TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director

RE: S.F. xxx; H.F. 2264 (Knoblach); MTRFA; Investment Authority Transfer and Other Financing Provisions Modified

DATE: April 19, 2005

Summary of S.F. xxx; H.F. 2264 (Knoblach)

S.F. xxx; H.F. 2264 (Knoblach) amends Minnesota Statutes, Chapter 354A, the governing law for the first class city teacher retirement fund associations, to implement the following changes related to the Minneapolis Teachers Retirement Fund Association (MTRFA):

1. Authorizes First Class City Teacher Retirement Fund Associations to Invest with the State Board of Investment. Any or all of the three first class city teacher retirement fund associations may invest some or all of their assets in the Minnesota Supplemental Investment Fund, governed by Minnesota Statutes, Section 11A.17, and operated by the State Board of Investment (Section 1);

2. MTRFA Membership Reimbursement of Investment Underperformance. The MTRFA active membership and the benefit recipients are required to pay an additional charge equal in total to the amount by which the MTRFA investment portfolio has underperformed the State Board of Investment investment performance with respect to the various statewide retirement plans, as determined by the State Auditor (Section 2);

3. State Investment of State Contributions to the Minneapolis Teachers Retirement Plan. The direct State aid payable on behalf of the Minneapolis Teachers Retirement Fund Association is required to be deposited with and invested by the State Board of Investment in the Income Share Account of the Minnesota Supplemental Investment Fund unless the State Board of Investment, upon consultation with the Board of Education of Special School District No. 1, determines that a different portfolio mix is more appropriate (Sections 3, 4, 5, and 6);

4. Reduced Threshold for Minneapolis Teacher Administrative Expense Surcharge. Members of the Minneapolis Teachers Retirement Plan would be required to pay a surcharge based on the amount by which the retirement plan administrative expenses exceed $428,381, the current average of $79.91 of the administrative expenses of the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) and the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General) per active member, multiplied by the MTRFA active membership, and indexed over time, rather than the TRA administrative expense percentage of covered payroll (Section 5); and

5. Modification of MTRFA Post-Retirement Adjustment Mechanism. The MTRFA post-retirement adjustment mechanism is modified, with a continuation of the annual two percent adjustment and the replacement of the investment performance-related post-retirement adjustment with an indexation to the investment performance-related portion of the Teachers Retirement Association (TRA) post-retirement adjustment mechanism, payable once the MTRFA funding ratio equals or exceeds 100 percent (Section 7).

Background Information on the Minneapolis Teachers Retirement Fund Association (MTRFA)

A. Establishment and Operation. Background information in the establishment and operation of the Minneapolis Teachers Retirement Fund Association (MTRFA) is contained in Attachment A.

B. Funding Problems. Background information on the funding problems of the Minneapolis Teachers Retirement Fund Association (MTRFA) is contained in Attachment B.

C. Financial Requirements and Contributions. Background information on the financial requirements of the Minneapolis Teachers Retirement Fund Association (MTRFA) and the contributions to the plan is contained in Attachment C.

D. Investment Performance. Background information on the investment performance of the Minneapolis Teachers Retirement Fund Association (MTRFA) is contained in Attachment D.

Actuarial Condition of the Minneapolis Teachers Retirement Fund Association (MTRFA)

The Minneapolis Teachers Retirement Fund Association (MTRFA) has had a history of problematic actuarial results and its current actuarial condition is its worst since 1990 in terms of the plan's funding ratio and is its worst ever in terms the plan's funding level deficiency as a percentage of covered pay and as a dollar figure. The following summarizes the funded condition and financial requirements of MTRFA every five years for the last 35 years as indicated in the official actuarial valuation reports for the plan:

	1969		1974		1979		1984	
Membership								
Active Members		4,197		3,942		3,149		3,099
Service Retirees		1,720		1,911		2,060		2,371
Disabilitants		30		40		60		0
Survivors		130		89		81		0
Deferred Retirees		183		211		445		0
Nonvested Former Members		0		0		0		0
Total Membership		6,260		6,193		5,795		5,470
Funded Status								
Accrued Liability		$148,835,491		$162,948,618		$333,302,046		$492,478,638
Current Assets		$56,568,831		$92,928,061		$137,172,512		$223,334,253
Unfunded Accrued Liability		$92,266,660		$70,020,557		$196,129,534		$269,144,385
Funding Ratio	38.01%		57.03%		41.16%		45.35%	
Financing Requirements								
Covered Payroll		$38,564,873		$53,657,729		$62,138,567		$82,035,896
Benefits Payable		$5,825,023		$7,476,776		$11,482,837		$17,265,960
Normal Cost	19.56%	$7,543,289	12.07%	$6,476,488	14.42%	$8,960,381	14.55%	$11,936,223
Administrative Expenses	0.46%	$177,398	0.49%	$262,923	0.64%	$397,687	0.82%	$672,694
Normal Cost & Expense	20.02%	$7,720,688	12.56%	$6,739,411	15.06%	$9,358,068	15.37%	$12,608,917
Normal Cost & Expense	20.02%	$7,720,688	12.56%	$6,739,411	15.06%	$9,358,068	15.37%	$12,608,917
Amortization	12.10%	$4,666,350	9.01%	$4,834,561	20.53%	$12,757,048	19.08%	$15,652,449
Total Requirements	32.12%	$12,387,037	21.57%	$11,573,972	35.59%	$22,115,116	34.45%	$28,261,366
Employee Contributions	6.50%	$2,506,717	6.50%	$3,487,752	8.40%	$5,219,640	8.02%	$6,579,279
Employer Contributions	6.50%	$2,506,717	6.50%	$3,487,752	13.14%	$8,165,008	12.29%	$10,082,212
Employer Add'l Cont.	9.52%	$3,671,376	9.39%	$5,038,461	0.00%	$0	0.00%	$0
Direct State Funding	0.00%	$0	0.00%	$0	0.00%	$0	0.00%	$0
Other Govt. Funding	0.00%	$0	0.00%	$0	0.00%	$0	0.00%	$0
Administrative Assessment	0.00%	$0	0.00%	$0	0.00%	$0	0.00%	$0
Total Contributions	22.52%	$8,684,809	22.39%	$12,013,966	21.54%	$13,384,647	20.31%	$16,661,490
Total Requirements	32.12%	$12,387,037	21.57%	$11,573,972	35.59%	$22,115,116	34.45%	$28,261,366
Total Contributions	22.52%	$8,684,809	22.39%	$12,013,966	21.54%	$13,384,647	20.31%	$16,661,490
Deficiency (Surplus)	9.60%	$3,702,228	(0.82%)	($439,993)	14.05%	$8,730,469	14.14%	$11,599,876
Amortization Target Date	1997		1997		2009		2009	
Actuary	Flott		Peat, Marwick & Mitchell		Peat, Marwick & Mitchell		Mercer Meidinger	

