

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% 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% and 85% 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%.

Section 24415.5 also requires the board—if it determines there are funds available beyond the amount needed to maintain 85% 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% 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 2018–19, the SBMA received \$737 million in contributions, of which \$730 million came from the State General Fund and approximately \$7 million from state school and lieu lands revenues.

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. This is done regardless of the actual return on assets in the program. For fiscal year 2018–19, the SBMA assets were credited with a return of 7%, the assumed investment return for the Defined Benefit Program.

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 fiscal year 2019–20, the SBMA provided purchasing power benefits to approximately 71,000 members at an average of \$261 per month.

Today, SBMA payments are paid to all members and beneficiaries of members who retired in 1999 or earlier and those who retired in 2000 but only on or after September 1 of that year. 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

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1 have to wait an extra year. The additional one-year wait for those who retired on or after September 1 in 2000 resulted in them falling just below 85% purchasing power for 2019-20, 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.

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% annual benefit adjustment, more retirement benefits were kept at or above 85% 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% purchasing power level can be sustained indefinitely if inflation stays at or below the current 2.75% assumption, the SBMA will be depleted by 2065 if inflation increases to 3.5% and by 2048 if inflation increases to 4% annually.

The current board-approved long-term assumption for inflation is 2.75%. Since the completion of the last actuarial analysis, inflation in California has exceeded the assumed long-term inflation. Inflation in California was 3.9% in fiscal year 2017–18 and 3.1% in fiscal year 2018–19.

Benefits for current retirees

Prior to any discussions regarding potential changes to the SBMA, an understanding of the factors that impact benefit levels as well as the types of benefits received by current CalSTRS retired members is very important.

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. For comparison purposes, beneficiaries of members who have died since retirement are not included in the table below since benefits are often reduced following a member's death, according to the option selected by the member at the time of retirement. The table 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 2019–20 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	\$519	\$1,240	\$2,037
2% Improvement factor	428	801	991
Ad hoc COLA	52	90	63
Minimum guarantee	143	77	11
SBMA	1,036	539	170
Total monthly benefit	\$2,178	\$2,747	\$3,272
SBMA as % of total benefit	48%	20%	5%

As can be 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, higher SBMA benefits are paid to members who have been retired the longest. For CalSTRS members who retired prior to 1980, SBMA payments represent almost half of their CalSTRS benefits.

CalSTRS retirees are entitled to a benefit at retirement based on their years of service credit, their final compensation at retirement and the age factor based on their age at retirement. More years of service credit and higher final compensation will translate into a higher retirement benefit.

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The age factors are set in statute. Retiring at age 55 will generally result in a lower benefit than retiring at age 60 since the age factor is lower at age 55. For example, someone who retired at age 55 in 1975 would have received a benefit equal to 1.4% of final compensation for each year of service. At age 60, the factor would have been 2% for each year of service.

To help compare the average benefits shown in the previous table, the following table shows the average age at retirement, the average years of service credit and the average final compensation for current retired members with a retirement date prior to 1999. To facilitate comparing the final compensation figures, they have been adjusted for inflation up to July 1, 2019. The table also includes the replacement ratio at retirement as well as the replacement ratio today based on the inflation-adjusted final compensation.

Average monthly benefit by type and decade of retirement

	Retirement in the 1970s	Retirement in the 1980s	Retirement in the 1990s (prior to 1999)
Average age at retirement	57.0	58.7	60.0
Average years of service	20.8	24.6	26.8
Inflation adjusted average final compensation	\$6,455	\$6,878	\$7,594
2019–20 Monthly benefit	\$2,178	\$2,747	3,272
Replacement ratio at retirement	36.2%	44.4%	49.6%
Replacement ratio today	33.7%	39.9%	43.1%

CalSTRS members who retired in the 1970s receive about one third of their inflation-adjusted final compensation today. This is called the replacement ratio. The table above shows the SBMA is doing its part in protecting these members' purchasing power. The SBMA combined with the improvement factor, ad hoc increases and the minimum guaranteed benefit have ensured the replacement ratio did not drop significantly for these members.

