TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director

RE: S.F. 621 (Betzold, by request); H.F. 1756 (Smith): PERA-P&F; Employee and Employer Contribution Rate Increase

DATE: March 30, 2005

Summary of S.F. 621 (Betzold, by request); H.F. 1756 (Smith)

S.F. 621 (Betzold, by request); H.F. 1756 (Smith) increases the Public Employees Police and Fire Retirement Plan (PERA-P&F) employee contribution rate from 6.2 percent to 9.0 percent and the employer contribution rate from 9.3 percent of salary to 13.6 percent, effective on January 1, 2006. The sum of the employee and employer contribution increase is 7.0 percent of salary.

Background Information on PERA-P&F

The Public Employees Police and Fire Retirement Plan (PERA-P&F) was established in 1959 (Laws 1959, Chapter 650), to assist police officers and firefighters employed by local government. Prior to 1959, local government public safety employees were covered by the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General). Initially, PERA-P&F coverage applied to any public employee in law enforcement or fire suppression, but the membership qualifications were refined as the licensing of police officers began in the 1970's. Currently, PERA-P&F membership requires that the police officer meet the following requirements:

1. Police Employment. Employment must be as a police officer by a municipal police department or a county sheriff's office.
2. Primary Law Enforcement Function. Primary employment function must be to enforce the law.
3. POST Board Licensure. Peace officer must be licensed by the Peace Officers Standards and Training Board (POST Board).
4. Property and Safety Protection. Peace officer must be engaged in the hazards of protecting the property and safety of others.
5. Arrest with a Warrant. Peace officer must be empowered to arrest with a warrant.

Since 1959, all newly employed county deputy sheriffs have pension coverage by PERA-P&F and since 1980, all newly employed municipal police officers have pension coverage by PERA-P&F.

Unlike general employee plans, members of PERA-P&F are not covered by the Social Security Old Age Insurance Program for their law enforcement employment. Due to the public safety nature of the employment, PERA-P&F pays larger retirement annuities, disability benefits, and survivor benefits than a general employee retirement plan and has an earlier normal retirement age for the retirement annuity. Because of these benefit plan differences, the plan has a greater actuarial cost and greater member and employer contributions than a general employee retirement plan.

The retirement benefit provided for a member retiring at the plan's normal retirement age, age 55, is three percent of the high-five average salary for each year of service. A member who is age 55 or older with 30 years of service and has a high-five average salary of $60,000 will receive an annuity of $54,000. Members can retire as early as age 50 with only a slight reduction due to early retirement. The reduction is 1/10 of one percent for each month (1.2 percent per year) that the individual is under age 55. These early retirement annuities are subsidized. For disability determinations, the plan uses an occupational definition of disability, an inability to perform the specific job, rather than the more stringent definition used by general employee plans, which require an inability to perform any gainful employment. The disability benefit is generous. If the disability is duty-related, the benefit is computed just like a service pension except there is no reduction due to early receipt. The minimum service-related disability benefit is equivalent to a 20-year service pension. Non-duty-related disability benefits are computed the same way, except that the minimum benefit is equivalent to a 15-year pension and the individual must have at least one year of service credit to be eligible.

The policy reason for having a more lucrative benefit program for public safety employee retirement plans is that public safety employment (police officer or firefighter service) is particularly hazardous, that it requires the maintenance of a particularly vigorous and robust workforce to meet the strenuous requirements of the employment position, and that the normally expected working career of a public safety employee will be significantly curtailed as a consequence of the hazards and strenuous requirements of that type of employment when compared to a general public employee.

Public employee pension plans are intended to assist the governmental personnel system by encouraging the recruitment of qualified and motivated new employers, the retention of able and valued existing employees, and the orderly and predictable out-transitioning of employees at the expected end or normal conclusion of their working career. For public safety employees, public safety employee retirement plans provide more lucrative benefits to assist in the recruitment and retention of new and existing personnel, but most clearly emphasize the out-transitioning function.