	1989		1994		1999		2004	
Membership								
Active Members		3,164		4,484		5,308		5,074
Service Retirees		2,171		2,497		2,881		3,449
Disabilitants		38		48		21		24
Survivors		197		219		243		291
Deferred Retirees		525		652		715		1,243
Nonvested Former Members		139		671		1,628		3,384
Total Membership		6,234		8,571		10,796		13,465
Funded Status								
Accrued Liability		$781,132,000		$920,470,000		$1,394,357,000		$1,729,551,327
Current Assets		$385,146,000		$514,138,000		$939,459,000		$877,763,977
Unfunded Accrued Liability		$395,986,000		$406,332,000		$454,898,000		$851,787,350
Funding Ratio	49.31%		55.86%		67.38%		50.75%	
Financing Requirements								
Covered Payroll		$118,036,000		$165,789,000		$242,288,000		$249,069,999
Benefits Payable		$30,859,000		$48,209,000		$75,813,000		$118,352,032
Normal Cost	13.75%	$16,229,950	12.36%	$20,491,520	10.90%	$26,411,000	9.59%	$23,889,438
Administrative Expenses	1.78%	$2,101,041	0.36%	$596,840	0.23%	$559,000	0.28%	$697,396
Normal Cost & Expense	15.53%	$18,330,991	12.72%	$21,088,361	11.13%	$26,970,000	9.87%	$24,586,834
Normal Cost & Expense	15.53%	$18,330,991	12.72%	$21,088,361	11.13%	$26,970,000	9.87%	$24,586,834
Amortization	14.75%	$17,410,310	12.31%	$20,408,626	12.75%	$30,881,000	28.24%	$70,337,368
Total Requirements	30.28%	$35,741,301	25.03%	$41,496,987	23.88%	$57,851,000	38.11%	$94,924,202

	1989		1994		1999		2004	
Employee Contributions	7.37%	$8,699,253	6.25%	$10,361,813	6.21%	$15,035,000	5.78%	$14,405,402
Employer Contributions	10.84%	$12,795,102	9.89%	$16,396,532	9.08%	$22,001,000	8.52%	$21,216,367
Employer Add'l Cont.	0.00%	$0	0.00%	$0	0.00%	$0	0.00%	$0
Direct State Funding	0.00%	$0	1.51%	$2,500,000	7.47%	$18,094,000	7.56%	$18,829,000
Other Govt. Funding	0.00%	$0	1.51%	$2,500,000	1.03%	$2,500,000	1.00%	$2,500,000
Administrative Assessment	0.00%	$0	0.00%	$0	0.00%	$0	0.00%	$0
Total Contributions	18.21%	$21,494,356	19.16%	$31,758,345	23.79%	$57,630,000	22.87%	$56,950,769
Total Requirements	30.28%	$35,741,301	25.03%	$41,496,987	23.88%	$57,851,000	38.11%	$94,924,202
Total Contributions	18.21%	$21,494,356	19.16%	$31,758,345	23.79%	$57,630,000	22.87%	$56,950,769
Deficiency (Surplus)	12.07%	$14,246,945	5.87%	$9,738,642	0.09%	$221,000	15.24%	$37,973,433
Amortization Target Date	2020		2020		2020		2020	
Actuary	Wyatt		Milliman & Robertson		Milliman & Robertson		Segal	

If the market value of assets, rather than the actuarial (averaged) value of assets, were used to determine the funded condition and the financial requirements of the MTRFA, the current funding situation of the retirement plan is worse, as indicated for fiscal years 2003 and 2004, as follows:

	2003				2004			
	Valuation Results Actuarial Value of Assets		Adjusted Valuation Results Market Value of Assets		Valuation Results Actuarial Value of Assets		Adjusted Valuation Results Market Value of Assets	
Membership								
Active Members		5,381		5,381		5,074		5,074
Service Retirees		3,334		3,334		3,449		3,449
Disabilitants		23		23		24		24
Survivors		285		285		291		291
Deferred Retirees		1,123		1,123		1,243		1,243
Nonvested Former Members		3,057		3,057		3,384		3,384
Total Membership		13,203		13,203		13,465		13,465
Funded Status								
Accrued Liability		$1,671,982,000		$1,671,982,000		$1,729,551,327		$1,729,551,327
Current Assets		$956,913,000		$719,599,000		$877,763,977		$763,089,276
Unfunded Accrued Liability		$715,069,000		$952,383,000		$851,787,350		$966,462,051
Funding Ratio	57.23%		43.04%		50.75%		44.91%	
Financing Requirements								
Covered Payroll		$264,766,000		$264,766,000		$249,069,999		$249,069,999
Benefits Payable		$113,649,000		$113,649,000		$118,352,032		$118,352,032
Normal Cost	10.36%	$27,426,000	10.36%	$27,426,000	9.59%	$23,889,438	9.59%	$23,889,438
Administrative Expenses	0.30%	$794,000	0.30%	$794,000	0.28%	$697,396	0.28%	$697,396
Normal Cost & Expense	10.66%	$28,220,000	10.66%	$28,220,000	9.87%	$24,586,834	9.87%	$24,586,834
Normal Cost & Expense	10.66%	$28,220,000	10.66%	$28,220,000	9.87%	$24,586,834	9.87%	$24,586,834
Amortization	21.30%	$56,395,000	28.37%	$75,111,000	28.24%	$70,337,368	32.04%	$79,806,764
Total Requirements	31.96%	$84,615,000	39.03%	$103,331,000	38.11%	$94,924,202	41.91%	$104,393,598
Employee Contributions	5.84%	$15,460,000	5.84%	$15,460,000	5.78%	$14,405,402	5.78%	$14,405,402
Employer Contributions	8.59%	$22,750,000	8.59%	$22,750,000	8.52%	$21,216,367	8.52%	$21,216,367
Employer Add'l Cont.	0.00%	$0	0.00%	$0	0.00%	$0	0.00%	$0
Direct State Funding	7.11%	$18,829,000	7.11%	$18,829,000	7.56%	$18,829,000	7.56%	$18,829,000
Other Govt. Funding	0.94%	$2,500,000	0.94%	$2,500,000	1.00%	$2,500,000	1.00%	$2,500,000
Administrative Assessment	0.00%	$0	0.00%	$0	0.00%	$0	0.00%	$0
Total Contributions	22.49%	$59,539,000	22.49%	$59,539,000	22.87%	$56,950,769	22.87%	$56,950,769
Total Requirements	31.96%	$84,615,000	39.03%	$103,331,000	38.11%	$94,924,202	41.91%	$104,393,598
Total Contributions	22.49%	$59,539,000	22.49%	$59,539,000	22.87%	$56,950,769	22.87%	$56,950,769
Deficiency (Surplus)	9.47%	$25,076,000	16.54%	$43,792,000	15.24%	$37,973,433	19.04%	$47,442,829

