TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director

RE: S.F. xxx; H.F. 853 (Kelliher): MERF; Director Salary, Fund Investment, and Transfer Liquidity Flexibility

DATE: February 16, 2005

General Summary of S.F. xxx; H.F. 853 (Kelliher)

S.F. xxx; H.F. 853 (Kelliher) amends portions of Minnesota Statutes, Chapters 43A and 422A, the political subdivision compensation limit and various provisions governing the Minneapolis Employees Retirement Fund (MERF), by making the following changes:

1. Exempts MERF Executive Director From Compensation Limits. The salary of the MERF Executive Director would be exempt from the compensation limit applicable to political subdivision employees other than school districts (Section 1);

2. MERF Authority to Invest with the State Board of Investment. The MERF Board is permitted to invest some or all of the fund's assets with the State Board of Investment through either the Minnesota Supplemental Investment Fund, a mutual fund-like family of investment accounts, or the Minnesota Combined Investment Funds, an investment pool made up of the active member assets of the various statewide retirement plans (Section 2);

3. MERF Internal Transfer Liquidity Flexibility. The transfer of assets between the MERF active member investment account (the MERF Deposit Accumulation Fund) and the MERF retired member investment account (the MERF Retirement Benefit Fund), if the Deposit Accumulation Fund has insufficient assets to make the transfer upon the retirement of an active member, can be made with an internal interest-bearing promissory obligation. The obligation would bear interest at the rate of five percent, plus the percentage increase in the Consumer Price Index over the period, and the interest and the principal of the obligation would be payable first from any balance in the Deposit Accumulation Fund (Sections 3, 4, and 6); and

4. Correction/Provision Update. An incorrect reference to the maximum MERF State aid amount and an incorrect reference to the actuary retained by the Legislative Commission on Pensions and Retirement are corrected (Section 5).

Background Information on the Minneapolis Employees Retirement Fund (MERF)

Background information on the creation, plan design, benefits, and administration of the Minneapolis Employees Retirement Fund (MERF) is attached, as Attachment A.

Background Information on Minnesota Retirement Plan Investment Authority

Background information on the investment authority of the Minneapolis Employees Retirement Fund (MERF) as compared to the State Board of Investment and other major local retirement plans is presented in Attachment B.

Background Information on the MERF Post-Retirement Adjustment Mechanism

Background information comparing the operation of the Retirement Benefit Fund of the Minneapolis Employees Retirement Fund (MERF) with the Minnesota Post Retirement Investment Fund operated by the State Board of Investment is contained in Attachment C.

Background Information on State Aid to MERF

Attachment D sets forth background information on the State aid payable to the Minneapolis Employees Retirement Fund (MERF).

Background Information on Retirement Plan Administrations and Administrative Salary Maximums

Background information comparing the administrative staffs of the Minneapolis Employees Retirement Fund (MERF) and the other statewide and major local retirement plans and the applicable compensation maximums for retirement administrators is attached, as Attachment E.

Discussion and Analysis

S.F. xxx; H.F. 853 (Kelliher) is a package of changes applicable to the Minneapolis Employees Retirement Fund (MERF), eliminating the MERF Executive Director from a limitation on public employee compensation, authorizing the MERF Board to invest the assets of the retirement plan in the Minnesota Supplemental Investment Fund or in the Minnesota Combined Investment Funds, both operated by the State Board of Investment, allowing the transfer of the equivalent of internal promissory notes from the MERF Deposit Accumulation Fund to the MERF Retirement Benefit Fund, and eliminating a special additional city contribution to MERF to meet the liquidity needs of Retirement Benefit Fund transfers, thereby reducing the need for the City of Minneapolis to bond for these transfers.

S.F. xxx; H.F. 853 (Kelliher) raises several pension and related policy issues for potential Commission consideration and discussion, as follows:

1. Appropriateness of Removing the MERF Executive Director's Salary from the Local Government Compensation Cap. The policy issue is the appropriateness of permitting the MERF Board to set the salary of the MERF Executive Director in excess of the compensation maximum in Minnesota Statutes, Section 43A.17, Subdivision 9. Minnesota Statutes, Section 15A.0815, Subdivision 3, places a maximum on the salaries of the executive directors of the Minnesota State Retirement System (MSRS), the Public Employees Retirement Association (PERA), and the Teachers Retirement Fund Association (TRA). Minnesota Statutes, Section 43A.17, Subdivision 9, places a maximum on the salary of the MERF Executive Director, and Minnesota Statutes, Section 423C.03, Subdivision 3, places a maximum on the salary of the Executive Secretary of the Minneapolis Fire Relief Association (MFRA). There is no statutory maximum on the salaries payable to the executive directors of the Duluth Teachers Retirement Fund Association (DTRFA), the Minneapolis Teachers Retirement Fund Association (MTRFA), or the St. Paul Teachers Retirement Fund Association (SPTRFA), the chief administrative officer of the Minneapolis Police Relief Association (MPRA), the secretaries of the Bloomington Fire Department Relief Association, the Fairmont Police Relief Association, or the Virginia Fire Department Relief Association, or the secretaries of the 700+ volunteer firefighter relief associations. The compensation maximum currently coded as Minnesota Statutes, Section 43A.17, Subdivision 9, was first enacted in 1977 (Laws 1977, Chapter 35, Section 3), but lacked any specific reference to the MERF Executive Director, was repealed between 1980 and 1983 (Laws 1980, Chapter 614, Section 191), and was reenacted in 1983 (Laws 1983, Chapter 299, Section 14), with the explicit reference to the MERF Executive Director. The compensation maximum reference to the MERF Executive Director occurred during the period when the late and controversial John C. Chenoweth was the MERF Executive Director. If the compensation maximum reference to the MERF Executive Director was related to concerns about or controversies connected with Mr. Chenoweth, the reference may now be argued to be unnecessary. If the MERF Executive Director's duties more closely reflect the duties of the first class city teacher plans and there is reason to believe that those salaries are both market driven and appropriately reflective of qualifications, experience, and duties, the elimination of the maximum may be argued to be appropriate. However, MERF is phasing out, unlike the first class city teacher plans, and MERF does not actively manage its assets in-house, unlike the first class city teacher plans, which makes the comparison between MERF and those plans either blurred or inapplicable. If MERF intends to shift all or a sizable portion of its assets to the State Board of Investment under section 2, the arguments for removing the compensation cap based on investment duties may be less compelling. Because MERF is an instrumentality of the City of Minneapolis and Special School District No. 1, rather than a nonprofit corporation, which is the situation of the first class city teacher plans, MERF may still be a political subdivision or an agency of a political subdivision and the language of section 1 may not be sufficient to eliminate the maximum for MERF. Amendment LCPR05-058 adds clearer exception language if it is the Commission's intent to exclude MERF. A collateral issue with any resulting compensation increase is the effect that the compensation increase will have on the special 2001 prior service credit purchase made by the current MERF Executive Director. Although the purchase under First Special Session Laws 2001, Chapter 10, Article 17, Section 7, was made under a "full actuarial value" payment method, any sizable later career salary increases will produce an additional gain to the purchaser. If the combination of the compensation maximum exception and the 2001 special service credit purchase and the purchase's imposition of additional unpaid liabilities onto the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General)

