LCPR10-003

Executive Summary of Commission Staff Materials

Affected Pension Plan(s): MnSCU
Relevant Provisions of Law: Minnesota Statutes, Sections 354B.25, 354C.14, 354C.15
General Nature of Proposal: MnSCU Administrative Provisions
Date of Summary: November 10, 2009

Specific Proposed Changes

- Provides authority for MnSCU to contract out for investment selection and review services for the Individual Retirement Account Plan (IRAP) with providers other than the State Board of Investment (SBI).
- Permit institutions other than SBI to provide selection and review of investment vehicles for the Higher Education Supplemental Plan.
- Repeals Minnesota Statutes, Section 354C.15, a provision authorizing the MnSCU Board to redeem SBI Supplemental Investment Fund shares held by plan members who want to redirect their assets to other investments.

Policy Issues Raised by the Proposed Legislation

1. Implications of investment provider other than SBI; incentives for new provider.
2. Position of SBI and MnSCU unions.
3. Implications of the repealer.

Potential Amendments

LCPR10-003-1A removes the repealer of Minnesota Statutes, Section 354C.15, and revises that section of statute by removing reference to the State Board of Investment.

State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Edward Burek, Deputy Director EB

RE: LCPR10-003: MnSCU Administrative Provisions, Expanding Authority to Contract for Investment Selection and Review Services

DATE: October 20, 2009

Summary of Document LCPR10-003

LCPR10-003 revises various provisions in the Minnesota State Colleges and Universities System (MnSCU) Individual Retirement Account Plan (IRAP) chapter, Minnesota Statutes, Chapter 354B, and the Supplemental Plan chapter, Minnesota Statutes, Chapter 354C, to expand MnSCU authority to contract for investment selection and review services. All sections are effective upon final enactment.

Section-by Section Summary of LCPR10-003

Section 1. Minnesota Statutes, Section 354B.25, Subdivision 1, an IRAP plan administration provision, is revised by specifying that the MnSCU board may contract out for investment selection and review services. *(1.9-1.16)*

Section 2. Minnesota Statutes, Section 354B.25, Subdivision 3, a provision governing use of the State Board of Investment (SBI) to select investment products for IRAP, is revised by providing authority to contract out for investment selection and review services with other providers of those services. *(1.17-2.18)*

Section 3. Minnesota Statutes, Section 354C.14, a Higher Education Supplemental Plan investment authority provision, is revised to permit institutions other than SBI to provide selection and review of investment vehicles. *(2.19-2.30)*

Section 4. Repealer. Minnesota Statutes, Section 354C.15, a provision authorizing the MnSCU Board to redeem SBI Supplemental Investment Fund shares held by plan members who want to redirect their assets to other investments, is repealed. *(2.31-3.1)*

Background Information

The MnSCU IRAP and the Higher Education Supplemental Plan are defined contribution plans. A general discussion of defined benefit plans compared to defined contribution plans, and more information on the MnSCU IRAP and the Supplemental Plan appear in Appendix A.

Discussion and Analysis

The provisions in Document LCPR10-003 raise a number of pension policy issues, as follows:

1. General Intention. The most significant policy change contained in the bill is to permit providers other than the State Board of Investment to provide selection and review of investment products. Under current law, the MnSCU board must contract with SBI to provide a review of investment vehicles and to provide investment services. The MnSCU board seeks the authority to use parties other than SBI to provide those services. If the Commission is not comfortable with that change, it should take no action on this bill.

2. Implications of Provider Other Than SBI; New Provider's Incentives. The issue is who the new provider or providers of investment selection/review services will be, and the incentives that provider or provider will have. SBI is the current provider and SBI is not motivated by profit. Its actions presumably will be solely in the interest of MnSCU members. A new provider or providers may have the welfare of shareholders as its highest priority, and is very likely to have a higher cost structure than SBI. Added costs will be passed on to IRAP members, lowering the net return to the member. A new provider may also be more likely to recommend mutual funds or other investments with loads, which again serves to erode the plan member returns. Commission may wish to determine through testimony whether arrangements have already been made with a new provider or providers and the identity of that firm or firms. The Commission may also wish to determine how the selection was

made or will be made, and if the interests of the plan membership was or will be adequately represented in that process.

