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 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 was withheld in 2003.

Revenues from the use of state school lands, including revenues from the sale of the Elk Hills Naval Petroleum Reserve, are also used to fund the purchasing power program.

Under Section 22216, SBMA assets are augmented by interest credited at the rate of investment return assumed for the Defined Benefit Program, which is currently 7.5 percent, regardless of the actual return of assets in the program. In 2014–15, $589 million in contributions, including $582 million from the General Fund, were deposited into the account for the purchasing power program.

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 2014–15, $193 million in supplemental benefit payments were paid to benefit recipients.

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 paid will 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. The low rate of inflation has persisted in recent years—2.19 percent in fiscal year 2013–14 and 1.28 percent in 2014–15—meaning benefit recipients have not received payments from the SBMA unless their Defined Benefit Program benefits began in 1990 or earlier.

The stability of the SBMA depends significantly on the rate of inflation. Realized inflation rates have been less than the 3 percent assumed for the SBMA actuarial analysis, contributing to the excess resources. 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 3 percent assumption, the SBMA will be depleted by 2080 if inflation increases to 3.5 percent, and by 2045 if inflation increases to 4 percent annually.

Option Discussion

The $18 billion in resources—current assets plus projected future contributions on current member payroll—identified in the June 30, 2015, SBMA Actuarial Analysis exceeds the $12.4 billion projected value of future purchasing power benefits for current members. The result is $5.6 billion in resources in excess of the amount projected needed to maintain 85 percent purchasing power through June 30, 2089, primarily from future contributions. This analysis, prepared in compliance with 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, PEPRA, 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.

The board identified three options for the use of the excess SBMA resources:

Option 1—One-time permanent increase in benefits for members and beneficiaries for members who retired before 1999, increasing progressively the earlier the member retired.

This adjustment would apply to the total benefit currently being paid, including the 2 percent annual benefit adjustment and any purchasing power payments. It is assumed these additional benefits would be paid from the SBMA. It is also assumed 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 a retired member receives a $100 additional payment effective July 1, 2015, 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 2016 and each September thereafter.

Table 1 shows a possible schedule of increases in the benefits for members and retirees. This schedule is very similar to that enacted in AB 429 of 2000 (Correa), which provided a one-time permanent increase in benefits for those whose first benefit was paid in 1997 or earlier.

TABLE 1 – Illustrative Schedule of Benefit Increases

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 one-time increase described above is applied effective July 1, 2015, the present value of future purchasing power benefits for current benefit recipients will increase by $424 million. This increase is multiplicative. For example, if all of the percentage increases are doubled, the cost impact will double to $848 million. If the effective date is in the future, there will be some reduction in the cost due to fewer expected future payments.

Option 2—Increase the purchasing power benefit.

The June 30, 2015, SBMA Actuarial Analysis projects the current SBMA balance, plus expected contributions, to be sufficient to pay purchasing power benefits at a 91 percent level through 2089. This 6 percent margin above the current 85 percent purchasing power level is mainly due to the fact that recent inflation has been less than the 3 percent assumption.

The analysis indicates that an increase in the purchasing power benefit, based on current assumptions, can be sustained through 2089. Table 2 shows several scenarios that incorporate varying assumptions and purchasing power levels. This includes varying the investment return and inflation assumptions, and the purchasing power level relative to the current valuation assumptions and plan provisions. The table also shows the maximum inflation rate in the next five or 10 years that would deplete the SBMA by 2089.

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.

TABLE 2 – Scenarios with Varying Assumptions and Purchasing Power Levels

Assumption		Purchasing Power Level	Year of Depletion	Probability of Sufficiency*
Average Inflation	Investment Return			
3.00%	7.50%	85%	Never	74%
3.00%	7.25%	85%	Never	70%
3.00%	7.00%	85%	Never	68%
3.50%	7.50%	85%	2080	49%
4.00%	7.50%	85%	2045	24%
5.00%	7.50%	85%	2032	1%
5.75% ** from 2016 to 2021 and 3.00% thereafter	7.50%	85%	2089	50%
4.46% ** from 2016 to 2026 and 3.00% thereafter	7.50%	85%	2089	50%
3.00%	7.50%	86%	Never	69%
3.00%	7.50%	87%	Never	66%
3.00%	7.50%	88%	Never	64%
3.00%	7.50%	89%	Never	61%
3.00%	7.50%	90%	Never	59%

*Probability of sufficiency is based on the stated purchasing power level and assumes no future reductions.
** Maximum inflation rate over a five- or 10-year period that depletes the SBMA by 2089.

As Table 2 indicates, although the program can sustain a higher purchasing power level given the current investment return and inflation assumptions, the likelihood that a higher level can be sustained decreases significantly if the investment return assumption is decreased or, more principally, inflation increases even a relatively small amount.

Option 3 – Make no changes to the purchasing power program.

Given the sensitivity of the sustainability of the purchasing power program to the rate of inflation and, to a lesser degree, future changes in the investment return assumption, it would be more prudent to maintain the purchasing power program as it currently exists 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 benefit payments would decline below current levels.

Recommendation

At its June 2016 meeting, the board adopted the staff recommendation to make no change to the SBMA given the sensitivity of the purchasing power program to inflation.