Background Information on
Deferred Annuities Augmentation

1. Definition. In Minnesota public pension plans, deferred annuity augmentation refers to increasing the amount of a deferred retirement annuity by a percentage amount over time prior to receipt. This replaces all or part of lost purchasing power in the unpaid retirement annuity due to inflation. Under current law as revised in 2010, for Teachers Retirement Association (TRA) members who were hired before July 1, 2006, if, when they defer receipt of the annuity when they terminate service, the deferred annuity increases (augments) by 3% annually until the first of the year after the individual turns age 55, and by 5% per year thereafter. However, due to 2010 legislation, after June 30, 2012, the augmentation rate will be 2% per year, regardless of the person's age. For teachers first hired after June 30, 2006, when they terminate service the deferred annuity augmentation rate is 2.5% per year, and 2% per year after June 30, 2012.

   Deferred annuity augmentation was added in 1971 to Public Employees Retirement Association (PERA) plans, Minnesota State Retirement System (MSRS) plans, TRA, and was also added to the first class city teacher plans in 1989.

   Minnesota public pension plans are relatively unique among public and private defined benefit plans in providing deferred annuities augmentation. To the best knowledge of the Commission staff, only the Oregon statewide public employee defined benefit plans also provide deferred annuity augmentation.

   The Minnesota and Oregon plans that have deferred annuities augmentation are defined benefit plans. Defined benefit plans utilize a fixed formula to determine pension benefit amounts (typically years of service multiplied by a percentage benefit accrual rate amount and applied to a final salary or final average salary base). Since the benefit is fixed or specified in law from the individual's salary and service, the variable element is the contributions needed to fund those benefits. Defined benefit plans are distinguished from defined contribution plans, such as the Higher Education Individual Retirement Account Plan (IRAP), Individual Retirement Accounts (IRAs), or Section 401(k) plans, where the fixed element is the level of contributions funding the plan, and the variable element is the benefit to be derived, which is dependent on the investment earnings over time on the stream of contributions and the age of the individual at retirement.

   When a person covered by a defined contribution plan changes employment and thus is no longer eligible for the employer's plan, the value of the account will continue to increase over time due to investment earnings on the account. Thus, the eventual retirement annuity that can be supported by the account's value will increase. Deferred annuity augmentation in a defined benefit plan provides a somewhat comparable effect. The individual's deferred retirement annuity is not locked in amount at the time the individual leaves covered service. It continues to grow over time by the percentages specified in law.

   Having deferred annuity augmentation in a defined benefit plans does add to plan cost. Because of the augmentation, the deferred annuitants receive higher benefits at the time of retirement than would be the case if the benefit were fixed at the time of termination of the covered employment.

2. Minnesota Plans with Deferred Annuity Augmentation Provisions. Several Minnesota public pension plans have deferred annuity augmentation provisions, although there are minor differences between provisions in the various plans. All these provisions were revised in 2010 to reduce deferred annuities augmentation or, in the case of PERA plans, to eliminate it entirely as of January 1, 2012. The current law deferred annuity augmentation provisions are:

Section:	Applies to:
3A.02, Subd. 4	Legislators Retirement Plan
352.72, Subd. 2	General State Employees Retirement Plan (MSRS-General) Correctional State Employees Retirement Plan (MSRS-Correctional)
352B.30, Subd. 2	State Patrol Retirement Plan
353.71, Subd.2	PERA/PERA-P&F plans, and presumably also to the Local Government Correctional Service Retirement Plan (PERA-Correctional).
354.55, Subd.11	TRA
354A.37, Subd. 2	First class city teacher retirement fund associations.

   The Judges Retirement Plan (administered by MSRS) has no deferred annuities augmentation provision, which may reflect an assumption that Judges will continue in office until retirement.

3. Application in Service In More Than One Plan Provisions. When deferred annuities augmentation was first added to various Minnesota plans in 1971, the record suggests that the Legislature wanted to add a tool to complement the service in more than one plan provisions (MSRS-General: Minn. Stat.

Sec. 352.72; PERA: Minn. Stat. Sec. 353.71; and TRA: Minn. Stat. Sec. 354.60), to make that portability provision more adequate. However, the Legislature did not restrict its use solely to that provision. Deferred annuity augmentation applied to all deferred annuities, including those where the service in more than one plan provisions do not apply.

