S.F. 1267
(Olson, M.)

H.F. 1528
(Kahn)

Executive Summary of Commission Staff Materials

Affected Pension Plan(s):	TRA and MnSCU-IRAP
Relevant Provisions of Law:	Minnesota Statutes, Section 354B.21, Subdivision 2
General Nature of Proposal:	Second chance election of defined benefit plan coverage by defined contribution plan members
Date of Summary:	March 17, 2009

Specific Proposed Changes

- The proposed legislation permits MnSCU-IRAP members who reach tenure or its equivalent one year in which they can elect to shift past MnSCU service and prospective retirement coverage to TRA.

Policy Issues Raised by the Proposed Legislation

1. Appropriateness of permitting second chance retirement coverage election by MnSCU faculty members.
2. Potential for adverse selection impact on TRA.
3. Appropriateness in light of uncertainties about tenure and related concerns.
4. High potential cost of full actuarial value service credit purchases.
5. Likelihood of future transfer/prior service credit purchase demands from omitted MnSCU faculty.
6. Appropriateness of changing retirement benefit plan default.

Potential Amendment

S1267-1A (substantive) would change the default retirement coverage for newly hired MnSCU faculty from MnSCU-IRAP to TRA.

TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director LAM

RE: S.F. 1267 (Olson, M.); H.F. 1528 (Kahn): TRA; Permitting Tenured MnSCU Faculty Defined Benefit Plan Retirement Coverage Election Authorization.

DATE: March 17, 2009

Summary of S.F. 1267 (Olson, M.); H.F. 1528 (Kahn)

S.F. 1267 (Olson, M.); H.F. 1528 (Kahn) amends Minnesota Statutes, Section 354B.21, Subdivision 2, a provision of the Individual Retirement Account Plan of the Minnesota State Colleges and Universities System (MnSCU-IRAP) permitting MnSCU faculty members to elect prospective retirement coverage by the Teachers Retirement Association (TRA) within one year of starting employment, by permitting MnSCU faculty members a second opportunity to elect TRA coverage within one year of achieving tenure and by requiring those faculty members to purchase service credit for the pre-tenure service at the full actuarial value purchase price.

Background Information

A. Background information on the differences between defined benefit retirement plans and defined contribution retirement plans is set forth in **Attachment A**.

B. Background information on the Higher Education Individual Retirement Account Plan is set forth in **Attachment B**.

Discussion and Analysis

S.F. 1267 (Olson, M.); H.F. 1528 (Kahn) adds a second opportunity for a faculty member employed by the Minnesota State Colleges and Universities System (MnSCU) to change from retirement coverage by the Individual Retirement Account Plan (IRAP) to retirement coverage by the Teachers Retirement Association (TRA) within one year of the date on which the faculty member achieves tenure. The selection of TRA coverage also must include the purchase of prior MnSCU faculty employment at the full actuarial value purchase payment amount.

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

1. Appropriateness of Permitting Second Chance Retirement Coverage Election by MnSCU Faculty Members. The policy issue is the appropriateness of permitting faculty members and other administrative personnel of MnSCU an additional opportunity to elect retirement coverage for their MnSCU employment. In Minnesota public employment, public retirement plan coverage is generally mandatory and public employees generally do not have any options in their retirement coverage. Most Minnesota public employees are covered by defined benefit plan retirement programs, which are particularly well suited for career employees. Minnesota public employees with a choice between defined benefit plan coverage and defined contribution plan coverage, which is well suited for shorter duration employees, are largely limited to MnSCU faculty members and some administrative personnel and to state employees employed by the Legislature, constitutional officers, and agency, department, division, and bureau heads and their deputies. For MnSCU faculty members and affected administrative personnel, the choice of retirement coverage is between the Higher Education IRAP, a defined contribution plan, or the TRA defined benefit plan, with the choice to be made within one year of initial employment. For affected state employees, the choice of retirement coverage is between the Unclassified State Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified), a defined contribution plan, or the MSRS General State Employees Retirement Plan (MSRS-General), a defined benefit plan, with the election to be made within one year of initial eligibility for MSRS-Unclassified coverage and with an option to transfer to MSRS-General upon the person attaining ten years of state employment before the termination of state employment. The argument made in summary fashion by the Inter Faculty Organization (IFO), the collective bargaining representatives of state university faculty, on its website, is that a second chance election upon acquiring tenure allows faculty members the best opportunity to determine the retirement coverage with the best fit in their circumstance. While the faculty member's career is