3. Position of SBI and MnSCU Unions. The issue is whether the State Board of Investment and the union or unions representing MnSCU employees covered by the Higher Education IRAP plan and the Higher Education Supplemental Plan are supportive of these changes. The Commission may wish to hear testimony from these groups.

4. Implications of the Repealer. The issue is whether the repeal causes harm. In Section 4, a provision authorizing the MnSCU Board to redeem SBI Supplemental Investment Fund shares held by plan members who want to redirect their assets to other investments, is repealed. Gary Janikowski, System Director of Personnel, MnSCU, has indicated that plan members no longer have any investments in the SBI Supplemental Fund. The Commission may wish to seek reassurance of that through testimony. If no plan members hold these investments, the repealer simply removes obsolete language. If not, then it may be better to retain that provision, along with an amendment to its language to revise current wording referring to SBI as the selector of investment institutions.

   Amendment LCPR10-003-1A removes the repealer, retaining Minnesota Statutes, Section 354C.15, and revises that section of statute by removing reference to the State Board of Investment.

Background Information on
Defined Contribution Plans and the
Higher Education Individual Retirement Account Plan (IRAP)

1. Difference Between Defined Contribution Retirement Plans and Defined Benefit Retirement Plans. There are two major factors in designing retirement plans and attempting to fix or make predeterminable one or the other factors constitutes the difference between defined contribution retirement plans and defined benefit retirement plans. When one factor is fixed or made predeterminable, the other factor is automatically made variable. The factors are the level of the benefits and the level of contributions.

   a. In a defined contribution retirement plan, the level of contributions or the amount of member and/or employer funding are specified or fixed in some manner, making the level of eventual benefits and/or their duration the variable factor. Most commonly, in a defined contribution plan, the funding of the plan is specified as a percentage of the covered payroll of plan members. Those contributions, allocated to individual accounts and frequently invested based on individual selection, along with any investment return obtained, constitute the benefit available to the plan member upon termination of employment or retirement. Most commonly, the individual account balance is payable in a lump sum upon the termination of plan coverage or is available to be transferred to an insurance company for the purchase of a retirement annuity. Some retirement plans that generally are classified as defined contribution plans permit the individual account balance amount to be converted into a retirement annuity within the retirement plan at a specified rate, although the assumption of that retirement annuity mortality risk actually defines the post-retirement benefit amount and subjects the retirement plan to potential future mortality and investment return experience losses and a chance for an unfunded actuarial accrued liability, akin to a defined benefit plan.

   b. In a defined benefit retirement plan, the level of benefits at the time of retirement or after retirement are specified or fixed in some manner, making the level of contributions or the amount of funding from period to period the variable factor. Most commonly, in a defined benefit plan, the retirement benefit is specified as a percentage of the final salary or of the final average salary per year of credited service rendered. Thus, the plan tracks and awards allowable service credit and salary credit and amasses a liability for the service and salary credit rendered to date that requires the periodic calculation and assessment by an actuary. The resulting actuarial valuation report both assesses the amount of actuarial accrued liability that the retirement plan has amassed to date and the amount of total contributions needed for the future plan year or plan years. Most commonly, in defined benefit plans, any lump sum amount is limited to a pre-retirement employment termination member contribution refund, with the regular retirement benefit only payable as a retirement annuity. Generally, a regular retirement annuity has optional equivalent value forms that open for election by the plan member. Retirement plans that are defined benefit plans can take on defined contribution retirement plan aspects, such as determining post-retirement adjustment amounts from the amount of investment gain in whole or in part generated by the plan.

