Stakeholder Comments

On April 1, 2011, a draft of the Retirement Plan Design Study was released by the directors of the three statewide retirement systems to allow Legislators and stakeholders the opportunity to review the study and provide comments. Many of the comments have been incorporated into this study. Attached are copies of the written comments received by the three statewide retirement systems.

MINNESOTA
TAXPAYERS
ASSOCIATION

Mark Haveman
Executive Director

April 13, 2011

Mr. David Bergstrom
Executive Director
Minnesota State Retirement System

Ms. Mary Most Vanek
Executive Director
Public Employees Retirement Association

Ms. Laurie Fiori Hacking
Executive Director
Teachers Retirement Association

Dear Pension Plan Directors:

Following are our comments on the draft "Retirement Plan Design Study." We appreciate both your efforts to take on this challenging task and the opportunity to comment on the document and the important issues it addresses.

We feel obligated, however, to begin by pointing out our disappointment with how the release of the draft was managed. A "draft" should be embargoed recognizing that the document is subject to change based on stakeholder review, critique, and commentary. Indeed, you explicitly state that you are seeking feedback and comment. However the study findings have already been reported publicly, press releases have been issued, and public impressions and opinions on this important topic have been shaped by at least one high profile editorial referencing this draft. We hope all commentary and recommendations submitted to you in this review process will be given serious consideration.

MTA believes that government employees should have access to a high quality retirement plan that is competitive with what is offered by the private sector's largest employers. However, we also believe it is critical that public retirement systems meet two additional objectives: reduce taxpayer exposure and risk; and avoid substantive, harmful, and lasting impact to governments' operating budgets and their delivery of public services. Our comments below reflect the belief that these considerations are a legitimate and essential part of any effort to analyze the "feasibility, sustainability, financial impacts and other design considerations" per your statutory charge.

We also note that we remain agnostic to the specific design and structure of public retirement plans as long as these two objectives are addressed in a satisfactory manner.

Section 1 – Pension and Retirement Security

The discussion of the potential retirement crisis is a worthy inclusion in the report providing important context. However, we take significant issue with the discussion of income replacement ratios, senior standards of living, and the role of defined benefits in this calculus.

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The analysis on page 6 is based on the principle that households require 85% of their pre-retirement income to "maintain their pre-retirement standard of living." We disagree with the implied premise that the state's defined benefit plans should be designed to meet this objective. Taxpayers should not be expected to guarantee defined benefit retirement income at levels that provide seniors with the lifestyle they experienced during the highest-earning period of their working careers. If a defined benefit component guaranteed by taxpayers is to be part of a retirement plan, the benefit level should be designed to augment Social Security to eliminate longevity risk while providing adequate income for life basics and necessities. Retirees themselves should bear the responsibility to make the transition to retirement living as seamless and "opportunity filled" as they wish.

The above argument takes on even greater relevance when recognizing that many household spending obligations decline substantially in retirement; especially those related to pensions and Social Security, housing, and transportation. According to the BLS Consumer Expenditure Survey average annual expenditures for seniors 65 years and older average 28% less than expenditures for those aged 55-64 and 36% than the 45-54 age cohort. An 85% replacement income ratio may often result in higher disposable income levels than existed during peak earning years.

With respect to this section of the report draft, we recommend the following:

- A recognition and discussion of the argument above.
- Recognition that for a career Minnesota civil servant in a coordinated plan, Social Security plus pension alone (i.e. no other retirement savings) already equates to about 85-90% of pre-retirement income.
- A fuller discussion and expansion of the table on page 8. We believe that an appropriate threshold or standard for "senior income security" should be identified, and this analysis provides an essential foundation for that research. Rather than include undocumented placeholder amounts for senior expenditure line items like housing, health, and transportation; we urge you to use Consumer Expenditure Survey data or similar information to assemble a complete analysis of senior expenditure requirements to enable further assessment of appropriate levels of retirement income security.

Section 2 – Minnesota Retirement Plans Described

Our primary concern in this section relates to the demographic tables at the beginning of each plan's overview. Specifically, we believe the reporting of the "average retirement benefit" provided by each plan is a meaningless and misleading statistic. It provides no information or perspective on what the state's pension plans are designed to do: provide retirement security for long-term public employees. Yet it does significantly understate what a career public employee would receive from these plans.

The "average benefit" cited includes large numbers of employees who have willingly chosen to enter and leave public service at various stages of their professional careers. These individuals earn a much lower pension benefit than do career public servants, but we fully expect them to have access to private-sector retirement plans to complement any accrued public pension benefit and Social Security. Importantly, these individuals make such choices willingly based on an assessment of their own economic self-interest and retirement needs.

Evaluation of pension policy and its adequacy should revolve around career public servants who are fully dependent on their history of government employment for their retirement income.

With respect to this section of the report draft, we recommend the following:

- For retiree demographics, report the "average benefit" on the basis of the cohort of employees in each plan who retired in 2010 with 30 or more years of service.
- For active member demographics, include an "average projected initial benefit" based on the average salary listed and the actuarial assumptions pertaining to each plan.

Section 3 – Investing in Minnesota's Statewide Public Pension Assets

The graphic on page 23 illustrating the revenue sources of pension funds by "share" is an example of a significantly flawed representation of public pensions that public pension expert Girard Miller of Governing magazine has described in the following way:

> The argument, which has made the rounds through the public pension community, is that public employers — and hence the taxpayers — only contribute about 20 percent of the cost of public pensions. The rest is paid for by the employees and investment income. It's as if investment income grew from some kind of magic beans that are peculiar only to public pension funds, and simply wouldn't exist if we didn't have pension funds to create money out of thin air.
>
> This idea started circulating several years ago, and it has oddly gained a life of its own despite its intellectual dishonesty. Following the old adage that repeating the same lie enough times will make people believe it, labor union and pension plan spin-doctors have taken long-term accounting information and added up the numbers using second-grade math. But they completely ignored the time value of money as well as the fiduciary concept that interest (and investment income) follows principal...
>
> "Poor Pension Math" *Governing*, February 17, 2011

One example of the misleading perspective this graphic creates can be demonstrated by asking the question who will pay for unfunded liabilities if pension funds fail to meet their investment expectations. Investment portfolio managers will not write checks to retirees. Rather it will be public employers and ultimately taxpayers who either face higher taxes or reduced services.

With respect to this section of the report draft, we recommend the following:

- Note that money for benefits come from three sources but eliminate the "source of funds by share" graphic (or, preferably, allocate investment earnings to each contributing party).
- It is imperative that somewhere in this document, it is prominently and unambiguously stated that taxpayers, through government, bear the ultimate obligation to pay benefits if the funds' investments fail to perform as expected.

Section 4 – Retirement Plan Options Described

We believe our comments on the previous sections can also be placed as "bullets" where appropriate in the proponent/opponent discussion. In addition, we offer the following recommendations:

- Proponent view, DB plan design, bullet 4: Defined benefit plan transparency and understanding exists in abstract theory, not reality. Given the byzantine terms of art, actuarial science, and myriad of assumptions involved with defined benefit plans, average taxpayers find them very opaque and difficult to understand. We urge you to remove this bullet and strengthen the corresponding "lack of public understanding" bullet in the opponent section.
- Proponent view, DB Plan Cost bullet 6; and Investment Performance, bullet 1: Per our discussion above, the notion that earnings pay for two thirds of pension benefits is distorting and misleading. The statement ignores the time value of money by treating today's dollar of employee contributions as being worth no more and no less than yesterday's. It ignores the potential cost taxpayers face when there is a long-term shortfall in investment income. And it embodies a hypocritical approach to discount rates. Pension funds advocate using expected return on investments to discount pension liabilities. Yet this bullet suggests that previous taxpayer contributions should be discounted at zero when calculating share of costs paid by taxpayers via employers. These two bullets should be removed.
- Opponent View on DB plans – suggested additions and modifications: We recommend that a bullet be added at the very beginning of the defined benefit plan opponent view, which should clearly address the fundamental issue of taxpayer exposure created by these plans and the public's legal obligation to pay these benefits regardless of economic, budget, or pension fund conditions.
- The report should clearly note that "higher contributions" mean either a redirection of taxpayer dollars away from government operations and the actual delivery of public services or higher taxes.
- Overly optimistic assumptions about investment returns should be included in the list of items that understate the true cost of the plan. Minnesota's 8.5% assumed rate of return should be identified as among the highest in the nation.
- It should be noted that lengthening amortization periods for unfunded liabilities pushes the cost of these obligations into the future and onto future taxpayers.
- It should be noted that the political process can result in a substantial lag between the time that the need for higher contributions is recognized and the time they are implemented. Such a lag can result in further deterioration of fund health and a higher likelihood that the additional financial resources are not available to take full advantage of a market recovery.
- It should be noted that this highly back-ended form of compensation can make it more difficult to offer competitive salaries.
- Defined Contribution Plans The discussion presumes that such plans must use commercial investment firms and their products with all the associated administrative and investment costs. It is not clear to us why the State Board of Investment cannot be identified as a defined contribution investment option allowing access to all the unique investment opportunities, professional management, and inherent cost advantages of defined benefit investment management discussed elsewhere in the report.

Section 5: Mercer Analysis / Cost of Transition

We greatly appreciate the efforts of Mercer and the pension plans in assembling transition cost information. However, to provide a balanced perspective on the cost and merits of a transition, we believe the report should provide complementary information on the cost exposure of maintaining the status quo. If you are going to present an alternative, you should present a baseline for comparison.

Mercer has provided a transition cost analysis based on a 7% investment return assumption. We recommend a similar cost analysis be presented for our current defined benefit plans which would include the following: (also based on an assumed 7% return and assuming no future adjustments to amortization periods)

- Projected unfunded liabilities
- Projected contribution deficiencies
- Projected needed employee and employer contribution rates

We also recommend an analysis be included of the implications of GASB's "Preliminary Views" on proposed modifications to *Pension Accounting and Financial Reporting By Employers* in which unfunded liabilities supported by existing assets would be discounted at expected rates of return, but unfunded liabilities for which there are no assets would be discounted at an appropriate government bond rate.

Final General Comment

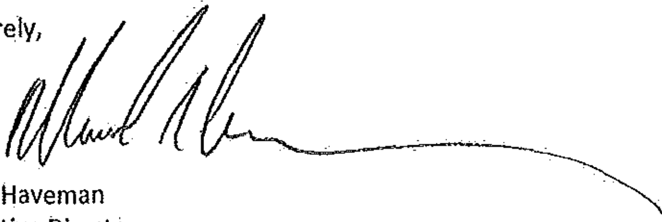
We would also strongly encourage you to carefully review the document for consistent editorial tone and treatment. The report has a tendency to describe potential implications for taxpayers and government operations in rather abstract policy terms, but potential implications for pension beneficiaries in much more clear, unambiguous, and impactful language.

For example, in the first Executive Summary bullet under "Plan Design Comparison", the report states, "DBs run the risk of having unfunded liabilities and less predictable costs, but DCs run the risk of providing inadequately funded retirement incomes that may lead to higher public assistance costs." "Unfunded liabilities and less predictable costs" may be accurate, but it also fails to adequately capture the implications and consequences in a way that the accompanying DC statement does very well.

We encourage you to provide a stronger sense of rhetorical equivalence. For example, in the example above, we would recommend, "DBs run the risk of having to redirect significant amounts of public tax dollars away from the actual provision of public services, but DCs run the risk of providing inadequately funded retirement incomes that may lead to higher public assistance costs."

Thank you again for all your efforts in assembling this report. Please feel free to contact me if you have any questions about our comments.

Sincerely,



Mark Haveman
Executive Director
Minnesota Taxpayers Association

Cc: MTA Board of Directors
Members of the Legislative Commission on Pensions and Retirement
Executive Director of the Legislative Commission on Pensions and Retirement

May 2, 2011

Ms. Mary Most Vanek
Executive Director
Public Employees Retirement Association

Ms. Laurie Fiori Hacking
Executive Director
Teachers Retirement Association

Mr. David Bergstrom
Executive Director
Minnesota State Retirement System

Dear Pension Plan Directors:

We are responding to your request for public comments to the draft Retirement Design Study released on April1, 2011 required by the following statute:

Chapter 359 – Article 1, Section 86 - Study
"The executive directors of the Minnesota State Retirement System, the Public Employees Retirement Association, and the Teachers Retirement Association shall jointly conduct a study of defined benefit, defined contribution, and other alternative retirement plans for Minnesota public employees. The study must include analysis of the feasibility, sustainability, financial impacts, and other design considerations of these retirement plans. The report must be provided no later than June 1, 2011, to the chair, the vice-chair, and the executive director of the Legislative Commission on Pensions and Retirement."

We appreciate your attempts to incorporate design suggestions from stakeholders and the fact that you have a limited budget. The way the draft study was released, however, and the editorial tone of the Executive Summary suggest a lack of objectivity in assisting lawmakers and the

public in understanding the nature of the funding challenges and alternative pension options for public employees in Minnesota.

Despite sobering unfunded liabilities and a broad legislative mandate to examine alternatives, the draft study and the handling of the release reveals that the pension plans are deeply wedded to the current defined benefit plan and its assumptions about contributions from taxpayers and income guaranties in retirement. We feel it is fair to conclude that the study is biased against serious analysis of the myriad problems facing the pension system and any fundamental change.

The Executive Summary, for example, offers gratuitous praise for the State Board of Investment without balancing that assessment with an acknowledgment that the assumed rate of return (8.5%), which has come under national scrutiny, drives a high risk investment policy or that the pension system funds current liabilities by pushing out future liabilities indefinitely on to future taxpayers (for example, MSRS pushed out the amortization schedule from 2020 to 2040). It also gives legislators cover if they are looking to minimize current contributions rather than fully funding the normal cost of generous pension promises.

The editorializing in the study is at times alarmist in tone, raising the specter of elder poverty and other predictions that deflect attention away from the reasons that the Legislature ordered the study (taxpayer exposure to large unfunded liabilities, a high risk investment policy driven by an 8.5% assumed rate of return, generous assumptions about what is an "adequate" pension income in retirement, a growing gulf between public and private pensions, generational inequities among retirees and so forth).

We share your concerns about income security for our elders, whether they are relying on public pensions or private savings, but the status quo will not insure a secure future for either group. In fact, a secure retirement for both groups is intertwined, with one group (call them "private retirees") funding the other while trying to save for their own retirement.

The release of the study and the accompanying press gave the impression that the study was in fact final rather than a draft. The over-arching conclusion, that it is expensive to close a defined benefit system and transition to a defined contribution system, surprised no one. The question was supposed to be, where do we go from here?

The assumptions given to Mercer for the actuarial analysis (e.g. 5 percent employee and 5 percent employer contributions) seemed to insure the conclusion that the current system is superior to alternatives. This may be blamed in part on the general nature of the statute ordering the study; and it may be naive—or at least unrealistic---to ask a state bureaucracy to objectively evaluate the pensions that it administers. This is especially true in light of the fact that its most active constituents are retired public employees and their union representatives but also state legislators from both parties who ask you to manage a pension system that costs as little as possible in the short term by pushing out obligations to the indefinite future. We recognize that it is state legislators who design the pensions system and set the policies that determine pensions and other benefits. But lawmakers, overwhelmed by their duties and the complexity of pensions, look to the pension plans for guidance and expertise; where should they go for an objective review of MSRS, PERA and TRA?

We view taxpayers as our primary constituent. They pay for pensions and will be on the hook for any unfunded liabilities, though we are also concerned about the retirement security of public employees and the economic health of the state. Our efforts, therefore, have been focused on educating the public on pensions and working with interested legislators to find solutions to the short and long term challenges presented by Minnesota's defined benefit pension plans. Our research has naturally expanded to include wages and non-pension benefits (such as health care) as the state looks for cost-savings.