troubles Commission members, Amendment LCPR05-059 requires an additional "full actuarial value" service credit purchase payment by the MERF Executive Director or limits the future salary history for use in calculating the MERF Executive Director's retirement annuity to the five percent PERA-General salary actuarial assumption.

2. Appropriateness of a Continued Separate Plan Administration for MERF. The policy issue is the appropriateness of retaining a separate plan administration for the Minneapolis Employees Retirement Fund (MERF). The MERF benefit plan has been closed to new members since 1979 (1977 in actuality, since the MERF Coordinated Program created for all new entrants in 1977 was consolidated into the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General) in 1979), MERF has only 552 active members (down from 836 in 2002 and 705 in 2003), has shifted from actively managing its investment portfolio to solely employing outside investment managers to handle its portfolio, MERF is considering placing all or most of its assets with the State Board of Investment, and MERF has a considerably larger administrative expense per plan member than PERA-General ($125.65 per member for MERF compared to $38.92 per member for PERA-General in Fiscal Year 2004). At some point, arguably, a pension plan becomes too small in size, has shifted sufficient functions to outside contractors, and is too expensive in administrative costs to justify a continuation as a separate plan administration. If MERF has reached that point in the opinion of the Commission, there are at least three options that could be considered for reorganizing the MERF administration. These options are:

    a. Administration by PERA. The MERF Board either could be authorized to contract with PERA for the provision of plan administrative services for MERF or PERA could be mandated to administer MERF. Amendment LCPR05-060 authorizes the MERF Board to contract with the PERA Board for plan administrative services. Amendment LCPR05-061 mandates that PERA administer MERF.

    b. Combine Minneapolis Pension Plan Administrations. The plan administrations of some or all of Minneapolis' pension plans could be combined into a single plan administration. Amendment LCPR05-062 would require that the MERF plan administration provide administrative services for the Minneapolis Fire Relief Association (MFRA) and the Minneapolis Police Relief Association (MPRA). Amendment LCPR05-063 would require the plan administration of MERF and the Minneapolis Teachers Retirement Fund Association (MTRFA) be combined and reorganized, under the direction of the City Finance Director, and provide administrative services to the two plans.

    c. Convert MERF to a Trust Fund Administered by the City. MERF could be converted to a trust fund to be administered by the City of Minneapolis, akin to the situation of the former Eveleth Police Relief Association, the former Eveleth Fire Department Relief Association, and the former Thief River Falls Police Relief Association. Amendment LCPR05-064 converts MERF to a trust fund of the City of Minneapolis to be administered by the City Finance Director.

3. Appropriateness of Authorizing MERF to Invest with the State Board of Investment. The policy issue is the appropriateness of permitting MERF to utilize the services of the State Board of Investment for the investment of some or all of the assets of the plan, either by purchasing shares in one or more accounts of the Minnesota Supplemental Investment Fund, a family of investment accounts similar to a mutual fund family operated by the State Board of Investment, or in fixed income pools or in a separately managed account in the Minnesota Combined Investment Funds, the current investment vehicle operated by the State Board of Investment for the active member funds of the various statewide retirement plans. The five remaining local police or paid fire relief associations (Bloomington Fire, Fairmont Police, Minneapolis Fire, Minneapolis Police, and Virginia Fire) and the 700+ volunteer firefighter relief associations have had authority to utilize the Minnesota Supplemental Investment Fund under Minnesota Statutes, Section 69.77 (enacted in 1969) or 69.775 (enacted in 1971). The various local public safety plans have varied considerably in the extent to which they have utilized the Minnesota Supplemental Investment Fund. Authority to utilize the services of the State Board of Investment has not been extended previously to the three first class city teacher retirement fund associations or to MERF. The MERF proposal for the authority to use the Minnesota Combined Investment Funds is without current precedent in any other local Minnesota public pension plan. The proposal also grants MERF discretion to allocate assets to the Minnesota Combined Investment Funds while also granting the State Board of Investment discretion as to whether to place MERF assets in fixed income pools or separately managed accounts. The Commission should consider taking testimony from MERF and from the State Board of Investment about how they envision this joint discretion will operate in practice.

4. Appropriateness of According MERF Full Discretion on the Amount of Its Assets Allocated to the State Board of Investment. The policy issue is the appropriateness of letting the MERF Board determine the amount of its assets to be invested with the State Board of Investment. Under the authority, the MERF Board could increase or reduce the amount of its assets invested by the State Board of Investment month to month or year to year as it saw fit. The policy principles pursued by this degree of latitude in the amount of asset discretion would be continuing a commitment to local pension plan autonomy and placing the State Board of Investment into a competitive position with other potential investment managers.