Background Information on PERA-P&F Funding Condition

Historically, PERA-P&F has been a well funded plan. For decades, this plan had contribution sufficiencies in nearly every year. In the information shown in the attachment covering the years 1991 through 2004, the plan had contribution sufficiencies in every year until 2003. The highest sufficiency for the years covered here occurred in 1998, when the sufficiency was 7.6 percent of payroll. The funding ratios are above 100 percent in all years, with a high of 134 percent funded in 1998.

In the last few years, however, the funding ratio has fallen considerably, although it remains above 100 percent. In 2002, the funding ratio was 121 percent, dropping in 2003 to 107 percent and to 101 percent in 2004. Although the plan remained fully funded in the last valuation, the plan has developed a large contribution deficiency, 6.55 percent of payroll or $38.9 million. That deficiency marks a large turnaround from the high point in 1998. The plan moved from a sufficiency of 7.6 percent of payroll in 1998 to a deficiency of 6.55 percent of payroll in 2004, a swing of 14.15 percent of pay.

The change in condition is due to changing demographics, benefit increases, use of negative amortization, and other actuarial methodology changes, coupled with recent poor investment markets. Normal cost has increased from 17.5 percent of pay in 1991 to 22.4 percent in 2004. The following notes some of the years where significant changes in plan benefits or assumptions occurred:

- In 1993, benefits were improved by increasing the accrual rate from 2.5 percent of the high-five average salary per year of service to an accrual rate of 2.65 percent. Disability and survivor benefits were similarly increased. Contribution rates were reduced from 8.0 percent of pay to 7.8 percent of pay for the employees and from 12 percent of pay to 11.7 percent for the employers. Negative amortization was also created, where assets in excess of accrued liabilities will be treated like a negative liability, with the excess amortized over the same period as an unfunded liability, but reducing the required contributions rather than increasing it. These changes had a noticeable impact. The normal cost increased from 18.05 percent of pay to 19.26 percent of pay. The negative amortization, however, more than offset the normal cost increase and employee and employer contribution rate decrease. The contribution sufficiency increased from 1.4 percent of pay a year earlier to 2.05 percent of pay.
- In 1994, law was revised to allow PERA-P&F members to use the accrual rate enacted in 1993 in combined service annuities. The maximum disability earnings provision was revised to considerably increase the earnings a PERA-P&F disabilitant could earn without having disability benefits reduced. The employee and employer contribution rates were again adjusted downward slightly.
- In 1995, subsidized early retirement was created, when the required actuarial reduction for early retirement was replaced with a 2.4 percent per year reduction.
- In 1997, the Post Retirement Fund was revised to produce approximately one percent per year less in post retirement adjustments, in partial exchange for higher benefits to be paid at the time of retirement. The accrual rate for retirement benefits was increased from 2.65 percent to 3.0 percent of the high-five average salary for each year of service, and corresponding changes were made in disability benefits. The plan's normal cost increased considerably, from 19.73 percent of pay to 21.65 percent of pay.
- In 1999, several changes occurred that impacted the plan. The PERA-P&F consolidation accounts were merged into PERA-P&F. Negative amortization provisions for the fund were revised to amortize excess assets over rolling 30-year periods, rather than to use the same time horizon that would be used to amortize an unfunded liability. Early retirements are further subsidized, requiring only a reduction of 1.2 percent per year, rather than 2.4 percent per year. Contribution rates were further reduced to 6.2 percent for the employees and 9.3 percent for the employers.

- In 2000, the Legislature revised the way the actuarial value of assets is computed, moving to a system based on market value and weighted past deviations between the expected value of assets, assuming 8.5 percent investment returns, and the actual value of assets given the investment return that actually occurred.

- In 2002, a terminated member actuarial assumption was revised, with the liabilities for terminated members to be increased by 30 percent to account for combined service annuities.

Current Financial Situation of PERA-P&F

For many years, this pension fund looked healthy because of negative amortization. A closer examination, however, would have revealed a pending problem. When the excess assets disappeared, the plan would have a serious contribution rate shortfall. The excess assets were depleted rather quickly by benefit increases, modest changes in actuarial assumptions, and bad investment markets.