2. Contrasting Development of Defined Contribution Plans Between the Private Sector and the Public Sector. In the private sector as a whole, defined contribution plans are very prevalent, while in the public sector as a whole, defined benefit plans predominate. However, many of those private sector defined contribution plans have been established and are maintained by sole proprietor businesses or similar small employers. Among industrial employers in the private sector and other large employers, defined benefit plans are more prevalent. Public sector pension plans, which are typically very large membership single employer or multiple employer pension plans, tend to follow the private sector industrial model in utilizing defined benefit pension plans. In the private sector, defined contribution plans, in the form of Internal Revenue Code Section 401(k) plans are relatively common and generally function as supplemental thrift or savings plans. In the public sector, supplemental defined contribution pension plans also occur frequently. Primary coverage private sector pension plans, either defined benefit plans or defined contribution plans, are most commonly funded by the employing unit, while primary coverage public sector pension plans are most commonly funded by a combination of member and employer contributions. Supplementary pension plans, both private sector and public sector, are almost always funded by member contributions and frequently include some employer funding.

3. Higher Education Individual Retirement Account Plan (IRAP). Public pension coverage for public university and public college faculty and upper level administrators frequently follow the private and nonprofit sector practice of utilizing defined contribution plan coverage, frequently through the use of the Teachers Insurance and Annuity Association-College Retirement Equity Fund (TIAA-CREF). The coverage generally either is exclusive defined contribution plan coverage or is the inclusion of defined contribution plan coverage as an elective alternative to the defined benefit plan coverage otherwise applicable to governmental employees at that level.

   The Minnesota State Colleges and Universities System (MnSCU) Individual Retirement Account Plan (IRAP) stems from the late 1980s, when state university and state college teachers and related employees sought coverage by a defined contribution plan rather than by TRA, which is a defined benefit program. That IRAP plan, currently coded as Minnesota Statutes, Chapter 354B, was established by the 1988 Legislature (Laws 1988, Chapter 709, Article 11), but was not implemented until mid-1989 due to problems in ensuring proper Social Security coverage. The plan was expanded to include technical college managerial employees in 1993 and technical college faculty in 1994. The Higher Education IRAP plan covers faculty members and upper-level administrators at MnSCU, but does not cover faculty or administrators at the University of Minnesota.

   The argument made by the initial proponents of a defined contribution plan for higher education faculty and administrators is that higher education faculty, as a group, are highly mobile. If an individual changes employment to another college in another state, the individual retains the full value of the IRAP account, and the account continues to grow in value over time due to the continuing investment earnings on the account. A defined benefit plan may be a better choice for higher education faculty members who are less mobile, by reason of personal choice or lack of opportunity, particularly as these individuals become long-term employees. A defined benefit plan may also be best for higher education faculty members who have considerable prior TRA or first class city teacher plan covered service. The MnSCU higher education faculty is also covered by the Higher Education Supplemental Retirement Plan (SRP), which is also a defined contribution plan. Higher education faculty and administrators are covered by the SRP whether the individual is a TRA member or an IRAP member. The SRP was created in 1968. At that time, TRA provided the primary coverage for higher education faculty and the SRP was created to address deficiency in the benefits provided by TRA. Those deficiencies in TRA benefits were addressed decades ago when TRA moved to use of the high five average salary to compute benefits, and benefits were further enhanced in more recent years. The problem that the SRP was intended to address has been eliminated. Given that elimination, the purpose for continuing the SRP currently is unclear.

   The Minnesota State University System and the Minnesota State Community College System shifted to defined contribution plan coverage as an option in the form of the Individual Retirement Account Plan (IRAP) in the late 1980s. Technical College faculty members were added to IRAP in the mid-1990s, when IRAP was also shifted from being the exclusive type of pension benefit coverage for new hires to an option as an alternative to defined benefit plan coverage by the statewide Teachers Retirement Association (TRA) or by one of the first class city teacher retirement fund associations. The creation of IRAP was as a result of active lobbying by the union representatives of State University and State Community College faculty members. Coverage by IRAP is the primary retirement vehicle for teaching personnel employed by the Minnesota State Colleges and Universities (MnSCU), which is the successor to the three prior higher education systems.

.... moves to amend LCPR10-003, as follows:

Page 2, delete lines 31 to 32 and insert:

"Sec. 4. Minnesota Statutes 2008, section 354C.15, is amended to read:

354C.15 REDEMPTION OF SUPPLEMENTAL INVESTMENT FUND SHARES.

