MSRS Pension Enhancements for Privatized Employees:

S.F. 1705; H.F. 2126: Background information, section-by-section summary and policy considerations

Addendum: MSRS Report

MARCH 6, 2017

Legislative Commission on Pensions and Retirement
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Introduction

Last session, MSRS proposed legislation that would have reduced the augmentation rate prospectively for MSRS members whose public employment ended as a result of a "privatization" transaction in 1996 and related employee departures in1997. The proposal would have reduced the rate at which these former public employees' pensions are automatically increased each year to 2%, from 5.5%, compounded annually (until age 55), and 7.5% compounded annually (after age 55). This would have aligned the rate of augmentation with the current rate for all other MSRS members.

The Pension Commission considered the legislation in two meetings, but took no action on the legislation. The Pension Commission approved a motion to directing MSRS to meet with stakeholders over the interim and work with LCPR staff to produce a report recommending different legislation for the 2017 session.

This document is the LCPR staff portion of the report and provides background information, a section-by-section summary of S.F. 1705; H.F. 2126 and possible amendments, and policy considerations. MSRS has produced a separate report that summarizes the recommendation of the MSRS board of directors regarding new legislation and an overview of stakeholder feedback. **The MSRS report is attached as an addendum to this report.**

History

The enhanced benefits modified by S.F. 1705; H.F. 2126 date back to events in 1996 and 1997 relating to the spin-off by the University of Minnesota of the University of Minnesota Hospital and Clinics to Fairview Hospital and Healthcare Services. After this transaction closed on January 1, 1997, two groups of physicians and their staffs voluntarily left University of Minnesota employment to form their own non-profit corporations, through which they would provide services to the U of M and Fairview.

The spin-off (or "privatization") transaction was highly contentious, involving difficult and public negotiation of transaction terms and conditions over many months. While retaining MSRS pension benefits for the affected employees was a significant concern of these employees, this topic was not addressed in the transaction agreement nor was it subject to negotiation by the labor organization that represented the employees. As with all public pension benefits, the benefits provided to the employees affected by these events remain subject to legislative action.

The following is a timeline of events during this period:

Timeline

November 16, 1995: A letter of intent entered into between the University of Minnesota and Fairview Hospital and Healthcare Services ("Fairview") regarding sale of U of M assets and transfer of employees to Fairview. Due diligence and negotiations commenced.

April 11, 1996: Legislation enacted that adds new Chapter 352F, which provides enhanced pension benefits for employees affected by the sale, effective as of the date employees of the U of M cease to be public employees due to the sale to Fairview.

July 29, 1996: U of M Board of Regents approved the sale and directed that an agreement be finalized by September 30, 1996, and the transaction closed by January 3, 1997.

December 31, 1996: U of M and Fairview signed the asset transfer agreement and closed the transaction on January 1, 2017.

June 3, 1997: Legislation enacted that amends Chapter 352F to add two groups of physicians and staff who left the U of M to form separate non-profit corporations, University of Minnesota Physicians ("UMP") and University Affiliated Family Physicians.

June/July 1997: Two groups of physicians and staff left employment at the U of M to form UMP and University Affiliated Family Physicians.

Enhanced Benefits

Employees transferred to Fairview and the physician groups granted pension increases of 5.5% and 7.5% (after age 55),

Former public employees who were transferred from the U of M to Fairview in the 1996 transaction or who left public employment with the U of M to form two physician groups in 1997 receive the following enhanced benefits under Chapter 352F of the Minnesota Statutes:

- Automatic annual increases in the pension amount earned while employed at the U of M ("augmentation") by 5.5%, compounded annually, until age 55, and by 7.5%, compounded annually, after age 55 (all other MSRS members, at that time, were receiving 3% and 5%, respectively);

compounded annually, among other benefits

- Immediate full vesting, regardless of number of years of service;
- Service credit is given for ongoing future employment with Fairview or with the physician groups for purposes of qualifying for early retirement and Rule of 90, but not for the purpose of computing a higher pension benefit.

(Even though the group benefiting under these provisions includes more than just Fairview employees since the group also includes the physician groups, these employees are referred to as "Fairview employees" for the rest of this report.)

Under Minnesota Statutes section 352F.04, subdivision 2, a Fairview employee receives enhanced augmentation until either of two situations arise:

(i) the member returns to service covered by one of the public pension plans, or

(ii) the member begins to receive an annuity from MSRS while still employed at the successor employer.

