Background Information on the Implications of Benefit Improvements

1. Implications: Employee Financed Improvements in Early, Mid-1990s. In the early to mid-1990s, the Legislature granted benefit improvements in the form of higher accrual rates for the Teachers Retirement Association (TRA) (1993), the Duluth Teachers Retirement Fund Association (DTRFA) (1995), and the State Patrol Retirement Plan of the Minnesota State Retirement System (1995). In 1993, the accrual rates in the Public Employees Police and Fire Retirement Plan (PERA-P&F) were increased, and in 1995 penalties for early retirement were reduced. With the exception of the PERA-P&F increases, the benefit improvements were to be paid for by higher employee contributions with no change in the employer contributions. The new employee contribution rate was to be sufficient to cover the higher normal cost of the revised plan and the necessary payments to retire the unfunded liability created by applying the higher accrual rates to past years of service.

These employee-financed benefit improvements had significant pension policy implications. First, the contribution rate changes caused further variation from the policy stated in the Commission’s Principles of Pension Policy, which recommends an equal sharing of normal cost and expenses between the employee and the employer for nonpublic safety plans, and a 60% employer, 40% employee sharing of normal cost in public safety plans. Second, employee-financed benefit improvements within a defined benefit system are inconsistent with the concept that our defined benefit plans are employer personnel policy tools to attract, retain, and out-transition employees at the end of their working careers. The employer is relinquishing control over retirement benefit adequacy issues to the employees, but the employer is continuing to guarantee the outcome. Third, these employee-financed benefit improvements also lead to disparity in benefit levels between plans covering similar employees, which can create pressure from members of the other plans for further benefit improvements to equalize benefits between comparable plans.

2. Implications: Windfall to Older Employees When Applying Increased Accrual Rates to All Years of Service with Benefit Improvement Financed by Employee Contributions. The discussion at the time of the TRA, DTRFA, and State Patrol plan employee-financed benefit improvements in the early and mid-1990s also made the Legislative Commission on Pensions and Retirement more aware of the impact from following the typical practice of including past service in the benefit improvement. The revised employee contribution rates were intended to cover the cost of the benefit improvement and the necessary payment toward the unfunded, with employers paying nothing toward the benefit increase. Within the employee group, some received a windfall. Because this increase was financed solely by employees, it follows that the cost of that windfall had to be covered by the remaining employees. The windfall group was the employees close to retirement. They paid higher contributions for only a brief period, and the total contributions they made over their remaining work period were far less than the value of the increased benefit they received. It follows that those farther from retirement had a net loss. For younger employees, the present value of their additional contributions over time is greater than the value of the additional benefits they would receive in retirement. Younger and many mid-career employees would be better off making a contribution to a supplemental defined contribution plan and forgoing the change in the defined benefit plan.

To illustrate the effect for employees about to retire, assume a coordinated TRA member who retires with 30 years of service at age 65, one year after the effective date of the 1993 TRA benefit improvement, with a high-five average salary of $40,000. For simplicity we also will assume a final salary of $40,000. Due to the benefit improvement, the accrual rate (the percentage of the high-five average salary received per year of service) used to compute benefits at the time of retirement was 1.63% rather than 1.5%. To pay for the benefit improvement the employee contributions were increased by 2.0% of pay for all active teachers. In the one year this teacher worked following the effective date of the benefit improvement, he or she contributed $800 toward the cost of the benefit improvement ($40,000 x .02 = $800). The annual benefit will be $1,560 higher due to the benefit change, $19,560 per year rather than $18,000. The individual will recoup that $800 added cost by the seventh month of retirement. In contrast, younger employees will pay higher contributions for many years, and these higher contributions must be sufficient to cover the added cost of their own retirements plus the windfall to those who retire shortly after the benefit improvement went into effect.

In general, pressure for benefit improvements come mainly from individuals nearing retirement. It generally is not until people approach retirement age that they pay attention to retirement issues. If younger and mid-career employees supported the State Patrol, TRA, and DTRFA employee-financed benefit improvements of the early to mid-199s, either they did not understand the implications of the proposals, or they believed that the employee financing agreement would soon be changed with
employers agreeing to pick up part of the cost, or employees expected a further benefit increase with a general realignment of contribution rates.

3. Implications: Windfall to Older Employees When Applying Increased Accrual Rates to All Years of Service with Benefit Improvement Cost Shared by Employee and Employer. If past service is included in a benefit improvement, windfalls can be greater when benefit improvements are financed by increasing both the employee and employer contributions. The windfall to the older employee is likely to be greater than with an increase financed solely by additional employee contributions, because part of the cost is being picked up by the employer. Consider the example used above, where the employee retired one year after the benefit improvement is implemented. The employee paid only $800 toward the benefit improvement, which the individual recouped after only seven months in retirement. If, instead, the employer had covered half the cost of the benefit improvement, the person would have paid only $400 toward the benefit improvement, which would have been recouped after only three or four months in retirement.