5. Appropriateness of Mandating the Investment of MERF Assets by the State Board of Investment. The policy issue is the appropriateness of continuing the investment autonomy of the MERF Board or of mandating the investment of MERF assets by the State Board of Investment. Until 1969, MERF was responsible for investing all of its assets, and when the predecessor to the Minnesota Post Retirement Investment Fund was established in 1969, MERF retired member assets were invested by the State Board of Investment until 1982, when MERF regained investment authority for the entirety of its assets. If the MERF Retirement Benefit Fund had not been created in 1981 to replace the Minnesota Post Retirement Investment Fund, all MERF assets would be currently invested by the State Board of Investment, since essentially all of the MERF assets are retired member reserves. As Appendix B indicates, over the long term, MERF investment performance has not been more advantageous than the State Board of Investment (i.e. lower returns in nine out of the past 15 years), potentially arguing for a change in MERF's investment authority. Amendment LCPR05-065 would transfer the investment authority with respect to all MERF assets to the State Board of Investment, effective on July 1, 2005.

6. Appropriateness of Permitting Transfers of Internal IOU's Instead of Cash to the MERF Retirement Benefit Fund. The policy issue is the appropriateness of replacing the obligation for the Minneapolis Employees Retirement Fund (MERF) to transfer cash or assets from the Deposit Accumulation Fund to the Retirement Benefit Fund with authority for an interest-bearing internal transfer payable. As indicated in Appendix C, the MERF Retirement Benefit Fund was established to replace and to parallel the Minnesota Post Retirement Investment Fund, which requires the transfer of the full actuarial required reserves for a retirement annuity upon the retirement of an active member from the active member investment account to the retired member investment account. Currently, the MERF Deposit Accumulation Fund likely has a nominal amount of assets that will not support many full required reserve transfers and the City of Minneapolis has had large and increasing additional contributions required under Minnesota Statutes, Section 422A.101, Subdivision 4, to maintain solvency in both funds, necessitating the City of Minneapolis to issue bonds to fund the liquidity transfers. The proposed addition of internal IOU transfer authority would alleviate the need for the current practice of bonding for liquidity transfers, but as the remaining 552 active members, with 179 able to retire immediately, actually retire with an individual required reserve transfer amount that averages almost $350,000, there is considerable potential that the internal IOU's could represent a large percentage of the Retirement Benefit Fund assets. The Minnesota Post Retirement Investment Fund and the MERF Retirement Benefit Fund have been portrayed to annuitants as beneficial because the full funding of the retired member investment account provides the security of tangible assets to them. Internal IOU's meet an accounting and a financing difficulty, but do nothing to maintain this sense of full funding security, replacing tangible assets with a promise of future city funding that is still based on actuarial assumptions and using an amortization period (i.e. until 2020) that was chosen by MERF to moderate the fiscal impact of resolving the investment losses inherited from the John Chenoweth era in 1991, but did not reflect the actual investment markets, historic salary increase practices, or the remaining working lifetime of MERF active members.

7. Appropriateness of the Internal IOU Interest Charge Calculation Procedure. The policy issue is the appropriateness of the formula proposed for calculating the interest on the internal transfer payable amounts credited to the MERF Retirement Benefit Fund. The internal IOU's are required to be credited with interest at a rate that is unrelated to the actual investment return of the plan, which could affect future investment performance component post-requirement adjustments. The interest rate to be credited on the internal IOU's is five percent plus the percentage increase in the Consumer Price Index during the fiscal year, without a maximum. While the credited interest rate would cover the potential minimum post-retirement adjustments (i.e. the five percent baseline post-retirement interest rate actuarial assumption plus up to a 3.5 percent increase in the Consumer Price Index), the rate does not cover lost investment returns during bull market periods (i.e. investment returns in excess of 8.5 percent) and will overstate actual investment returns during bear markets if there is

moderate or high inflation. Inflation and investment returns are not well correlated[1], so when the interest crediting procedure would produce a high rate (five percent + a high CPI increase percentage), actual MERF Retirement Benefit Fund performance is unlikely to also be high, meaning that the proposed interest crediting procedure will work to actually produce a higher investment performance component adjustment that is unreflective of what the situation would have been without internal IOU's. Similarly, in periods of nominal inflation and high investment returns, the internal IOU's authority will work to depress investment performance component adjustments.

8. Appropriateness of Creating a Priority for Redeeming Internal Transfer IOU's Interest Over Principal. The policy issue is the appropriateness of the proposed manner in which any future internal transfer IOU's and their interest charges will be redeemed when the MERF Deposit Accumulation Fund receives additional revenue. The proposed legislation would redeem the interest on the internal transfer IOU's first, before redeeming the principal. Given the large differential between the actuarial funding required under Minnesota Statutes, Section 422A.101, Subdivision 1, and the liquidity funding required under Minnesota Statutes, Section 422A.101, Subdivision 4, internal transfer IOU's are likely to be considerable and payment of the contrived interest charge on the IOU's instead of the principal of the IOU's could artificially increase future MERF unfunded actuarial accrued liability that drives the amount of the State contribution to MERF. MERF officials or Minneapolis city officials should be requested to disclose any projections that they have prepared that would shed some light on the magnitude of the anticipated internal transfer IOU's, IOU's interest charges, city contributions, and State support of MERF.