MTRFA: Pattern of Unfunded Accrued Liability Changes 1997-2004

Source of Actuarial (Gain) or Loss	1997	1998	1999	2000	2001	2002	2003	2004
Salary Increase	9,263,000	(591,000)	14,753,000	7,869,000	(12,689,000)	(17,097,000)	(15,735,000)	--
Investment Performance	(3,227,000)	(53,220,000)	(22,485,000)	37,030,000	13,655,000	71,199,000	99,686,000	94,369,236
Mortality	6,620,000	(281,000)	1,809,000	856,000	848,000	(5,007,000)	(18,966,000)	--
Other (Gains)/Losses	(3,317,000)	3,971,000	3,922,000	21,870,000	17,173,000	8,686,000	6,000,000	9,882,415*
Total (Gain) or Loss	9,339,000	(50,121,000)	(9,845,000)	67,625,000	18,987,000	57,781,000	58,985,000	104,251,651
UAL Change from Plan Amendments	11,482,000	0	0	0	0	(319,000)	0	0
UAL Change from Assumption Changes	12,780,000	0	0	(12,506,000)	0	10,940,000	0	0
UAL Change Due to Insufficient Contributions	24,391,000	7,364,000	7,297,000	6,708,000	12,669,000	14,846,000	24,455,000	32,466,699
Total UAL Change	57,992,000	(42,757,000)	(2,548,000)	61,827,000	31,656,000	83,248,000	83,440,000	136,718,350

** The 2004 Minneapolis Teachers Retirement Fund Association (MTRFA) actuarial valuation did not allocate the changes in the unfunded actuarial accrued liability of the plan except to categorize the gain or loss as produced as investments or as demographics. The total demographic gain or loss is indicated under the "other items" category.*

Discussion and Analysis

S.F. xxx; H.F. 2264 (Knoblach) provides first class city teacher retirement fund associations with the authority to invest all or a portion of their portfolio with the State Board of Investment in the Minnesota Supplemental Investment Fund, requires the members of the Minneapolis Teachers Retirement Fund Association (MTRFA) to reimburse the fund annually for any MTRFA investment underperformance, requires that all future State aid to MTRFA be invested by the State Board of Investment in the Minnesota Supplemental Investment Fund, resets the trigger for the imposition of MTRFA administrative expense surcharge, and revises the MTRFA post-retirement adjustment mechanism.

S.F. xxx; H.F. 2264 (Knoblach) raises several pension and related public policy issues that may merit Commission consideration and discussion, as follows:

1. Extent of Remedy to MTRFA Funding Problem by Proposed Legislation. The policy issue is the extent to which the proposed legislation would resolve the funding and related problems of the Minneapolis Teachers Retirement Fund Association (MTRFA). A strong argument can be made that there are seven problems with respect to MTRFA that contribute directly or indirectly to its funding problem, which are:

   - a significant default risk,
   - a funding ratio decline,
   - a growing contribution rate deficiency,
   - overrepresentation of membership interests in plan governance,
   - high administrative and investment expenses,
   - investment return underperformance, and
   - undeserved past and potential future post-retirement adjustments.

   The proposed legislation addresses some of the various problem areas, but does not conclusively resolve the funding problem. Based on the current levels of administrative expenses, MTRFA revenues would increase by 0.11 percent of pay from the administrative expense surcharge, but the surcharge can be expected to induce behavior changes by MTRFA that will decrease fund expenses rather than increase fund revenues. The investment underperformance reimbursement will offset the underperformance of the MTRFA investment portfolio compared to the State Board of Investment, but will not eliminate the potential for future actuarial investment losses. The reimbursement will probably induce more MTRFA assets being invested by the State Board of Investment. The changes in the MTRFA post-retirement adjustment mechanism will not directly recover any past overpayment of investment-related post-retirement adjustments, but will eliminate or greatly reduce near-term future post-retirement adjustments and the associated liability increases. The changes will not result in MTRFA becoming fully funded by the 2020 full funding target date, but do likely postpone a potential MTRFA default for a significant period of time.

2. Appropriateness of Additional MTRFA Funding Problem Remedies. The policy issue is the extent of the remaining need to address the MTRFA funding problem and the appropriateness of any additional remedy or remedies. After the potential for additional funding leakage is resolved, which the proposed legislation largely does, the remedy to a funding problem is additional funding from some source or sources. The two significant approaches to remedy the MTRFA funding would be a one-time infusion of significant additional assets or would be an ongoing increase in annual contributions or aid paid to the fund. A lump sum infusion could come from local sources, perhaps bonding by Special School District No. 1, or from State sources, from a special appropriation. Because of bond rating declines for Special School District No. 1 and State budget limitations, a lump sum infusion does not seem possible. Additional member contributions, additional employer contributions, or additional State aid could provide additional funding, but an increase in member contributions would significantly burden MTRFA members in comparison to other teachers, an increase in employer contributions would arise in the context of recurring budget shortfalls for Special School District No. 1, and an increase in State aid to MTRFA would displace revenue for some other set of state-funded services.

