TO:	Members of the Legislative Commission on Pensions and Retirement
FROM:	Susan Lenczewski, Executive Director
RE:	LCPR16-016: MSRS; Augmentation Rate and Exception for Fairview Employees
DATE:	February 22, 2016

Summary of Bill Draft LCPR16-016

Chapter 352F applies only to the group of MSRS members whose employment was transferred from University of Minnesota Hospital and Clinic ("University Hospital") to Fairview Hospital and Healthcare Services ("Fairview") in 1996 when the assets and employees were spun-out of the University of Minnesota system and merged into Fairview. (These employees are referred to as "Fairview employees" in this memo).

LCPR16-016 amends Minnesota Statutes § 352F.04 to make the following changes:

1. Section 1 of the bill ends the enhanced augmentation rates applicable to the pensions of Fairview employees, effective December 31, 2016. These augmentation rates are currently 5.5% per year until age 55 and then 7.5% per year upon attaining age 55 until retirement.

2. Section 2 of the bill adds a new subdivision 1a which states that beginning January 1, 2017 until retirement, the augmentation rate is the same rate that applies to MSRS members, generally. That rate is currently 2%.

3. Section 3 of the bill amends subdivision 2, which sets forth two exceptions to the enhanced augmentation rates, by deleting the exception that ends enhanced augmentation when a Fairview employee returns to employment in a position covered by any of the pension plans for public employees, including MSRS, PERA and TRA. Fairview employees who return to public employment are now addressed in a new subdivision 3, which is set forth in Section 4 of the bill.

4. Section 4 of the bill adds a new subdivision 3, which provides that when a Fairview employee returns to public employment, he or she will receive one of three alternative pensions, whichever produces the largest monthly benefit. This more generous treatment of Fairview employees who return to public employment is in lieu of the exception deleted from subdivision 2, which ended enhanced augmentation upon return to public employment, replacing it with the augmentation rate that applied to MSRS members, generally. The three alternatives are:

   (1) the annuity plus enhanced augmentation, which the Fairview employee would have received had he or she not returned to public employment, reduced dollar for dollar by the pension the Fairview employee earned after returning to public employment.

(2) a combined service annuity under Minnesota Statutes § 356.30, which takes into account the pension calculated under each plan in which the employee participates, but calculates the benefit under each plan using the employee's highest average pay for five consecutive years.

(3) an annuity calculated using the method for "coverage by more than one fund" as set forth in Minnesota Statutes § 352.72.

All provisions of the bill, except Section 4, are effective immediately following enactment. Section 4 is retroactively effective to any Fairview employee who begins to receive a pension on or after July 1, 2015.

Background

MSRS is proposing legislation that will reduce the augmentation rate, **on a prospective basis**, for MSRS members whose employment was transferred from University of Minnesota Hospital and Clinic to Fairview Hospital and Healthcare Services in 1996. In connection with the spin-off of assets and employees to Fairview, legislation was enacted in 1997 to provide certain benefit enhancements to these members, one of which was generous augmentation (5.5% annually to age 55 and 7.5% annually thereafter to retirement as compared to 3% and 5% for other MSRS members at that time).[1]

The cumulative effect of this enhanced rate of augmentation after nearly 20 years of application is that the monthly benefits to be paid to these members upon their retirement far exceeds the monthly benefit that will be paid to similarly situated MSRS members who were not part of the spin-off and will not receive the enhanced augmentation. MSRS' proposal is to drop the augmentation to 2%, prospectively, which will bring the rate in line with all other MSRS members. Augmentation up to December 31, 2016, is unaffected by the proposed changes, as is the pension benefit currently being paid to any former Fairview employee currently receiving a pension.

Example Set I, below, provides examples of pension benefits to be paid to the Fairview employees as compared to the pension benefits they would have received had they stayed in MSRS-covered public employment. The chart shows six different members, their age, years of service, high five salary and employer and employee contribution amount. For each member, the monthly benefit at retirement age is calculated under current law (with enhanced augmentation until retirement), proposed law (with enhanced augmentation until December 31, 2016, and regular augmentation thereafter), and as if the member was not a Fairview employee, so had received no enhanced augmentation. The shaded columns shows what each member would receive as a pension benefit and what the member would have had for employee and employer contributions had the member continued in covered employment and not been transferred to employment as a Fairview employee.

[1] Augmentation is like a post-retirement adjustment or COLA except that it is applied to the pension of a person who is not yet receiving the pension, because he or she has not reached retirement age. Augmentation is an annual increase in the amount of the pension earned by the employee that is calculated by applying the designated percentage (*i.e.*, 5.5%) to the pension amount plus prior augmentation. Augmentation has nothing to do with the formula for calculating the underlying pension, which is based on the employee's service and salary up to the date the employee leaves employment. Augmentation is unheard of in the private sector and is rare even in the public sector.