potentially more certain at the point of attaining tenure, it is unclear that the faculty member is actually in a better position to predict the future and to make a second irrevocable election about retirement coverage at this time. Even if the faculty member is in a better position to make a final choice, that situation means that the applicable defined benefit retirement plan could bear a significant "selection against the fund" risk by gaining risk pool members who deviate significantly from the average plan membership. The adverse selection risk study recently performed by the consulting actuary retained by TRA is summarized in Issue No. 2 below.

2. Potential for Adverse Selection Impact on TRA. The policy issue is the likelihood that allowing a delayed second chance option for MnSCU faculty members to elect defined benefit retirement plan coverage by the TRA rather than defined contribution retirement plan coverage by the Higher Education IRAP will have an adverse financial effect on TRA. The notion of adverse selection can be analogized to the situation of purchasing fire insurance on a building before the building catches fire and the situation of purchasing fire insurance on a building once it catches fire. Before the fire, liability is some degree of possibility and, after the fire, liability is a certainty. The later into one's career a person is permitted to select between defined contribution retirement plan coverage or defined benefit retirement plan coverage, the more the situation is akin to a post-fire purchase of fire insurance. Under a mandate in Laws 2008, Chapter 349, Article 9, Section 7, TRA had an analysis prepared of the actuarial condition of the retirement fund as of July 1, 2008, if all 5,317 current IRAP-covered faculty members were permitted to elect TRA coverage and did elect TRA coverage, with a full actuarial value payment for the purchase of prior IRAP-covered service. The analysis found that 55 percent of faculty would produce a gain for TRA in electing to transfer coverage, that 44 percent of faculty would produce a loss for TRA in electing to transfer coverage, and that one percent would be neutral because of their short MnSCU service. The net impact of a prior service credit purchase by all current MnSCU faculty members was an $8 million gain (contributions of $369.3 million and actuarial accrued liability of $361.3 million). The analysis also indicated that the current full actuarial value purchase payment methodology does produce losses for purchases of prior service after age 50, with losses in proportion to advanced age, meaning that there is a considerable adverse selection risk. The adverse selection risk is moderated in the proposed legislation by not permitting existing (pre-July 1, 2009) MnSCU faculty who have already (before July 1, 2009) attained tenure to make the coverage transfer and prior service credit purchase, by requiring the service credit purchase to be made for all prior MnSCU faculty employment, and by sunsetting the transfer and service credit purchase provisions for MnSCU faculty initially hired after June 30, 2014. The Commission may wish to question TRA about the extent to which those potential mitigating provisions reduce the adverse selection risk in the proposed legislation.

3. Appropriateness in Light of Uncertainties about Tenure and Related Concerns. The policy issue is the appropriateness of triggering a second chance benefit plan coverage election on acquiring tenure when tenure acquisition is variable as to the length of prior employment and when there are other potential timing difficulties. Attached are excerpts from a recent IFO- MnSCU contract relating to tenure, which appears to indicate that the probationary period before gaining tenure in state universities can range from one year to five years. The tenure periods and tenure requirements for other faculty and related employee bargaining units is reported to be after two years for community and technical college faculty members and after three or four years for administrative faculty. Although achievement of tenure might indicate that the MnSCU faculty member or comparable employee has a clearer picture of the person's long-term career track, it is not necessarily a significantly better time to make the selection and the variability of pre-tenure probationary periods will raise concerns about the capability of MnSCU or TRA to provide appropriate counseling about the individual consequences of a retirement coverage transfer. Additional testimony from MnSCU and from MnSCU employee representatives may be necessary to determine whether a grant of tenure is as opportune a time for making this second chance irrevocable benefit coverage election as the IFO suggests.

