TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: S.F. 1557 (Betzold); H.F. 1738 (Murphy): MnSCU IRAP/TRA; Allowing up to Five Years to Elect TRA Coverage

DATE: March 22, 2005

General Summary of S.F. 1557 (Betzold); H.F. 1738 (Murphy)

S.F. 1557 (Betzold); H.F. 1738 (Murphy) authorizes Minnesota State Colleges and Universities System (MnSCU) employees to elect Teachers Retirement Association (TRA) coverage rather than Individual Retirement Account Plan (IRAP) coverage within five years of the initial employment date rather than within 90 days.

Background Information on the Individual Retirement Account Plan

The Minnesota State Colleges and Universities System (MnSCU) Individual Retirement Account Plan (IRAP) stems from the late 1980s, when state university and state college teachers and related employees sought coverage by a defined contribution plan rather than by TRA, which is a defined benefit program. That IRAP plan, currently coded as Minnesota Statutes, Chapter 354B, was established by the 1988 Legislature, but was not implemented until mid-1989 due to problems in ensuring proper Social Security coverage. The plan was expanded to include technical college managerial employees in 1993 and technical college faculty in 1994. The Higher Education IRAP plan covers faculty members and upper-level administrators at MnSCU, but does not cover faculty or administrators at the University of Minnesota.

When the Higher Education IRAP plan was initially implemented, IRAP coverage was mandatory for new hires without prior covered service, while employees in eligible positions who had prior TRA service were given an option to elect IRAP rather than continuing defined benefit coverage. Election rights and election procedures have been frequently revised over the years. In 1994, the current procedure was established, permitting individuals with prior defined benefit plan coverage to continue that coverage or to elect IRAP, and permitting new hires to choose within 90 days between IRAP and the defined benefit plan that would otherwise provide the coverage. The election is irrevocable.

The argument made by the initial proponents of a defined contribution plan for higher education faculty and administrators is that higher education faculty, as a group, are highly mobile. If an individual changes employment to another college in another state, the individual retains the full value of the IRAP account, and the account continues to grow in value over time due to the continuing investment earnings on the account. A defined benefit plan may be a better choice for higher education faculty members who are less mobile, by reason of personal choice or lack of opportunity, particularly as these individuals become long-term employees. A defined benefit plan may also be best for higher education faculty members who have considerable prior TRA or first class city teacher plan covered service. The MnSCU higher education faculty is also covered by the Higher Education Supplemental Retirement Plan, which is also a defined contribution plan. Higher education faculty and administrators are covered by the Supplemental Retirement Plan whether the individual is a TRA member or an IRAP member. The Supplemental Retirement Plan was created in 1968. At that time, TRA provided the primary coverage for higher education faculty and the Supplemental Retirement Plan was created to address deficiency in the benefits provided by TRA. Those deficiencies in TRA benefits were addressed decades ago when TRA moved to use of the high five average salary to compute benefits, and benefits were further enhanced in more recent years. The problem that the Supplemental Retirement Plan was intended to address has been eliminated. Given that elimination, the purpose for continuing the Supplemental Retirement Plan currently is unclear.

Background Information on the Teachers Retirement Association

The Teachers Retirement Association (TRA) is a large defined benefit pension plan with, according to the most recent actuarial valuation, 72,000 active members and over 37,000 pensioners and survivors. The plan provides a range of benefits, including refunds, disability benefits, survivor benefits, and retirement benefits. The benefits (other than refunds) are specified in law and are based on the high-five average salary of the member (the average salary over the five-year period that produced the highest average, which typically occurs in the years just prior to retirement), years of service, and an accrual rate. The

accrual rate is the percentage of the high-five average salary that the individual receives for each year of service. For an individual who retires at the normal retirement age for the plan (about age 65), the accrual rate specified in law is 1.7 percent. An individual with a high-five average salary of $50,000 who retires at the normal retirement age with 30 years of service will receive an annual retirement benefit of $25,500 ($50,000 x 1.7 percent x 30 = $25,500). A survivor benefit is based on the retirement benefit, while the disability benefit is computed comparably to a retirement benefit, but the high-five average salary is computed using the years prior to the disability.

