Background Information on
Retention Elements of Defined Benefit Plans

Public employee defined benefit retirement plans have been designed to attract capable employees, retain those employees, and out-transition those employees at the end of their productive working careers. Historically, many of the plans were designed with a strong emphasis on retention. Plan elements which encouraged retention include back-loaded accrual rates, vesting requirements, and refund procedures.

1. Back-Loaded Accrual Rates. Back-loaded accrual rates provide a low accrual rate for early years of service and an increased accrual rate in later years, after the individual has provided a considerable length of service. This feature may encourage public employees who have been in service for several years to remain in public employment because of the enhanced accrual rate used in later service. In recent decades the Legislature has moved away from back-loaded rates toward level accrual rates (use of the same accrual rate per year of service throughout the person's career), but remnants of back-loaded rates continue to exist for pre-July 1, 1989, hires in the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General), the Teachers Retirement Association (TRA), and the remaining first class city teacher retirement plans. For a pre-July 1, 1989, hire under any of these plans who is retiring before normal retirement age, the person's best option may be an annuity computed using back-loaded rates. For example, the Rule of 90 uses back-loaded rates. Under a Rule of 90 retirement in MSRS-General, the individual receives 1.2% of the high-five average salary for each of the first ten years of service, and 1.7% per year of service for each year thereafter, with no reduction due to early retirement. This may produce a higher benefit for the individual than a level benefit computed using a 1.7% accrual rate for all years of service, but with a sizable reduction due to early retirement.

2. Vesting Periods. Another retention element is a long vesting period to qualify for an annuity. Any individual who leaves service prior to vesting is not entitled to any annuity under the plan. Long vesting periods were often found in the local police and paid fire relief associations, with 20-year vesting being fairly common. At one time there were over 40 local police or paid fire relief associations. Many of these merged into the Public Employees Police and Fire Retirement Plan (PERA-P&F) under procedures specified in general legislation enacted in 1987 (Laws 1987, Ch. 296). Others consolidated into PERA-P&F under legislation developed for specific relief associations. The last of the local police or paid fire relief associations consolidated into PERA-P&F under 2012 legislation.

   In Minnesota general employee public plans, vesting requirements tended to be relatively short, but still lengthy by current standards. Prior to the mid 1980s ten-year vesting was the norm in the statewide general employee plans. That vesting requirement was reduced from ten years to five years in the mid-1980s, and to three years in 1989. Recently, as part of changes enacted in 2010 as Financial Sustainability Provisions (Laws 2010, Ch. 359, Art. 1) to address the damage to pension funds by the financial melt-down of 2008-2009, vesting was generally increased from three years to five years. For the two statewide public safety plans, the MSRS State Patrol Plan and PERA-P&F, vesting also was increased under the 2010 Financial Sustainability Provisions, but the changes were not uniform. For the MSRS State Patrol Plan, vesting was increased from three years to five years. For PERA-P&F, rather than three-year vesting, a scaled vesting schedule will be used. The person is 50% vested at five years, 60% at six years, 70% at seven years, 80% at eight years, 90% at nine years, and fully vested at ten years.

3. Refund Policy. The refund policy specified in plan provisions, or the lack thereof, also can impact retention. An extreme case was the St. Paul Police Relief Association, which had a 20-year vesting requirement and no refund provision. If a person left service before 20 years, the person had no retirement assets due to the service, neither an annuity nor a refund.

   All currently open defined benefit plans do include refund provisions. The refund provisions can be viewed as retention tools because they penalize individuals who leave the plan. While the departing employee is provided with some retirement assets, the person is not made whole. The refund consists of the employee contributions only, plus interest. Prior to 1980, some plans may not have provided interest on a refund, but for many decades refunds have included some interest. In 1989 (Laws 1989, Ch. 319) refund interest rates were increased to 6%, from 5% under prior law. This remained generally unchanged until the 2010 Financial Sustainability Provisions. Under those provisions or follow-up legislation a year later, the refund interest rate in the plans was reduced from 6% to 4 %.

By not making the departing employee whole, the refund policies in our defined benefit plans create a gain for the pension fund equal to the employer contributions made on behalf of the employee, the full investment earnings on the employer contributions, and the investment earnings on the employee contributions in excess of the refund interest rate. Turnover gain is an essential feature of our defined benefit plans. Turnover gain helps to cover the plan liabilities for those who remain in covered employment. Without turnover gain, plan costs would be a higher percentage of covered payroll.

The cost of a plan's refund provision as a percentage of covered salary will increase the higher the interest paid on refunds. If interest equal to the plan's rate of return were provided on the refunded employee contributions, there would be no turnover gain on those employee contributions. If a portion, or all, of the employer contributions plus interest were also included in a refund, turnover gain would be correspondingly reduced. In the extreme, if everyone were to receive the value of the employee and employer contributions plus the investment return, regardless of when the individual terminated employment (at retirement or well before), what we have is a defined contribution plan.