TO:	Members of the Legislative Commission on Pensions and Retirement
FROM:	Susan Lenczewski, Executive Director
RE:	MSRS Unclassified Plan: Change in factors used to convert a lump sum account to an annuity, effective July 1, 2017
DATE:	April 24, 2017

Issue

This memo responds to questions we've received regarding a change in the factors MSRS uses to calculate an annuity when a member of the Unclassified Plan retires and elects to have his or her account be paid out in the form of an annuity. Last summer, members of the Unclassified Plan received notice of this change from MSRS and that the annuity as calculated using the new factors would result in a smaller monthly pension than under the current factors. The change is to take effect on July 1, 2017. We understand that this reduction in the monthly benefit amount may be having an impact on legislative staff and other Unclassified Plan members who are eligible to retire and may lead to more retirements before the change takes effect.

Introduction

The Unclassified Plan is a defined contribution plan that is part of the Minnesota State Retirement System and administered by MSRS. Members of the Unclassified Plan include elected officials, legislators first elected on or after July 1, 1997, legislative staff and certain other employees of the State of Minnesota. Eligible employees are required to participate and immediately contribute 5.5% of salary each pay period. Employers contribute 6% of salary each pay period.

Data on the Unclassified Plan, as of June 30, 2016:

Active Members:	1,380
Inactive Members:	1,846
Total Members:	3,226
Participating Agencies or Units of Government:	10
Assets (member accounts):	$312 million

The Unclassified Plan is connected in several ways to the MSRS General Plan, which is a defined benefit pension plan. One way is that Unclassified Plan members, other than legislators, have the option, within specified timeframes, to elect to leave the Unclassified Plan and be covered by the General Plan and receive a benefit that is not determined by the size of the member's account balance, but by the pension benefit formula. Another way the Unclassified Plan is connected to the General Plan is that a member, upon retirement, is entitled to transfer his or her account balance to the General Plan, where the account balance is converted to an annuity, to be paid monthly for the life of the member, or in another annuity form, such as a joint and survivor annuity for the life of the member and his or her designated survivor.

As noted, the concern at issue dates back to the end of June, 2016, when Unclassified Plan members were notified that the factors used to calculate members' monthly retirement benefit will be changed effective July 1, 2017. The notice explains that the factors are being changed due to an increase in life expectancy and a decrease in the assumed investment rate of return. The notice states that the MSRS Board of Directors approved the change. Along with the notice, MSRS attached a benefit estimate unique to the member. The benefit estimate shows monthly benefit amounts for different payment options as calculated using the current factors, on June 30, 2017, and using the new factors, on July 1, 2017.

Based on several notices I collected from legislative staff, it appears that the average reduction in members' monthly pension is approximately 7%, or, put another way, beginning July 1, 2017, members who elect an annuity will receive approximately 93% of the monthly amount they would have received before July 1, 2017.

Governing Law

The relevant statute is Minnesota Statute § 352D.06 ("Annuities"), which states:

> Subdivision 1. **Annuity; reserves.**
>
> When a participant attains at least age 55, terminates from covered service, and applies for a retirement annuity, the cash value of the participant's shares must be transferred to the general state employees retirement fund and must be used to provide an annuity for the retired employee ***based upon the participant's age when the benefit begins to accrue according to the reserve basis used by the general state employees retirement plan in determining pensions and reserves.*** The annuity under this subdivision is eligible for postretirement adjustments under section 356.415.

"Reserve basis" is not defined anywhere in Sections 352 (MSRS, generally), 352D (Unclassified Plan) or 356 (Public pension plans, generally).

Erin Leonard, Executive Director of MSRS, provided this explanation of the language in the statute and how MSRS administers this statutory requirement:

> The present value was calculated based on the assumed post-retirement interest assumption that existed in 356. I believe that once this was removed from the statute, the actuaries continued to use the same methodology for calculating the annuity factors for this plan….The actuaries use the same assumptions that are in place for the General Plan.
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> This pre/post assumption remained in statute for several years after the post-fund dissolved; from my research, it was removed in 2014. The actuary used the same methodology (for this updated factor) because the pre-retirement assumption was 8.5% and the post-retirement was 6% when COLAs were 2.5% (6+2.5=8.5). Now 8% assumption with 2% COLA would retain the

same 6%. Similarly if we move to 7.5% with a 1.5% COLA, we would retain the 6% assumption for the Unclassified factor.

Under Section 352D.06, a change in the factors for converting an account in the Unclassified Plan to an annuity (in other words, converting a lump sum to an annuity), should occur whenever there is a change in the factors for determining optional forms of annuities under the MSRS General Plan. Minnesota Statute § 352.116, subdivision 3, authorizes MSRS to offer optional forms of annuity, including joint and survivor annuities and for a period certain followed by life, but the optional forms "must be actuarially equivalent to the normal single life annuity…." "Actuarially equivalent" is defined, at section 352.01, subdivision 12, as follows:

> the condition of one annuity or benefit having an equal actuarial present value as another annuity or benefit, determined as of a given date at a specified age with each actuarial present value based on the appropriate mortality table adopted by the board of directors based on the experience of the fund as recommended by the actuary retained under section 356.214, and approved under section 356.215, subdivision 18, and using the applicable preretirement or postretirement interest rate assumption specified in section 356.215, subdivision 8.

The conversion factors must be based on the mortality table adopted by the board of directors and approved by the Pension Commission (under section 356.215, subdivision 18).

Considerations

1. The Pension Commission was not informed that approving new actuarial assumptions for the MSRS General Plan would mean changing the factors used for calculating annuities under the Unclassified Plan.