Discussion and Analysis of S.F. 1557 (Betzold); H.F. 1738 (Murphy)

Under S.F. 1557 (Betzold); H.F. 1738 (Murphy), Minnesota State Colleges and Universities System (MnSCU) employees would have up to five years, rather than 90 days, to make a final decision regarding the nature of their retirement coverage. The choice is between the Teachers Retirement Association (TRA) defined benefit plan coverage and Individual Retirement Account Plan defined contribution plan coverage.

Pension plans, whether in the public sector or in the private sector, are either defined contribution plans or defined benefit plans. In a defined contribution plan, the input (contributions) is fixed, while in a defined benefit plan the output (the pension benefit) is fixed by formulas, typically based on salary late in the individual's career and length of covered service. In a defined contribution plan the funding for the pension plan is fixed as a dollar amount or as a percentage of payroll and the fixed element of funding leaves a variable element, which is the benefit amount that is ultimately payable. The eventual benefit resulting from those contributions depends on the investment returns earned on the contributions. Thus, under a defined contribution plan, the plan member bears the inflation and investment risks. If there is poor investment performance, the plan member's pension assets will be depressed. If inflation is high, the plan member's benefit will be less adequate in keeping pace with the person's pre-retirement standard of living.

A defined contribution plan favors employees who are employment-mobile, where employment changes beyond a single employer or a multiple-employer group, because the value of the individual's account stays with the individual. Defined contribution plans also favors short-term employees in comparison to defined benefit plans. Again, the reason is that the individual is entitled to the full value of the individual's account. In contrast, under a defined benefit plan, the short-term employee who leaves covered service is likely to be entitled to only a refund of employee contributions with interest. The employer contributions that the employer made on behalf of the employee and all investment earnings on those contributions remain with the employer. Defined contribution plans also favor employees with very stable and modestly increasing salary histories and employees who work considerably beyond the plan's normal retirement age.

A defined benefit plan is a pension plan where the pension benefit amount that is ultimately payable is pre-determinable or fixed using a formula or comparable arrangement. For Minnesota public pension plans, these formulas or procedures are stated in law. The most typical procedure, and the procedure stated in law for TRA and the first class city teacher plans, is to pay a retirement benefit based on high-five average salary (typically, the average salary for the five consecutive years of service that produces the highest average), and the years of service. In these teacher plans, the benefit at normal retirement age is computed by multiplying the high-five salary, times years of service, times an accrual rate. The accrual rate, currently set in law at 1.7 percent for individuals retiring at normal retirement age, is the percentage of the high-five average salary that the individual receives for each year of covered service. Given that accrual rate, an individual with a $50,000 high-five average salary and 30 years of service would receive an annual benefit of $25,500.

Fixing the retirement benefit through a formula leaves a variable element, which is the funding required to provide these defined benefit plan benefits. Actuaries compute the necessary funding level (contribution rates). These necessary contribution rates depend on the level and types of benefits provided by the plan, by the demographics of the covered group (ages of members, sex of the members since females tend to live longer, and active and retired mortality), salaries over time, investment income, and turnover. When individuals leave a defined benefit plan after working several years, they may not be entitled to any annuity from the plan, or even if they are, the plan benefit that has the most value for them may be a refund. A refund consists of the employee contributions plus six percent interest. The employer contributions, all investment earnings on the employer contributions, and all investment earnings on the employee contributions above six percent remain with the plan and are used to fund the benefits of those that remain. These amounts are referred to as turnover gain. Turnover gain plays an important role in financing defined benefit plans. Without turnover gain, the necessary contributions to the plan would need to be higher to offset reduction or complete loss of turnover gain.