We appreciate that you have a difficult job and that it is political in nature. You have to manage a pension system that you did not design and that is subject to legislative tinkering every year. Hence, we should perhaps not be surprised that when making the rounds at the Legislature or the media, your collective message is protective of the current system and routinely includes how much money public retirees spend in lawmakers' districts while claiming great benefits to the economy (as if pension dollars are more productive than regular dollars). This all makes for good politics but perhaps not good public policy.

The websites for each major system, moreover, are quite active in commenting on pension related legislation and the current scrutiny of pensions; we note that the PERA website and "Director's Corner" in particular are aggressively defensive of the current system and quite critical of any perceived challenge.

Both the MSRS and PERA websites contain encouraging news about recent upswings in the markets and the impact on unfunded liabilities while pointing to market losses in 2008 as the primary culprit in creating the poor funding rations. We agree that market losses focused our attention on public pensions but would argue that market downturns, like changes in the weather, should be expected and that the defined benefit pensions and promised pension levels are predictably vulnerable given their dependence on a high average return.

With all that said, we believe that the pension plans want to take a prudent and disciplined approach to public pensions to at least insure that Minnesota can pay the pensions and other benefits currently promised to retirees and current public employees.

We also believe that the 2010 Omnibus bill contained responsible adjustments to the defined benefit system and hope that you and the LCPR will continue to refine the current system while the Legislature (and perhaps the Governor) takes the lead in deciding whether or not to move in another policy direction.

The 2010 Omnibus bill offers many tools for controlling the losses: For example, Post-Retirement Adjustments, Accrual Rates, Interest on Refunds, Vesting Periods, Contribution Rates, Early Retirement Penalties, and Reemployment Penalties.

Aside from transitioning to a defined contribution or hybrid system, what other tools does the legislature have at its disposal? These are listed in no particular order of importance

but are offered as a menu of option for lawmakers to consider and include some 2010 Omnibus tools that are the subject of litigation:

- Revise assumptions about income security in retirement currently set at about 85% of pre-retirement income (and include anticipated social security payments and modeling that includes a reduction in cost of living expenses post-retirement)
- Terminate employees/workforce reduction through attrition and layoffs
- Furlough employees
- Extend retirement age
- Disallow public employees from retiring from one job and getting rehired in another public job while drawing a pension
- Freeze and lower salaries; tie salaries to private sector (see MTA study)
- Reduce nonpension benefits
- Disallow or restrict collective bargaining on non-pension benefits
- Increase employee contributions to nonpension benefits (e.g. healthcare, disability, life insurance)
- Reduce the cost of health care premiums (see MTA study) and/or increase cost to employees
- Increase Employee Contribution Rates *Sundquist*
- Decrease Employer Contribution Rates *Sundquist*
- Decrease Post-Retirement Adjustment (COLAs) TBD in the Ramsey County Case
- Eliminate Post-Retirement Adjustment (COLAs) The Ramsey County Case should shed light on decreases but may not answer whether state can eliminate COLA altogether. For example, what if the state eliminated the COLA for those retirees who received Post Fund increases resulting in much higher base pensions than other state retirees? Note: the COLA compounds annually, thus raising the base pension.
- Tie Post-Retirement Adjustment (COLAs) to full funding (define full funding as at least 90% as in 2010 Omnibus and as high as 110% +) and/or external measurement like CPI so that state employees are not getting gratuitous increases in base pensions.
- Set base pension on a lower average salary (e.g. career average) without increases from over-time and other techniques that increase the base at the end of career. (Note that over-time is used mostly by police as a tool to increase pensions.)
- Review and redefine disability policies to avoid fraud and to encourage employees to find new work that they can perform despite any disability
- Eliminate pre-retirement moves from a DC plan to a DB plan (currently permitted in MSRS)

We would also suggest the following changes to increase transparency and accountability/due diligence :

- Lower the assumed rate of return from 8.5% to 8.0% or less
- Consolidate the administration of three pension systems,
- Require pension costs to be part of budget process (employer contribution comes from taxes, report on taxpayer risk re: funding ratios)
- Prohibit pension fund from using balloon payments that push out liabilities indefinitely (level percentage v. level dollar)
- Conduct/report annual sensitivity analysis of pension funding using T-bill rate for market/reality check
- Use "value added performance" annual auditing of fund performance as instituted by Gov. Dayton when he was State Auditor
- Review stabilizer used by plan administrators to make up contribution deficiency (currently .25%)
- Review SBI investment policy and assumptions about long term returns

The rapid and uncontrolled growth in the cost of public employment in state and local operating budgets is crowding out dollars for core government services and exposing taxpayers to unreasonable future liabilities. We think solutions will be found in creatively reinventing public employment and the state's obligations to employees one they have left public employment. This will require careful study and courageous leadership.

We offer these observations in hopes of encouraging the Legislature and Governor Dayton to view the reform of the public pension system as part of the solution to the now perennial budget deficits faced by taxpayers.

Sincerely,

Kim Crockett
President
Minnesota Free Market Institute

cc: Governor Mark Dayton
Senator Amy Koch
Representative Kurt Zellers
Members of the Legislative Commission on Pensions and Retirement
Executive Director of the Legislative Commission on Pensions and Retirement

Minnesota Nurses Association

Professional Distinction

Personal Dignity

Patient Advocacy

April 29, 2011
E-Mailed
U.S. Mailed

David Bergstrom, Executive Director (Dave.Bergstrom@state.mn.us)
Minnesota State Retirement System
60 Empire Drive Suite 300
St Paul, Minnesota 55103-1855

Mary Most Vanek, Executive Director (Mary.Vanek@state.mn.us)
State of MN Public Employees Retirement Association
60 Empire Drive Suite 200
St Paul, Minnesota 55103-1855

Dear Executive Directors,

Three thousand active public sector Minnesota Nurses Association Registered Nurses and many more retirees over the years are in the Minnesota State Retirement System (MSRS) and Public Employee Retirement Association (PERA) pensions.

Registered Nurses devote their careers to a lifetime of caring for the well being of others. Registered nurses are not financial experts who would choose to work after their shifts are over to manage their retirement savings.

Public Sector Registered Nurses appreciate the defined benefit pensions they earn, which provide a modest retirement pension. Similarly, Registered nurses working in the private hospitals in the metropolitan area also have defined benefit pensions. Indeed, nearly all twenty thousand Minnesota Nurses Association (MNA) represented Registered Nurses have defined benefit pensions. MNA Registered Nurses would not want it any other way.

Registered Nursing is an intellectually and physically demanding profession. At the end of such a career, it is only fair that Registered Nurses have a modest middle class pension. Defined benefit pensions can be depended on to pay for health insurance premiums, food, housing and taxes. Pensions maintain jobs.

Public Sector Registered Nurses have rightly trusted the MSRS and PERA pension funds and the State Board of Investment for their long term fiscal success in maintaining healthy pension plans. Registered Nurses laud the low costs and exceptional fund choices made on their behalf.

Reading the 2011 Retirement Study of the Minnesota Retirement Systems further assures the MNA that no change to our current healthy defined benefit pensions should be prescribed.

Sincerely,

Linda Lange

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AFL-CIO

MNA\SKMA_MONTH\#1 Current Correspondence\STATE\Bergstrom Vanek State RN RetirementFunds 4-29-11\LLskn

DB/DC Study Comments

Hello,

I would like to say, after teaching in MN for 26 years, I am SO dismayed by all the talk of changing our pension plan. When I look at other states and organizations, I've felt so fortunate to be a part of Minnesota, and I have had such confidence in the staff at TRA. Thank you for all you've done, please keep up the good work!

Also, I am wondering, if changes that involve privatization or hybrid plans would be mandated, will those of us who have the majority of our years in be required to change? Will there be some type of "grandfathering" in?

