

Options for Supplemental Benefit Maintenance Account Excess Funds

Background

The Supplemental Benefit Maintenance Account (SBMA) is a special account in the Teachers' Retirement Fund that provides inflation protection to CalSTRS members. California Education Code section 24415.5 authorizes the Teachers' Retirement Board to adjust the purchasing power protection level provided by the SBMA between 80% and 85%, based on actuarial projections. In 2009, the board adopted regulations to outline and implement the process to adjust the purchasing power protection provided by the SBMA, including the timing and frequency of actuarial projections. Pursuant to these regulations, an actuarial analysis is performed every two years and must use June 30, 2089, as the date through which the sufficiency of the SBMA is measured.

The current SBMA balance, along with future contributions and future investment earnings, is expected to be sufficient to pay the SBMA benefits at the current 85% level through June 30, 2089, for current members of the Defined Benefit Program. In addition, actuarial projections show that purchasing power benefits could be sustained at a level of 92% through 2089, based on the current long-term inflation rate. In May 2022, CalSTRS staff presented the most recent actuarial projections to the board, and the board opted to keep the purchasing power protection at the 85% level, the maximum allowed by statute.

Since the SBMA is projected to have funds available beyond the amount needed to maintain 85% purchasing power protection through 2089, Education Code section 24415.5 requires the board to develop options for the use of these excess resources. The statute requires these options be for the exclusive benefit of members and beneficiaries and that at least one of the options be an increase in benefits paid to members who retired prior to 1999, which is when the first of two sets of previous benefit enhancements for active members took effect.

SB 868 (Cortese), introduced in January 2022, would provide additional SBMA benefits to members who retired prior to 1999 using the excess resources, if adopted by the Legislature. This legislation reflects Option 1 as presented in this report. In March 2022, the board adopted a support position on SB 868, which is consistent with previous direction from the board to support options designed to help older members most in need of economic assistance, while not compromising the financial integrity of the SBMA and its long-term ability to provide inflation protection.

SBMA funding

To fund the SBMA, the State General Fund provides an annual transfer equal to 2.5% of total creditable compensation from the fiscal year ending in the prior calendar year, reduced by \$72 million each fiscal year. This contribution is in addition to the state's contribution to fund the Defined Benefit Program. The state is contractually obligated to make the contribution to the SBMA, and the board successfully litigated that issue when \$500 million in contributions to the account were withheld in 2003. The SBMA is also funded with revenues received from the use of state school lands (land granted to California by the federal government to support schools) and lieu lands (properties purchased with the proceeds from the sale of school lands).

In fiscal year 2020–21, the SBMA received \$782 million in contributions, of which \$775 million came from the State General Fund and approximately \$7 million from state school and lieu lands revenues. Benefits paid from the SBMA totaled \$195 million in 2020–21.

SBMA payments

When inflation depletes the value of the current benefit to less than 85% of the value of the original benefit, CalSTRS pays a quarterly payment from the SBMA to the benefit recipient to restore the value of the benefit to the 85% purchasing power level. In accordance with statute, CalSTRS measures inflation for each fiscal year using the California CPI-U index issued by the Department of Finance for the month of June. The current board-approved long-term assumption for inflation is 2.75%. Since the completion of the last actuarial analysis, inflation in California has averaged close to the assumed 2.75%. Inflation was 1.4% in 2019–20 and 4.4% in 2020–21. Inflation in 2021–22 is on pace to far exceed 2.75%.

Over the last two years, the number of members receiving SBMA has declined compared to the last actuarial analysis performed in 2020. In 2021–22, the SBMA provided purchasing power benefits to approximately 68,000 members at an average of \$310 per month. Two years ago, about 71,000 members were receiving a benefit from the SBMA at an average of \$261 per month. Considering the high level of inflation experienced in 2021–22, it's likely the number of members receiving SBMA benefits will significantly increase the next fiscal year.

In 2021–22, SBMA payments were paid to all members and beneficiaries of members who retired in 2000 or earlier and those who retired in 2001 and 2002 but only on or after September 1 of those years. For members who retired in 2001 and 2002, only those who retired in the months of September through December have started to receive SBMA payments since they had to wait an extra year for their first 2% annual benefit adjustment. Pursuant to statute, members who retire prior to September 1 are eligible for their first annual benefit adjustment the following calendar year. Those who retire on or after September 1 have to wait an extra year. The additional one-year wait for those who retired in the September through December time period in 2001 and 2002 resulted in them falling just below 85% purchasing power for 2021–22, triggering a benefit from the SBMA.