As shown in the table above, members who retired in the 1970s and who are still alive today retired at earlier ages and had fewer years of service on average at retirement. Members who retired at older ages in the 1970s are more likely to have died. Since members who retired in the 1970s did so on average at age 57 with 20 years of service, it is expected that their retirement ratio is below 40% since the age factor prior to age 60 was less than 2%.

Option discussion

The \$26.7 billion in resources—current assets plus projected future contributions on current member payroll—identified in the June 30, 2019, SBMA Actuarial Analysis exceeds the \$15.5 billion projected value of future purchasing power benefits for current members. The result is \$11.2 billion in projected resources in excess of the amount needed to maintain 85% 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 92% 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. In preparing options, previous board direction that some of the options should be designed to help older 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 was taken into consideration.

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.

Three options for the use of the excess SBMA resources were analyzed and presented to the board on September 3, 2020. Each option would require legislation to provide the board with additional authority.

Options to use the SBMA excess resources are discussed 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, 2019, SBMA Actuarial Analysis, the probability of sufficiency was estimated to be 68% prior to the consideration of any options.

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

When the board is considering 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 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 table below 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, were assumed to continue to be subject to the current 85% purchasing power protection level.

The table below shows the estimated present value of increased SBMA payments for Option 1, and it provides the probability of sufficiency if benefits were increased as per Option 1. Option 1 would not materially impact the probability of sufficiency.

Option 1 – Estimated cost Impact

Present value of increased SBMA benefits	Probability of sufficiency
\$859 million	68%

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 2019–20

Retirements in the 1970s	Retirements in the 1980s	Retirements in the 1990s (prior to 1999)
\$327	\$275	\$164

Option 2: Increase the purchasing power benefit

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

The following table shows the estimated present value of increased payments 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 in the table. 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)	68%
86%	\$2.147 billion	66%
87%	\$4.484 billion	64%
88%	\$7.023 billion	62%
89%	\$9.779 billion	57%
90%	\$12.764 billion	51%

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 51% of the time, compared to 68% 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 2019–20

Purchasing power level	Retirements in the 1970s	Retirements in the 1980s	Retirements in the 1990s (prior to 1999)
86%	\$25	\$31	\$38
87%	\$51	\$64	\$76
88%	\$76	\$96	\$115
89%	\$102	\$128	\$153
90%	\$128	\$161	\$192

Option 3: Purchasing power level based on age

Option 3 sets the purchasing power level provided by the SBMA to different levels based on the age of retired members. For this analysis, it was assumed that the current 85% protection level provided by SBMA would remain as is for anyone below the age of 90. For members age 90 or older but less than 100 years old, the purchasing power level would be set at 90%. Once a member reaches age 100, the purchasing power level would be increased to 100%, restoring the purchasing power of the member to the same level it was at the time of retirement.

The table below shows the estimated present value of increased SBMA payments for Option 3 and the probability of sufficiency if benefits were increased as per Option 3. Option 3 would decrease the probability of sufficiency from 68% to 66%

Option 3 – Estimated cost impact

Present value of increased SBMA benefits	Probability of sufficiency
\$2.471 billion	66%

The table below shows the expected increase in SBMA payments for existing retirees based on the decade of retirement. As shown below, Option 3 would also provide greater increases in benefits for members who have been retired the longest, although the increases would be less than under Option 1. Note that under Option 3, additional increases would be provided in the future when members attain the various age thresholds. For this reason, Option 3 has a greater cost impact long term than Option 1 even though Option 1 would have a greater immediate impact on members’ benefits.

Option 3 – Estimated increase in SBMA monthly benefit for 2019–20

Retirements in the 1970s	Retirements in the 1980s	Retirements in the 1990s (prior to 1999)
\$297	\$144	\$22

Conclusion

At its September 2020 meeting, the board reviewed three options for use of the excess SBMA funds and directed staff to present them to the Legislature as required, and to continue to engage with stakeholders on this important issue. While CalSTRS is not proposing changes, should the Legislature decide to pursue one of the options, the board would be supportive of Option 1. 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.