Thank you again for all your professional service!

Sincerely,

Barb Matz

As a state retiree I can attest that the forced savings component of a DB plan works to protect the interests of both the state and the employee.

As a taxpayer I find it very difficult to support any change away from a cost effective DB plan. The state benefits in several ways.

1. High quality employees are both recruited/retained. (Avoiding future recruitment costs should be included as part of the savings achieved by the state.)
2. The pension benefits paid act to stabilize main street through consistent predictable support of demand.
3. By all reckoning any pension plan changes raise costs for both the state and employee.

R/S
Peter Westre RN

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Richard Mesenburg

April 28, 2011

Retirement Systems of Minnesota
60 Empire Drive
St. Paul, Minnesota 55103

Attention: Dave Bergstrom, Executive Director
Minnesota State Retirement System
60 Empire Drive, Suite 300
St. Paul, Minnesota 55103-3000

Dear Mr. Bergstrom;

The Minnesota Retired State Employees Association (MRSEA) appreciates the opportunity to review and comment on the draft "Retirement Design Study" dated April 1, 2011. Similarly, we are briefly responding to the retirement and pension policy issues associated with this report. The MRSEA is a statewide organization of approximately 8,000 retired public employees in Minnesota. We advocate for the retirement interests of public retirees, particularly issues associated with pensions and health insurance.

The leadership of the three major public pension systems in Minnesota is to be commended for a very factual in-depth analysis of retirement systems in general but also specific to Minnesota's public employees and retirees. This leadership in consort with the members and staff of the Legislative Commission on Pensions and Retirement has consistently maintained a focus on appropriate pension policy and management that best serves the citizens of Minnesota. Also to be commended must be the State Board of Investment (SBI) and its Investment Advisory Council for effectively managing the $40+ billion of pension fund investments. Long term investment performance by the SBI has been among the best in the country and has contributed to keeping employee and employer costs to a minimum.

The "Retirement Design Study" provides a good foundation for understanding the current public pension plans in Minnesota, the options available for change and the impacts of potential change on various interested parties. The study: is very factual and provides substantial documented data; furnishes significant information from prior studies throughout the country on pension systems by un-biased reputable organizations and professionals; draws on experience, both good and bad, from other public entities; and provides important comparisons of public versus private pension plans and the impacts on employee retention. The study also contributes rationale for

Defined Benefit plans versus Defined Compensation plans including proponent and opponent views. However, it is our view that most of the statements of the "opponent view" of a Defined Benefit plan (see "study" pages 36 – 38) are not supported with the data and other human resource, economic, investment and pension studies.

This study also helps us to directly face and understand another major emerging problem in America. Based on numerous recent studies, it is obvious that most current employees in this country are financially unprepared for their retirement years. As a result, retirees may spend less money to purchase goods and services in their communities and, out of necessity, will have to increasingly rely on public assistance programs. We urge the legislative leadership to acknowledge and address this reality and seek solutions which will minimize its impacts on we as taxpayers and also on the emotional response of future retirees faced with this reality. Minnesota's public pension plans directly serve ½ million persons who play a major role in supporting the state's economy and tax revenues to the state; we must continue that support.

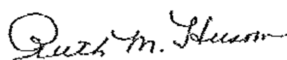
Minnesota, contrary to the actions of many other states, has historically been disciplined in managing its three statewide plans. The most recent pro-active action was in response to the 2008 – 2009 investment market downturn. The 2010 Legislature adopted the recommendations of the three statewide plan boards' to protect the financial status of the plans (including reduction in post-retirement adjustments) resulting in a cost reduction of nearly $6 billion. Our organization supported this legislation in the interest of sustaining a solid long-term financial foundation for the pension plans even though it adversely affected the short-term finances of all of our members.

It is readily apparent to the Minnesota Retired State Employees Association that there is no benefit to the employees, the employer or retirees in converting the present Defined Benefit retirement plan to another form such as a Defined Contribution plan or some other combination. On the basis of this study and other similar studies published by un-biased reputable organizations in America, it is obvious that, for a comparable retirement benefit, a Defined Benefit plan is more cost effective than a Defined Contribution plan (see "study" page 31).

We urge the Legislature and other policy-makers to use a diligent and cautious response to changes in pension policy and plans because ill-conceived changes can result in multi-million dollar consequences that may take decades to correct. We believe that actions of this sort require careful consideration of all economic, financial, demographic and societal factors. It also requires compassionate consideration of employees and retirees and their families.

The Minnesota Retired State Employees Association looks forward to continued public dialogue on public employee retirement issues and more specifically on pension policy, human resources, economic and investment issues.

Respectfully Submitted,



Ruth Husom, President

Dr. Norman Ehrentreich
Ehrentreich LDI Consulting & Research, LLC
4146 Sheridan Ave. N.
Minneapolis, MN 55412

April 29, 2011

Ms. Mary Most Vanek
Executive Director
Public Employees Retirement Association

Ms. Laurie Fiori Hacking
Executive Director
Teachers Retirement Association

Mr. David Bergstrom
Executive Director
Minnesota State Retirement System

Dear Executive Directors:

I am responding to your request for public comments for the recently published draft for the Retirement Design Study. I ask you to include these comments in the study's public comment section. Where I think that my comments should result in a change of the study or warrant an additional point of view that should be included in the study, I will mention this explicitly.

Let me start by expressing my strong belief that any retirement system that disposes of defined benefit elements will be inefficient – both on the level of the individual and the economy. Due to risk pooling, defined benefit plans provide a cost efficient longevity insurance that defined contributions plans can't offer – or only at much higher costs if the DC balance is converted to an annuity. The moment employees are switched from a DB to a DC plan, they should increase their savings rate to compensate for the loss of longevity insurance. Depending on where in their life cycle they are, employee may need to increase their saving rate up to 40% or more to reduce – and not to eliminate – the probability of outliving their savings. Such a rational increase in the savings rate would mean inefficient oversaving in the economy. However, the recent trend of DB to DC transitions in the private sector has not been followed by an adequate increase in the national savings rate. I therefore agree with your statement in section 1 that a widespread move from DB to DC retirement savings plans will increase the need for public assistance in retirement.

We should therefore create an environment in which DB plans can thrive. I do believe, however, that **if we do not alter the legal and regulatory environment in which DB plans operate in Minnesota, they will sooner or later vanish as they are non sustainable**. Last year's omnibus pension bill explicitly requires "*an analysis of the feasibility, **sustainability, financial impacts**, and other design considerations*" of various retirement plan designs for Minnesota public employees. I strongly believe that to fulfill this statutory task, the study needs to include a better analysis of the interactions between the Minnesota State Board of Investments (MSBI) and the plan administration side.

Before discussing in more detail why the MSBI's investment strategies cannot be viewed independent of the plan administration side, let me point out several inaccuracies and omissions in the section about the MSBI.

Revenue Sources of Pension Funds 1991 – 2010

First, I ask you to drop the part about the revenue sources of pension funds 1991 – 2010. It is misleading and only intended to give the impression that providing pensions isn't expensive at all since it would cost the taxpayer only 18 cent for every dollar paid out in pension benefits.

To understand the misleading nature of this argument, we need to look at how these numbers were derived. Add up all contributions from employers and employees during the 1991 – 2010 period. Add up all investment income during this period and set these aggregated numbers in relation to the cumulative pension benefits paid out during this period. By doing this, we value a dollar in 1991 the same as a 2010 dollar. Thus, we ignore inflation and the time value of money. The implied discount rate is zero. Girard Miller, a former member of the Governmental Accounting Standards Board (GASB), calls this popular argument intellectually dishonest and a lie:

> *This idea started circulating several years ago, and it has oddly gained a life of its own despite its intellectual dishonesty. Following the old adage that repeating the same lie enough times will make people believe it, labor union and pension plan spin-doctors have taken long-term accounting information and added up the numbers using second-grade math. But they completely ignored the time value of money as well as the fiduciary concept that interest (and investment income) follows principal.*
>
> Girard Miller, "Poor Pension Math" (Governing February 17, 2010)
> (http://www.governing.com/columns/public-money/Poor-Pension-Math.html)

In addition, it is entirely legitimate to question the distinction between employer and employee contributions. Employee salaries and wages are labor costs and thus paid for by the employer, i.e., the taxpayer. Whether we have a situation where public unions negotiate a lower salary and the employer pays all pension contributions or whether we have higher salaries from which employees contribute a share to their pension plans – in both cases it is taxpayer dollars that are going into the pension fund. It doesn't matter whether they take a detour through an employee's paycheck or not. By picking up Girard Miller's comment that interest and investment income follows principal, I conclude that public pension are funded in their entirety by taxpayer dollars.