The Pension Commission approved updated actuarial assumptions for the MSRS General Plan, PERA General Plan and TRA, at its meeting on February 3, 2016. None of the materials presented to the Commission indicated that new assumptions would lead to the plans' developing and implementing new factors for converting a single life annuity to optional forms of annuities, including converting a lump sum amount to an annuity under the Unclassified Plan. The motion stated that the approval of assumption changes affected, for MSRS, only the General Plan, and there was no mention of the Unclassified Plan.

There is no requirement in the statutes that changes to the factors used in determining actuarially equivalency must be approved by the Pension Commission or the legislature. However, in the interest of full disclosure, it would have been helpful for the Commission to understand the impact that changing the assumptions would have on the conversion factors under the Unclassified Plan, especially in view of the fact that many legislators and staff participate in the Unclassified Plan.

When the Pension Commission approved the new mortality table and other assumptions at its meeting on February 3, 2016, whether it realized it or not, it set in motion the process for changing the factors used in converting a single life annuity to other annuity forms, which in turn resulted in changes to the factors used in converting a lump sum to an annuity under the Unclassified Plan. However, these changes were not considered automatic, in that the executive director requested approval by the board of directors of MSRS of the new factors. The MSRS board of directors approved the new factors for the

Unclassified Plan at its meeting on January 4, 2016, effective July 1, 2017, and for the General Plan at its meeting on July 28, 2016.

2. Even with the reduction that will take effect on July 1, 2017, annuities under the Unclassified Plan compare favorably to a similar annuity purchased from an insurance company.

Members nearing retirement from the Unclassified Plan may be giving retirement more serious consideration because the change in the factors means that the monthly amount they would have received had they retired by June 30, 2017, will be approximately 7% less than the monthly amount they will receive when they retire on or after July 1, 2017. The cover letter that informed members of the change and other communication materials enclosed with the letter did not provide much explanation regarding the advantages of the Unclassified Plan over other defined contribution plans that are not connected to a pension plan. The cover letter and related information also did not provide any explanation of the advantages of taking an annuity from the General Plan over a similar annuity from an insurance company. Better communication may have provided comfort to members close to retirement.

A member of the Unclassified Plan has the option to take his or her account balance in a lump sum distribution and invest it elsewhere or roll it into another retirement plan or IRA. A member could also take the lump sum distribution and use it to purchase an annuity from an insurance company. To determine the value of the option to take an annuity from the General Plan, Erin Leonard contacted an insurance company MSRS worked with in the past and was able to obtain quotes for two forms of annuity (single life and life with 20 years certain), purchased with three different lump sum amounts.

As shown in the table below, these quotes allow for a very rough comparison of what a lump sum amount can buy from the insurance market versus through the General Plan using the new conversion factors. The insurance company quotes assume a 20-year pay-out, starting when the individual is approximately 60, and no COLA, whereas the MSRS estimates assume life expectancy starting at age 66 (normal retirement age) and a COLA that increases the monthly benefit by 2% each year. Under the MSRS mortality assumptions, a member at age 66 will live approximately an additional 20 years.

	Set 1	**Set 2**	**Set 3**
Account balance (lump sum amount)	$136,462	$163,987	$627,136
A: MSRS single life (using new conversion factors)	$840	$1,007	$3,954
B: Insurance Co. single life	$850	$927	$3,800
A: MSRS Life with 15 years certain (using new conversion factors)	$812	$975	$3,795
B: Insurance Co. life with 20 years certain	$840	N/A	$3,906

The monthly amounts for these two forms of annuity under MSRS General, using the new factors, are similar to the monthly amounts for the annuities from the insurance company. The monthly amounts are slightly higher for MSRS, except in the case of the smallest lump sum amount.

In addition to the COLA, there are other benefits when a member converts his or her account balance under the Unclassified Plan to an annuity from the General Plan, as compared to an annuity from an insurance company.

- If a member elects a single life annuity from the General Plan and dies before receiving enough monthly payments to have received at least the value of the account balance transferred to the General Plan to purchase the annuity, the member's beneficiary will receive a distribution of the difference between the account balance and the value of the monthly benefits paid. This means the General Plan loses the actuarial gain from early death that every insurance company counts on when underwriting annuities.
- In addition, there is a bounce back feature, which applies when a member elects a joint and survivor annuity and the designated survivor dies before the member. The monthly amount, which is less than the monthly amount payable as a single life monthly amount, to compensate for the cost of the survivor coverage, is increased to the single life annuity monthly amount as if a joint and survivor annuity had never been elected. Here again, the General Plan loses the actuarial gain that insurance companies depend on in pricing annuities.

I was not able to locate provisions for these additional benefits in Chapter 352D, which suggests that either the statutes should be amended to provide for these benefits or MSRS should cease paying these benefits since there is no statutory authority for them.

Additional communication to members nearing retirement may be helpful to educate them on the value of annuities from the General Plan and that, even with the planned reduction effective July 1, 2017, they will likely receive a more generous benefit than could be purchased from an insurance company.

Next steps

If the Commission would like to take any action regarding the new conversion factors that will go into effect on July 1, 2017, there appear to be a few options, all of which would involve amending the omnibus pension bill next week when that bill is considered. An amendment could amend the statute to provide any of the following:

- a phase-in of the reduction to the monthly annuity amount over several years;
- delay the effective date for using the new conversion factors for another year; or
- require use of the current conversion factors (stop the implementation of the new factors), regardless of any change in the actuarial assumptions.

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