Current augmentation rate for all other MSRS members is 2%

The cumulative effect of annual increases of 5.5% and 7.5% over the 20 years since these members left public service is that the monthly benefits to be paid to these members upon their retirement far exceeds the monthly benefit that will be paid to similarly situated MSRS members who have the same length of service. Moreover, the purpose of Chapter 352F, which is to make sure these members receive the value of their employee and employer contributions to MSRS for their period of public service, has been met and surpassed.

Augmentation for all other members of MSRS was reduced to 2%, compounded annually, beginning in 2012.

2016 Legislative Proposal

During the 2016 legislative session, MSRS proposed a reduction in the augmentation rate for Fairview employees to 2%, for future years. 2% was proposed because it aligns the rate of increase for the Fairview employees with all other MSRS members. Increases to the pension benefit for all prior years would remain intact.

The bill also proposed to amend the treatment of Fairview employees when they return to public employment. Under current law, enhanced augmentation ends when a Fairview employee returns to public service. The bill would allow enhanced augmentation to continue for the subsequent period of public service but would offset the resulting pension amount by the amount of the pension benefit earned during the subsequent period of public service. When the Fairview employee eventually retires, the individual's pension benefit will be equal to whichever one of three alternatives produces the largest total monthly amount:

- The MSRS pension plus enhanced augmentation to retirement reduced by the value of the benefit earned after returning to public service;

- The pension calculated under the combined service annuity provisions ("CSA"); or

- The pension calculated under the provisions for coverage by more than one fund ("CBMTOF").

The effective date of the changes was July 1, 2017.

2017 Legislative Proposal

S.F. 1705; H.F. 2126

S.F. 1705 (Rosen); H.F. 2126 (O'Driscoll). S.F. 1705; H.F. 2126 makes the following changes to Minnesota Statute section 352F.04, which applies to all former public employees whose employment was transferred from the U of M to Fairview in 1996 or who left the U of M to form either of two physician groups in 1997:

Section 1: Ends enhanced augmentation at 5.5% and 7.5% (after age 55) on December 31, 2020.

Section 2: Adds a new subdivision that establishes a "regular" augmentation rate for these employees of 4.5%, beginning January 1, 2021.

Section 3: Modifies the exceptions from enhanced augmentation by eliminating the exception for return to public service and revising the exception that applies when a Fairview employee begins to receive an MSRS pension so that the exception does not apply if the pension begins at age 62 or later.

Section 4: Adds a new subdivision that states that if a Fairview employee returns to public service, the member's pension benefit is the largest of three alternatives:

- The MSRS pension earned before leaving public employment in 1996 or 1997, increased by enhanced augmentation (5.5%/7.5%), and then reduced by the pension amount earned for the subsequent period of public service; or

- The pension calculated under the combined service annuity ("CSA") provisions at Minnesota Statute section 356.30; or

- The pension calculated under the coverage by more than one fund ("CBMTOF") provisions at Minnesota Statute section 352.72.

Section 5: Adds a provision that will not be codified that modifies the application of sections 3 and 4 of the bill so that the changes in these sections will have retroactive effect to July 1, 2015. Section 5 states that if a Fairview employee began to receive an MSRS pension on or after July 1, 2015, but prior to the effective date of the changes, and the changes in the bill increase the Fairview employee's pension, the Fairview employee will begin to receive the new higher pension immediately and MSRS will pay the member, in a single lump sum payment, the difference between the old and new pension amount for payments already made. This retroactive application of the changes made by sections 3 and 4 of the bill are intended to benefit at least two constituents whose pension benefit has been reduced due to having returned to public employment.

Effective dates: All sections take effect immediately after enactment, except the changes to the exceptions, Section 3, are retroactively effective as of July 1, 2015.

Possible amendments to S.F. 1705; H.F. 2126

Possible amendments to S.F. 1705; H.F. 2126. The Commission may wish to consider the following amendments to S.F. 1705; H.F. 2126, copies of which are being provided separately:

- **S-1705-1A.** This amendment reduces the augmentation rate applicable to Fairview employees to make it the same as the rate for other MSRS members, which is 2%. The augmentation rate for other MSRS members is set forth in Minnesota Statutes Section 352.72, subdivision 2, so the amendment refers to that section. If the generally applicable augmentation rate changes in the future or augmentation is eliminated entirely, the augmentation rate for Fairview employees will similarly change.