Regarding younger employees, their burden is lessened due to the cost sharing. If the benefit improvement was financed solely through employee contributions, costs are covered over time mainly by younger and mid-career employees covered by the plan. When cost is shared between the employee and employer, some of the burden for the additional normal cost and additional unfunded liability is shifted to the general taxpayer.

4. Implications: 1997 and Later Accrual Rate Increases. In 1997 benefits were revised in the MSRS, PERA, and TRA plans, and also first class city teacher plans. From 1980 through 2009 the retirement assets for members of MSRS, PERA, and TRA plans were divided into two funds invested by the State Board of Investment, the Basic Fund which contained assets of active and deferred employees, and the Post Fund which contained the assets of plan retirees. In 1997, the boards and administrators for MSRS, PERA, and TRA were successful in changing law to permit higher annuities at the time or retirement. This was done by increasing the accrual rates applicable to all years of service, both past and future. Increasing accrual rates would increase liabilities in these plans, but the intention was to reduce retiree liabilities to offset these increases, at least on average, making the revisions cost neutral. Leading into 1997, retirees received an annual increase matching inflation up to 3.5%, plus additional increases could be paid if additional reserves were generated, due to investment performance of the Post Fund in excess of 8.5%. In 1997, the inflation match component was revised downward to 2.5%, which lowered retiree liabilities.

The plan administrators may have concluded that this tradeoff was reasonable and appropriate because accrual rates in the Minnesota nonpublic safety plans were low compared to similar public plans in other states, while our system of providing increases to retirees during retirement had been far more generous than most states. Indeed, due to favorable investment markets in much of the 1980s and 1990s, the investment-based component of the Post Fund provided additional increases to retirees which were generous, well in excess of inflation. Administrators may have felt that the inflation match could be trimmed, financing higher annuities at retirement, while still keeping retirees more than whole during retirement.

For the plans included in these benefit revisions, the changes were accomplished by a combination of appropriation reductions for some systems and new appropriations and aid for others. MSRS-General and TRA had been running contribution surpluses. By reducing employee and employer contributions, and the appropriations or aid which supported the employer contributions, the contribution sufficiencies were reduced or eliminated, freeing up revenue to direct toward PERA General and the first class city teacher plans to address expected deficiencies in those plans. For MSRS, PERA, and TRA, a key drawback to this tradeoff was that it was inconsistent with the Commission’s Statement of Principles which states that benefits should be increased during retirement to offset the impact of inflation. The best way to meet that objective is with an uncapped inflation match. Changing the inflation match from a match up to 3.5% to one that is capped at 2.5% is a movement away from the preferred policy. Retirees were made more vulnerable to high inflation, and would be made whole if inflation is in excess of 2.5% only if the system continued to provide benefit recipients with additional adjustments due to high investment performance. Any adjustments based on investment performance disappeared in the 2000s, due to the weak condition of the investment markets. In 2009, the Post Fund and its system for generating adjustments were abandoned, and the Post Fund and Basic Fund were merged. The Legislature specified for that for MSRS, PERA, and TRA plan retirees a fixed 2.5% annual adjustment would be paid. In 2010, this was reduced downward, and for TRA all increases were temporarily ended.
The 1997 legislation increased accrual rates in the first class city teacher plans to match those provided in TRA. However, for these first class city teacher plans there was no tradeoff of lower post-retirement adjustments. These plans were never part of the Post Fund, and so were not impacted by the post-retirement adjustment revisions to the Post Fund. Thus, liabilities in these plans increased, although it was at least partly offset by increased state aid.

In 1997, at the request of the St. Paul Teachers Retirement Fund Association (SPTRFA), the Legislature passed a revised post-retirement adjustment for that plan, matching a procedure enacted in earlier years for the Minneapolis Teachers Retirement Fund Association (MTRFA) and DTRFA. This procedure provided an automatic annual 2% post-retirement increase plus an investment-based adjustment based on five-year annualized rates of return in excess of 8.5% earned on the applicable association’s total fund. The procedure had a superficial resemblance to that used by the State Board of Investment, but the specific first class city teacher plan procedure was seriously flawed, permitting assets to flow to retirees in excess of what was supportable. If the fund’s asset value dipped below the full actuarial reserves for retirees, it becomes impossible for a fund to increase its funding level through investment performance, no matter how outstanding those returns might be. All returns in excess of 8.5% flowed out to the retirees, leaving nothing to allocate toward paying off unfunded liabilities. The MTRFA found itself in this situation. To address that fund’s problems, the 2006 Legislation merged the MTRFA into TRA. The SPTRFA and DTRFA have stopped using this flawed procedure, but both are left with serious funding problems.

5. **2006 TRA Increase in Accrual Rate.** In 2006 the MTRFA was merged into TRA, and as part of that package TRA’s accrual rate was increased. Rather than applying to all past and future service, the increase applies to new service only (service provided on or after July 1, 2006). The employee and employer contribution rates were both increased by one-half percent of pay.