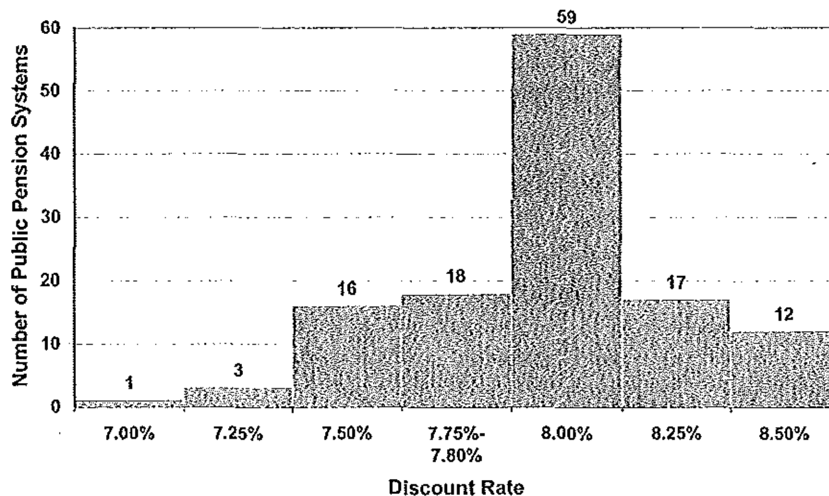
Furthermore, this argument is logically inconsistent with the practice of assuming the highest possible discount rate when valuing accrued pension liabilities. Designed for showing that providing pension benefits isn't expensive at all, this argument implicitly assumes a discount rate of zero.

Assumed Rate of Return, Investment Performance and Funding Costs

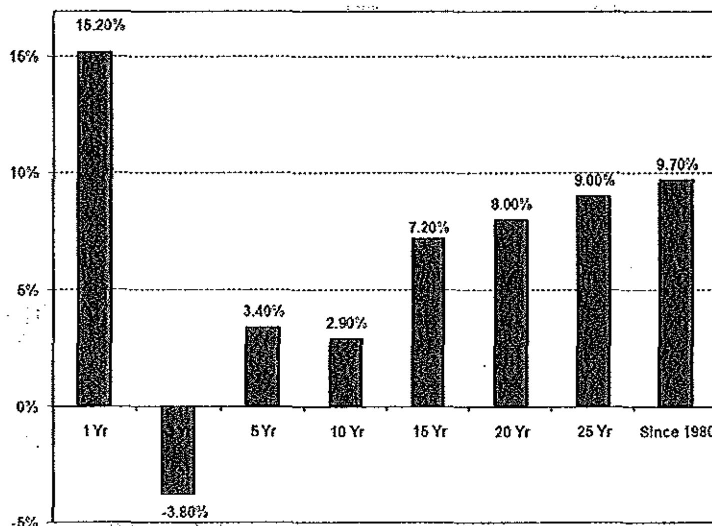
This brings me to a discussion of the MSBI's assumed rate of return of 8.5%. Since the expected rate of return serves as a discount rate, this assumption is crucial when valuing the accrued pension liabilities. A higher expected rate of return lowers the present value of pension liabilities and thus increases the reported funding status of Minnesota's public pensions. First, I would like to point out that there is a strong incentive by all stakeholders to assume the highest possible rate of return. Incentives to be overly optimistic about future investment returns is a big "public" governance problem. These governance issues have led to pressures to adopt higher than advisable return expectations. Adjustments to the expected rate of return tends to come to late or not at all. For instance, the CalPERS board recently rejected a recommendation by the system's actuaries to lower the expected rate of return from 7.75% to 7.5% because state and municipal representatives pointed to the additional fiscal pressures

such a move would create. The primacy of market expectations when forming a return expectation is thus called into question.

Second, I also believe that the pension study needs to put the investment return assumption of the MSBI in relation to the return expectations of other public pension plans. The MSBI return assumption is in the top ten percent among 126 surveyed plans by the National Association of State Retirement Administrators (NASRA) and the National Council on Teacher Retirement (NCTR). No other plan has a higher return assumption. Thus, the MSBI adopted the most aggressive and riskiest return assumption among its peers.



You also state in your draft that "***in order to meet projected pension costs, SBI must generate average investment returns of 8.5 percent.*** *While SBI has exceeded this 8.5 percent return over long periods of time, in recent returns have fallen below 8.5 percent due to the severe market downturns of 2001-2002 and 2008-2009*".



In conjunction with the chart on the left showing SBI's investment returns for periods ending 6/30/2010, I assume that you want to convey the following message: Over periods exceeding 25 years, the SBI's investment strategies have resulted in lower pension expenses than initially projected and thus have saved taxpayer dollars.

However, no such statement can be made from looking at simple average returns and I consider the opposite more likely to be true.

Unfortunately, **average investment returns say nothing about whether actual pension costs were lower than, met, or exceeded projected pension costs.** Realized pension

funding costs are path dependent on the specific return sequence with which an average return was achieved. Above average returns early on, followed by below average returns later on during the investment period lower actual funding costs. On the other hand, if early investment returns are below the final average return, actual funding costs exceed their initial projection.

Now it is interesting to note that the SBI has to go back more than 25 years to report average returns that exceed the current expected rate of return. Since that is the good investment scenario – above average returns early on, followed by below average returns in the second half of the investment period – Minnesota's DB pension plans should post a healthy funding surplus by now. An analysis why the good investment scenario has still resulted in substantial funding deficits for our pension plans will reveal conditions that need to be satisfied such that an eventual risk premium can be translated into lower funding costs. These conditions are not satisfied, however.

The Missing Links – Endogenous Pension Liabilities and Reverse-Dollar Cost Averaging

How is it possible that the good average returns for periods exceeding 25 years still resulted in substantial underfunding? For active DB pension plans, good investment results aren't the only determining factors for pension costs. There are at least two neglected mechanisms that cause realized pension funding costs to regularly exceed the projected pension funding costs under the expected return scenario.

Endogenous Pension Liabilities

A key characteristic of DB pension plans is their guarantee of a fixed benefit payment upon retirement, even if projected investment results do not materialize. Plan sponsors bear all the investment risks while beneficiaries are guaranteed to receive a well-defined monthly benefit upon retirement. Critics of the expected rate of return as a discount rate have often pointed out that guaranteeing a defined benefit and investing pension assets in risky asset classes creates a "Heads we win, tails you loose" situation for the employees. They thus haven an incentive to press for investment strategies with high expected returns. If investments go as planned, employees receive their promised benefits. If investments go bad, employees receive their promised benefits and the employer has to make up the funding shortfall. And if investments go really well, then employees are likely to ask for an increase in pension benefits. (Temporary) investment success beyond expectations is likely to trigger an increase in those pension benefits.