- **S-1705-2A.** This amendment reduces the augmentation rate applicable to Fairview employees to make it equal to the rate for other MSRS members, plus 2.5%. In 1996, when enhanced augmentation for the Fairview employees was enacted, the new rate was 2.5% higher than the rate currently in effect for other

MSRS employees. In 1996, the augmentation rates for MSRS members who had left public employment were 3%, compounded, annually, until age 55, and 5%, compounded annually, after age 55. This amendment would retain the preferential treatment of Fairview employees as compared to other MSRS members, with respect to the rate of augmentation applied to pensions accrued by former public employees. If the generally applicable augmentation rate changes in the future or augmentation is eliminated entirely, the augmentation rate for Fairview employees will similarly change, while retaining the 2.5% increase from the generally applicable rate.

- **S-1705-3A.** This amendment reduces the augmentation rate applicable to Fairview employees by 1% each year starting January 1, 2018, until the rate is equal to the augmentation rate for other MSRS members. The rates for members up to age 55 and after age 55 would be:

  - 4.5%/6.5% effective January 1, 2018
  - 3.5%/5.5% effective January 1, 2019
  - 2.5%/4.5% effective January 1, 2020
  - 2% (assuming no change to augmentation generally)/3.5% effective January 1, 2021
  - 2% (assuming no change to augmentation generally)/2.5% effective January 1, 2022
  - 2% for all (assuming no change to augmentation generally) effective January 1, 2023

  If the generally applicable augmentation rate changes in the future or augmentation is eliminated entirely, the augmentation rate for Fairview employees will continue to decrease by 1% until it is the same as the rate of augmentation for MSRS members, generally.

Policy Considerations

Proposal will save MSRS $13.7 million versus $53 million (2016)

Cost savings to MSRS. The current proposed legislation is estimated to reduce MSRS' actuarial liability for pension benefits by $13.7 million. Under the 2016 proposal, the estimated reduction in actuarial liability was $53 million. MSRS is underfunded and runs a contribution deficiency each year and this savings will help with the shortfall.

MSRS is seeking an increase in both employer and employee contributions this session. If the legislation is enacted, employees will be required to pay an additional .5% of pay in exchange for no increase in their pension benefits. Current public employees will be required to pay more to help MSRS address its funding shortfall, while Fairview members, who are no longer making employee contributions through ongoing public service, continue to accrue enhanced pension benefits.

Pension benefits are statutory and subject to change by the legislature

Legislatively-provided benefits are not permanent. Annual increases in accrued pension benefits are considered earned each year due to the passage of time. Until January 1 of the next year is reached, there is no guarantee or enforceable promise to pay the next annual increase.

The change in the rate of automatic future increase in the pension benefit for this group of former employees is prospective and does not reduce the pension benefit already earned and annually increased since 1997. The legislature approved a prospective reduction in the rate of augmentation for all other MSRS members in 2011, to take effect in 2012. For unknown reasons, the rate of augmentation for Fairview employees was not reduced at that time and these former public employees have received five more years of enhanced augmentation than any other MSRS member.

Fairview employees are not current state employees, so may not have been aware of the reductions in automatic increases (both augmentation and COLAs) enacted since 1996 or even, generally, that pension benefits are statutory and thus subject to change by the legislature. In recent years, when MSRS sends out a benefit calculation to its members, including the Fairview employees, the benefit calculation included the following statement: "Changes to your work pattern or legislative actions could affect the final monthly benefit amount." The Commission will need to determine whether it was reasonable for the Fairview employees to believe that augmentation could never change.

Fairview provides retirement benefits to these employees, as negotiated in the 1996 asset sale agreement

Fairview provides retirement benefits for the Fairview employees, as stated in the privatization agreement. The agreement that governs the asset sale and employee transfer, entitled "Asset Transfer and Statutory Merger Agreement," dated December 31, 1996, between Fairview and the U of M, requires that the transferred employees be given service credit for their prior years with the U of M for purposes of eligibility and vesting under the Fairview Pension Plan and requires that these employees immediately enter the Fairview Pension Plan and 403(b) Plan. The relevant provisions from Article III ("Human Resource Matters") of the agreement state:

> **3.7.1 Basic Pension Benefit**. A Transitioned Employee will be eligible to participate in the Fairview Hospital and Healthcare Services Pension Plan ("Pension Plan") at such time as such Transitioned Employee meets all of the eligibility requirements of the Pension Plan. A Transitioned Employee's service with the University shall be deemed to be service with Fairview for purposes of determining eligibility, vesting and for any

other provision of the Pension Plan for which a determination of the Transitioned Employee's service is or may be relevant. Only compensation earned as a Fairview employee shall be used for allocating contributions and forfeitures. The University will assist Fairview in determining the amount of service to credit to a Transitioned Employee. If the University's records will not permit a determination of a Transitioned Employee's service based on the use of an hours of service counting method used in the Fairview Pension Plan, then past service will be credited to such Transitioned Employee based on procedures outlined in the Pension Plan document. All service will be credited based on the provisions in the Pension Plan relating to service and breaks in service.