3. Appropriateness of Saddling the MTRFA Membership With Investment Underperformance and Administrative Expense Surcharges. The policy issue is the appropriateness of the portion of the proposed legislation, Sections 2 and 5, that requires the Minneapolis Teachers Retirement Fund Association (MTRFA) active and retired membership to reimburse the fund for any underperformance by MTRFA compared to the State Board of Investment basic retirement plans and that requires the MTRFA active and retired membership to reimburse the fund for the amount by which MTRFA administrative expenses exceed $428,381, indexed to the Consumer Price Index percentage increase

since July 1, 2005. For the period 1990-2003, the MTRFA underperformed the comparable State Board of Investment retirement fund portfolio by 1.2 percent annually on average, which would be $9.2 million on the current market value of MTRFA assets, or $1,036 per active or retired member, or a 3.29 percent deduction from retirement annuities and benefits payable for retired members and a 2.11 percent of covered pay additional assessment for active members. The administrative expense assessment would total $270,000, or $30.55 per active or retired member. The combination of the two, potentially $1,067 per member annually, is a significant increase over the current average $2,704 active member contribution and a significant deduction from the current average $14,462 retirement annuity.

4. <u>Appropriateness of the Lack of Any Additional Special School District No. 1 Financing Burden</u>. The policy issue is the appropriateness of not imposing any additional financing burden to resolve the pension funding crisis on the employing units participating in the Minneapolis Teachers Retirement Fund Association (MTRFA), principally Special School District No. 1, Minneapolis. The current employer contribution by Special School District No. 1, Minneapolis, is 8.52 percent of covered salary plus $1.25 million, or approximately $22.5 million in 2004. Although MTRFA does provide retirement coverage to a modest number of Minnesota State Colleges and Universities System (MnSCU) faculty members at the Minneapolis Technical College, MTRFA is primarily a single employer pension plan and has been so since the plan was established in 1910. Although the school district has a limited voice on the MTRFA Board of Trustees (one member out of a board of seven trustees, with six elected by the MTRFA membership), the school district is the primary plan sponsor and would be significantly adversely affected by any retirement fund default as it attempts to attract new employees and retain existing employees. While the current MTRFA employer contribution is significantly higher than for school districts covered by the statewide Teachers Retirement Fund Association (TRA), an effective current rate of 9.02 percent for MTRFA compared to 5.00 percent for TRA, and the resources of Special School District No. 1, Minneapolis, are limited and needed for ongoing educational programs, it is in the interest of the school district to maintain the solvency of the retirement fund and the school district, logically, should be a participant in any comprehensive solution.

5. <u>Appropriateness of the Investment of First Class City Teacher Retirement Fund Association Assets Through the Minnesota Supplemental Investment Fund</u>. The policy issue is the appropriateness of authorizing first class city teacher retirement fund associations to utilize the Minnesota Supplemental Investment Fund, operated by the Minnesota State Board of Investment, as an investment option. The Minnesota Supplemental Investment Fund was created in 1967, is the sole investment vehicle for the assets of three retirement plans and the Post Retirement Health Care Savings Plan, is one of a number of investment vehicles of the Individual Retirement Account Plan and College Supplemental Retirement Plan offered by the Minnesota State Colleges and Universities System (MnSCU) and is a potential investment vehicle for the five remaining local police and paid firefighter relief associations and for the 700-plus volunteer firefighter relief associations. The Minnesota Supplemental Investment Fund has seven accounts and functions akin to a family of mutual funds, with the several accounts reflecting different investment strategies. The authority to utilize the Minnesota Supplemental Investment Fund was extended to the various local public safety retirement funds in 1969 and 1971 and the use of the Minnesota Supplemental Investment Fund by local retirement plans has not produced any identifiable problems. The local public safety retirement plans tend to be potentially less sophisticated investors than the three first class city teacher retirement fund associations and there is not particular reason to believe that extending the authority to the three first class city teachers retirement fund associations would produce any problematic results. The use of the Minnesota Supplemental Investment Fund will not necessarily improve the MTRFA investment performance, because portfolio mix decisions would continue to be made by the MTRFA Board of Trustees and the board could make strategic errors in the total portfolio mix of the retirement fund. In an actuarially funded retirement plan, investment income can be expected to finance two-thirds or three-quarters of the eventual benefit payouts from the fund, so the investment function of a retirement plan is more important than the contribution function in many respects. The proposed change could induce MTRFA to invest MTRFA assets with the State Board of Investment in the Minnesota Supplemental Investment Fund, but the proposed legislation does not substitute the portfolio composition judgment of the State Board of Investment for that of the MTRFA board. The State Board of Investment in the Combined Investment Funds historically has been an average investment performer.

6. <u>Appropriateness of State Board of Investment to Invest MTRFA State Aid Amounts</u>. The policy issue is the appropriateness of supplanting the MTRFA Board of Trustees in the investment of MTRFA revenue attributable to direct State aid to MTRFA. In Minnesota, for statewide pension plans the

State Board of Investment is the investment authority, and for local pension plans the pension plan board of trustees is the investment authority. The State Board of Investment, through the vehicle of the Minnesota Supplemental Investment Fund, which is essentially a family of mutual funds, is available as an investment mechanism for most local pension plans. Approximately a quarter of the Minnesota volunteer firefighter relief associations have utilized the Minnesota Supplemental Investment Fund, but there is no express authority for the first class city teacher retirement fund associations to utilize the State Board of Investment and the three plans have not sought such authority. The proposed change would mandate that all future direct State aid for MTRFA be invested in the Minnesota Supplemental Investment Fun's Income Share Account, which generally mimics the portfolio mix of the statewide retirement plans, unless the State Board of Investment, in consultation with Minnesota Teacher Retirement Plan officials, determines that some other investment mix is more appropriate. The direct State aid to MTRFA annually is almost $19 million, or about 30 percent of the total MTRFA contribution revenue. The argument for the mandate is that the MTRFA has historically underperformed the State Board of Investment in investing pension plan assets and that the likely future investment opportunity losses should be avoided when State money is involved. If the mandate had been imposed since the start of direct State aid in 1993, exclusive of investment gains or losses, the State Board of Investment would currently be investing $113 million in MTRFA assets. An investment mandate would make the overall MTRFA investment process more complex, and if a benefit default potential is relatively imminent, would make the payment of future benefits more difficult, with numerous asset transfers between the State Board of Investment and the plan required.