9. Appropriateness of the Internal IOU Impact on Future State Aid to MERF. The policy issue is the appropriateness of the impact on future State aid payments to the Minneapolis Employees Retirement Fund (MERF) under Minnesota Statutes, Section 422A.101, Subdivision 3, of the proposed internal IOU transfers between the MERF Deposit Accumulation Fund (Active Account) and the MERF Retirement Benefit Fund (Retired Account). The State currently provides $6.6 million annually to MERF, based on the actuarially determined financial requirements of the plan, based on the 2020 amortization date, and reduced by the member and regular employer contributions. With the current additional employer contribution to MERF under Minnesota Statutes, Section 442A.101, Subdivision 4, requiring additional funding to allow for the transfer of required reserves from the Deposit Accumulation Fund to the Retirement Benefit Fund when a MERF active member retires, necessitating the City of Minneapolis to issue municipal bonds to meet the obligation, MERF will be fully funded well in advance of 2020 and the State aid to MERF would end prior to 2020. The internal IOU transfer procedure would cause the State funding to maintain that 2020 termination date because the IOU transfers are internal, do not constitute actual assets of MERF, and do not increase its funding ratio over time. During the strong investment markets of the 1990s, MERF officials were communicating to the Legislature that the State aid to MERF would be heavily diminishing in the near term and would end in the early middle term. The investment decline beginning in 2000 has slowed or eliminated MERF's funding progress and has ended that optimism. With the proposed internal IOU transfer procedure, barring a return to the bull markets of the 1990s in the near future, the State can expect that the aid to MERF will continue to 2020. In approving the 1991 MERF revised amortization target date (Laws 1991, Chapter 345, Article 4), the State approved the potential continuation of State aid to MERF until 2020. The proposed internal IOU transfer procedure, thus, would not constitute the imposition of a new obligation for the State, but rather a foregoing of an uncertain potential early conclusion of the State aid program.

Drafting Clarifications

Amendment LCPR05-066 attempts to clarify the provisions of the proposed legislation without changing the intent of the proposed legislation.

[1] See Frederick Novomestky, "Geometric Brownian Motion Model for U.S. Stocks, Bonds and Inflation: Solution, Calibration and Simulation", 2001, p. 30.

Attachment A

Background Information on the Minneapolis Employees Retirement Fund (MERF)

The Minneapolis Employees Retirement Fund (MERF) was established in 1919 and is governed by Minnesota Statutes, Chapter 422A. MERF was closed to new entrants in 1979. The membership of MERF is largely composed of employees of the City of Minneapolis and Special School District No. 1. Police officers employed by the Metropolitan Airports Commission before June 30, 1979, are members of MERF and are entitled to receive retirement benefits under either the MERF benefit Plan or the law governing PERA-P&F. Metropolitan Airports Commission firefighters employed before June 30, 1979, are also covered by MERF.

MERF is a defined benefit pension plan and is not coordinated with the federal Social Security System. For most MERF members, the retirement annuity is calculated based on the member's final average (highest five successive years) salary and a two part (2.0 percent for each of the first ten years; 2.5 percent for each subsequent year) benefit accrual rate. The normal retirement age is age 60 or any age with 30 years of allowable service. Police officers and firefighters covered by MERF receive the retirement benefit payable under the PERA-P&F benefit plan if that benefit plan produces a larger benefit than the MERF retirement benefit. Post-retirement adjustments are provided through the Retirement Benefit fund, modeled on the pre-1997 Minnesota Post Retirement Investment Fund law. MERF also provides disability and survivorship benefits.

MERF’s two primary funds are the Deposit Accumulation Fund and the Retirement Benefit Fund. The Deposit Accumulation Fund, also called the Active Fund, accumulates and invests active member assets. At the time of retirement, the full reserves needed to pay the retirement benefits for the expected remaining lifetime of the new retiree transfer to the Retirement Benefits Fund. From the Retirement Benefit Fund, MERF pays the retirement benefits, and individuals receive increases composed of a partial inflation match and an investment-based increase. In addition to MERF's Active and Post Fund, MERF has two minor funds, a survivor benefits fund and a disability benefits fund. These are largely accounting constructs and the assets are merged with other MERF assets for investment purposes.

The State makes large annual contributions to MERF to help that fund retire its unfunded liabilities. The level of unfunded liabilities that currently exist in MERF is partially due to MERF’s very weak investment performance under John Chenoweth, a former State legislator who was MERF’s Executive Director for a period during the 1980s and very early 1990s, and the MERF Board at that time. MERF received several million dollars from an insurance policy as settlement of a fiduciary breach lawsuit, stemming from the activities of John Chenoweth and the Board. Losses, however, as measured by the difference between MERF assets and the assets that would have been generated for the fund under competent investment management was much higher than the recovery from the insurance policy. That opportunity loss, as measured by MERF staff during the early 1990s, ranged from $60 million to as high as $130 million, depending upon the exact time period under study. Some of that opportunity loss impacted MERF retirees in the form of lower post-retirement adjustments. The rest impacted the State and employing units through an increased need for State aid and employer contributions.

MERF is managed by a governing board of seven members, of which five are elected by the members of the Minneapolis Employees Retirement Fund Association, the mayor or the mayor’s designee, and a Minneapolis city council member selected by the council. In addition to maintaining records and determining benefit amounts, the MERF governing board is the investment authority for the assets of its various funds, although the MERF Board is required to use independent professional investment firms.

In fiscal year 2003, MERF received total contributions of slightly over $48.9 million (77.9 percent from the city, 13.6 percent from the State, and 8.5 percent from the employees), received net investment income of almost $19.7 million, paid total retirement benefits of almost $134.8 million, and paid administrative expenses of slightly more than $700,000 (53 percent for personnel, 28 percent for conferences and professional services, and 19 percent for communications, office rent, and other expenses).

Attachment B

Background Information on Minnesota Retirement Plan Investment Authority

The investment authority for Minnesota's various retirement plans and funds is vested either in the State Board of Investment or in the governing board of the particular retirement plan.

The Minnesota State Board of Investment is the State agency responsible for administering and directing the investment of all State funds and of the pension assets of the statewide public pension systems. As of September 30, 2004, the State Board of Investment is responsible for assets in excess of $45.5 billion and is one of the largest institutional investors in the United States. About $40.5 billion are retirement funds for Minnesota State employees, teachers, and public employees. Approximately $580 million is a permanent trust established for the benefit of Minnesota public schools. Approximately $273 million is a workers compensation assigned risk pool. Approximately $343 million is a trust established for the benefit of Minnesota's environment. Numerous State cash accounts total $3.8 billion.

