



## Regular Meeting

### Item Number 12 – Open Session

**Subject:** Options on the Use of Supplemental Benefit Maintenance Account

**Presenter(s):** David Lamoureux and Rick Reed

**Item Type:** Action

**Date & Time:** May 2, 2024 – 10 minutes

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**Attachment(s):** Analysis of Potential SBMA Plan Changes (Analysis by Milliman)

**PowerPoint(s):** None

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#### **Item Purpose**

This item is to comply with current law requiring the board to present the California Legislature with options for the use of Supplemental Benefit Maintenance Account (SBMA) funds in excess of the amount needed to maintain 85% purchasing power through 2089.

#### **Recommendation**

Staff recommends the board present the options discussed in this item to the California Legislature, as directed by Education Code section 24415.5.

#### **Background and summary**

SBMA is a special account in the Teachers' Retirement Fund that provides inflation protection to CalSTRS members. Section 24415.5 of the Education Code 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. As per 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.

A separate agenda item provides the results of the most recent actuarial projections for the program. As shown in that separate item, the current SBMA balance along with future contributions and future investment earnings are 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 fact, actuarial projections showed that purchasing power benefits could be sustained at a 90% level through 2089, based on the current long-term inflation rate of 2.75% per year. In that item, staff recommended that the purchasing power be kept 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 section requires that these options be for the exclusive benefit of members and their beneficiaries and that at least one of the options be an increase in benefits paid to those who retired prior to 1999 (when the first of two sets of previous benefit enhancements for active members took effect).

Note that in May 2022, the board supported the option that was under consideration by the California Legislature through Senate Bill 868. Later that year, SB 868 was enacted by the Legislature and signed into law, providing an additional 5% to 15% increase for all members and their beneficiaries that began receiving a benefit prior to 1999. These increases became effective on July 1, 2023. CalSTRS paid the benefits provided through Senate Bill 868 for the first time with the October 1, 2023 quarterly payments. Almost 46,000 CalSTRS members and beneficiaries received an additional increase as a result of Senate Bill 868.

### **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. This rate is 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 is important to realize these projections 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. Attached to this item is an analysis performed by Milliman providing further information on the cost of the options discussed in this item and the impact of different levels of inflation on the sufficiency of the program.

The ability of the SBMA to sustain an 85% protection level was also measured by varying levels of future inflation on an annual basis. To perform this analysis, a stochastic model was used that varied inflation in the future. Based on this stochastic analysis, it was determined that there was a

68% chance that the SBMA would be able to sustain an 85% level through 2089. This is called the probability of sufficiency. The options discussed in this analysis were also analyzed using the same stochastic model. The item includes the expected impact of each option on the probability of sufficiency for the SBMA.

### **Discussion of options**

This analysis, prepared in compliance with Education Code section 24415.5, identifies options to use SBMA excess resources for the exclusive benefit of members and their beneficiaries. 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 below meets this requirement.

In addition to option 1, an option that would increase the inflation protection level for all members was also analyzed for the use of excess resources. As stated earlier, for each option, 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.

### **Option 1— one-time permanent increase in benefits based on year of retirement**

Option 1 would replicate the benefit increases that were granted through Senate Bill 868. 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 cost estimates assume the one-time increases would be effective on July 1, 2024.

The table below shows the schedule of one-time increases that were included for this analysis.

**Schedule of One-Time Increases**

<b>Retirement Date</b>	<b>Percentage Increase</b>
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%

These additional benefits would be paid from the SBMA and future 2% improvement factor 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 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. As stated earlier, the probability of sufficiency is currently estimated to be 68% prior to the consideration of any of the options analyzed for this agenda item. As can be seen below, option 1 would lower the probability of sufficiency for the SBMA to 67%, a reduction of 1%.

**Estimated Cost Impact**

	<b>Present Value of Increased SBMA Benefits<sup>1</sup></b>	<b>Probability of Sufficiency</b>
<b>Option 1 (SB 868)</b>	\$518 million	67%

**Option 2 - varying purchasing power levels**

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

Next 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% 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.

**Estimated Cost Impact**

<b>Purchasing Power level</b>	<b>Present Value of Increased SBMA Benefits<sup>1</sup></b>	<b>Probability of Sufficiency</b>
<b>85%</b>	N/A (Current level)	68%
<b>86%</b>	\$2.807 billion	64%
<b>87%</b>	\$5.814 billion	61%
<b>88%</b>	\$8.998 billion	56%
<b>89%</b>	\$12.345 billion	51%
<b>90%</b>	\$15.855 billion	47%

As can be seen in the above table, increasing the purchasing power level would significantly reduce the probability of sufficiency. At a 90% purchasing power level, the SBMA fund would be expected to be able to maintain that level only 47% of the time, compared to 68% at the current 85% level.

**Summary**

When SBMA options have been discussed with the board the last few years, the board provided direction that 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. One of those options was eventually included as part of Senate Bill 868, which became effective in 2023.

Staff recommends the board present both options to the California Legislature, as directed by Education Code section 24415.5.

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<sup>1</sup> The present value is as of June 30, 2023 and is based on the increase in projected SBMA payments through June 30, 2089 for current Defined Benefit Program members only.

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**Strategic Plan Linkage:** Goal 1: Trusted stewards – Ensure a well-governed financially sound trust fund.

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