4. High Potential Cost of Full Actuarial Value Service Credit Purchases. The policy issue is the appropriateness of implementing a system of benefit plan elections that will produce regular periodic prior service credit purchases with a sizable full actuarial value purchase payment price. Because service credit purchases alter the risk pool after the fact and permit individuals to select from options to their benefit and with a potential liability increase to the retirement plan, the normal contribution structure of the retirement plan is not an adequate way to fund these purchases and the Commission has resolved over the past 30 years that service credit purchases are to be funded with a full actuarial value payment based on the benefit to be obtained by the purchase. The full actuarial value prior service credit purchase payment amount is frequently a very large dollar amount and is likely to be greater than the IRAP account balance amassed during the pre-tenure grant period. The large service credit purchase payment required will likely limit the actual utilization of the second chance election

by MnSCU faculty and will likely disappoint a number of potential purchasers, who may then complain to their local legislators and seek personal special legislation, likely unsuccessfully. The 2008 special actuarial study of allowing current IRAP-covered MnSCU faculty members to transfer to TRA and purchase prior service credit provides some sense of the current population of MnSCU faculty who would become eligible under the proposed legislation to transfer retirement coverage and purchase prior service credit, as follows:

Age	Under Five Years Service	% of Total	Five or More Years Service	% of Total	Total
20-24	9	0.17%	0	0.00%	9
25-29	159	3.03%	18	0.34%	177
30-34	313	5.96%	151	2.87%	464
35-39	362	6.89%	346	6.59%	708
40-44	264	5.03%	500	9.52%	764
45-49	223	4.25%	573	10.91%	796
50-54	191	3.64%	675	12.85%	866
55-59	164	3.12%	636	12.11%	800
60-64	86	1.64%	372	7.08%	458
65-69	28	0.53%	123	2.34%	151
70-74	7	0.13%	45	0.86%	52
75+	0	0.00%	8	0.15%	8
	1,806	34.38%	3,447	65.62%	5,253

The older a service credit purchaser is, the larger typically is the required purchase payment under Minnesota Statutes, Section 356.551, and the greater is the adverse selection risk.

5. Likelihood of Future Transfer/Prior Service Credit Purchase Demands from Omitted MnSCU Faculty. The policy issue is the likelihood that current IRAP-covered MnSCU faculty members with more than five years of service currently (before July 1, 2009) who have already achieved tenure or its equivalent will demand similar treatment as the less-senior faculty permitted to transfer retirement coverage to TRA and purchase prior service credit under the proposed legislation. It is likely that the interest that generated this proposed legislation and an earlier attempt during the 2007-2008 Legislative Session (2007 H.F. 1953; S.F. 2154) represent the desires of the current MnSCU faculty members who are closely approaching tenure or who recently attained tenure, but who are likely to be excluded from the limitation in this proposed legislation, added at the request of TRA, that the transfer/prior service credit purchase authority include only that portion of the MnSCU faculty who have not yet (before July 1, 2009) attained tenure. If the proposed legislation is recommended by the Commission and enacted, it likely would be cited by the post-tenure grant portion of the MnSCU faculty as precedent for similar treatment in their circumstance, despite the limitation, on the basis of fairness and equal treatment. If the Commission does not want the proposed legislation to be used as precedent for an extension, it should ensure that the policy basis for its limitation to the one-third least senior portion of the current MnSCU faculty is clearly set forth on the record with testimony on the point by the IFO, MnSCU, and TRA, so that record can be cited by this Commission in 2010 or by future Commissions.

6. Appropriateness of Changing Retirement Benefit Plan Default. The policy issue is whether the actual or perceived problem that gave rise to the proposed legislation would be better resolved by changing the default retirement coverage for newly employed MnSCU faculty and comparable staff from the Higher Education IRAP to the TRA. If new MnSCU faculty believe that they would be better off with defined benefit plan retirement coverage rather than defined contribution plan retirement coverage and if most MnSCU faculty members achieve tenure, reducing the advantage they may find in IRAP coverage, then TRA would be the better default coverage option. It is less financially problematic to transfer past contributions out of a defined benefit plan for deposit into a defined contribution plan than it is to utilize full actuarial value prior service credit purchases to convert past defined contribution retirement coverage into defined benefit retirement coverage.

   If this change of the default option appears to the Commission to be an appropriate way to address the perceived or actual problem giving rise to this proposed second chance election legislation, **Amendment S1267-1A** would change the default from IRAP to TRA.