In addition to the contribution to the SBMA being a contractual obligation of the state, the right of Defined Benefit Program benefit recipients to receive SBMA payments is also vested, but only to the extent there are funds in the account. If SBMA funds are insufficient to maintain even the 80% purchasing power, the supplemental benefit would be reduced to an amount that can be funded with available money.

Risks related to higher inflation

Pursuant to Education Code section 22216, the assets in the SBMA are credited each year at the rate of investment return assumed for the Defined Benefit Program, currently set at 7%. This is done regardless of the actual return of the assets in the account. In effect, this means that SBMA assets are shielded from the investment volatility experienced by CalSTRS assets.

Therefore, the stability of the SBMA depends significantly on the rate of inflation. Before considering any options, it's important to realize the projections included in this report assume inflation will remain stable at 2.75% each year into the future. If inflation were to exceed the assumed 2.75% for an extended period, the surplus could rapidly be depleted.

For example, although the 85% purchasing power level can be sustained indefinitely if inflation stays at or below the current 2.75% assumption, the SBMA would be depleted in approximately 30 years if inflation was 5% for the next decade, even if inflation reverted to 2.75% annually after 10 years. If inflation is 3.75% each year in the future, the SBMA would run out of funds in 35 years.

The ability of the SBMA to sustain an 85% protection level was measured by varying levels of future inflation on an annual basis. To perform this analysis, CalSTRS used a stochastic model that varied inflation in the future. Based on the analysis, CalSTRS determined there was a 66% chance that the SBMA would be able to sustain an 85% protection level through 2089, which is referred to as the probability of sufficiency. CalSTRS used the same stochastic model to analyze the options presented in this report.

Benefits for current retirees

The following table compares the various components of a member's benefit, by decades, for those members who retired prior to 1999. The year 1999 was selected since January 1, 1999, was the effective date of the first of two sets of benefit enhancements for active members adopted by the California Legislature in the late 1990s and early 2000s. The table also includes both the ad hoc increases and the minimum guaranteed benefits that were adopted by the California Legislature in 1999 and 2000 and provided increases in retirement benefits to all members who retired prior to 1999.

Average monthly benefit in 2021–2022 by type and decade of retirement

Type of benefit (averages)	Retirements in the 1970s	Retirements in the 1980s	Retirements in the 1990s (prior to 1999)
Base retirement benefit	\$470	\$1,157	\$1,942
2% improvement factor	348	777	1,103
Ad hoc increase	38	83	61
Minimum guarantee	96	78	11
SBMA	1,207	619	273
Total monthly benefit	\$2,159	\$2,714	\$3,300
SBMA as % of total benefit	55.9%	22.8%	8.3%

As seen above, both the annual 2% improvement factor and the SBMA benefit play an important role in helping CalSTRS members cope with inflation after their retirement. Since the SBMA provides inflation protection, it should come as no surprise that higher SBMA benefits are paid today to those members who have been retired the longest. For CalSTRS members who retired prior to 1980, SBMA payments represent more than half of their CalSTRS benefits.

Option discussion

The \$30.7 billion in resources—current assets plus projected future contributions on current member payroll—identified in the June 30, 2021, SBMA Actuarial Analysis exceeds the \$18.8 billion projected value of future purchasing power benefits for current members. The result is \$11.9 billion in projected resources in excess of the amount needed to maintain 85% purchasing power through June 30, 2089, an increase of about \$700 million since 2019. The current SBMA balance plus expected contributions would be sufficient to pay purchasing power benefits at a level of 92% through 2089. This measure has remained the same since the last actuarial analysis. As stated earlier in this report, the SBMA balance is highly dependent on future inflation and could quickly be depleted if inflation continues to exceed 2.75% over an extended period of time.

This report, prepared in compliance with Education Code section 24415.5, identifies options to use these excess resources for the exclusive benefit of members and beneficiaries. In preparing options, consideration was given to SB 868, which was introduced on January 24, 2022. Option 1 reflects the additional benefits currently included in SB 868. In addition, an option that would increase the inflation protection level for all members was also analyzed for the use of excess funds. As stated earlier, a stochastic model that varied inflation levels from year to year was used to assess the likelihood of the SBMA paying all benefits through 2089. These two options were presented to the board on May 4, 2022. Each option would require legislation to provide the board with additional authority.