The service in more than one plan provisions were early portability provisions, preceding the Combined Service Annuity provision, Minnesota Statutes, Section 356.30, which was enacted in 1975. The service in more than one plan provisions, which still exist in law, allow service with one of the plans covered by these provisions to be used for purposes of vesting in another covered plan. This was an important feature back in the 1970s and early 1980s because vesting normally required ten years of service. Without the service in more than one plan provisions, individuals who were job mobile, moving to various positions covered by various Minnesota public plans within different systems, might fail to vest in some of the plans due to the long vesting requirement. By allowing service in one fund to be used for purposes of vesting in another, the service in more than one plan provisions helped job-mobile individuals to vest in the applicable plan or plans and made them eligible to receive benefits.

While this helped job-mobile individuals to vest, these individuals still faced a problem. The value of the benefit from the early plans would erode considerably in value over time if the benefit was fixed at the time the individual left that service. Deferred annuities augmentation addressed that problem by allowing the annuity from the early plan or plans that provided coverage to increase over time, providing a benefit at retirement that was at least somewhat similar to what would have occurred if coverage had been provided by a single plan for the individual's entire public service.

To demonstrate, the following compares the total retirement annuity of a public employee with 30 years of public service under three different scenarios. Scenario A shows coverage by three different plans and without deferred annuity augmentation. Scenario B shows coverage by three different plans with deferred annuity augmentation. Scenario C shows coverage by one plan for all service. The individual is assumed to begin service in 1970 with TRA coverage, and the individual leaves that service after ten years with a high-five average salary of $22,500. The individual then moves to PERA-covered employment, having that coverage until 1990, with a high-five from that service of $33,100. The individual then moves to MSRS-covered employment, retiring in 2000 with a high-five of $46,660. Without deferred annuities augmentation, Scenario A, the sum of the three retirement annuities is $13,492 per year. Under Scenario B, deferred annuities augmentation is applied and it boosts the value of the TRA and PERA pensions, creating a total from the three plans of $17,117 per year. Under Scenario C, the individual spends all 30 years of employment under a single plan, MSRS-General. The individual's pension is $23,796 per year. While deferred annuities augmentation does help, in this example it falls short of providing the same pension that would have occurred if all service had been under a single plan.

Scenario A		**Scenario B**		**Scenario C**	
Coverage by TRA, 1970-1980		Coverage by TRA, 1970-1980		Coverage by MSRS, 1970-2000	
Final Average Salary	$22,500	Final Average Salary	$22,500	Final Average Salary	$46,660
Annual Deferred Retirement Annuity	$2,250	Initial Annual Deferred Retirement Annuity	$2,250	Annual Retirement Annuity	$23,796.60
		Augmented Deferred Retirement Annuity	$4,503.60		
Coverage by PERA, 1980-1990		Coverage by PERA, 1980-1990			
Final Average Salary	$33,100	Final Average Salary	$33,100		
Annual Deferred Retirement Annuity	$3,310	Initial Annual Deferred Retirement Annuity	$3,310		
		Augmented Deferred Retirement Annuity	$4,682.00		
Coverage by MSRS, 1990-2000		Coverage by MSRS, 1990-2000			
Final Average Salary	$46,660	Final Average Salary	$46,660		
Annual Retirement Annuity	$7,932	Annual Retirement Annuity	$7,932		
Total Annual Annuity		Total Annual Annuity			
TRA Annuity	$2,250.00	TRA Annuity	$4,503.60		
PERA Annuity	$3,310.00	PERA Annuity	$4,682.00		
MSRS Annuity	$7,932.00	MSRS Annuity	$7,932.00		
Total	$13,492.00	Total	$17,117.60		

4. Combined Service Annuity Provision. Service in more than one plan provisions are less used now than in the distant past. In 1975, the Legislature enacted the Combined Service Annuities law, Section