7. Appropriateness of MTRFA Administrative Expense Surcharge Modifications. The policy issue is the appropriateness of changing the threshold amount that triggers a surcharge on active and retired members to reimburse MTRFA for administrative expenses deemed excessive. The MTRFA administrative expense surcharge was first imposed in 1993, when the MTRFA administrative expenses were 0.43 percent of covered payroll ($144.52 per active member) while the TRA administrative expenses were 0.15 percent of covered payroll ($49.56 per active member). Since 1993, MTRFA administrative expenses were redefined to exclude investment expenses, more of the MTRFA internal expenses have been allocated to investment expenses rather than administrative expenses, and TRA administrative expenses have tripled as a percentage of covered pay or have quadrupled as a dollar amount. The intent of the 1993 administrative expense surcharge was to compel MTRFA members to bear the additional cost of administering a small local pension plan when compared to a potentially more efficient statewide pension plan. With the huge increases in the TRA administrative expense levels, TRA may not any longer be the best measure of administrative efficiency. The proposed change would set the threshold trigger at the average per-member administrative expense of the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) and the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General). The supplemental administrative expense member surcharge can be expected to raise about $300,000 annually, or about 0.12 percent of covered pay. Some testimony would be appropriate from MTRFA about the nature of its administrative expenses and from MSRS-General and PERA-General about the prospects for significant administrative expense changes.

8. Appropriateness of Changes in the MTRFA Investment-Related Post-Retirement Adjustment Mechanism. The policy issue is the appropriateness of the various proposed changes in the investment-related post-retirement adjustment mechanism of the MTRFA. The actual MTRFA post-retirement adjustment mechanism in practice is different from the adjustment mechanism as set forth in the statute, Minnesota Statutes, Section 354A.28. Assets related to the retiree reserves have not actually been segregated from the assets related to active members, as the law clearly requires. The investment performance used to calculate the excess investment income is not measured based on those retiree assets and retiree reserves. The five-year investment performance averaging process lacks a mechanism to recoup the impact of any investment losses and of the continuation of prior adjustments during investment downturn periods. The proposed change would condition future investment-related MTRFA post-retirement increases on MTRFA achieving full funding of its current actuarial accrued liability and would index the investment-related MTRFA post-retirement increases to those paid by the Teachers Retirement Association (TRA) during the previous year. The impact of the proposed change will be to eliminate or diminish future post-retirement adjustments for a considerable potential period of time. To be sustained upon a legal challenge, a basis for the proposed change will need to be formed in public testimony so that the defects in the current mechanism in practice are clearly demonstrated and the corrective intent and effect of the proposed change becomes more evident.

Attachment A

Background Information on the Minneapolis Teachers Retirement Fund Association (MTRFA) Establishment and Operation

The Minneapolis Teachers Retirement Fund Association (MTRFA) was created in 1909 by the teaching body of the Minneapolis public schools with the consent of the city council and was incorporated on September 17, 1909. The plan primarily covers teachers employed by Special School District No. 1, Minneapolis, but also includes some faculty members employed by the Minnesota State Colleges and Universities System (MnSCU). Teachers employed by charter schools located in Minneapolis previously were members of MTRFA, but were made members of the Teachers Retirement Association (TRA) in 2002.

In 1924, the Minneapolis teachers' pension plan was restructured to address major pension funding problems that arose during its initial 15 years of operations. In 1952, the pension benefit plan changed from a defined contribution plan to a defined benefit plan. The school district, as a legal entity separate from the city, was established in 1953. In 1967, state aid for teacher retirement plans was enacted when Minnesota enacted a sales tax and the Minneapolis teachers' pension plan received state aid equivalent to the funding provided to the statewide TRA, first as a dollar amount per active member and then as an identical percentage of covered pay, factoring in Social Security contributions for post-1959 TRA members. After 1967, the local property tax levy otherwise to be certified for the Minneapolis teachers pension plan was reduced by the amount of the state teacher retirement aid. In 1975, as part of a property tax relief effort initiated by Speaker of the House, Martin O. Sabo, the local property tax levy authority was eliminated, a pending benefit improvement was delayed, future benefit changes were required to obtain legislative approval rather than local approval, and the employer contribution to MTRFA was set based on a percentage of covered payroll.

The MTRFA coordinated plan, for teachers with Social Security coverage, was created for new members hired after July 1, 1978, and any existing members who elected the plan. Before 1978, MTRFA was a "basic" program, meaning that its members had retirement coverage solely by the local retirement plan and without Social Security coverage by virtue of the Minneapolis teaching service. A Social Security referendum was conducted in 1978 for MTRFA basic program members who desired Social Security coverage to elect to have Social Security coverage, to be supplemented by the MTRFA "coordinated" program. The MTRFA coordinated program substantially replicated the coordinated program of the TRA. All newly hired Minneapolis teachers after July 1, 1978, automatically were covered by Social Security and the MTRFA coordinated program. In 1985, the state funding was converted to a categorical education aid to the school district. The direct payment of employer contributions by the state was replaced by employer contributions from the school district. In 1987, the categorical teacher retirement and Social Security aid was folded into the general education aid program and the basic State funding for teacher retirement and Social Security coverage currently is incorporated into the general state aid to school districts.

MTRFA requested benefit increases that were approved by the Legislature in 1979, 1985, 1986, 1987, 1989 and 1997. MTRFA requested additional State funding and special state aid programs were created in 1993, 1996, and 1997. In 1993, a supplemental $2.5 million annual state contribution to the MTRFA was enacted, to match additional contributions by Special School District No. 1 and by the City of Minneapolis. In 1996, some state funding previously paid to local police and paid firefighter relief associations was redirected to MTRFA if Special School District No. 1 and the City of Minneapolis make additional contributions to MTRFA ($1 million each in 2003 and thereafter). In 1997, an additional annual state contribution to MTRFA was also enacted, which provided $13.3 million in 2003.