EXAMPLE SET I

1	2	3	4	5	Monthly Benefit at Full Retirement Age			If member had remained in covered position	
Member	Age	Years of Service	High 5 Salary	Contributions EE+ER	6 Current Law	7 Proposed Law	8 Non-Fairview Deferred Calculation	9 Benefit	10 Contributions
L	62.25	21.83	$3,551	$46,749	$5,227	$4,575	$2,085	$3,637	$138,395
M	58.92	19.33	$2,639	$32,644	$4,085	$2,747	$1,584	$3,627	$129,960
H	55.58	17	$2,400	$28,007	$3,930	$2,390	$1,380	$3,058	$103,895
A	52.83	12	$2,105	$20,932	$2,805	$1,530	$902	$2,687	$71,362
O	63.58	9.42	$1,768	$14,018	$1,045	$965	$519	$2,157	$74,467
F	47.16	4.67	$1,719	$7,294	$1,215	$543	$326	$2,381	$63,465

Example Set II, below, provides examples of pension benefits to be paid to Fairview employees under current law and under the proposed legislation and the impact of the reduction in augmentation rates. The chart shows Fairview employee pensions currently and as proposed. This example assumes that a pension of $500 per month was earned by the employee by 1996, when Fairview was spun-off. This pension amount is based on service and salary credited up to the date of the spin-off, while employed in a MSRS-covered position. The dollar amounts in the chart result from the application of augmentation. Column A show the $500 benefit increased by applying the current 5.5% and 7.5% augmentation until retirement. Column B shows the $500 increase by applying augmentation under the proposed change in law, which would apply 5.5% and 7.5% until December 31, 2016, followed by 2% beginning January 1, 2017.

EXAMPLE SET II

Age Today	Age in 1997	Age at Retirement (year)	A $500 Benefit Augmented under Current Law	B $500 Benefit Augmented Under Proposed Law	% Change
45	26	55 (2026)	$1049	$748	29%
		62 (2033)	$2858	$1412	51%
		65 (2036)	$4486	$1898	58%
55	36	55 (2016)	$614	$614	0%
		62 (2023)	$1673	$1158	31%
		65 (2026)	$2626	$1553	41%
65	46	65 (2016)	$1538	$1538	0%
		70 (2021)	$2395	$1842	24%

MSRS is also proposing changes to an exception to enhanced augmentation that applies when a Fairview employee returns to public employment. Currently, when a Fairview employee returns to employment covered by one of the state pension plans, augmentation at the enhanced rates ends and the rate of augmentation drops to the current rate for other MSRS employees, which is 2%. The proposed change is targeted at situations where a short period of public employment ends the enhanced augmentation and looks like a penalty for simply returning for a short stint as a public employee. Where the period of subsequent public employment is longer, the combined service annuity or coverage by more than one fund annuity will likely result in a larger benefit than the augmented benefit in any case.

For example, assume a member worked for University Hospital for 10 years until being transferred to Fairview in 1996. By the time of the transfer, she had earned an MSRS deferred retirement benefit. The member then worked at Fairview for 5 more years, before taking a job in 2002 as a substitute teacher for six months covered by TRA. Thereafter, the member continued the rest of her career in the private sector.

Under current law, this Fairview employee would not be eligible for the enhanced augmentation rates after 2002, because of the six months of substitute teaching. She would have 5 years of 5.5% augmentation followed by many years of 2% augmentation, simply because she returned for a short period of public employment that earned her a small additional pension. Under the proposed legislation, she would be eligible for the enhanced augmentation until 2017, and the extent of the penalty for the short period of TRA service would be to offset this augmented benefit by the small TRA pension she earned for six months of teaching service.

Considerations

1. Cost Savings to MSRS. The actuarial savings to MSRS in dropping the rate of augmentation to the same rate as other members of MSRS will be significant: MSRS' actuary calculates that the proposed change will save the plan $58.6 million or .14% of pay. MSRS is underfunded and runs a contribution deficiency each year and this savings will help with the shortfall.

2. Legislatively-Provided Benefits are Not Permanent. We are not aware of any reason to consider enhanced augmentation more of a guaranteed benefit than any other pension benefits provided by statute. Constituents and representatives who have contacted us refer to an "agreement" entitling the Fairview employees to enhanced augmentation rates until retirement. After searching our files and contacting MSRS and other sources, we are not able to locate such an agreement. We have obtained a copy of the 1996 Fairview spin-off transaction agreement,[2] which does not include any covenants on particular retirement benefits to be maintained by the State of Minnesota or MSRS for these employees. The transaction agreement requires that these employees be given service credit for their prior years with the University for purposes of eligibility and vesting under the Fairview Pension Plan and requires that these employees immediately enter the Fairview Pension Plan and 403(b) Plan. The relevant provisions from Article III ("Human Resource Matters") of the agreement state:

> **3.7.1 Basic Pension Benefit**. A Transitioned Employee will be eligible to participate in the Fairview Hospital and Healthcare Services Pension Plan ("Pension Plan") at such time as such Transitioned Employee meets all of the eligibility requirements of the Pension Plan. A Transitioned Employee's service with the University shall be deemed to be service with Fairview for purposes of determining eligibility, vesting and for any other provision of the Pension Plan for which a determination of the Transitioned Employee's service is or may be relevant. Only compensation

[2] The agreement, titled "Asset Transfer and Statutory Merger Agreement," is dated as of December 31, 1996, and was entered into by Fairview Hospital and Healthcare Services, The Regents of the University of Minnesota, and University of Minnesota Health System Affiliated Clinics, Inc.

earned as a Fairview employee shall be used for allocating contributions and forfeitures. The University will assist Fairview in determining the amount of service to credit to a Transitioned Employee. If the University's records will not permit a determination of a Transitioned Employee's service based on the use of an hours of service counting method used in the Fairview Pension Plan, then past service will be credited to such Transitioned Employee based on procedures outlined in the Pension Plan document. All service will be credited based on the provisions in the Pension Plan relating to service and breaks in service.