As a defined benefit plan, TRA and the employing units contributing to these plans bear the risk of inflation, investment performance problems, adverse change in turnover, and the mortality risk that

individuals will live longer than predicted, which lengthens the benefit payout period. If the investment returns on plan assets are poor, or if inflation produces ever-increasing final salaries and benefit payouts, if individuals live longer than expected or if turnover declines, the plan and its associated employers must cover the liabilities that result. The member also is impacted by a turnover risk. If a plan member terminates with little service he or she will receive either a refund (employee contributions plus six percent interest) or an inadequate benefit. A defined benefit plan favors long-term or long-service employees. It also favors employees who receive regular promotions and sizable salary increases throughout their careers or who achieve substantial salary increases in their compensation at the end of their career. Defined benefit plans also favor employees who retire at or before the plan's normal retirement age.

IRAP is a defined contribution plan created in the late 1980s, when state university and state college teachers and related employees sought coverage by a defined contribution plan rather than TRA. The enacting legislation passed in 1988 (Laws 1988, Chapter 709, Article 11) and was coded as Minnesota Statutes, Chapter 354B, but was not implemented until mid-1989 due to problems in ensuring proper Social Security coverage. The plan was expanded to include technical college managerial employees in 1993 and technical college faculty in 1994. The Higher Education IRAP plan covers many faculty members and upper-level administrators at MnSCU, but does not cover faculty or administrators at the University of Minnesota.

The argument made by initial IRAP proponents for higher education faculty and administrators is that higher education faculty, as a group, are highly mobile. If an individual changes employment to another college in another state, the individual retains the full value of the IRAP account, and the account continues to grow in value over time due to the continuing investment earnings on the account. A defined benefit plan may be a better choice for higher education faculty members who are less mobile, by reason of personal choice or lack of opportunity, particularly as these individuals become long-term employees. A defined benefit plan may also be best for higher education faculty members who have considerable prior TRA or first class city teacher plan covered service prior to hire, or due to their past higher education service benefit plan coverage.

MnSCU is now proposing to amend IRAP law to allow individuals to have up to five years to decide between defined benefit coverage or defined contribution plan coverage, rather than 90 days. The argument made by MnSCU for this change is that after five years of MnSCU employment all employees would know whether they will be tenured or otherwise receive permanent status. Presumably, prior to having that knowledge, most individuals would prefer defined contribution plan coverage, since it is fully portable and the individual retains the full value of the account. A tenured or permanent employee might prefer defined benefit plan coverage.

The principal issue raised by extending the election to five years is adverse selection against TRA. Adverse selection is likely to impact a defined benefit plans whenever individuals have a choice between a defined benefit and a defined contribution plan, even when they must elect very soon after commencing covered employment. Those who intend to move to other employment in a few years, or feel that they will be forced to find other employment due to layoffs or lack of tenure, are likely to choose the defined contribution plan. Those who intend to remain as long-term employees are far more likely to choose the defined benefit plan. Thus, even with the current requirement that MnSCU employees must choose between the two types of plans within 90 days of becoming employed, TRA will suffer some adverse selection. The adverse selection problem will be worse the longer the elections are delayed. By allowing individuals to wait up to five years before making an election, considerable uncertainty is removed for the individual; all tenure and permanency issues will have been decided. Those who are permanent or who are tenured and expect to remain in MnSCU employment are likely to choose the defined benefit plan coverage. Thus, they are likely to eventually draw retirement benefits from the plan. The turnover from this self-selecting group is likely to be lower, perhaps much lower, than that of other TRA members. Since turnover gain helps to lower TRA contribution requirements, reduction in turnover will increase TRA cost and contribution requirements. Thus, this proposal could be viewed as a benefit enhancement for MnSCU employees, with a cost to be borne by all TRA employing units, including the K-12 units.