The MTRFA is managed by a governing board of seven members, of which six are elected by the members of the association and one is a member of Special School District No. 1, appointed by the school board chair. In addition to maintaining member records and determining benefit amounts, the Minneapolis Teachers Retirement Fund Association governing board is the investment authority for the assets of the retirement fund.

According to its annual financial report and annual actuarial report, in fiscal year 2003, MTRFA received total contributions of slightly over $59.8 million (40 percent from the school district, 27 percent from the state, and 30 percent from the membership), experienced a net investment loss of $110.9 million, paid total retirement benefits of slightly in excess of $110.1 million, and paid administrative expenses of slightly over $800,000 (48 percent for personnel, 15 percent for professional services, and 37 percent for conferences, communications, office rent, and other expenses).

Attachment B

Background Information on the Minneapolis Teachers Retirement Fund Association Funding Problems

The Minneapolis Teachers Retirement Fund Association (MTRFA) is the state's poorest funded teacher retirement fund, with a funding ratio for 2004 of 50.8 percent based on the actuarial value of assets or 44.1 percent based on the market value of assets, and is the Minnesota public pension plan that is the most likely to default in the payment of benefits, with that default likely in the next 10 to 20 years. The plan was 41 percent funded in 1957, was 38 percent funded in 1969, was 46 percent funded in 1972, was 57 percent funded in 1975, when the state first became involved in setting benefits and funding for the plan, was 51 percent funded in 1976, after the Legislature approved the MTRFA benefit increase proposal that was delayed in 1975, was 41 percent funded in 1982, was 54 percent funded in 1992, was 62 percent funded in 2002, and is 51 percent funded in 2004. The unfunded actuarial accrued liability of the plan increased from $457 million in 1998, despite the receipt of significant additional state aid annually, to $852 million in 2004, the annual benefit payout of the plan increased from $67 million to $118 million in 2004, and the contribution shortfall (actuarial requirements in excess of contributions) has grown from $0.9 million in 1998 to $38 million in 2004.

The MTRFA has had funding problems since very early in its history. The plan was restructured in 1924 and was again revised in the 1930s when it was in danger of default. Funding concerns about the plan were being discussed by the MTRFA Board in the 1940s, when Hubert Humphrey was the mayor of Minneapolis and was a member of the MTRFA Board and the school system was part of the city. For most of its history, the plan has had a funded ratio of less than 50 percent (from 1957 to 1972, from 1977 to 1986, and from 1989 to 1990). The plan has only had a contribution sufficiency (total member and employer contributions greater than total actuarial requirements) only twice in its history, in 1974 (sufficiency of 0.82 percent of covered pay, or $0.4 million) and in 1997, as a result of a significant additional state aid program (sufficiency of 0.38 percent of covered pay, or $0.7 million).

The MTRFA funding problems derive from several sources, although the plan representatives point almost solely to the factor of the disallowance of future local property tax levies for the plan from 1975 to 1993. These factors, at a minimum, are the legacy of the plan's historic poor funding practices, the plan's opposition to coordinating with Social Security in the 1950s, 1960s, and 1970s, the plan's addition of a "30 years of service and out" normal retirement age, a pattern of early age retirements, with 35.95 percent of all MTRFA retirees under age 65 in 2004, its 1950s shift to the final average salary base for benefit calculations, its 1976 benefit improvements in the face of diminished contributions, its 1981 creation of a lump sum investment-related post-retirement adjustment mechanism, its 1987 revision of the 1981 post-retirement mechanism into a permanent percentage increase adjustment, and its 1993 further modification in the adjustment mechanism, its 1989 extension of the level benefit accrual rate increase to its "30 years and out" Basic members, large pre-1993 administrative expenses, post-1993 re-designations of administrative expenses as investment expenses not covered by the 1993 excess administrative expense charge, large investment program expenses, including the cost of its significant pre-1999 real estate portfolio, and decades of poor investment performance. The MTRFA funding problems and the process of assessing potential solutions has been complicated by problems within the MTRFA and an apparent lack of interest regarding the problem by Special School District No. 1, Minneapolis. The MTRFA has the legal status of a Minnesota nonprofit corporation, not a pure governmental subdivision, and its board is member dominated (seven of eight board members are MTRFA members, with only one school board representative). The plan historically and properly has viewed its investment role as its most important function, but its pre-1999 significant commitment to equity real estate investment in Minnesota, Texas, and other states, its unsuccessful mid-1980s experiment with portfolio insurance, and its recent significant investment losses raise questions about the value of the plan's investment function. The plan unsuccessfully attempted to sue the State of Minnesota over its funding problems in the late 1980s rather than seek other avenues to address the problem or correct internal structural and operational problems. Special School District No. 1, although it was the sole employing unit covered by the plan until the creation of the Minnesota State Colleges and Universities System (MnSCU) and the creation of charter schools, does not appear to have any overriding sense of responsibility for the plan and has not taken any public role in any legislative deliberations on retirement coverage or funding issues since before 1975.

The Legislative Commission on Pensions and Retirement and the Legislature have attempted to address the Minneapolis Teachers Retirement Fund Association funding issue over the years, first requiring the production of regular actuarial work by or on behalf of the plan in 1965, including the first class city teacher retirement plans in state teacher retirement funding in 1967, when the first state sales tax was enacted, studying first class city teacher retirement coverage issues by the Commission during the 1975-1976 interim, closing the MTRFA Basic Program to new entrants with the 1977 creation of the less costly MTRFA-Coordinated Program, providing increased employer funding in 1978 and 1984, creating a direct state aid program in 1993, studying approaches to a consolidation of teacher retirement plans during the

1993-1994 interim, creating an additional direct state aid program in 1996 and again in 1997, and mandating a study of a restructuring of teacher retirement plans during the 2001-2003 interims. The three direct state aid programs have totaled $127.6 million of funding to MTRFA since 1993, or 168 percent of the plan's 1975 MTRFA unfunded actuarial accrued liability.