(a) The Board of Trustees of the Minnesota State Colleges and Universities shall redeem all shares in the accounts of the Minnesota supplemental investment fund held on behalf of personnel covered by the supplemental retirement plan upon the election by the person of an investment option other than the supplemental investment fund, except as provided in paragraph (b).

(b) The redemption of shares in the fixed interest account attributable to a guaranteed investment contract as of July 1, 1994, may not occur until the expiration date of the applicable guaranteed investment contract.

(c) The Board of Trustees of the Minnesota State Colleges and Universities shall transfer the cash realized from a redemption of Minnesota supplemental investment fund shares to the financial institution or institutions selected ~~by the State Board of Investment~~ under section 354B.25, subdivision 3."

Amend the title accordingly

A bill for an act

relating to retirement; Minnesota State Colleges and Universities System and individual retirement account plan and higher education supplemental retirement account plan administrative revisions; expanding authority to contract for investment selection and review services; amending Minnesota Statutes 2008, sections 354B.25, subdivisions 1, 3; 354C.14; repealing Minnesota Statutes 2008, section 354C.15.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MINNESOTA:

Section 1. Minnesota Statutes 2008, section 354B.25, subdivision 1, is amended to read:

Subdivision 1. **General governance.** The individual retirement account plan is the administrative responsibility of the Board of Trustees of the Minnesota State Colleges and Universities. The Board of Trustees of the Minnesota State Colleges and Universities may administer the plan directly or may contract out for administrative services with a qualified third-party plan administrative entity and may contract out for investment review and selection service.

EFFECTIVE DATE. This section is effective the day following final enactment.

Sec. 2. Minnesota Statutes 2008, section 354B.25, subdivision 3, is amended to read:

Subd. 3. **Selection of financial institutions.** (a) The investment options provided under subdivision 2 must be selected by the board. The board may contract with the State Board of Investment or with a third party to provide the investment review and selection services.

In making its selection, at a minimum, the ~~State~~ board ~~of Investment~~ shall consider the following:

(1) the experience and ability of the financial institution to provide benefits and products that are suited to meet the needs of plan participants;

(2) the relationship of those benefits and products provided by the financial institution to their cost;

(3) the financial strength and stability of the financial institution; and

(4) the fees and expenses associated with the investment products in comparison to other products of similar risk and rates of return.

(b) After selecting a financial institution, the ~~State~~ board ~~of Investment~~ must periodically review each financial institution and the offered products. The periodic review must occur at least every three years. In making its review, the ~~State~~ board ~~of Investment~~ may retain appropriate consulting services to assist it in its periodic review, establish a budget for the cost of the periodic review process, and charge a proportional share of these costs to the reviewed financial institution.

(c) Contracts with financial institutions under this section must be executed by the board~~ and must be approved by the State Board of Investment before execution~~.

~~(d) The State Board of Investment shall also establish policies and procedures under section 11A.04, clause (2), to carry out the provisions of this subdivision.~~

EFFECTIVE DATE. This section is effective the day following final enactment.

Sec. 3. Minnesota Statutes 2008, section 354C.14, is amended to read:

354C.14 INVESTMENT OF DEDUCTIONS AND CONTRIBUTIONS.

(a) The Board of Trustees of the Minnesota State Colleges and Universities shall invest the deductions and contributions under section 354C.12, after deduction of administrative expenses under section 354C.12, subdivision 4, in annuity contracts or custodial accounts from financial institutions selected ~~by the State Board of Investment~~ under section 354B.25, subdivision 3.

(b) The retirement contributions and death benefits provided by annuity contracts or custodial accounts purchased by the Board of Trustees of the Minnesota State Colleges and Universities are owned by the supplemental retirement plan and must be paid in accordance with those annuity contracts or custodial account agreements.

EFFECTIVE DATE. This section is effective the day following final enactment.

Sec. 4. **REPEALER.**

Minnesota Statutes 2008, section 354C.15, is repealed.

EFFECTIVE DATE. This section is effective the day following final enactment.