3.7.2 403(b) Programs. There is no waiting period or eligibility requirement for participation in the 403(b) Tax Deferred Annuity programs available to Fairview employees. Participation is optional. A Transitioned Employee will be eligible to participate in a 403(b) program on the Effective Time. All contributions are immediately vested. Fairview has applied to the Internal Revenue Service (the "Service") for a Private Letter Ruling on the issue of what service can be included for the purposes of calculating Maximum Exclusion Allowances for Transitioned Employees and will instruct 403(b) program representative(s) to act on their findings in this matter.

As mentioned, there was legislation passed shortly after the spin-off, but as with any other legislation, it would have been subject to future action by the legislature. It is not known why the transaction agreement did not require MSRS to maintain a certain specific level of augmentation, so that there was a contractual obligation to maintain enhanced augmentation.

Fairview employees are not current state employees, so may not be aware of the serial reductions in augmentation and COLAs imposed on MSRS and the other public pension plans since 1996 and may not be aware of the underfunded status of public pension plans in this State and nationwide. We understand that Fairview employees are counting on ongoing enhanced augmentation and have relied on and planned around augmentation rates never changing. The Commission will need to determine whether such reliance is reasonable in view of similar reductions in future benefits, including the reduction of augmentation of MSRS pensions, generally, to 2% in 2010. In recent years, when MSRS sends out a benefit calculation to its members, including the Fairview employees, the benefit calculation includes the following statement: “Changes to your work pattern or legislative actions could affect the final monthly benefit amount.” The Commission could reasonably conclude that Fairview employees were on notice that legislation could change their pension benefits.

3. Objective of Providing Enhanced Augmentation Has Been Met and Exceeded. Minnesota Statutes § 352F.01, under the title “Purpose” states as follows:

> The purpose of this chapter is to assure, to the extent possible, that persons employed at the University of Minnesota hospital and clinics will be entitled to receive future retirement benefits under the general state employees retirement plan of the Minnesota State Retirement System **commensurate with the prior contributions made by them or on their behalf** upon the integration of the University of Minnesota hospital and clinics and Fairview hospital and health-care services.

(Emphasis added.) Please see the attached Example Set I, and columns 5 and 10 for comparison of the employee and employer contribution amounts and the corresponding monthly pensions to be paid. Fairview employees have contributed less for larger pension benefits. Even the example with the smallest pension amounts shows that for twice the pension benefit, a similarly situated MSRS employee would have contributed (along with employer contributions in equal amount) approximately four times the contribution made by the Fairview employee.

According to Dave Bergstrom, Executive Director of MSRS, whose tenure dates back to the time of the Fairview spin-off, the rationale for providing enhanced augmentation to the Fairview employees was that the enhancements, along with the Fairview retirement benefits promised in the transaction agreement, would provide these employees with a pension benefit payable at retirement age that would approximate the pension benefit they would have received had they remained in MSRS-covered employment. Our understanding is that this objective has been achieved and exceeded and that Fairview employees are on track to receive a pension with a value that, in many cases far exceeds the pension they would have received had they remained employed in public employment covered by MSRS.

4. Alternative Legislation. Since the reaction of Fairview employees to the proposed changes seems to be as much surprise as anything else, the Commission could consider alternatives to the proposed legislation in its current form that would soften the impact. One option would be to phase-in the reduction over two or more years, such as by reducing the current rates of augmentation by 1% each year until they reach 2%. Another option would be to reduce the rate of augmentation to a percentage between 5.5% and 7.5% and 2%, for example, to 3% up to age 55, and 4% thereafter. Any variation or combination of these concepts might give the Fairview employees more time to prepare for the change and maximize other options they have available for funding their retirement, such as the 403(b) Plan still available at Fairview or their current employer, if that is not Fairview.

Summary

Important points to keep in mind regarding the proposed legislation:

- Pensions of former Fairview employees who are now retired and currently receiving benefits, are not affected.
- The change in the augmentation rate will reduce the rate of increase in the future (from 5.5% or 7.5% annually to 2% annually). The current pension accrued to date, together with augmentation credited to date, is **not** being reduced. The rate reduction is prospective.
- Fairview employees have retirement benefits from employment with Fairview after the spin-off in 1996, including an array of welfare benefits and money purchase pension and 403(b) plans.
- All other members of MSRS receive augmentation on their pension at a rate of 2%. The rate of augmentation was reduced from 3% and 5% (after age 55) to 2% (regardless of age) in 2010 for all other MSRS members.

Attachment

- Bill Draft LCPR16-016