Notes for Testimony before the LCPR on February 14, 2012
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Minnesota's Public Pension Funding Principles , dated 2010, are:
://www.house.leg.state.mn.us/hrd/pubs/ppfundg.pdf

1.Minnesota "prefunds pension benefits" as opposed to a "pay-as-you-go" approach. This means that taxpayers and employees are supposed to fund the benefits that employees earn each year. This is based on the notion that it is unethical to shift the cost of government today onto taxpayers of tomorrow.

2. While the exact amount of funding needed is unknown, the state makes assumptions about unknown variables and updates funding estimates annually.

3.Another principles is that pension funds must pay off unfunded liabilities. While an unfunded liability does not mean that a pension fund does not have enough money to meet current obligations, it does mean that contributions were too low, an increase in benefits was applied to past serve and not paid for or that that one or more of the funding assumptions was wrong.

While Minnesota tackled its unfunded liabilities in 2010 with some incremental changes, the unfunded liabilities continue to grow. The actuarial UL as of June 30th 2011 was about $13.7 billion for all plans, while the UL for the general employee plans was just under $11 billion (in 2010 it was closer to $10.1 billion so it has grown).

I also note that Minnesota has not made the Actuarial Recommended Contribution (or ARC) to its pensions funds in 2008, 2009, 2010 or 2011.

So today you are considering further adjustments, including changing the assumed rate of return (or discount rate), moving over-time earnings into supplemental funds and hybrid pensions.

GASB has recently suggested that pension funds increase the transparency of pension funding by treating them as long-term liabilities and reporting them in financial statements rather than as a footnote.
GASB has been joined by many economists and policy organization like ours in not only encouraging greater transparency but also reviewing the assumptions used to measure the assets and liabilities of a pension fund including the assumed rate of return or discount rate.

GASB recommends a "combo approach" using the historical rate of return and lower rate pegged to a high-quality municipal index. Others have suggested that this does not fully account for the risk to the taxpayer, and suggest that a "risk free rate" is a better measure.

GASB has also warned against using 30-year amortization schedules and instead immediately recognize changes such as an increase in benefits to retirees, projected earnings and new demographic assumptions for retired workers. Minnesota's 2010 Omnibus pension bill availed itself of the 30-year amortization and thus re-set the payment schedule.

Because of the 2008 recession, as well as a recognition that markets and funds may not recover as expected, the recommendations from GASB and many pension experts point to a reduction in the assumed rate of return which means that, if adopted :

- Minnesota's UL, as restated, would be larger
- The contributions for pension funds would increase

While this is not a politically comfortable place to be, it is a good outcome because it more accurately reflects the true financial state of the pension funds.

Andrew Biggs testified before this commission last fall that actuaries did not understand the economics of pension funds; they are good at designing assumptions to cover the unknown factors about employees (such as how long they will work or how long they will live). I think it is fair to say that very few people, whether they are economists, actuaries or rocket scientists, understand pensions.

What is clear, is that Minnesota is not meeting its own funding principles and that the cost of government today is being pushed into the future. That is fundamentally unfair particularly when you consider that young people today will already be paying off other government debt and benefits for their parents and grandparents.

The 8.5% assumed rate of return in Minnesota is the highest in the nation; it drives the investment policy at SBI and determines contributions from the state budget (Taxpayers) and state employees.

I note that the average ARR is 8.0% but that is dropping as we speak. Caltrs just dropped their rate to 7.5%----and other states and municipalities are following suit.

From the December 2011 Loop Capital Markets Pension Report:

"Out of the 245 state-level plans examined, the average investment return assumption was 7.79%, and the median was 8%. Similarly, of the 72 local-level plans examined, the average investment return assumption was 7.88%, and the median was 8%. Plans with over $1 billion in assets had an average investment return assumption of 7.91% at the state-level, and 8.01% at the local-level. Plans with less than $500 million in assets had an average investment return assumption of 7.67% at the state-level, and 7.69% at the local-level.

"Some states, however, have begun to take proactive steps in lowering their investment return assumptions. Thirteen plans decreased their investment return assumption by an average of 0.38%. Montana lowered their investment return assumption for all state-level plans, except the teachers retirement system, (whose return was already 7.75%), from 8.00% to 7.75%. All other states that lowered their rate did so for just one, or a couple of their state-level plans." (p. 6)

I also note that Minnesota's asset allocation, between equities and bonds, is different from the average fund that assumes 8%. According to Loop Capital Markets report in December, plans that assume 8% have a mix of 50 equities and 30% fixed income. Minnesota has about 60% equities and 20% bonds. Because we ask SBI to achieve an 8.5% return over the long run, SBI has to have a more high-risk investment strategy and gets more volatile returns.

With that said, SBI has reported these 10 year returns at SBI are:

- Stocks 3.3%
- Intl Stocks 6.8%
- Bonds 5.8%
- Alternative 13.2%---this is where some of the more risky, volatile returns take place.

A survey of 100 large companies with private, define benefit pensions and OPEB obligations. "The median pension discount rate at the end of 2010 was 5.40% (compared with 5.86% at the end of 2009)….The median expected long-term rate of return on plan assets of 8.00% decreased approximately 10 basis points compared with 8.11% at eh end of 2009. This decrease may be caused by a number of factors including lower asset return expectations and changes in asset mix." Page 2, Pension/OPEB 2011 Survey ://www.pwc.com/en_US/us/hr-management/assets/NY-12-0010_Pension_OPEB_Assumptions_Survey.pdf

I am neither an economist or actuary—and do not wish to pick a fight with either professional group. I do know that as a taxpayer, I find the pension system too complicated. I marvel at all the hard work and time elected officials put into understanding and designing the pension plans but at the end of the day, I do not think anyone can fully account for the pension plans and why they are so underfunded.

On behalf of employees who are counting on pensions and taxpayers who help pay for them, I urge you to make the pension reporting more transparent and to modify the return assumptions as you consider fundamental reform to the defined benefit pension plans.

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Other citations:

NASRA: Among the 126 plans in the Public Fund Survey (see Figure 4), 19 plans have reduced their investment return assumption since fiscal year 2008. Since fiscal year 2001, 44 plans have reduced their assumption. Eight percent remains the predominant rate assumption, with all retirement systems in the Survey falling in the range from 7 to 8.5.

://westvirginia.watchdog.org/3057/state-local-pension-accounting-takes-a-gasb-step-toward-transparency/ (Great summary of what GASB means, discussion of big issues).

://www.bloomberg.com/news/2012-02-02/california-teachers-pension-fund-reduces-assumed-return-rate-to-7-5-.htmlThe California State Teachers' Retirement System, the second-largest U.S. public pension, cut its assumed annual rate of return to 7.5 percent from 7.75 percent, the second reduction since 2010