the contribution rates to the plans.

5. Cost Savings Provided by Proposal. The issue is the cost savings expected from the proposal. If the savings are modest, that might support not making any change, given that the change does create harm and may not be viewed favorably by the plan membership. PERA should be able to provide that information. The proposal grandfathers in any existing PERA plan deferred annuitants and those who terminate before January 1, 2006. That may make the change more palatable and it may reduce the likelihood of a legal challenge, but it also lowers the cost savings that will occur under the proposal, making it less effective in addressing the contribution deficiencies in the PERA-General and PERA-P&F plans. The approach least likely to draw legal challenge would be to make the change in deferred annuity augmentation apply only to new hires. However, this would yield virtually no immediate cost savings and thus would be ineffective in reducing the contribution sufficiency.

6. Implications of Eliminating Augmentation After Age 55. The proposal reduces deferred annuity augmentation prior to age 55 to 2.5 percent per year, but eliminates it entirely after age 55. This increase matches the maximum inflation match provided under the State Board of Investment Post Fund, and the removal of any augmentation after age 55 will provide an incentive for deferred annuitants to start drawing an annuity from the Post Fund at age 55, the earliest retirement age generally permitted under general employee plans. The Commission may wish to explore through testimony why PERA wants to create that incentive. Annuities prior to the plan's normal retirement age (age 65 to 66), would often be subject to early retirement penalties. Drawing an annuity early may not harm pre-1989 hirees greatly, since they have access to various forms of subsidized early retirement options (Rule-of-90 and various other provisions which use less than an actuarial reduction). But it may be a considerable hardship for post-June 30, 1989 hirees, who have access to few if any subsidized early retirement provisions. For both pre-July 1, 1989 and post-June 30, 1989 hires, revised deferred annuity augmentation provisions will lead to tax effects if it causes individuals to begin drawing the annuity sooner. People may have preferred to delay receipt of the annuity until later years when they have left the workforce and their tax brackets are lower.

7. Benefit Reduction, Possible Court Challenge. The Commission may wish to consider that reducing or eliminating deferred annuity augmentation might lead to legal challenges, although apparently there were none when the 1978 Legislature reduced deferred annuity augmentation after January 1, 1981. The bill revises deferred annuity augmentation for those members who have not yet terminated (those who will terminate on or after January 1, 2006). By not reducing the benefit to anyone who already is deferred, the bill is less likely to be successfully challenged in court. If there were a challenge, the courts might conclude that a benefit reduction is justifiable if the plan were in extreme financial condition and if the benefit reduction was accompanied by other steps (including contribution rate

increases) to address the problem. PERA-General is far from being in a crisis condition, while PERA-P&F still has a funding ratio (assets divided by liabilities) of 100 percent.

8. Effective Date Issue. The Legislature delayed the start of the 1978 deferred annuity augmentation reduction a few years, until January 1, 1981. The current proposal would only delay the impact of the reduction to January 2006. The Commission may wish to delay the change further. Delaying the reduction may be of value to the membership by giving them more time to react to the change, and may help in any legal challenge. However, the delay will lessen and delay any positive impact on the financial condition of the PERA plans.

9. Inflation Concern. The proposed change will make future deferred pensioners more vulnerable to high rates of inflation, if that were to occur.

10. Conflict with Commission Policy, Creating Inconsistencies Among Comparable Plans. The Commission has long followed a policy of ensuring that different public benefit plans which cover similar individuals should provide comparable benefits. Thus, changes in the PERA-P&F benefit plan are generally accompanied by comparable changes in the MSRS State Patrol Plan, and changes in PERA-General are generally accompanied by comparable changes in MSRS-General, TRA, and the first class city teacher plans. The proposed PERA changes would add to inconsistencies between PERA-P&F and MSRS State Patrol, and would make PERA-General inconsistent with the other general employee plans.

11. Scope. If the Commission concludes that the bill has merit, and is concerned about the inconsistencies the bill creates between comparable plans, the Commission may wish to consider an amendment to expand the proposed treatment to similar plans.

Amendments

Several amendments are attached for your consideration, but because of the wide range of possible combinations, it may be necessary for the Commission to give staff specific direction for additional language to be considered at a future meeting.

LCPR05-076 is a technical amendment, specifying that augmentation rates compound annually, lettering paragraphs, and clarifying the treatment of those who terminated service on May 16, 1989.

LCPR05-077 is a substantive amendment, and could be used to revise the augmentation rate for the post-December 2005 terminated employees up to age 55 from 2.5 percent to a percent to be specified.

LCPR05-078 is an alternative to LCPR05-077. The amendment deletes the 2.5 augmentation rate to age 55 and allows the Commission to insert a different rate to be specified and permits augmentation after age 55 at a rate to be specified.

LCPR05-079 allows the Commission to set a different effective date for revised benefits provided by the bill, from January 1, 2006 to a date to be specified.

LCPR05-080 can be used to revise the deferred annuity augmentation rates in the MSRS and PERA privatization chapters, Chapter 352F and 353F respectively, from 5.5 percent per year to the year in which the individual turns age 55, and by 7.5 percent thereafter, to rates to be specified. If the Commission wishes to provide no augmentation after age 55 under a privatization, the Commission could use a verbal amendment to LCPR05-080 to strike the sentence in the MSRS privatization provision and in the PERA privatization provision containing the current 7.5 percent augmentation rate.

LCPR05-081 will apply the treatment specified in the bill (2.5 percent annual augmentation to age 55, and no augmentation thereafter, rather than three percent annual augmentation to age 55 and five percent annual augmentation thereafter) to the MSRS Legislators Plan, MSRS-General, MSRS State Patrol, TRA, and the first class city teacher fund associations. This amendment creates uniformity between comparable plans. If the Commission revises the PERA and PERA augmentation provision differently than is stated in the bill or uses a different effective date for the change, by using one or more of the prior amendments, then the Commission can give staff direction to revise LCPR05-081 accordingly to be consistent.