Current law limits the types of benefit enhancements that could be enacted from these excess resources. The California Public Employees' Pension Reform Act provides that any enhancement to a public retirement system's retirement formula or benefit that is adopted on or after January 1, 2013, would apply only to service performed on or after the operative date of the enhancement.

The options to use the SBMA excess resources are in the following sections, with the impact of each broken out by the decade of retirement to convey how each option would affect older retirees versus more recent retirees. In the June 30, 2021, SBMA Actuarial Analysis, the probability of sufficiency was estimated to be 66% prior to the consideration of any options.

Option 1: One-time permanent increase for pre-1999 retirees only

When the board considers options pursuant to Education Code section 24415.5, one of these options must be an increase in benefits paid only to members and beneficiaries of members who retired prior to 1999. Option 1 meets this requirement.

Option 1, which reflects the additional benefits currently included in SB 868, is a one-time permanent adjustment that applies to the total benefit currently being paid, including the 2% improvement factor and any applicable purchasing power payments. The percentage increase would be based on the year of retirement and apply only to members and beneficiaries of members who retired prior to 1999.

The following table shows the schedule of one-time increases included for this analysis.

Schedule of one-time increases

Retirement date	Percentage increase
After December 31, 1998	0%
Between January 1, 1990, and December 31, 1998	5%
Between January 1, 1980, and December 31, 1989	10%
Prior to January 1, 1980	15%

For this analysis, it was assumed these additional benefits would be paid from the SBMA and that future 2% improvement factor adjustments would apply to the resulting additional benefits based on the effective date of the increase. These additional benefits, along with existing benefits, would continue to be subject to the current 85% purchasing power protection level.

The following table shows the estimated present value of increased SBMA payments for Option 1 as of June 30, 2021, and provides the probability of sufficiency if benefits were increased pursuant to Option 1. As stated earlier, the probability of sufficiency is currently estimated to be 66% prior to the consideration of any of the options analyzed for this report. As noted below, Option 1 would lower the probability of sufficiency for the SBMA to 65%, a reduction of 1%.

Option 1 – Estimated cost impact

Present value of increased SBMA benefits	Probability of sufficiency
\$517 million	65%

To illustrate how Option 1 would impact CalSTRS retirees, below is a table showing the expected increase in SBMA payments for existing retirees based on the retirement date. As shown below, Option 1 would provide for greater increases in benefits for members who have been retired the longest.

Option 1 – Estimated increase in SBMA monthly benefit for 2021–22

Retirements in the 1970s	Retirements in the 1980s	Retirements in the 1990s (prior to 1999)
\$324	\$271	\$165

Option 2: Varying purchasing power levels

Option 2 would increase the purchasing power level permanently to a higher percentage.

The following table shows the estimated present value of increased payments as of June 30, 2021, if the SBMA purchasing power level was permanently increased to a higher level, ranging from 86% to 90%. For comparison purposes, the current 85% level is included. The table also provides the probability of sufficiency for each of the purchasing power levels analyzed under Option 2.

Option 2 – Estimated cost impact

Purchasing power level	Present value of increased SBMA benefits	Probability of sufficiency
85%	N/A (current level)	66%
86%	\$2.2 billion	64%
87%	\$4.5 billion	60%
88%	\$7.0 billion	56%
89%	\$9.8 billion	52%
90%	\$12.7 billion	45%

Although the SBMA would be able to sustain a 90% level if inflation remained at 2.75% per year, the stochastic model showed that the probability of sufficiency would decrease. At a 90% purchasing power level, the SBMA fund would be expected to be able to maintain that level only 45% of the time, compared to 66% at the current 85% level.

The following table shows the expected increase in SBMA payments for existing retirees based on the decade of retirement. As shown below, more recent retirees would receive higher increases in benefits if the purchasing power were to be increased to higher levels immediately for all retirees.

Option 2 – Estimated increase in SBMA monthly benefit for 2021–22

Purchasing power level	Retirements in the 1970s	Retirements in the 1980s	Retirements in the 1990s (prior to 1999)
86%	\$25	\$32	\$39
87%	\$51	\$64	\$78
88%	\$76	\$96	\$117
89%	\$102	\$128	\$155
90%	\$128	\$160	\$194

Conclusion

At its May 2022 meeting, the board reviewed two options for use of the excess SBMA funds and directed staff to present them to the Legislature as required. The board supports Option 1, the option currently under consideration by the Legislature in SB 868, which the board took a support position on in March 2022. It is the option that will help CalSTRS retired members most in need of assistance while not compromising the financial integrity of the SBMA and its ability to provide inflation protection long term.