The governing boards of the Minneapolis Employees Retirement Fund (MERF), Fairmont Police Relief Association, the Minneapolis Firefighters Relief Association, the Minneapolis Police Relief Association, the Virginia Fire Department Relief Association, the Duluth Teachers Retirement Fund Association (DTRFA), the Minneapolis Teachers Retirement Fund Association (MTRFA), the St. Paul Teachers Retirement Fund Association (SPTRFA), the Bloomington Fire Department Relief Association, and the 700+ local volunteer firefighter relief associations are the investment authorities for the retirement plans and funds not invested by the Minnesota State Board of Investment. These independent investment operations are responsible for assets of $4.3 billion, generally as of June 30, 2004, as follows:

Plan	Assets (in millions)
Minneapolis Employees Retirement Fund	$1,485.3
St. Paul Teachers Retirement Fund Association	$871.9
Minneapolis Teachers Retirement Fund Association	$763.1
Minneapolis Police Relief Association	$300.2
700+ volunteer firefighter relief associations	$265.7
Duluth Teachers Retirement Fund Association	$258.8
Minneapolis Firefighters Relief Association	$237.0
Bloomington Fire Department Relief Association	$92.2
Fairmont Police Relief Association	$6.4
Virginia Fire Department Relief Association	$2.5
Total	$4,283.1 million

The investment of public employee pension fund assets is regulated by statute, principally either Minnesota Statutes, Sections 11A.09 and 11A.24, or Sections 356A.04 and 356A.06, Subdivision 6 or 7. The statutory regulation contains two parts, a general prudent person standard of care in performing investment duties and a list of authorized investment securities. Thus, Minnesota public pension plan investments must be both prudent (done in good faith, with the exercise of that degree of judgment and care, under circumstances then prevailing, that persons of prudence, discretion, and intelligence would exercise in the management of their own affairs, not for speculation, considering the probable safety of the plan capital as well as the probable investment return to be derived from the assets) and in an approved type, with several individual requirements applicable to each variety of approved security. Some additional statutes broaden the approved list (referred to frequently as a "legal list") for a number of the local Minnesota public pension plans.

Over the past 35 years, the investment authority for most public pension plan assets has grown less restrictive both with respect to type and relative quality.

In a pension plan that is funded on a full actuarial basis (annual contributions essentially equal the actuarial requirements,) investment income at the investment performance actuarial assumption rate will provide two-thirds to three-fourths of the total revenue to be received by the pension plan. Investment income that exceeds the investment performance actuarial assumption rate will provide a further funding cushion, offsetting the need for some future amount of member contributions, employer contributions, or both.

Appropriate public pension fund investment management would include a clear understanding by the investment policy making board or entity of the applicable investment authority, the formulation by the investment policy making board or entity of an investment policy statement with sufficient specificity to be meaningful, a clear communication of that investment authority and that investment policy statement to any investment advisors, managers, brokers, operatives or agents, the acquisition and analysis of investment performance information calculated on a total time weighted rate of return basis, the maintenance of sufficient diversification of investment types, and the maintenance of sufficient liquidity.

Although Minnesota public pension plans have been investing their assets virtually from their inception as plans, investment performance reporting from the plans has only been required by State law since 1990 (see Laws 1990, Chapter 570, Article 2, Section 1). The 1990 law originated with the Legislative Commission on Pensions and Retirement. The 1990 law, coded as Minnesota Statutes 1990, Section 356.218, has been replaced by Minnesota Statutes, Section 356.219 (source: Laws 1994, Chapter 565, Article 2, Section 1). The 1990 investment reporting law was administered by the Commission staff, while the 1994 replacement investment reporting law is administered by the Office of the State Auditor. The 1990 and 1994 public pension plan investment reporting laws both require the reporting of time-weighted total rate of return investment performance numbers. A time-weighted rate of return measures the return earned on assets invested for the entire period. The time-weighted rate of return calculation method weights an account's cash flows by the amount of time each has been invested. A cash flow is an external capital addition or withdrawal of cash and/or securities that is investor-initiated, with dividend and interest income not considered cash flows. By filtering out the effects on return caused by a board's decisions to give additional assets to a manager during a period under study, or a board's decision to withdraw assets from a manager to cover benefit checks or other operating expenses, the time-weighted rate of return procedure removes the impact of events over which the investment manager has no control. A time-weighted rate of return is a different measure from a dollar-weighted rate of return. The dollar-weighted return, also known as internal rate of return, takes an investment's performance into consideration, but also uses the timing and size of an investment in its calculation. This method does not provide the ability to distinguish between a plan's performance and the effect of market timing on the rate of return. Return calculated under the dollar-weighted method might have more to do with when and how much was invested than where monies were invested. Since actuarial work does not focus on the relative value produced by investment managers in a competitive context, investment performance results for actuarial purposes and presented in actuarial valuations will be dollar-weighted rates of return. For comparisons among investment managers, among funds, or to compare fund or manager performance to returns offered by the market, time-weighted returns are the accepted industry standard. In investment manager presentations, the use of time-weighted rates of return rather than other forms of returns are required by Association of Investment Management and Research (AIMR) presentation standards and by the Securities and Exchange Commission (SEC).

The following tables set forth information on the portfolio mix, the time-weighted total rate of return numbers, and the comparative impact on funding for the State Board of Investment, the Minneapolis Employees Retirement Fund (MERF), the three first class city teacher retirement fund associations, the Minneapolis Firefighters Relief Association, the Minneapolis Police Relief Association, and the Bloomington Fire Department Relief Association:

Table 1

Asset Mix

Calendar Year-End 2003

			Stock		
	Cash	Bonds	Domestic	Foreign	Other
SBI Combined	1.0%	22.9%	50.6%	16.6% [1]	8.9%
MERF Combined	1.5%	27.9%	39.7%	25.5%	5.4%
DTRFA	1.5%	27.4%	56.5%	12.6%	2.0%
MTRFA	2.0%	25.0%	57.0%	15.0%	1.0%
SPTRFA	0.0%	27.0%	52.2%	20.6%	0.2%
Minneapolis Fire	1.0%	30.0%	69.0%	0.0%	0.0%
Minneapolis Police	2.0%	30.0%	54.5%	13.2%	0.3%
Bloomington Fire	5.2%	30.6%	64.2%	0.0%	0.0%