If the MTRFA funding problems are to be addressed by the Legislature, the most immediate problem and the most important problem to be solved is the problem of a likely default in the payment of benefits. Although the first class city teacher retirement fund association law has included a provision for a prorated payment of benefits in the event of a default since 1909, any default would be tragic for the plan, the plan membership, Special School District No. 1, and the State. To avert a potential default, at a minimum, the solution must maximize revenue and minimize unnecessary expenditures. Increasing positive investment performance by or on behalf of the plan, reducing any unnecessary administrative or investment expenses, and restructuring the MTRFA post-retirement adjustment mechanism to reduce its adverse funding impact will lengthen the period before a potential default. Beyond those steps, a total solution to the MTRFA funding problem will require additional contributions from some source and the productive investment of that new revenue.

Attachment C

Financial Requirements of and Contribution Levels to the Minneapolis Teachers Retirement Fund Association (MTRFA)

The Minneapolis Teachers Retirement Fund Association (MTRFA) was created in 1910 under state legislation enacted in 1909 (Laws 1909, Chapter 343).

The MTRFA was created in 1910 based on a plan formulated by the teaching body of the Minneapolis public schools and was established after the formulated plan for the collection and disbursement of a fund was approved by the Minneapolis city council and by a majority of Minneapolis teachers, in writing, as evidenced in an affidavit filed by an officer of the Minnesota Board of Education. The formulated plan for the establishment of the MTRFA provided for both member contributions and taxes levied on the property of the city.

The 1909 law provided that the MTRFA officers were to certify annually to the city and county property tax levy authorities the amount of the property tax levy needed to fund the retirement association for the coming year, but without any specificity as to how that amount was to be determined, and with a limit on the levy of one-tenth of one mill on all city taxable property. In 1917 (Laws 1917, Chapter 300, Section 1), the maximum property tax levy for a teachers retirement fund association was increased to two-tenths of one mill for first class cities that were not operating under a home rule charter (i.e. Minneapolis) and retained the one-tenth of one mill limit for other cities of the first class. Minneapolis was authorized to formulate a home rule charter in 1896, but the initial charter proposed in 1898 was defeated, a second (1900) charter was defeated, as were the 1902, 1904, 1906, and 1913 proposed charters. Minneapolis adopted its home rule charter in 1920. In 1919 (Laws 1919, Chapter 144), the maximum property tax levy in cities of the first class without a home rule chapter (Minneapolis) was modified, with authority for the city levy officials to determine that a larger property tax levy was needed, when the levy limit became three-tenths of one mill. In 1921 (Laws 1921, Chapter 303), the city was given explicit authority to approve the teacher retirement levy and three different potential levy limits were established, set at two-tenths of one mill for cities of the first class not operating under a home rule charter (formerly Minneapolis), and at 1.5 mills for cities of the first class operating under a home rule charter that does not fix the amount of tax levies for school purposes (presumably Minneapolis), and set at one-tenth of one mill for all other cities of the first class. In 1923 (Laws 1923, Chapter 310), the 1.5 mill levy limit was extended to all first class cities, whether operating under a home rule charter or not, and the levy limit for other cities was set at one-tenth unless local property tax authorities determined more revenue for the teachers retirement fund association was needed, whereupon the limit was three-tenths of a mill.

In 1935 (Laws 1935, Chapter 111), prior plan amendments of the Minneapolis Teachers Retirement Fund Association (MTRFA) (described as a narrow class rather than specifically named) that had not been subjected to city council approval and any actions based on those plan amendments were validated retroactively, a maximum retirement annuity amount was specified for MTRFA and MTRFA officials were required to file with the clerk of the board of education a statement of assets and liabilities, a statement of receipts and disbursements, and a list of annuities paid. In 1945 (Laws 1945, Chapter 390), in addition to authorizing, with city approval, the "$2.00 bill and annuity" retirement annuity, the prior 1.5 mill limit was eliminated for first class city teacher retirement fund associations in favor of individual home rule charter limitations, and if the teacher retirement fund association certified requirements exceeded the amount actually levied because of a city charter cost of government limitation, the teacher retirement fund association was permitted to record and book those amounts, increase them by the interest rate actually earned by the association, and add them to the amount certified for the following year. In 1949 (Laws 1949, Chapter 523), the retirement annuity maximum was restated. In 1955 (Laws 1955, Chapter 722), the retirement annuity maximum was again revised. In 1957 (Laws 1957, Chapter 655), a separate maximum retirement annuity was specified to accommodate the coordination of the Duluth Teachers Retirement Fund Association (DTRFA) with Social Security.

In 1967 (Extra Session Laws 1967, Chapter 32, Article 3, Sections 2 and 3), as part of the sales tax enactment, the employer obligation to the Teachers Retirement Fund Association (TRA), then 7.00 percent of pay, was removed from the state property tax levy and became an obligation of the property tax relief (sales tax) fund in the state treasury and a state obligation to the first class city teachers retirement fund associations from the property tax relief fund was created, based on the average dollar amount per active TRA member multiplied by the number of active first class city teacher retirement fund associations, but not to exceed the amount that would have been levied as property taxes for the respective retirement associations. In 1969 (Laws 1969, Chapter 399, Section 45), the property tax relief fund was renamed as the general fund. Also in 1969 (Laws 1969, Chapter 485, Section 38), the distribution to the first class city teacher retirement fund associations was reset from the average dollar amount of aid provided per active TRA member to the average percentage of the TRA payroll and was expanded to include Social Security taxes. In 1971 (Laws 1971, Chapter 535, Section 2), the first class city teacher retirement fund association state support obligation was reduced to account for the portion of teacher salaries paid by other than normal school operating funds (primarily Federal funds). In 1974 (Laws 1974, Chapter 213), the manner in which the state support obligation to the Duluth Teachers Retirement Fund Association (DTRFA) was revised to distinguish between the equivalent TRA employer contributions and the equivalent Social Security employer contributions.

In 1975 (Laws 1975, Chapter 306, Sections 30, 31, and 34), the 1909-1974 tax levy limits provision and the 1967-1974 state support obligation provisions were repealed, the state contributions to the first class city teacher retirement fund associations was recodified as Minnesota Statutes, Section 354A.12, future local property tax levies for teacher retirement fund associations were disallowed, future teacher retirement fund association benefit plan amendments were required to receive prior legislative approval, and the Legislative Commission on Pensions and Retirement was required to review the benefit programs of the first class city teacher retirement fund associations as well as the pending Minneapolis Teachers Retirement Fund Association (MTRFA) benefit improvement over the 1975-1976 Interim. The 1975 pending MTRFA benefit improvement was given legislative approval in 1976 (Laws 1976, Chapter 238), when an MTRFA Coordinated Program was created. The implementation of the MTRFA Coordinated Program was delayed until 1978.