Girard Miller put this mechanism in these words:

> *When investment performance fails to meet actuarial expectations, guess who pays the costs? Well, you can be sure that it isn't the employees. They get what I have previously called the "public pension fund straddle option" in which employees typically get a "call option" with bigger benefits when investments exceed the actuarial assumption, and a "put option" to force their employer to pay the losses when prices head south.*
>
> Girard Miller, "For Pension Funds, a Smarter Application of the 'Risk-Free Discount Rate'" (Governing December 2, 2010) (http://www.governing.com/columns/public-money/For-Pension-Funds-Smarter-Application-Risk-free-Discount-Rate.html)

It is the nature of a DB plan that these benefit increases are permanent. If they were as easily retractable as they were granted, we would not necessarily have a sustainability problem. In reality, **pension liabilities display a ratchet effect: Never down, but flexible on the upside. Pension liabilities are thus endogenous, i.e, dependent on the investment success.** Sometimes, benefit pressure exists at

funding levels well below 100%. Some states have found it necessary to pass laws that prohibit benefit increases as long as funding levels are below 80%. That threshold is far too low. This threshold should be dependent on the implemented investment strategies and should be far above 100%. I would like to point out that in the past, **Minnesota pension plans have experienced several episodes where temporary investment gains were transformed into permanent benefit increases.**

Because of the neglect of endogenous pension liabilities, the typical asset-allocation algorithms employed by DB pension plans are misapplied. I do not know any asset allocation model that, when correctly applied, could possibly justify an asset allocation as implemented by the MSBI. For instance, the Capital Asset Pricing Model (CAPM) is a one-period model that knows nothing about multi-period phenomena such as reverse-dollar cost averaging and which type of average return to use. It cannot account for behavioral and institutional interdependencies.

Multi-period algorithms such as Monte-Carlo simulations analyze thousands of different economic scenarios and produce a range of possible outcomes. There are, however, several pitfalls and omissions when using Monte-Carlo simulations. First, it is common to not present to decision makers the total range of possible scenarios, but to focus instead on mean or most-likely outcomes. Second, attaching probabilities to unlikely down-scenarios is also often not done. Similarly, spelling out the financial consequences of experiencing unfavorable outcomes is generally ignored. For instance, even if the probability of an outright disastrous outcome is less than one percent, what is the financial impact for the plan sponsor? These omissions may lead to inefficient decision making. Most importantly, however, is that **the mean and the range of possible scenarios is systematically biased towards more favorable outcomes since the endogenous nature of pension liabilities is neglected.** While Monte-Carlo simulations are capable of modeling the path dependencies of stochastic return paths, we typically forget to adjust the liabilities up when the plan is temporarily overfunded. If we would calculate the implied funding levels for all periods and for all investment scenarios, we would see that many of them are at least temporarily heavily overfunded which would result in an upward adjustment of pension liabilities in reality. Since we typically neglect these adjustments in our Monte-Calro simulations, the resulting distribution of funding cost scenario is systematically biased in one direction – towards lower funding costs.

While both asset-allocation methodologies determine an asset-allocation under the assumption that liabilities do not adjust upwards, pension liabilities are, in reality, a moving target. I, therefore, consider the asset-allocation recommendation by the MSBI's investment consultant as the answer to a different investment problem, perhaps appropriate for a mutual fund or for a young 401(k) pension plan, but not for DB pension plans with current liability requirements and endogenous pension liabilities.

Reverse-Dollar Cost Averaging and Inadequate Funding Policies

Endogenous pension liabilities are a problem when plans become overfunded. More often than not, they are underfunded. And as long as a plan remains underfunded, it is subject to reverse-dollar cost averaging: While the investment portfolio has lost value and the funded status has fallen below 100%, the plan is responsible for paying out 100% of the retirement benefits to current retirees. The plan has no flexibility to adjust its spending down. These outflows are an additional drag on investment performance – measured in money-weighted rates of return – as plans need to earn more than their discount rate just to maintain their funding status. Reverse-dollar cost averaging is well known in private retirement planning, but pension officials either ignore it or refuse to acknowledge its effects on their pension costs.

The effects of reverse-dollar cost averaging are well masked by the simultaneous existence of contribution inflows. The question is, however, whether those contributions are paid in full and in time?

While Minnesota – unlike other states – has made this actuarial contributions in time, amortizing investment losses over the time frame allowable under GASB accounting rules is not fast enough to actually profit from eventual higher average returns of high-risk investment strategies. **Amortizing investment losses over long time periods negates the original intent of using those high risk investment strategies.** The longer it takes to get a plan back to full funding status, the more expensive the plan will become in the long run. **Investment returns can only be earned on physically existing assets and not on those that only exist as an accounting fiction.**

The time that a pension plan remains underfunded should be less than half of a typical business cycle. During the second half, the pension plan needs to build up a healthy funding cushion. The riskier the investment strategy, the higher that funding cushion needs to be. For various reasons, such as the threat of increased pressure to grant higher benefits, these necessary funding cushions are unlikely to be acquired. Instead, plan sponsors take contribution holidays, i.e., they suspend contributions for newly accrued benefits when the plan is temporarily overfunded. Funding levels are thus capped on the upside, and trapped on the downside. Therefore, they typically exhibit a saw tooth behavior over time with average funding levels well below 100%.

For each drop in average funding levels below 100%, we need higher asset returns to make up for the missing assets. Investment returns are only one side of the investment story. Almost more importantly is with which asset base these investment returns are earned. If our investment strategies are likely to result in lower average funding levels, the original intent of using those high-risk strategies is negated. It is not only possible, but likely that within our current pension framework, lower returning, but less volatile investment strategies lead to lower funding costs in the long run.

Let me illustrate this funding cost paradox with a stylized example. Consider two investment strategies – one highly volatile strategy with a time-weighted average return of 8% and a less volatile (liability-matched) strategy with 6% average returns. The liability-matched investment strategy is designed to keep a plan, once it was fully funded, close to that full funding level. Due to the mechanism described above – reverse-dollar cost averaging, benefit bargaining, asset smoothing – the high risk strategy is likely to result in average funding levels less than 100%, say 75%. A back-of-the-envelope approximation of the relevant return measure are funded-status weighted returns. The highly volatile investment strategy posts a 0.75 x 8% = 6% funded status-weighted return, the same as the liability-matched investment strategy. On an absolute basis, both investment strategies post the same funding status-weighted return of 6%. However, on a risk-adjusted basis, the less volatile investment strategy is far more efficient than the risky investment strategy. For each drop in average funding level, there is a threshold premium that a riskier investment strategy needs to earn just to have the same funding cost consequences than lower-returning, but fully funded strategies.

Expected Returns and Expected Pension Expenses

Funding cost expectations that are based on expected rates of return neglect the endogenous nature of pension liabilities. They similarly neglect multi-period phenomena such as reverse-dollar cost averaging and the negative impact of inadequate funding policies on pension funding costs. Therefore, **the expected rate of return of high-risk investment portfolios is a bad discount rate candidate as it systematically underestimates future pension funding costs.** While it may be true that market-based discount rates, risk-free or not, may overestimate future funding costs, we should ask ourselves whether we want to err on the side of caution or not. It seems to me that the consequences of systematically underestimating future pension costs are worse than the other way around.

Recommendations for Legislative Action

As long as we operate in a system in which the above mentioned mechanisms are not properly addressed and prevented, it does not make sense to pursue highly volatile investment strategies. **We do not have the safeguard measures in place that allows us to convert an eventual risk premium into lower funding costs.**

For a DB pension system to be sustainable in the long run, plan sponsors have a choice between two different options. They can attempt to lower their pension funding costs through investment strategies with higher expected returns, or they can lower their contribution volatility through so-called Liability Driven Investing (LDI) strategies. **Lowering long-term funding costs through riskier investment strategies and lowering contribution volatility through various smoothing mechanisms at the same time is impossible. Both goals cannot be simultaneously accomplished as we currently attempt to do.**

Mark Twain has been attributed with saying that history doesn't repeat itself, but it rhymes. To prevent that good investment results by the MSBI are again turned into bad funding outcomes, the Minnesota Legislature has to decide which of the two possible systems it wants to implement.