[1] *Identified by the State Board of Investment as International Stock.*

Table 2
Total Portfolio Returns
Calendar Years 1990 Through September 30, 2004
with Multiple Year Returns Ending December 31, 2003

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004[1]	Average (Annualized) Returns for Periods Ending 12/31/2003		
																3-Year	5-Year	10-Year
SBI Combined Fund	2.15%	22.93%	7.06%	11.90%	-0.4%	25.5%	15.3%	21.5%	16.1%	16.5%	-2.8%	-6.0%	-11.6%	23.1%	3.9%	0.76%	2.98%	8.94%
MERF Combined Fund	-5.90%	13.25%	8.75%	13.69%	1.2%	23.4%	12.9%	18.5%	15.7%	15.5%	-1.3%	-6.2%	-11.3%	25.2%	3.4%	1.37%	3.50%	8.66%
DTRFA	-3.20%	22.00%	6.50%	12.80%	0.2%	25.5%	13.4%	15.5%	11.1%	29.4%	-1.6%	-4.7%	-12.8%	28.1%	--	2.11%	6.27%	9.51%
MTRFA	-2.54%	24.99%	8.19%	12.29%	0.1%	25.0%	13.6%	15.5%	14.2%	21.5%	-6.0%	-7.7%	-16.2%	22.8%	1.8%	-1.70%	1.64%	7.36%
SPTRFA	4.57%	19.79%	7.20%	11.32%	0.3%	26.2%	12.6%	19.6%	12.0%	13.6%	-0.2%	-1.4%	-9.6%	27.0%	4.2%	4.22%	5.12%	9.39%
Minneapolis Fire	3.12%	27.45%	9.86%	10.47%	-1.8%	26.6%	14.0%	23.8%	21.9%	17.8%	-2.7%	-3.3%	-10.5%	19.6%	1.7%	1.16%	3.48%	9.76%
Minneapolis Police	2.06%	16.77%	6.82%	10.49%	-1.3%	20.6%	12.5%	12.7%	11.4%	11.1%	-2.0%	-4.1%	-10.1%	22.3%	1.8%	1.78%	2.80%	6.79%
Bloomington Fire	3.97%	17.75%	9.86%	12.79%	-9.1%	26.1%	12.5%	19.7%	13.8%	13.2%	-3.9%	-7.8%	-14.3%	19.9%	--	-1.79%	0.61%	6.11%
40% Bond/60% Stock	n/a	n/a	n/a	n/a	-1.3%	29.3%	14.1%	22.7%	17.5%	13.9%	-1.9%	-3.2%	-8.4%	20.6%	--	2.26%	3.62%	9.63%

[1]*The 2004 returns are partial year returns through September 30, 2004.*

Sources:
The 1994-1998 and 2001-2004 returns are as reported to the Commission staff by the pension fund administrators.
The 1998-2000 returns are as reported by the Office of the State Auditor.

Table 3
Gain or Loss Compared to SBI Combined Fund
Calendar Years 1994-2003

	10-Year Annualized Return 1994-2003	1994 Assets	Gain or Loss Relative to the SBI Combined Portfolio Given 1994 Assets
	%	$ millions	$ millions
SBI Combined Fund	8.94%	$18,852.0	--
MERF Combined Fund	8.66%	$967.5	-$57.9
DTRFA	9.51%	$135.5	$17.1
MTRFA	7.36%	$541.1	-$173.2
SPTRFA	9.39%	$410.6	$40.7
Minneapolis Fire	9.76%	$177.5	$32.5
Minneapolis Police	6.79%	$288.9	-$122.9
Bloomington Fire	6.11%	$58.8	-$32.0
Total:			-$295.7

Attachment C

Background Information on the MERF Post-Retirement Adjustment Mechanism

For the statewide and major local retirement plans, an automatic post-retirement adjustment mechanism has existed since 1969 (see Laws 1969, Chapter 485, Section 32) and post-retirement adjustments were first payable as of January 1, 1972.

The initial automatic post-retirement adjustment mechanism was the Minnesota Adjustable Fixed Benefit Fund, which was created to provide increases in the pensions of the subject retired persons to help meet increased costs of living. The adjustments under the Minnesota Adjustable Fixed Benefit Fund were funded from investment gains in excess of the post-retirement interest rate actuarial assumption on the fully funded reserves for the retirement annuities covered by the mechanism. Under the Minnesota Adjustable Fixed Benefit Fund, of the mechanism experiences investment losses, previous increases, if any, can be reduced, but the retirement annuity amount payable at retirement is guaranteed. Thus, the Minnesota Adjustable Fixed Benefit Fund was a variable annuity mechanism with a benefit floor. The Minneapolis Employees Retirement Fund (MERF) was a participant in the Minnesota Adjustable Fixed Benefit Fund in 1969, and MERF retirement annuity reserves made up 27.92 percent of the initial participation in the adjustment (the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General) accounted for 17.97 percent, the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General) accounted for 31.86 percent, and the Teachers Retirement Fund Association (TRA) accounted for 19.45 percent).

The Minnesota Adjustable Fixed Benefit Fund was substantially revised in 1980 (see Laws 1980, Chapter 607, Article XV, Section 16) and was renamed the Minnesota Post Retirement Investment Fund. The 1980 Minnesota Post Retirement Investment Fund retained the pooling of fully funded retirement annuity reserves and increases were based on investment performance in excess of the post-retirement interest rate actuarial assumption, but the investment performance was determined on a yield basis (i.e. dividends on equities, interest on debt equities, and realized gains on the sale of investments). In 1981 (Laws 1981, Chapter 298, Sections 5, 9, and 10), MERF was permitted to withdraw its participation from the Minnesota Post Retirement Investment Fund and created an identical internal post-retirement mechanism, the Retirement Benefit Fund.

