



Regular Meeting

Item Number 7 – Open Session

Subject: Options on Use of Supplemental Benefit Maintenance Account

Presenter(s): David Lamoureux and Rick Reed

Item Type: Action

Date & Time: May 4, 2022 – 10 minutes

Attachment(s):

Attachment 1 – Analysis of Potential SBMA Plan Changes (Analysis by Milliman)

PowerPoint(s):

None

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.

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 92% 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 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 Senate Bill 868 (Cortese) was introduced earlier this year and if adopted by the legislature, would provide a benefit increase, using SBMA excess resources, to those who retired prior to 1999. Option 1 discussed in this item replicates the benefit increases being proposed by Senate Bill 868. On March 4, 2022, the board voted to support Senate Bill 868, which was consistent with previous direction from the board that support would be provided to options 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.

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 66% 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.

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 previous benefit enhancements for active members adopted by the California Legislature in the late 1990s and early 2000s. Those who retired prior to 1999 also represent the group of members who would receive a benefit increase if Senate Bill 868 is adopted by the Legislature. 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 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	\$1,013
Ad Hoc COLA	\$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 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, 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.

As options to use the SBMA excess resources are discussed below, the impact of each option will be separated based on the decade of retirement to better understand how each option would impact older retirees versus more recent retirees.

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 beneficiaries. In preparing options, staff took into consideration Senate Bill 868, introduced earlier this year. Option 1 discussed below replicates the benefit increases currently included in Senate Bill 868.

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.

Note, however, that current law limits the types of benefit enhancements that could be enacted from these excess resources. The California Public Employees’ Pension Reform Act of 2013 (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.

Option 1— One-Time Permanent Increase in Benefits Based on Year of Retirement

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 replicates the benefit increases currently included in 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 table below shows the schedule of one-time increases that were 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%

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 66% 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 65%, a reduction of 1%.

Estimated Cost Impact

	Present Value of Increased SBMA Benefits	Probability of Sufficiency
Option 1 (SB 868)	\$517 million	65%

To illustrate how option 1 would impact CalSTRS retirees, below is a table prepared by CalSTRS staff 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.

Estimated Increase in SBMA Monthly Benefit for 2021-22

	Retirements in the 1970s	Retirements in the 1980s	Retirements in the 1990s (Prior to 1999)
Option 1 (SB 868)	\$324	\$271	\$165

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

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%

As can be seen in the above table, although the SBMA would be able to sustain a 90% protection 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, prepared by CalSTRS staff, 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.

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%	\$127	\$160	\$194

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. Of the options presented in this item, option 1 is the option that best meets these criteria. It provides for the largest increase in benefits for members who retired prior to 1999 while also having the lowest cost impact and lowest impact on the probability of sufficiency.

RECOMMENDATION

Staff recommends the board present all options to the California Legislature, as directed by Education Code section 24415.5, and support option 1, the option currently under consideration by the California Legislature through Senate Bill 868. If adopted into law, Senate Bill 868 (option 1) will help CalSTRS retired members most in need of assistance while not comprising the financial integrity of the SBMA and its ability to provide inflation protection long term.