Options for Supplemental Benefit Maintenance Account Excess Funds

Background

The Supplemental Benefit Maintenance Account (SBMA) is a special account in the Teachers' Retirement Fund that provides inflation protection to CalSTRS members. California Education Code section 24415.5 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. Pursuant to 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.

The current SBMA balance, along with future contributions and future investment earnings, is 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 addition, actuarial projections show that purchasing power benefits could be sustained at a level of 90% through 2089, based on the current long-term inflation rate of 2.75% per year. In May 2024, CalSTRS staff presented the most recent actuarial projections to the board, and the board opted to keep the purchasing power protection at the 85% level, the maximum allowed by statute. These projections are performed every two years.

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 statute requires 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 members who retired prior to 1999, which is when the first of two sets of previous benefit enhancements for active members took effect.

SB 868 (Cortese), a bill enacted in 2022 that was supported by the board, provided an additional 5% to 15% increase for all members and their beneficiaries who began receiving a benefit prior to 1999 using the excess resources. These increases became effective on July 1, 2023, and were paid for the first time with the October 1, 2023, quarterly payments. Almost 46,000 CalSTRS members and beneficiaries received an additional increase as a result of SB 868.

SBMA funding

To fund the SBMA, the State General Fund provides an annual transfer equal to 2.5% 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 were withheld in 2003. The SBMA is also funded with revenues received from the use of state school lands (land granted to California by the federal government to support schools) and lieu lands (properties purchased with the proceeds from the sale of school lands).

In fiscal year 2022–23, the SBMA received $809.3 million in contributions, of which $801.7 million came from the State General Fund and approximately $7.6 million from state school and lieu lands revenues. Benefits paid from the SBMA totaled $485.6 million in 2022–23.

SBMA payments

When inflation depletes the value of the current benefit to less than 85% 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% purchasing power level. In accordance with statute, CalSTRS measures inflation for each fiscal year using the California CPI-U index issued by the Department of Finance for the month of June. The current board-approved long-term assumption for inflation is 2.75%. This assumption was last reviewed by the board as part of the 2024 CalSTRS Experience Analysis, which was presented to the board in January 2024. Since the completion of the last actuarial analysis, inflation in California has exceeded the assumed 2.75%. Inflation in California was 8.3% in fiscal year 2021–22 and 3.1% in fiscal year 2022–23. In fiscal year 2023–24, inflation in California was 3.3%, once again exceeding 2.75%.

As a result of recent high inflation, the number of members receiving SBMA has almost doubled compared to the last time the actuarial analysis was performed in 2022. In 2023–24, about 108,000 members received a benefit from the SBMA at an average of $505 per month or $1,515 per quarterly payment. In 2021–22, about 68,000 members were receiving a benefit from the SBMA at an average of $310 per month or $930 per quarter. SBMA payments are currently paid quarterly to all members and beneficiaries of members who began receiving a benefit in 2005 or earlier. Those who retired in 2006 or later have yet to see their purchasing power fall below 85%.

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% purchasing power, the supplemental benefit would be reduced to an amount that can be funded with available money.

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, 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’s important to realize the projections included in this report 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 by 2042 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 by 2052.

The ability of the SBMA to sustain an 85% protection level was measured by varying levels of future inflation on an annual basis. To perform this analysis, CalSTRS used a stochastic model that varied inflation in the future. Based on the analysis, CalSTRS determined there was a 68% chance that the SBMA would be able to sustain an 85% protection level through 2089, which is referred to as the probability of sufficiency. CalSTRS used the same stochastic model to analyze the options presented in this report.

Option discussion

The $36.2 billion in resources—current assets plus projected future contributions on current member payroll—identified in the June 30, 2023, SBMA Actuarial Analysis exceeds the $25.5 billion projected value of future purchasing power benefits for current members. The result is $10.7 billion in projected resources in excess of the amount needed to maintain 85% purchasing power through June 30, 2089. The projected excess resources have decreased by about $1.2 billion since 2021, mostly as a result of higher-than-expected inflation and the implementation of SB 868. Even with this reduction, it is expected that there will be sufficient funds to pay the SBMA benefits at the current 85% level through June 30, 2089. The current SBMA balance plus expected contributions are projected to be sufficient to pay purchasing power benefits at a level of 90% through 2089. This measure has decreased by 2% since the last actuarial analysis. As stated earlier in this report, the SBMA balance is highly dependent on future inflation and could quickly be depleted if inflation continues to exceed 2.75% over an extended period of time.

This report, prepared in compliance with Education Code section 24415.5, identifies options to use these excess resources for the exclusive benefit of members and beneficiaries. One of these options must be an increase in benefits paid only to members and beneficiaries of members who retired prior to 1999. In addition, an option that would increase the inflation protection level for all members was also analyzed for the use of excess resources. As stated earlier, 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. These two options were presented to the board on May 2, 2024. Each option would require legislation to provide the board with additional authority.

The options to use the SBMA excess resources are in the following sections. In the June 30, 2023, SBMA Actuarial Analysis, the probability of sufficiency was estimated to be 68% prior to the consideration of any options.

Option 1: One-time permanent increase for pre-1999 retirees only

When the board considers 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, which would replicate the benefit increases that were granted through SB 868, 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 cost estimate assumes the increase would be effective on July 1, 2024.

The following table shows the schedule of one-time permanent increases included for this analysis.

Schedule of one-time permanent 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%

For this analysis, it was assumed these additional benefits would be paid from the SBMA and that future 2% improvement factor adjustments 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 following table shows the estimated present value of increased SBMA payments for Option 1 as of June 30, 2023, and provides the probability of sufficiency if benefits were increased pursuant to Option 1. As stated earlier, the probability of sufficiency is currently estimated to be 68% prior to the consideration of any of the options analyzed for this report. As noted below, Option 1 would lower the probability of sufficiency for the SBMA to 67%, a reduction of 1%.

Option 1 – Estimated cost impact

Present value of increased SBMA benefits	Probability of sufficiency
$518 million	67%

Option 2: Varying purchasing power levels

Option 2 would increase the purchasing power level permanently to a higher percentage.

The following table shows the estimated present value of increased payments as of June 30, 2023, 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. The table also provides the probability of sufficiency for each of the purchasing power levels analyzed under Option 2.

Option 2 – Estimated cost impact

Purchasing power level	Present value of increased SBMA benefits	Probability of sufficiency
85%	N/A (current level)	68%
86%	$2.8 billion	64%
87%	$5.8 billion	61%
88%	$9.0 billion	56%
89%	$12.3 billion	51%
90%	$15.9 billion	47%

Although the SBMA would be able to sustain a 90% 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 47% of the time, compared to 68% at the current 85% level.

Conclusion

At its May 2024 meeting, the board reviewed two options for use of the excess SBMA funds and directed staff to present them to the Legislature, as required, and to engage with the Legislature and stakeholders if there is interest in pursuing either of the options.