Since 1994, the contributions to the plan have been lower than the normal cost plus expenses. Until 2003, that shortfall has been more than covered by negative amortization, but that is no longer the case. As normal cost continued to climb and surplus assets have nearly disappeared, the plan now has a contribution deficiency. In 2003, there was little change in the actuarial value of assets from a year earlier, but liabilities increased considerably. The funding ratio fell considerably and negative amortization was only 2.65 percent of payroll rather than the 7.26 percent of payroll it had been a year earlier. The result was a 4.02 percent contribution deficiency. In 2004, negative amortization was only 0.44 percent of pay, causing the deficiency to increase to 6.55 percent of pay. As of 2004, normal cost plus expenses are 22.49 percent of pay, while the employee and employer contributions total only 15.50 percent of pay, creating a 6.55 percent deficiency.

If all existing actuarial assumptions were to hold in the future, including the assumed annual 8.5 percent investment return, the plan's funding ratio will continue to fall, and very soon, possible as early as next year, the plan will have unfunded liabilities. The plan has contribution rates which are nearly seven percent of pay less than normal cost plus expenses. Amortizing an unfunded liability will further add to the shortfall.

Strong investment markets, if they occur, would be helpful, but the impact is unlikely to be sufficient, at least not in the short run, to cover the gap between contributions and the normal cost plus expenses. To cover the required contributions at current statutory contribution rates, the plan needs a large body of surplus assets to generate a large negative amortization factor. A large body of surplus assets will not be generated in the near future.

Background Information on Police State Aid and Excess Police State Aid

Any revision in employer contribution rates to the PERA-P&F fund will create a ripple effect in excess police state aid, and in the additional amortization aid program that is financed by excess police state aid.

Police state aid is generated by a two percent tax on automobile insurance premiums. All or nearly all public employers who employ police officers share in receiving police state aid, which is allocated on a per officer basis. Under law, any aid amount in excess of the employer's prior year employer contribution requirement to the public safety plan is declared to be excess police state aid. In 2003, the automobile insurance tax generated $64.3 million in revenue, which amounted to $7,497 per officer. In most cases, this is more than is needed to cover the employer contribution to the public safety plan. Of the $64.3 million in police aid, $14.2 million was in excess of amounts needed and was declared to be excess police state aid.

The excess police state aid is held in a holding account in the state's general fund. From the amount allocated to the holding account, $900,000 is allocated annually to fund the ambulance service personnel longevity award and incentive program, and if a police officer stress reduction program is created by law, the appropriation for that program is to be deducted from the excess police state aid holding account. Of what remains, half is used to fund the additional amortization aid program under Section 423A.02, and the remainder cancels to the general fund.

Background Information on the Additional Amortization Aid Program

The additional amortization aid program provides additional funding to local police or paid fire relief associations with unfunded liabilities, including those that consolidated into PERA-P&F and had unfunded liabilities to retire at the time that these consolidation accounts were merged into PERA-P&F. Of the program's funding, 64.5 percent is allocated to former PERA-P&F consolidation accounts which had unfunded liabilities. Another 34.2 percent of the funding goes to the Minneapolis Police Relief Association, and a final 1.3 percent of the funding goes to the city of Virginia, to assist in covering unfunded obligations in its Virginia Fire Department Relief Association trust account.

When the Minneapolis Police Relief Association or the Virginia Fire Department Relief Association reaches full funding, the amount that had been allocated for that local relief association will be reallocated, with 49 percent of that reallocation going to the Minneapolis Teachers Retirement Fund Association (MTRFA), 21 percent to the St. Paul Teachers Retirement Fund Association (SPTRFA), and 30 percent as additional funding to support the minimum fire state aid program.