3.7.2 403(b) Programs. There is no waiting period or eligibility requirement for participation in the 403(b) Tax Deferred Annuity programs available to Fairview employees. Participation is optional. A Transitioned Employee will be eligible to participate in a 403(b) program on the Effective Time. All contributions are immediately vested. Fairview has applied to the Internal Revenue Service (the "Service") for a Private Letter Ruling on the issue of what service can be included for the purposes of calculating Maximum Exclusion Allowances for Transitioned Employees and will instruct 403(b) program representative(s) to act on their findings in this matter.

This agreement does not mention the enhanced benefits provided by the 1996 legislation or require Fairview to compensate employees for any change to the enhanced benefits that could occur since these benefits, as with all other public pension benefits, are legislatively granted and, as such, would continue to be subject to legislative change. The agreement does not include any covenants on particular retirement benefits to be maintained by the State of Minnesota or MSRS for these employees.

Lack of uniformity among MSRS members

Uniform treatment among members of the same pension plan. The Fairview employees receive 5.5% annual increases per year (or 7.5% increase for each year after age 55) while all other members, including both current deferred vested members and retirees, receive 2% annual increases. The Commission will need to determine whether a small subset of the MSRS membership should receive a benefit that no other MSRS members receive.

Purpose of providing enhanced benefits has been met

Objective of providing enhanced benefits have been met. As noted above, the purpose of Chapter 352F, which provides the enhanced benefits for Fairview employees, "is to assure, to the extent possible, that persons employed at the University of Minnesota hospital and clinics will be entitled to receive future retirement benefits under the general state employees retirement plan of the Minnesota State Retirement System commensurate with the prior contributions made by them or on their behalf…"

Based on data provided by MSRS (to be presented to the Commission), this purpose has been fulfilled and exceeded. Due to the compounding effect of enhanced augmentation, Fairview employees are on track to receive pensions with a value that, in most cases, far exceed the value of their contributions and the employer contributions made on their behalves.

The attached addendum is the MSRS report.

TO: Susan Lenczewski, Executive Director, LCPR;

Rachel Barth, Deputy Director, LCPR

FROM: Chad Burkitt, Legislative Liaison, MSRS

DATE: March 6, 2017

SUBJECT: MSRS Board of Directors' Legislative Proposal for eligible former UMHC employees.

The MSRS Board of Directors recommends the following proposal:

- Reduce the enhanced deferred augmentation rate to 4.5% for all eligible members regardless of age effective January 1, 2021;
- Allow members who are currently working at Fairview Hospital to begin collecting a benefit at age 62 regardless of their status as a Fairview Employee;

	2016 Proposal	**2017 Proposal**
Augmentation Rate	2%	4.5%
Effective Date	2017	2021
Savings	$53 million	$13.7 million

Rationale

In 1996, enhanced deferred augmentation was set 2.5% higher than other deferred members. Deferred augmentation rates for other deferred members was changed to 2% in 2012. A 4.5% augmentation rate maintains the difference between the enhanced and the regular augmentation rates, while still lowering the enhanced rate to reflect the changes made by other deferred members. The MSRS Board of Directors approved a 2021 effective date in order to allow members close-to-retirement, time to plan their finances and make employment decisions. Allowing members who are still employed at Fairview to collect a benefit at age 62 is intended to offer additional flexibility to younger members.

Stakeholder Feedback

MSRS took several steps to communicate proposed changes with affected members and obtain member feedback. These steps included: launching a new webpage, creating an e-newsletter distribution list, several direct mailings, and three large-group meetings. Before developing the recommended proposal, MSRS received feedback from members and other stakeholders and incorporated that feedback into the recommendation.

Feedback was focused around three ideas: first, concern over the personal financial impact of a reduction in augmentation rates; second, a belief that the current augmentation rates were determined as part of an agreement that included concessions made in salary and other benefits; and third, understanding and acceptance of the MSRS financial position and of the changes that other stakeholder groups have accepted over the last 8 years. In response to the legitimate concerns of members, MSRS changed its recommendation to a 2021 implementation date and changed the augmentation rate to maintain the difference between regular and enhanced augmentation.

The general reaction to these changes have been positive with most members accepting the proposal. A handful of members and stakeholders have expressed a belief that any reduction in augmentation is inappropriate. At the November MSRS Board meeting, AFSCME Council 5 expressed their continued opposition to the recommended proposal and to any proposal that reduces the benefits that former UMHC employees are entitled to as a result of the UMHC privatization.