

Options for Supplemental Benefit Maintenance Account Excess Funds

Background

The Supplemental Benefit Maintenance Account (SBMA), a special account in the Teachers' Retirement Fund, provides quarterly supplemental payments to all Defined Benefit Program benefit recipients whose current purchasing power has fallen below 85 percent of the purchasing power of their initial allowance, as measured by the California Consumer Price Index.

California Education Code section 24415.5 authorizes the Teachers' Retirement Board to adjust purchasing power protection payments between 80 percent and 85 percent of the initial benefit based on actuarial projections through a period of time established by the board. In 2009, the board established June 30, 2089, as the date through which the purchasing power should be sustained. Regulations require the board to re-evaluate this sustainability date sometime between 2019 and 2029. Since 2009, the purchasing power benefit has remained at 85 percent.

Section 24415.5 also requires the board—if it determines there are funds available beyond the amount needed to maintain 85 percent purchasing power protection through 2089—to develop options for these excess resources. The section specifically requires the proposed options be for the exclusive benefit of members and beneficiaries. In addition, at least one of the options must be an increase in benefits paid to those who retired before 1999, when the first of two sets of benefit enhancements took effect.

SBMA Funding

To fund the SBMA, the State General Fund provides an annual transfer equal to 2.5 percent 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.

Revenues from the use of state school and lieu lands, including revenues from the sale of the Elk Hills Naval Petroleum Reserve, are also used to fund the purchasing power program. State school lands are lands granted to California by the federal government to support schools, and lieu lands are properties purchased with proceeds from the sale of school lands.

In fiscal year 2016–17, the SBMA received \$654 million in contributions, of which \$649 million came from the State General Fund and approximately \$5 million from state school and lieu lands revenues.

Under Education Code section 22216, the assets in the SBMA are credited each year at the rate of the investment return assumed for the Defined Benefit Program. This is done regardless of the actual return of the assets in the account. Effective July 1, 2017, the SBMA is credited interest at a rate of 7 percent. In effect, this means that SBMA assets are shielded from the investment volatility experienced by CalSTRS assets.

SBMA Payments

When inflation depletes the value of the current benefit to less than 85 percent 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 percent purchasing power level. In fiscal year 2016–17, the SBMA provided purchasing power benefits to approximately 50,000 members who had retired in 1992 or earlier, totaling \$161 million.

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 percent purchasing power, the supplemental benefit would be reduced to an amount that can be funded with available money.

Periods of low inflation reduce the quarterly supplemental payment amount. For example, the California Consumer Price Index declined during the 2008–09 fiscal year, and together with the 2 percent annual benefit adjustment, more retirement benefits were kept at or above 85 percent of their initial value. As a result, quarterly supplemental payments to individual benefit recipients were reduced or

eliminated for the 2009–10 fiscal year. Correspondingly, future increases in inflation could increase quarterly supplemental payments and eliminate the excess assets. For example, although the 85 percent purchasing power level can be sustained indefinitely if inflation stays at or below the current 2.75 percent assumption, the SBMA will be depleted by 2069 if inflation increases to 3.5 percent and by 2048 if inflation increases to 4 percent annually.

In the 10 years preceding June 30, 2017, realized inflation rates have been less than the 2.75 percent assumed for the SBMA actuarial analysis, contributing to the excess resources in place today. Of note, inflation rates recently started to increase, and for the first time in a decade, inflation rose above the 3 percent rate and was 3.4 percent in calendar year 2017.

Option Discussion

The \$22 billion in resources—current assets plus projected future contributions on current member payroll—identified in the June 30, 2017, SBMA Actuarial Analysis exceeds the \$12.2 billion projected value of future purchasing power benefits for current members. The result is \$9.8 billion in projected resources in excess of the amount needed to maintain 85 percent purchasing power through June 30, 2089, primarily from future contributions. In fact, the current SBMA balance plus expected contributions would be sufficient to pay purchasing power benefits at a level of 93 percent through 2089. 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.

Current law, however, 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. As a result, benefit enhancements that apply to retired members based on the benefits currently received, which themselves are based on service already performed, could be inconsistent with PEPRA. However, the Legislature could override this restriction to avoid conflict with current legislative policy.

Five options for the use of the excess SBMA resources were analyzed and presented to the board on May 10, 2018. All but Option 5 would require legislation to provide the board with additional authority.

Option 1: Permanent increase in benefits for members and beneficiaries of members retiring before 1999, increasing progressively the earlier the member retired

This option would be a permanent adjustment that would apply to the total benefit currently being paid, including the 2 percent annual benefit adjustment and any applicable purchasing power payments. For this analysis, it was assumed these additional benefits would be paid from the SBMA and that future 2 percent annual benefit adjustments would apply to the resulting additional benefits based on the effective date of the increase. That is, if the retired member receives a \$100 additional payment effective July 1, 2017 (the day after the valuation period upon which this analysis is based), the member would receive additional \$2 increases (2 percent of \$100) effective September of 2018 and each September thereafter.

The table below shows a possible schedule of increases in the benefits for members and retirees. This schedule is very similar to that enacted in AB 429 (Correa) of 2000, which provided a one-time permanent increase in benefits for those whose first benefit was paid in 1997 or earlier.