356.30, which was an improvement in many cases over the service in more than one plan provisions. The Combined Service Annuities law applies to those Minnesota public defined benefit plans which base annuities on the high-five average salary. Local police or paid fire plans are not included under the Combined Service Annuities provision because those plans base their annuities on the salary of a certain position, usually a top grade patrol officer or firefighter. The Combined Service Annuities calculation begins by determining the high-five average salary of the individual, which could include service under more than one employer, and that common high-five average salary is then used to compute the annuities from all the plans included in the calculation. Thus, the salary used to compute the annuities from the earlier plan or plans may be much higher than the salary the individual was receiving before terminating that earlier employment. The benefit computed from each of the applicable plans is determined using the most recent version of law, thus allowing the individual to access any benefit improvements that occurred in the earlier plans after the individual left service covered by the applicable plan. The individual must begin drawing annuities from all the plans included in the person's Combined Service Annuities benefit calculation within a one-year period. The use of Combined Service Annuities is in lieu of deferred annuities augmentation from the earlier covered plans.

Some individuals have service in more than one of the plans covered by the Combined Service Annuities law, but choose not to use that provision. In these cases, deferred annuity augmentation would apply if the plan has an applicable provision. This can occur in cases where the normal retirement ages in the plans that provided coverage to the individual are very different. If an individual age 55 had prior Public Employees Police and Fire Retirement Plan (PERA-P&F) coverage (a plan with normal retirement age of 55), and the individual is now covered by MSRS-General (which has an age 65 or 66 normal retirement age), the individual may be reluctant to leave current employment in order to use the Combined Service Annuities provision. He would face a stiff early retirement penalty from the MSRS plan if he begins drawing an MSRS annuity at age 55. Instead, the individual may choose to draw the PERA-P&F annuity, including any deferred annuity augmentation on that benefit, and continue working in MSRS-General covered employment.

Thus, at the current time, deferred annuities augmentation is used by individuals who could be covered by the Combined Service Annuities but who choose not to use that provision, by individuals moving among Minnesota public plans not all of which are included in the Combined Service Annuities law, and by individuals who move from public- to private-sector employment.

5. Actuary Commentary from 1978 on Augmentation Provisions. Franklin C. Smith was an actuary who provided advice to the Legislative Commission on Pensions and Retirement during the 1970s. In the memo written in 1978, he notes that following the addition of the Combined Service Annuities provision in 1975, deferred annuities augmentation provisions were no longer of much use to individuals who move to different positions within the public sector. Its main value had shifted to a measure to assist those who move to nonpublic employment. Since protecting that group had not been stated as a priority by the Legislature, he suggested that the Legislature consider repealing augmentation provisions. The Legislature did not act on the suggestion in 1979 or subsequently.

6. Deferred Annuities Augmentation Provisions, as Amended Over Time. The 1971 Legislature created deferred annuities augmentation. The 1971 legislation specified that deferred annuities will augment at the same rate as the investment earnings assumption used by the plan. The level of deferred annuities augmentation therefore changed as the investment return assumption was revised. In 1971 that assumption was 3.5%, but it was revised in 1973 (Laws 1973, Ch. 653, Sec. 45), to 5%. Deferred annuity augmentation provisions were revised again by the 1978 Legislature, which amended the deferred annuity augmentation provisions by removing the tying of the augmentation rate to the investment return assumption, and instead set the augmentation rate at 3% per year after January 1, 1981. By using a January 1, 1981, effective date on the deferred annuities augmentation provision, the 1978 Legislature provided a few years of lead time on the benefit reduction. The 1989 Legislature again revised the provisions, this time enhancing the deferred augmentation provisions by increasing augmentation after age 55. As revised in 1989, the provisions provided 3% per year augmentation until the first of the year after the individual turns age 55, and 5% annually thereafter. The 1989 revisions were part of a major benefit increase bill which in part increased the accrual rates in many plans, created subsidized joint and survivor annuities, and enhanced the deferred annuity augmentation provisions.

7. Motivation for Proposing to Reduce Deferred Annuity Augmentation. Deferred annuity augmentation under PERA's Section 353.71, Subdivision 2, is of considerable value to plan members who become deferred annuitants. The proposed reduction would harm existing members who terminate as deferred annuitants after calendar year 2005. This is not an action that PERA would take lightly. The probable reason for the proposal is that PERA seeks to reduce plan costs, to help with the contribution deficiencies occurring in the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) and in PERA-P&F.