Issues with PERA-P&F Disability Program

Rather than simply increasing contribution rates, the Legislature may wish to consider some increase in rates coupled with an effort to control plan costs. In the last few years, PERA has become concerned about the cost of its disability program, due to significant increases in disability applications. Since the disability program is a part of the retirement plan coverage, the increased disability cost is increasing the PERA-P&F normal cost. The plan uses a position specific definition of disability, an inability to perform the job held prior to the disabling event. The disability benefit is computed like a retirement benefit, with minimum benefits for non-duty and duty-related disabilities of a 15-year service-equivalent pension or a 20-year service-equivalent pension, respectively, with no reduction due to receiving a benefit prior to normal retirement age. In addition, disabilitants receive free spousal joint-and-survivor coverage, and if the disability is duty-related, employer paid healthcare to age 65.

These added benefits for disabilitants create a financial incentive to apply for a disability benefit rather than a retirement benefit as members approach retirement age. This incentive, plus weaknesses in the PERA-P&F disability application and verification procedures, leads to abuses. In an effort to control plan costs, PERA proposed some changes in PERA-P&F disability procedures, which were enacted in 2004 (Laws 2004, chapter 267, Article 8, Section 20 to 25). These changes included requiring prompt reporting at the time of the injury or illness of the disabling event, better proof-of-disability requirements, mandatory medical examinations and release of all relevant medical records, and input from the employers regarding the individual's ability to perform assigned work tasks.

Discussion and Analysis

S.F. 621 (Betzold, by request); H.F. 1756 (Smith) increases the Public Employees Police and Fire Retirement Plan (PERA-P&F) employee contribution rate from 6.2 percent to 9.0 percent and the employer contribution rate from 9.3 percent of salary to 13.6 percent, effective on January 1, 2006. The sum of the employee and employer contribution increase is 7.0 percent of salary.

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

1. Sufficient Need for an Increase. The issue is whether there is sufficient need for an increase. The actuarial reports over the last several years do support the need for a contribution rate increase.

2. Employee/Employer Relative Burden. The issue is the level of employee contributions relative to the employer contributions. For public safety plans, the Commission follows a policy of having the employees pay a contribution covering 40 percent of the normal cost plus expenses, while the employer pays 60 percent. The existing rates in the plan are consistent with this principle, as are the proposed rates.

3. Appropriate Increase Amount. If the Commission is convinced that an increase is needed, the issue is whether the amount of the increase proposed in the bill is the proper increase amount. The proposed increase seems adequate, given the existing deficiencies. Under the bill, contributions would increase by a total of seven percent of pay. This is approximately the amount of the deficiency in the 2004 valuation (6.55 percent of pay), and if there are no excess assets in 2005, and thus no negative amortization, the contribution deficiency is likely to be about 7.0 percent of pay, and possibly higher.

4. Controlling Cost/Plan Redesign. The question is whether the Commission should consider, at least over the longer term, some effort to reduce plan costs rather than simply increasing contributions to match the cost of the existing plan. One area that may warrant further work is in the area of PERA-P&F disabilities. The cost of the PERA-P&F disability program has been escalating considerably, in part due to abuse. Reasons of the high utilization are discussed above. According to information in the 2004 actuarial valuation report, the PERA-P&F disability program costs 3.5 percent of payroll. The State Patrol Retirement Plan, administered by the Minnesota State Retirement System (MSRS), provides benefits comparable to PERA-P&F, but the disability program in that plan costs 2.5 percent of pay, rather than 3.5 percent, due to lower utilization. The Commission and the Legislature took modest action in the 2004 Legislative Session to help PERA control the cost of the PERA-P&F disability program. A further Commission review might be justified in light of the request for more money to finance the PERA-P&F Plan.

5. Cost/Additional Amortization Aid Issues. The issue is the added employer contributions required under this bill. The requested employer increase is likely to be nearly fully funded by police state aid,

although there could be some impact on a few municipalities and other employers if the average employer contribution requirement exceeds the police state aid. In 2003, police state aid was approximately $7,500 per officer. With a new employer contribution rate of 13.6 percent of pay as proposed in the bill, that state aid would completely cover the employer contribution if the average pay for the officers is less than approximately $55,150. If the aid were $8,000 per officer, that would completely cover the employer contribution if average officer pay is less than $58,823. If aid were $8,500, the maximum fully covered average salary is $62,500. If aid were $9,000 per officer, the maximum fully covered average salary is $66,176.