MERF was obligated to operate the Retirement Benefit Fund in an identical manner as the Minnesota Post Retirement Investment Fund and, in 1992 (Laws 1992, Chapter 530, Sections 1 and 2), shifted the manner in which increases are calculated, effective for January 1, 1994, increases. The 1992 mechanism has two components, an inflation component and an investment performance-based component. Under the inflation component, the MERF Retirement Benefit Fund pays an inflation adjustment matching changes in the Consumer Price Index up to 3.5 percent. Under the investment performance-based component, the MERF Retirement Benefit Fund pays an increase from a form of five-year averaging of the total required reserves, calculated on a total return basis, above the five percent actuarial requirement and the additional actuarial reserves needed to cover the inflation component, allocated equally over five-year periods, and each year the positive or negative allocations to that year are expressed as a percentage of the total eligible required reserves and, if positive, are certified as an investment based-percentage increase in annuities.

In 1997, when the Consumer Price Index component of the Minnesota Post Retirement Investment Fund statewide post-retirement adjustment mechanism was reduced by one percent as part of the funding for an increase in the benefit accrual rates of the various statewide retirement plans (Laws 1997, Chapter 233, Article 1, Section 5), the MERF Retirement Benefit Fund was not similarly modified.

Under its participation in the Minnesota Adjustable Fixed Benefit Fund and the Minnesota Post Retirement Investment Fund through 1981 and through the MERF Retirement Benefit Fund after 1981, MERF has provided the following post-retirement adjustments, compared to other retirement plans:

		Percent Increase				
Effective Date	CPI*	MERF	MPRIF	MTRFA [1]	DTRFA [2]	SPTRFA [3]
	%	%	%	%	%	%
1/1/05	2.6	3.17372	2.500	2.00	2.00	2.00
1/1/04	2.2	2.10347	2.103	2.00	2.00	2.00
1/1/03	1.4	0.74456	0.7450	2.00	2.00	2.00
1/1/02	2.7	5.34299	4.4935	2.31	5.25	3.70
1/1/01	3.5	10.50999	9.5342	8.81	10.2391	7.6723
1/1/00	2.2	10.2275	11.1436	9.67	9.0275	9.2619

Effective Date	CPI*	MERF	MPRIF	MTRFA [1]	DTRFA [2]	SPTRFA [3]
1/1/99	1.3	8.0432	9.8254	7.33	7.0125	7.2145
1/1/98	2.3	6.6680	10.0876	7.28	6.3407	7.00
1/1/97	2.9	3.9500	8.0395	6.23	5.6315	--
1/1/96	2.9	3.5950	6.3954	3.85	4.6424	--
1/1/95	2.5	3.1440	3.9850	2.13	--	--
1/1/94	2.8	3.8240	6.0170	4.50	--	--
1/1/93	2.9	5.9840	4.5530	--	--	--
1/1/92	4.1	0.0000	4.2950	--	--	--
1/1/91	5.2	5.0790	5.1000	--	--	--
1/1/90	4.8	6.9180	4.0400	--	--	--
1/1/89	4.0	5.93591	6.9180	--	--	--
1/1/88	3.6	9.37158	8.0540	--	--	--
1/1/87	1.6	7.5890	9.7920	--	--	--
1/1/86	3.5	8.7160	7.9000	--	--	--
1/1/85	3.5	7.3370	6.9050	--	--	--
1/1/84	3.0	10.77	7.4990	--	--	--
1/1/83	6.0	9.17	6.8530	--	--	--
1/1/82	10.3	7.436	7.4360	--	--	--
1/1/81	13.4	3.209	3.2090	--	--	--
1/1/80	11.4	0	0	--	--	--
1/1/79	7.7	0	0	--	--	--
1/1/78	6.5	4.00	4.00	--	--	--

Note: These increases are permanent increases to retiree annuities.

[1] MTRFA first paid a post retirement adjustment under the new system on 1/1/94
[2] DTRFA first paid a post retirement adjustment under the new system on 1/1/96
[3] SPTRFA first paid a post retirement adjustment under the new system on 1/1/98

* Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) annual percent change (Dec. – Dec.)

Attachment D

Background Information on State Aid to MERF

Prior to 1979, the Minneapolis Employees Retirement Fund (MERF) was funded by its members and its participating employers, primarily the City of Minneapolis and Special School District No. 1, but also Hennepin County, the Metropolitan Airports Commission, the Metropolitan Council, and the Minnesota State Colleges and Universities System (MnSCU). In 1979 (Laws 1979, Chapter 303, Article 6, Section 10), MERF was closed to new members, the MERF-Coordinated Program was consolidated into the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General), and the need for achieving full funding for the plan at an earlier date rather than a later date became apparent.

The State contribution to the Minneapolis Employees Retirement Fund (MERF) also was established in 1979 (Laws 1979, Chapter 303, Article 6, Section 9). The requirement is contained in Minnesota Statutes, Section 422A.101, Subdivision 3. The addition of a State contribution to MERF accompanied a reduction in the local government aid payable to the City of Minneapolis and represented an attempt by the Legislature to freeze the amount of the Minneapolis city contribution to the plan. The State contribution provision was part of the 1979 tax bill. The State contribution to MERF is funded from the State General Fund. There are no qualification requirements for the City of Minneapolis and MERF to receive the annual State contribution.

The amount of the State contribution is a function of the annual actuarial valuation of MERF, prepared by the consulting actuary jointly retained by the statewide and major retirement administrators, and of the MERF financial requirements prepared by the MERF Board under Minnesota Statutes, Section 422A.101, Subdivision 1. The State contribution is currently capped at $9 million. The initial cap on the annual State contribution to MERF occurred in 1991 (Laws 1991, Chapter 345, Article 4, Section 10) and the initial State contribution maximum was set at $10,455,000. The cap on the annual State contribution to MERF was part of legislation sought by the retirement plan, following the death of its Executive Director, John Chenoweth, a former State legislator, and the hiring of James Hacking, the former Public Employees Retirement Association (PERA) Executive Director, as part of reforms to its investment program in the wake of the investment problems attributable to Mr. Chenoweth. The 1991 MERF-sponsored legislation, in addition to the State contribution maximum, included an additional employer contribution requirement if the State contribution maximum causes insufficient funding to meet the MERF financial requirements or to meet the MERF retired account transfers, a change in the MERF interest and salary actuarial assumptions (from five to six percent and from 3.5 percent to four percent respectively), a change in the MERF amortization date from 2017 to 2020, an increase in the MERF short service survivor benefit, the creation of a MERF bounceback joint and survivor optional annuity, the creation of a permanent pre-1974 MERF retiree post-retirement adjustment, a redefinition of MERF administrative expenses, the imposition of a limitation on parties to lawsuits relating to MERF, the authorization for awarding attorneys fees in MERF fiduciary litigation, and the requirement for Board approval for appointing MERF employees. The State contribution maximum was reset at $9 million, beginning with the 1999 fiscal year, under Laws 1997, Chapter 202, Article 2, Section 48.