- <u>Lower Contributions Through Higher Investment Returns</u>

  If the Legislature is tempted by the higher return potential of the risky investment strategies currently used by the MSBI, it needs to put various safeguard laws in place to ensure that an eventual risk premium can actually translated into lower funding costs. In the past, the good investment performance of the MSBI has often been negated by the action of others. We have to make sure that the pension funds are managed with an average funding status of 100% - preferably even with a funding target well above 100% as in the Dutch pension system. This means that for high risk - high return strategies, sufficient funding cushions need to be acquired in good economic times. In addition, the legislature needs to be aware of that when the funding status has fallen below 100%, additional contributions need to flow much faster into the pension fund than required under current accounting rules. In that case, I suggest to implement the following legislative actions:

  a) **Do not allow benefit increases as long as the funding status is below a certain threshold level.** That threshold level is dependent on the riskiness of the implemented investment strategies. Since the MSBI's investment strategies are among the riskiest in the country with an assumed rate of return of 8.5%, that threshold level is fairly high. Further studies need to establish that minimum threshold level below which no benefit increases are allowed. I suggest to study the Dutch pension system in more detail. Here is a glimpse of required funding ratios:

     - *"Less than 100%: you've got a problem, you have to submit a recovery plan outlining how you are going to get back to at least 100%."* (In fact, accrued pension benefits can be required by the regulator to be cut as it happened to 12 pensions plans in 2010)
     - *"100% - 105%: no indexation of pensions and accrued pension rights allowed.*
     - *105% - 125%: only partial indexation allowed.*
     - *125% - 145%: full indexation allowed.*
     - *Over 145%: compensation of previous missed indexation allowed."*

     Martin van Dalen, in Pension Pulse
     (<u>http://pensionpulse.blogspot.com/2010/09/recent-problems-in-dutch-pension-sector.html</u>)

b) **Make sure that current accruals are funded with current contributions.** In other words, do not allow contribution holidays even when the fund is overfunded. Allow contribution holidays only when the fund exceeds the threshold determined under a).

c) **Let the amortization period of funding shortfalls not exceed 4 years.** While a) and b) are precautionary measures to prevent that temporary funding surpluses are given away as permanent benefit increases, this item deals with the negative effects on funding costs while the pension plan is underfunded. When the DB pension portfolio incurs investment losses and becomes underfunded, the DB plan is still responsible for paying 100% of the liabilities to current retirees. DB plans have no capability of adjusting their liability payments, thus they are subject to reverse dollar cost averaging.

Advantages: It is possible – but not guaranteed – to lower long-term pension contributions.

Disadvantages: Contribution requirements will be substantially larger than the annual required contributions under current actuarial standards. Contributions will exhibit high volatility and will be hard to predict. They will be highly counter cyclical, i.e., they will come at a time when tax revenue is decreasing and plan sponsors are least able to make those contributions.

- <u>**Stable and Predictable Pension Contributions**</u>

If the Legislature desires stable and predictable pension contributions, it needs to direct the Minnesota State Board of Investments to implement Liability Driven Investing strategies for their Defined Benefit pension portfolios. In addition, the legislature should also pass similar bills as described above, even though the need for them would be greatly reduced.

Advantages:

- **LDI means WYSIWYG - What you see is what you get.**

  A properly implemented LDI strategy removes most of the uncertainties regarding final funding costs. The moment we enter an LDI strategy, it is immediately known what it costs to fund future pension promises. We buy investment instruments that have well defined future cash flows – coupon payments and principal repayments of Treasuries, TIPS, STRIPS, Treasury Futures and other government securities. With these instruments, investment risk is minimized and the distribution of final funding outcomes is very narrow around the expected outcome. LDI strategies can also be designed to take on investment risk by utilizing corporate bonds. Because some of these bonds may default before they mature, the distribution of funding outcomes is wider than in the previous scenario, yet the final outcome will still be in a narrower band than the realized outcomes under the current investment strategies.

- The funding status of LDI strategies fluctuates minimally, therefore, there will be less pressure to grant additional benefits when the plan is temporarily overfunded. If there is benefit pressure, it can be said with higher certainty what it actually costs to fund additional benefits. In the past, it was harder to resist benefit pressure since the costs could be hidden in a higher assumed rate of return and passed on to future generation of taxpayers and legislators.

Disadvantages:

- LDI strategies are fixed income based and thus have lower expected returns than other, more diversified investment strategies.

- Current funding deficits – calculated at market rates of the chosen LDI portfolio – need to be closed as soon as possible with additional contributions. Generally, LDI strategies are unlikely to help with closing an existing funding deficit through higher investment returns.

I would like to emphasize that **as long as Minnesota meets its actuarial contribution requirements, there is no danger of the pension funds to fail in the foreseeable future.** However, paying only the annual required contributions will not enable a pension fund to actually convert an eventual risk premium into lower funding costs. This will make our pension plans more expensive in the long run than what can be achieved with lower returning, but less volatile investment strategies. Profiting from a risk premium is not an automatism as many seem to believe. To do so, plan sponsors need to have the fiscal strength and funding capacity to keep their plans, on average, fully funded. Most plan sponsors, as we have seen in the recent decade, do not have this fiscal ability or willingness to maintain an economic average funding level of 100%. The ability to earn higher expected returns in the long run only constitutes a potential for lower funding costs. It is likely that in the past, we have let this potential go unused.

Conclusion

DB pension plans can only be managed in one of two institutional frameworks, each one with advantages (lower funding costs or lower contribution volatility) and disadvantages (higher funding costs or higher contribution volatility). We currently attempt to pick the two advantages of these two mutually exclusive pension systems, while thinking that the cons of each system can be avoided. This approach is bound to fail in the long run and our high-risk investment strategies will not deliver the hoped-for cost savings.

I believe that this current practice of managing DB pension makes them unsustainable in the long run. **If providing pension benefits is likely to turn out more expensive than initially projected, the viability of Minnesota's DB pensions is called into question.** A potential failure of our DB pension system is not necessarily a question solvency or fiscal capability. It is as much a question of public acceptance. However, if we continue to deceive ourselves about the costliness of future pension obligations, we will continue to overdemand, overpromise, and underdeliver. In that case, the public acceptance of DB pensions for public employees is likely to vanish.

I hope that my comments provide additional insight into the sustainability of DB pension systems. The Minnesota Legislature has the authority to pass the required regulations to put our DB pensions on a viable basis. Feel free to contact me if you have any questions about my comments. I'd be happy to collaborate with you on these issues.

Sincerely,

Dr. Norman Ehrentreich

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From: Steve Anderson [mailto:mathjarl@gmail.com]
Sent: Tuesday, May 17, 2011 8:46 PM
To: Dbstudy.Tra@state.mn.us
Cc: Laurie.Hacking@state.mn.us
Subject: Comments on Retirement Study

Ladies and Gentlemen:

Thank you for the opportunity to comment on the Retirement Plan Study. As both a teacher and a retired actuary, I appreciate the opportunity to add to the debate about the future of our retirement system. I have attached a document with my comments.

I plan on attending the meetings for public comments, and make additional comments to any interested parties that can affect the future of our retirement system. I would also welcome any opportunity to discuss these ideas with you at your convenience. I can be reached at 612-385-8512, or at mathjarl@gmail.com.

Thank you again for this opportunity.

Steve Anderson

COMMENTS ON THE RETIREMENT DESIGN STUDY FROM A RETIRED ACTUARY

Criteria for Evaluating Retirement Plan Design

Here are four suggested criteria for evaluating the appropriateness of a revised plan design for Minnesota's public retirement plans:

- Are the plans' affordable?
- Are the benefits both adequate and fair?
- Are the risks of retirement properly diversified?
- Is work after the traditional retirement age recognized?

ARE THE PLANS' AFFORDABLE?

First we need to identify the actual costs of the plans. In the actuarial reports, the costs are identified in total. In practice we refer to the employee and the employer contributions. This split causes some confusion about the actual costs of the plan. There should be no mistake that the actual cost of the plan is the sum of the employer and employee contributions. In effect, the employees are taking a 7.5% reduction in pay, and then 15% of pay is being contributed to the plan.