Based on the MTRFA annual financial reports on record with the Legislative Commission on Pensions and Retirement, the following sets forth the total annual receipts of the MTRFA from member contributions, local property tax levies, state contributions, and Federal contributions during the period 1954-2004, as characterized by the plan administration:

Year	Member Contributions	Local Property Tax Levies	State Contributions [1]	Federal Contributions
	$	$	$	$
1954	756,571	1,641,626		
1965	1,535,885	1,104,085		
1966	1,689,447	1,160,410		
1967	1,817,909	1,247,724		
1968	2,278,295	2,367,445		
1969	2,680,233	3,166,451	3,434,313	282,630
1970	2,819,489	2,943,538	4,033,873	148,515
1971	3,058,979	3,097,151	4,033,874	0
1972	3,455,306	3,664,558	4,186,727	346,044
1973	3,426,013	3,298,135	4,333,671	574,902
1974	3,632,354	4,566,293	4,673,084	0
1975	3,833,273	5,236,624	2,552,723	736,624
1976	4,399,891	107,399	5,818,980	347,226
1977	5,686,846	25,322	6,750,999	0
1978	5,671,271	592,604	6,949,692	0
1979	5,334,541	5,583	7,037,611	0
1980	5,818,365	8,518	8,371,188	2,053,877
1981	5,788,534	1,043	8,279,942	0
1982	6,150,499	1,263,829	8,755,388	0
1983	7,168,291	0	7,555,297	
1984	7,208,981	634,381	9,939,899	
1985	3,820,557	519,662	5,529,441	
1986	7,464,009	505,881	10,474,658	
1987	7,936,219		12,050,626	
1988	8,311,434		11,968,216	
1989	8,439,553		12,200,600	
1990	8,651,763		12,248,786	
1991	9,336,880		12,357,645	
1992	10,306,800		13,637,820	
1993	10,713,420		13,711,352	
1994	11,507,295	1,224,007	15,131,273	
1995	10,470,386	2,462,276	18,731,951	
1996	11,293,407	2,460,858	20,644,557	
1997	11,696,476	2,481,959	21,539,468	
1998	13,852,469	2,729,486	40,910,813	
1999	14,924,647	3,133,000	37,354,523	
2000	16,168,629	3,435,482	39,121,239	
2001	16,321,023	3,709,563	39,195,363	
2002	17,715,111	3,951,539	38,153,517	
2003	16,672,305	4,290,328	37,896,262	
2004	15,461,562	4,430,146	36,572,938	

[1] After 1986, the financial reports did not designate the source of the regular employer contribution to MTRFA. The state contribution column contains the regular employer contributions since it was paid in whole or in substantial part from state education aid.

Attachment D

<u>Background Information on the Investment Performance of the Minneapolis Teachers Retirement Fund Association (MTRFA)</u>

In Minnesota, statewide retirement plan assets are invested by the State Board of Investment and local retirement plan assets are invested by the governing board of the retirement plan.

The investment performance of the local retirement plans has historically lagged the investment performance of the State Board of Investment, even when the State Board of Investment has had average or below average investment performance. The Minneapolis Teachers Retirement Fund Association (MTRFA) has under-performed the State Board of Investment over the last decade or decade-and-a-half by between one percent and 1.5 percent. The following sets forth the year-by-year time weighted rate of return results for the State Board of Investment and for the major local retirement plans, based on reports filed with the Legislative Commission on Pensions and Retirement (before 2001) or with the Office of the State Auditor (after 2000):

Various Minnesota Public Pension Funds:
Annual Total Portfolio Time-Weighted Rates of Return

Year	SBI Combined Fund	SBI Basic Fund	SBI Post Fund	MTRFA	DTRFA	SPTRFA	MERF
1990		-0.7%	5.0%	-2.5%	3.2%	4.6%	-5.9%
1991		26.3%	19.6%	25.0%	22.0%	19.8%	13.3%
1992		6.8%	8.0%	8.2%	6.5%	7.2%	8.8%
1993		12.2%	11.6%	12.3%	12.8%	11.3%	13.7%
1994	-0.4%			0.1%	0.2%	0.3%	1.2%
1995	25.5%			25.0%	25.5%	26.2%	23.4%
1996	15.3%			13.6%	13.4%	12.6%	12.9%
1997	21.5%			15.5%	15.5%	19.6%	18.5%
1998	16.1%			14.2%	11.1%	12.0%	15.7%
1999	16.5%			21.6%	29.4%	13.6%	15.5%
2000	-2.8%			-6.0%	-1.6%	-0.2%	-1.3%
2001	-6.0%			-7.7%	-4.3%	-1.7%	-6.1%
2002	-11.6%			-16.1%	-12.8%	-9.6%	-11.3%
2003	23.1%			22.8%	28.1%	27.0%	25.2%
2004*	3.9%*			1.8%*		4.2%*	3.4%*

** The 2004 investment returns are partial year returns, through September 30, 2004.*

From 1995 to 2003, the State Board of Investment had higher returns than MTRFA in each year except for 1999. When the investment markets ran into a troubled period from calendar year 2000 through 2002, MTRFA had strongly negative returns, lower in each of those years than any other fund compared in the table.

The average annual investment returns for the period 1990-2003 can be compared, as follows:

Various Minnesota Public Pension Funds:

Annualized (Average) Total Portfolio Returns

Period	SBI*	MTRFA	DTRFA	SPTRFA	MERF
1990-2001	10.3%	9.4%	10.7%	10.1%	8.7%
1990-9/30/03	8.9%	7.7%	n/a	n/a	n/a

** SBI Combined Fund after 12/31/93, and SBI Basic Fund prior to that date.*

If the MTRFA had replicated the investment returns of the State Board of Investment during the period 1990-2003, MTRFA assets would have been more than $100 million greater than the actual 2003 MTRFA asset figure.