Attachment A

Background Information on Minnesota Defined Contribution and Defined Benefit Retirement Plans

Pension plans can be one of two types; either defined benefit plans or defined contribution plans. The difference is whether the benefits to be paid by the pension plan are pre-determined or whether the funding to be provided to the pension plan is pre-determined. Defined benefit plans make the benefit coverage pre-determined by either specifying the ultimate benefit or, more commonly, specifying a formula by which the eventual retirement annuity will be calculated. Having thus fixed the benefit, defined benefit plans leave the pension plan funding obligation variable, to be based on financial and demographic experience. Defined contribution plans make the pension funding pre-determined by specifying the contribution rate (or rates) either as a dollar amount, or more commonly, as a percentage of payroll, and leave the eventual retirement annuities variable in the amount payable based on individual choice and demographic and financial experience.

Each type of pension plans has distinct winners and losers. In the main, defined benefit plans tend to reward long term employees, the type who reflect the values underlying the traditional purpose for pension plans, while defined contribution plans tend, in comparison, to reward mobile employees, the type of employees that experts in labor economics and workforce trends indicate are the future trend.

In the private sector as a whole, currently, defined contribution plans are prevalent, while in the public sector as a whole, defined benefit plans predominate. However, many of those private sector defined contribution plans have been established and are maintained by sole proprietor businesses or similar small employers. Among industrial employers in the private sector and other large employers, defined benefit plans are more prevalent. Public sector pension plans, which are typically very large single employer or multiple employer pension plans, tend to follow the private sector industrial model in establishing defined benefit pension plans. In the private sector, defined contribution plans, in the form of Internal Revenue Code Section 401(k) plans are relatively common and generally function as supplemental thrift or savings plans. In the public sector, supplemental defined contribution pension plans also occur frequently.

Looking at the history of public pension plans, a checkered picture emerges. Among public pension plans that were established in the 19th century, generally public safety employee pension plans, a defined benefit plan along the lines of the federal military pension plan predominated. In the early portion of the 20th century, with the growth principally of teacher pension plans, defined contribution plans predominated, following the private insurance company annuity model. With the growth of general or non-uniformed public employees in the early middle portion of the 20th century, combinations of defined contribution and defined benefit plans were instituted, frequently with an annuity derived from accumulated member contributions and investment income and an additional benefit funded by employer contributions. In the immediate period after World War II, following the private sector large industrial corporation model, most new public pension plans were defined benefit plans. In recent years, there has been a mixed trend, with the creation of new pension plans of both types and some conversions from defined benefit plans to defined contribution plans or vice versa.

In Minnesota, public pension plans by both number and membership are predominantly defined benefit pension plans. The following sets forth a listing of defined benefit Minnesota public pension plans and of defined contribution Minnesota public pension plans:

Defined Benefit Plans

1. General State Employee Retirement Plan of the Minnesota State Retirement System
2. MSRS State Correctional Employees Retirement Plan
3. MSRS Military Affairs Retirement Plan
4. MSRS Transportation Department Pilots Retirement Plan
5. State Patrol Retirement Plan
6. Elective State Officers Retirement Plan
7. Legislators Retirement Plan
8. Judges Retirement Plan
9. General Employees Retirement Plan of the Public Employees Retirement Association
10. Public Employees Police and Fire Plan
11. Teachers Retirement Association
12. Duluth Teachers Retirement Fund Association
13. Minneapolis Teachers Retirement Fund Association
14. St. Paul Teachers Retirement Fund Association
15. Minneapolis Employees Retirement Fund
16. Local Police Relief Associations (total of 2)
17. Local Paid Fire Relief Associations (total of 2)
18. Volunteer Firefighter Relief Associations (approx. total of 625)
19. University of Minnesota Faculty Supplemental Plan
20. MSRS State Fire Marshal Arson Division Retirement Plan
21. PERA Local Government Correctional Employees Retirement Plan