We then need to ask ourselves, is 15% of pay an affordable cost for a retirement benefit. My experience says no. It would be extremely useful to survey Chief Financial Officers of major Minnesota corporations, and ask them if they think 15% of pay is an affordable cost for a pension plan. The past CFO's that I dealt with told me that they would not be able to hire the quality or quantity of employees needed to meet the business plan of the corporation if they were spending more than 9% of pay for pensions.

ARE THE BENEFITS ADEQUATE AND FAIR?

The study shows that the benefits are clearly adequate. Full service retirees (i.e. those with more than 30 years of service) will retire with replacement ratios in the 90% to 100% of final average earnings. In my twenty-nine years of experience as a pension actuary, I never dealt with a plan that provided that level of benefits.

There are, however, several issues concerning fairness. First, we need to ask ourselves whether or not it is fair to provide that level of benefits to the baby boom generation when we are laying off large numbers of employees from Generation X and Y. Even if we assume that the current layoffs are temporary, we have long had the problem of roughly 50% of the employees that enter the teaching profession leave the profession within 5 years. Low salaries that are further reduced by 7.5% of pay pension contribution make it extremely difficult to support a family on just a teacher's salary. Is it fair to create a retirement system that contributes to the problem of teachers leaving the profession?

Next, public pension plans were created so public workers would have pension benefits comparable to private employees. As stated in the study, private employers have converted most of their defined benefit plans to defined contribution and hybrid plans. Is it fair that public employees, who keep their jobs, have benefits that are so much larger than private employees?

Third, defined benefit plans by their very nature include forced inter-generational transfers. The benefit for employees in their 20's who terminate with 3-5 years of service have most of their benefit funded by

their employee contributions. The 7.5% of pay from employer contributions is then used to pay for benefits of older employees. Is this good public policy?

Fourth, subsidized early retirement benefits present several issues. Everyone in the plan pays for the benefits, but only those who retire early receive the benefit. If everyone retired at the earliest possible date, the plans would become prohibitively expensive. Subsidized early retirement benefits are also known as "cliff benefits" because the value of the benefit increases significantly on just one day. Depending on salary and service the increase in the benefit can be in the $50,000 to $100,000 level. It is not an uncommon experience for employees who should leave the profession to hang on until they qualify for the subsidized early retirement. Are these the types on incentives that should be part of our public plans?

Finally, the study assumes that the employees stay in the public plan for their entire career. Experience shows that employees are changing their careers every five to ten years. Since defined benefits are frozen at termination, employees who change their career and their retirement plans will not receive the level of benefits suggested by the study.

ARE THE RISKS OF RETIREMENT PROPERLY DIVERSIFIED?

A basic tenet of investing is to diversify risk. If a retirees' income is only coming from two sources, then are the risks of retirement sufficiently diversified? Employees can contribute to a 403(b), but with such low salaries and high employee contributions, it is very difficult to save in a 403(b).

Some may argue that a public pension backed by general revenues of the state is almost risk free. Given the funded status of many state plans, and the attacks on public plans that are currently being made in many state legislatures, it does not appear that state plans are risk free. The employees of the public plan of Pritchard, AL are the first test case of this issue. Currently, their public plan is bankrupt and not paying benefits to its retirees. The case is in the courts, and all concerned are watching with great interest.

IS WORK AFTER THE TRADITIONAL RETIREMENT AGE RECOGNIZED?

Today's demographics do not support a wholesale exit of the Baby Boomers from the workforce. There is an excellent article on retirement in the April 9th to 15th issue of "The Economist". Most baby boomers have not prepared for retirement. They will need to work into what would have been their retirement years. Even those who have prepared may still be needed in the workforce. Our world is used to societies where there are more young people the old people. There is roughly the same number of baby boomers as there are Generation X'ers. This has important implications for our economy.

Richard Bolles, the author of <u>What Color Is Your Parachute</u> addressed this issue in his book <u>The Three Boxes of Life.</u> Traditionally we have considered the three main stages of life as education, work, and retiree as three vertical boxes as follows:

Criteria for Evaluating Retirement Plan Design

We think that we should go through a period of education, then work, and finally retirement. While there may be some elements of each stage in the other, each stage in life is dominated by a single purpose. Mr. Bolles suggests a healthier model where there is lifelong education, lifelong work, and lifelong retirement (or recreation) as follows:

Retirement
Work
Education

This seems to be a much healthier and more productive model for life planning. When the Baby Boomers entered the workforce, early retirements were encouraged to make room for all the people entering the workforce. This is not a problem that will probably ever re-occur. We need to find ways to make our older citizens productive members of society. Due to the demographics of our country, it is required. However, it is also in the best interest of the retirees to remain integral part of society.

Fundamental Aspects of a Revised Public Pension System

While the Retirement Study shows the clear benefits of defined benefit plans, it does not address the need to diversify the risks of retirement between Social Security, defined benefit plans, defined contribution plans, and continued employment after the traditional retirement age. Every person's retirement income should come from all four sources. In order to facilitate this change, the following changes to our public pension plans seem appropriate:

- Change current plan to 1% of final average pay for each year of service.
- No subsidized early retirement.
- Have a mandatory 3% of pay defined contribution plan.
- Voluntary contributions could be made to 403(b) for those who want larger or earlier retirement benefits.

Something must also be done to encourage private plans. No public plans will be safe from change if most of the private employees only have 401(k) plans, if anything, while public employees have guaranteed defined benefit plans. Yet, the size of a defined benefit plan can cause the profits and loss of the entire company to be overshadowed by the profit and losses on the defined benefit pension plan. This is one of the main factors driving so many private employers to terminate their defined benefit plans. Some counties have started what they call a second level of Social Security that is really a multi-employer private pension plan. Such a plan could provide a 1% of final average salary with no subsidized early retirement. It would be funded just as current private and public plans are with a mix of stocks and bonds managed by an independent investment committee. These plans could be by state, by class of employment (e.g. a plan for the financial sector, a plan for manufacturing, etc.), or by an entirely national plan. Such a plan would also solve the problem of people changing jobs, and having a series of frozen defined benefits that do not produce an adequate income.

Also, changes need to be made to encourage work after the traditional retirement age. The changing demographics of our country just does not support the wholesale exit of the baby boomers from the workforce. Defined contribution plans allow employees to receive monthly incomes without a penalties for working. It seems equitable that defined benefit plans have the same policy.

TRANSITION ISSUES

Current case law appears to support the position that once a public employee becomes a participant in a pension plan, the future formula cannot be changed. However, it appears that our society cannot afford the benefits that have been promised to the current public employees. If current employees are guaranteed the future benefits that they have been promised, at some point future employees will have to receive less. The New York Times has pointed out that we currently spend more as a society on our retirees than we do on our children. This is not a healthy practice. We have to find a way to reduce our spending on retirees.

In the private sector such changes have been made by freezing the current accrued benefits of participants in a pension plan, and then retirees would receive the greater of the current frozen accrued benefit or the ultimate benefit from a new plan. This method would be much fairer to the Generation X and Y employees than keeping all current employees in the current plan and putting new employees

into a defined contribution plan. This also avoids the problem with have today with two sets of benefits for those eligible for the Rule of 90, and those not eligible for the Rule of 90.

It is probably safe to say that the Unions will never agree to such a proposal. However, this may encourage someone to start a private company to outsource public services. Such a company would not be burdened by the costs of today's retirement and health costs, and could provide the same or better services at a much lower costs. With today's tight budgets it may be wiser to cut your losses and keep the current public employees, rather than risk losing all public jobs. While this may not seem very plausible, I am old enough to remember when no one thought that all the manufacturing jobs that were in Minnesota could ever leave. They did. One of the main causes of those manufacturing jobs leaving was the union's refusal to negotiate lower health and retirement benefits. We should not make the same mistake twice.