Since 1980, the annual State General Fund contribution to MERF has been as follows:

Fiscal Year	State Contribution Amount	Percentage Increase/(Decrease) Over Prior Year
1980	$1,109,800	--
1981	$4,718,400	4.25%
1982	$3,889,000	(17.58)%
1983	$5,214,700	34.09%
1984	$6,607,000	26.67%
1985	$7,007,000	6.05%
1986	$7,650,000	9.18%
1987	$9,774,000	27.77%
1988	$10,892,000	11.44%
1989	$11,004,000	1.03%
1990	$11,782,000	7.07%
1991	$11,919,000	1.16%
1992	$10,455,000	(12.28)%
1993	$10,455,000	--
1994	$10,455,000	--
1995	$10,455,000	--
1996	$10,455,000	--
1997	$10,455,000	--
1998	$10,455,000	--
1999	$7,032,750	(32.74)%
2000	$3,085,000	(56.63)%
2001	$3,224,000	4.51%
2002	$3,232,000	0.25%
2003	$6,632,000	105.20%
2004	$7,093,000	6.95%

The State contribution to MERF becomes an asset of MERF and can be expended for any purpose for which any MERF asset can be expended.

Attachment E

Background Information on Retirement Plan Administrations and Administrative Salary Maximums

Minnesota has four local general employee retirement plans, three teacher retirement plans (the Duluth Teachers Retirement Fund Association (DTRFA), the Minneapolis Teachers Retirement Fund Association (MTRFA), and the St. Paul Teachers Retirement Fund Association (SPTRFA)) and one non-teacher retirement plan (the Minneapolis Employees Retirement Fund (MERF)). The three first class city teacher retirement fund associations were authorized in 1909 and were actually established in 1910. The Legislature created MERF in 1919.

The four local general employee retirement plans operate the plan, manage a retirement fund, and invest its assets. Each plan has a board of trustees and an administrative staff which assists in plan administration and investment management.

A comparison of the board composition and representation for the four local general employee retirement plans is as follows:

Plan	DTRFA	MTRFA	SPTRFA	MERF
Membership	9 Board members [Article V]	7 Board members [Articles, Art. 7, Sec. 7.2]	10 Board members [Articles, Art. V; By-laws Art. III, Sec. 1]	7 Board members [422A.02]
Active Member Representation	5 active members of the association elected by and from the active plan membership. [Article V]	6 members of the association elected by the MTRFA membership. [Articles, Art. 7, Section 7.2]	9 SPTRFA members elected by the SPTRFA membership. [Articles, Art. V; By-laws Art. III, Sec. 1]	Up to three legally qualified voters, selected by the active members who may form an association for that purpose. [422A.02]
Ex Officio Representation	One member of Independent School District No. 709 appointed by the school board chair and the Superintendent of Independent School District No. 709 or the designee of the superintendent. [Article V]	A member of the Special School District No. 1 board of education appointed by the school board chair. [Articles, Art. 7, Sec. 7.2]	Chair of Independent School District No. 625 (St. Paul) or another school board member appointed by the Independent School District No. 625 Board. [Articles, Art. V]	2 members, the Mayor or Mayor's designee, and City Council member, selected by the council. [422A.02]
Retiree Representation	2, elected by the retirees of the plan. [Article V]	No specific provision.	No specific provision.	At least 2 legally qualified voters, also selected by the Minneapolis Employees Retirement Association. [422A.02]
Other Appointed Representation	None	None	None	None
Other Elected Representation	None	None	None	None
Exclusions and Restrictions	Elected active member trustees must be contributing members of the association and cessation of that active membership automatically terminates Board membership, except that upon retirement, the trustee may continue Board service until the next annual Association meeting. The trustee representing the school board must be a member of the board of Independent School District No. 709 and cessation of service on	Board members are required to be members of the MTRFA. [Articles, Art. 7, Sec. 7.2]	No specific provision.	

Plan	DTRFA	MTRFA	SPTRFA	MERF
	the school board automatically terminates DTRFA Board membership. A trustee representing the active membership who takes a leave of absence from Independent School District No. 709 employment for more than 60 days for any reason will have the person's position on the Board declared vacant. [Article V]			

A comparison of the administrative staff complement and function of the four general employee local retirement plans is as follows:

	DTRFA	MTRFA	SPTRFA	MERF
Administration	Executive Director	Executive Director	Executive Director	Executive Director/ Chief Investment Officer
Staff Classifications	Retirement Technician Retirement Technician/ Accountant Retirement Technician/ Secretary Information Officer	Chief Financial Officer Investment Assistant Benefits Assistant Benefits Administrator Benefits Administrator Receptionist Benefits Clerk	Assistant Director Benefits & Technology Specialist Retired Member Clerk Active Member Clerk Information Clerk	Benefits Manager Accounting Manager Benefits Coordinator Accountant
Staff Complement	4.5	7	6	4
Total Membership/Staff Ratio	776.2 : 1	1,886.1 : 1	1,567.2 : 1	1, 463.5 : 1
Total 2003 Salaries	$245,855	$446,336	Undisclosed	$269,053
Average 2003 Staff Salary	$49,171	$55,792	Undisclosed	$53,811
Executive Director 2003 Salary	$106,000	$135,200	$96,249	$114,288