RETIREMENT DATE	PERCENTAGE INCREASE
After December 31, 1998	0%
Between January 1, 1997, and December 31, 1998	1%
Between January 1, 1995, and December 31, 1996	2%
Between January 1, 1990, and December 31, 1994	3%
Between January 1, 1985, and December 31, 1989	4%
Between January 1, 1975, and December 31, 1984	5%
Prior to January 1, 1975	6%

If the increase described above is applied effective July 1, 2017, the present value of future purchasing power benefits for current benefit recipients would increase by \$365 million. This increase is multiplicative. For example, if all of the percentage increases are doubled, the cost impact would double to \$730 million. If the effective date is in the future, there would be some reduction in the cost due to fewer expected future payments.

Note that this option satisfies the requirement imposed by statute that at least one of the options be an increase in benefits paid to those who retired prior to 1999.

If this option were to be implemented, the probability of sufficiency would not be materially impacted and would remain at 71 percent.

Option 2: Increase the purchasing power benefit

A different option would be to simply increase the purchasing power level permanently to a higher percentage. Below is a table showing the estimated present value of increased payments if the SBMA purchasing power level was permanently increased to a higher level ranging from 86 percent to 90 percent. For comparison purposes, the current 85 percent level is included in the table.

A stochastic model was used to assess the likelihood of the SBMA paying all benefits at the purchasing power levels through 2089, based on different patterns of inflation from year to year. This likelihood is shown in the Probability of Sufficiency column.

Purchasing Power Level	Present Value of increased Payments	Probability of Sufficiency
85%	N/A (Current Level)	71%
86%	\$1.727 billion	70%
87%	\$3.603 billion	68%
88%	\$5.635 billion	66%
89%	\$7.831 billion	65%
90%	\$10.199 billion	63%

As can be seen in the above table, although the SBMA would be able to sustain a 90 percent level if inflation remained at 2.75 percent per year, the stochastic model showed that it would be expected to maintain that level only 63 percent of the time.

Option 3: One-time temporary increase in the purchasing power payment

This option would provide a one-time only payment to all existing members currently receiving a payment from the SBMA. As of fiscal year 2017–18, only members who have retired in 1994 or earlier are receiving payments from the SBMA. In total, about 61,000 members are currently receiving SBMA benefits.

In contrast with Option 1, this payment option would be applied one time only and not repeated in future years. This option would have the least impact on the long-term sufficiency of the SBMA since it would not be a permanent change and would be paid solely as a one-time benefit. In future years, additional one-time increases could be considered depending on the sufficiency level at that time.

For this option, a one-time payment equal to 25 percent of the current SBMA payment was analyzed. The estimated cost impact of this option is provided in the table below.

Purchasing Power Level	Present Value of increased Payments	Probability of Sufficiency
One-Time Increase of 25% of SBMA Payment	\$ 41 million	71%

As shown in the table above, providing a one-time payment equal to 25 percent of all existing SBMA payments would use about \$41 million of the existing excess resources. The probability of sufficiency would not be materially impacted and would remain at 71 percent.

Option 4: Higher purchasing power level applied only to a portion of annual benefit

This option would provide for a 90 percent purchasing power protection level but applied only to a portion of the annual benefit paid to members. Two alternatives were studied, one providing 90 percent purchasing power to the first \$10,000 of base annual benefit and another providing 90 percent of the first \$20,000 of base annual benefit. The base annual benefit is the initial benefit, generally at retirement, against which the loss of purchasing power is measured each year.

This option has the advantage of helping members with lower benefits the most. Under the 90 percent of the first \$20,000 option, a member with a base benefit of \$20,000 would now be receiving a benefit equivalent to a 90 percent purchasing power level. Another member with a base benefit of \$40,000 would see the same dollar increase in their benefit, with such increase bringing their overall benefit to about 87.5 percent purchasing power.

The estimated cost impact of this option is provided in the table below.

Alternative Studied	Present Value of increased Payments	Probability of Sufficiency
90% Purchasing Power on First \$10,000 of Base Annual Benefit	\$ 2.314 billion	70%
90% Purchasing Power on First \$20,000 of Base Annual Benefit	\$ 3.811 billion	68%

As shown in the above table, these options would slightly reduce the probability of sufficiency to 70 percent and 68 percent.

Note that based on rules set in statute, the base benefit is not always the benefit provided at retirement. For example, in 2000 and 2001, legislation was passed providing a minimum retirement benefit ranging between \$15,000 and \$20,000 per year depending on the number of years of service. Members with 30 or more years of service received a minimum benefit of \$20,000, while members with 20 years of service received a minimum benefit of \$15,000.

As set by statute, these benefits have a base year of either 2000 or 2001, the year the member started to receive this minimum benefit, not the year the member retired. Members receiving the minimum benefit have yet to receive SBMA payments since the purchasing power of the minimum benefit has yet to fall below 85 percent. Since 2000, the minimum benefit paid to members has been increased to reflect the 2 percent annual benefit increase. Since inflation has outpaced the increases provided annually, members who began receiving the minimum benefit in 2000 are now receiving a benefit that covers about 89 percent of their purchasing power in 2000.

Option 5: Make no changes to the purchasing power program

This option would maintain the purchasing power program as it currently exists in order to protect the viability of the program against future adverse experience. The trade-off to an increase in the purchasing power benefit—as opposed to making no change to the program—is that for a period of time, increased benefits can be paid. However, over time, it becomes more likely that the purchasing power level would be reduced below current levels in the future.

Conclusion

The board did not recommend the adoption of any of the options presented at the May 2018 meeting. Instead, the board directed staff to work with the Legislature and stakeholders to further analyze and consider these options as well as any additional options that would use a portion of the excess resources in the SBMA to help the CalSTRS 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. CalSTRS will engage with the Legislature, the Administration and stakeholders and coordinate efforts on this important issue.