S.F. 1557 (Betzold); H.F. 1738 (Murphy) raises the following pension and related public policy issues:

1. <u>Lack of Consistency with Other Plan Elections</u>. Under current law, plan elections for MnSCU employees occur within 90 days. This is consistent with a similar group in the Public Employees Retirement Association (PERA), eligible physicians who work for governmental subdivisions. These individuals have 90 days to decide whether they want General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) coverage (a defined benefit plan comparable to TRA) or coverage by the PERA Defined Contribution Plan. A delay of five years, as proposed by the bill, considerably exceeds time periods allowed in other somewhat similar situations, worsening adverse selection concerns. Another model exists in current law, but it does not reflect

good pension policy. This model permits transfers between defined contribution coverage and defined benefit coverage late in individual's career. Various employees who are eligible for the Unclassified State Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified), which is a defined contribution plan, have one year following employment to decide between defined benefit plan coverage or defined contribution plan coverage. However, those who initially choose defined contribution plan coverage are permitted, at any time after ten years of covered MSRS employment, to transfer coverage to the defined benefit plan. In effect, an indefinite election period is created due to this transfer right. Individuals can make their final plan decisions anytime between their ten-year anniversary date and the end of their career. On several occasions, the MSRS Executive Director has correctly stated that this arrangement harms the defined benefit plan, and periodically legislation has been drafted to eliminate this transfer right. Such legislation has not passed to date, but several past and present legislators have supported those proposed changes to protect the defined benefit plan.

2. Adverse Selection Problems/Cost Impact on TRA. As discussed above, any election between a defined benefit plan and a defined contribution plan creates an adverse selection problem for the defined benefit plan; the problem becomes worse the longer the election period. Adverse selection adds to the cost of the defined benefit plan. That cost has not been estimated at this time, but the cost depends on the degree to which defined benefit plan turnover by MnSCU employees is reduced due to delaying elections, and upon the number of MnSCU employees who elect TRA coverage.

3. Possible Measure to Address the Adverse Selection Problem. There is nothing in this legislation that shields TRA's broad membership from the cost impact of adverse selection due to the proposed TRA election after five years of MnSCU service. One possible solution is an amendment to charge MnSCU, and its employees who chose TRA, higher TRA employee and employer contributions throughout their covered careers, sufficient to offset the lessened turnover gain of the pension fund. Accurately determining the necessary contribution rate increment could be difficult, MnSCU and its employees are unlikely to favor the approach, and it would require a treatment that the Legislature has not used to date. Within any large defined benefit pension fund, there are subgroups that tend to raise costs for the group as a whole. Some examples would be married couples imposing added costs on plan members who are single, one group (females) having a longer life expectancy than other members of the group (males), individuals entering the plan at an age which is older than the typical new hire, or in this case, one group having a lower rate of turnover than the group as a whole. In some cases, it is not possible to charge differential contribution rates due to prohibitions in federal or state law. In other cases it is possible, but the Legislature has chosen not to do so. The large defined benefit plans are designed to spread risks across the broad group, creating a stable cost structure. Differential rates would be a step away from this risk-sharing.

4. Pressure for Service Credit Purchases in the Future. The Commission may be concerned about future requests to purchase service credit. Individuals who elect TRA after up to five years of MnSCU employment are likely to want to purchase TRA service credit for the initial employment period as they approach retirement. Thus, extending the elections to five years could cause the Legislature to confront numerous future requests for service credit purchases. In an effort to minimize this pressure, the bill includes a statement prohibiting any purchases (page 2, lines 9 to 12). An issue for the Commission is whether this statement has any real impact. There will be future requests to purchase service credit despite this language, or requests to remove this language and permit a general service credit purchase.

Potential Amendments for Commission Consideration

Amendment LCPR05-147 can be used if the Commission concludes that neither the 90-day election period (as in current law) nor the five-year period (as proposed) is the most appropriate election period. Amendment LCPR05-147 permits the Commission to specify a different election period.

Amendment LCPR05-148 revises TRA law to charge MnSCU employees who elect TRA coverage more than 90 days after the effective date of this act, and the employer, a contribution rate in an amount to be determined, in excess of that paid by other TRA-covered employees and employers. The amendment is intended to avoid any cost shift due to adverse selection to non-MnSCU employees and employers. Hopefully, TRA will be able to suggest a rate or rates to be inserted. By shielding the rest of TRA from the cost of adverse selection, it imposes that cost on MnSCU and the MnSCU employees who elect TRA coverage, creating a cost issue for MnSCU and the future MnSCU employees who elect TRA coverage. Amendment LCPR05-148 may discourage some MnSCU employees from electing TRA coverage.