Defined Contribution Plans

1. MSRS Unclassified State Employees Retirement Plan
2. PERA Defined Contribution Retirement Plan
3. Higher Education Individual Retirement Account Plan
4. Higher Education Supplemental Retirement Plan
5. Volunteer Firefighters Relief Associations (approximate total of 74)
6. Ambulance Personnel Longevity Plan
7. Hennepin County Supplemental Retirement Plan
8. University of Minnesota Faculty Retirement Plan
9. Public Employee Supplemental Thrift Plan through State Deferred Compensation Plan or selected Tax Sheltered Annuity programs
10. Various Housing and Redevelopment Agency Retirement Plans
11. Pre-1971 School District Supplemental Retirement Plans (total of 8)
12. DTRFA Internal Revenue Code Section 403(b) Supplemental Retirement Plan
13. Historical Society, Arts Board, and Humanities Commission Individual Retirement Plan

Attachment B

Background Information on the Higher Education Individual Retirement Account Plan (IRAP)

1. Difference Between Defined Contribution Retirement Plans and Defined Benefit Retirement Plans.

   There are two major factors in designing retirement plans and attempting to fix or make pre-determinable one or the other factors constitutes the difference between defined contribution retirement plans and defined benefit retirement plans. When one factor is fixed or made pre-determinable, the other factor is automatically made variable. The factors are the level of the benefits and the level of contributions.

   In a defined contribution retirement plan, the level of contributions or the amount of member and/or employer funding are specified or fixed in some manner, making the level of eventual benefits and/or their duration the variable factor. Most commonly, in a defined contribution plan, the funding of the plan is specified as a percentage of the covered payroll of plan members. Those contributions, allocated to individual accounts and frequently invested based on individual selection, along with any investment return obtained, constitute the benefit available to the plan member upon termination of employment or retirement. Most commonly, the individual account balance is payable in a lump sum upon the termination of plan coverage or is available to be transferred to an insurance company for the purchase of a retirement annuity. Some retirement plans that generally are classified as defined contribution plans permit the individual account balance amount to be converted into a retirement annuity within the retirement plan at a specified rate, although the assumption of that retirement annuity mortality risk actually defines the post-retirement benefit amount and subjects the retirement plan to potential future mortality and investment return experience losses and a chance for an unfunded actuarial accrued liability, akin to a defined benefit plan.

   In a defined benefit retirement plan, the level of benefits at the time of retirement or after retirement are specified or fixed in some manner, making the level of contributions or the amount of funding from period to period the variable factor. Most commonly, in a defined benefit plan, the retirement benefit is specified as a percentage of the final salary or of the final average salary per year of credited service rendered. Thus, the plan tracks and awards allowable service credit and salary credit and amasses a liability for the service and salary credit rendered to date that requires the periodic calculation and assessment by an actuary. The resulting actuarial valuation report both assesses the amount of actuarial accrued liability that the retirement plan has amassed to date and the amount of total contributions needed for the future plan year or plan years. Most commonly, in defined benefit plans, any lump sum amount is limited to a pre-retirement employment termination member contribution refund, with the regular retirement benefit only payable as a retirement annuity. Generally, a regular retirement annuity has optional equivalent value forms that open for election by the plan member. Retirement plans that are defined benefit plans can take on defined contribution retirement plan aspects, such as determining post-retirement adjustment amounts from the amount of investment gain in whole or in part generated by the plan.

2. Contrasting Development of Defined Contribution Plans Between the Private Sector and the Public Sector.

   In the private sector as a whole, defined contribution plans are very prevalent, while in the public sector as a whole, defined benefit plans predominate. However, many of those private sector defined contribution plans have been established and are maintained by sole proprietor businesses or similar small employers. Among industrial employers in the private sector and other large employers, defined benefit plans are more prevalent. Public sector pension plans, which are typically very large membership single employer or multiple employer pension plans, tend to follow the private sector industrial model in utilizing defined benefit pension plans. In the private sector, defined contribution plans, in the form of Internal Revenue Code Section 401(k) plans are relatively common and generally function as supplemental thrift or savings plans. In the public sector, supplemental defined contribution pension plans also occur frequently. Primary coverage private sector pension plans, either defined benefit plans or defined contribution plans, are most commonly funded by the employing unit, while primary coverage public sector pension plans are most commonly funded by a combination of member and employer contributions. Supplementary pension plans, both private sector and public sector, are almost always funded by member contributions and frequently include some employer funding.