Given the PERA-P&F covered payroll in 2004, as indicated in the valuation, and assuming five percent salary increases, the total additional employer contribution under the bill in 2006 will be $28.1 million, and will increase at the rate of salary inflation thereafter. Since nearly all of that employer contribution increase will be funded out of state police aid, this will reduce the amount of excess police state aid, which will impact the state general fund since a considerable portion of excess police state aid cancels to the state general fund, and will impact the additional amortization aid program which is funded out of a portion of the remainder. This in turn will have implications for various former consolidation accounts (Anoka Police, Columbia Heights Police, Crookston Fire, Crookston Police, Duluth Fire, Duluth Police, Faribault Fire, Faribault Police, Hibbing Police, Hibbing Fire, Mankato Fire, St. Cloud Fire, St. Paul Fire, South St. Paul Fire, South St. Paul Police, Winona Fire, and Winona Police), and for Minneapolis Police, Virginia Fire, MTRFA, SPTRFA, and numerous communities that receive minimum fire state aid.

6. Phase-In Issues. The issue is whether a phase-in of increases should be used. The bill proposes no phase-in. There may be little need to phase-in contribution increases for employers since that is nearly all covered by state aid, but perhaps the Commission may feel a need to use a phase-in to ease the impact on the employees.
7. Position of Employee Groups. The Commission may wish to have testimony from groups representing police officers to hear their concerns and to determine the level of their support for this bill.
8. Uniformity Issues. The bill could add to uniformity problems. Plans are truly uniform when similar employees have the same benefit provisions and pay the same percentage of pay for that pension plan coverage. The State Patrol Retirement Plan and PERA-P&F provide comparable benefits, but contribution rates between these plans are not uniform. It is not clear, should the Commission and Legislature choose to consider the various contribution rate increase bills that have been introduced this Session, whether rates will become more uniform for similar plans. In the longer term, the Commission may wish to consider other options, such as merging comparable plans to create a system where similar individuals are paying the same percentage of pay for their pension coverage.

Potential Amendments for Commission Consideration

Amendment LCPR05-192 delays the effective date from January 1, 2006, to a date to be set.

Amendment LCPR05-193 provides an increase of half the amount requested, a total increase of 3.5 percent rather than 7.0 percent. This would reestablish the rates charged from 1994 through 1998, a 7.6 percent employee contribution, and an 11.4 percent employer contribution. This amendment could be used if the Commission chooses to delay fully addressing the current situation, with an expectation that Legislative action at a future date to control or reduce plan costs and improved investment markets will assist in closing the remaining contribution shortfall.

Amendment LCPR05-194 keeps the total increase as specified in the bill, but phases-in the increases over three years.

Amendments Requested by League of Minnesota Cities. The following two amendments were requested by the League of Minnesota Cities. Both are phase-in amendments, but with a longer phase-in than proposed in LCPR05-194, and with a higher final contribution rate. Some increase in the final rate compared to that requested in the bill may be necessary if unfunded liability begins to occur. Delay will allow that unfunded liability to grow, creating a need for a sufficient increase to amortize that unfunded liability. Presumably, the increases proposed in the following two amendments are based on discussions with PERA and upon input from an actuary. The Commission may wish to have brief testimony from PERA on these matters.

If a long phase-in increases the eventual final rates needed, that has implications for the employees and employers. The final rates for the employees will be higher than if no phase-in is used. The same is true of the employers, but for many employers that will not matter if the entire employer contribution is covered by state police aid. A long phase-in may be favored by those employers retaining police officers with salaries in excess of that fully covered by state aid, but assisting that group may have a negative impact on all police officers covered by PERA-P&F, due to the higher final employee contribution.

Amendment LCPR05-203 phases in the increases over four years, and with a final combined employee and employer contribution of 23.5 percent, rather than the combined total 22.5 percent contribution proposed under the bill.

Amendment LCPR05-204 phases in the increases over five years, and with a final combined employee and employer contribution of 24 percent, rather than the combined total 22.5 percent contribution proposed under the bill.