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As you consider alternatives to the current pension system and merging the very troubled Duluth teachers fund into TRA, I want to offer you the latest big contribution to the national conversation on pensions and do my best to apply it to Minnesota.

The report, "Strengthening the Security of Public Sector Defined Benefit Plans" from the Rockefeller Institute of Government, is a candid assessment of the defined benefit funding crisis and what real reform looks like to get to full funding.

This January 2014 report would suggest that if Minnesota remains committed to a defined benefit model, we will have to, just for starters, significantly raise contribution levels and reduce benefits.

The Rockefeller Institute would fairly be described as "center- to- left- of –center" politically. This candid report would also suggest that the actuarial estimates of what it will take to make TRA whole in the event of a merger with Duluth or Saint Paul, are flawed and deeply understate the liabilities. For example, this study would suggest that the true cost of merging the Duluth fund would be somewhere between $30 and $45 million a year—not the $15 million estimated by our actuaries. In fact, it also suggests that the valuation reports for all the state funds are flawed and deeply understate the liabilities. This throws into question whether Minnesota is receiving enough money from Minneapolis for past mergers of pension funds.

I will give you a quick overview of the report:

Fundamental Flaws in US Public Pensions. The report from the Rockefeller Institute of Government is a candid assessment of the defined benefit funding crisis and what real reform looks like to get to full funding.

The report highlights what it calls a "deeply flawed funding approach" that traps "pension administrators and government funders in potentially destructive myths and misunderstanding."

What are these myths and misunderstandings? These should be familiar to most of you as we have covered these ideas over the last year.

Inaccurate financial reporting that cascades throughout the system. The proper rate for valuing future liabilities is separate from what pension funds will earn on their investments—and there is no logical connection between them. *Funds like Minnesota that use the same rates for both functions produce valuation reports that do not accurately calculate future liabilities.* Even with understated liabilities, the valuation reports (from major funds) for 2013 all warn that none of the funds are expected to reach full funding under the statutory amortization period. So this gives your work great urgency.

See, for example the MSRS General report on page 1: *"Statutory contributions are not sufficient to fully amortize the unfunded actuarial accrued liability over the statutory amortization period of 27 years. Based on the current member and employer contribution rates and other methods and assumptions described in this report….an infinite number of years would be required to eliminate the unfunded liability (the unfunded liability will never be eliminated). Furthermore, based on current contributions, the unfunded liability as a percent of pay will increase without limit to an infinite amount."*

Rockefeller recommends that pensions should use a significantly lower rate that reflects the real risk. Failure to do so leads to the underfunding we now see. If you are in doubt, note that private and public pension funds throughout the world follow this more conservative practice. The United States public pension sector stands alone in this misunderstanding—and it is underfunded by an estimated $2 trillion to $3 trillion. Minnesota's share is between $17 billion at the low end and $50 billion at the high end.

Incentives to take risk. The financial reporting problem is made worse by the link between the assumed rate of return and the contribution rates. The higher the assumed rate of return, the lower the contributions. Minnesota remains an outlier

by continuing to assume a rate of 8 to 8.5% on its investments. Not only do we not put enough money away, but there is an incentive to take risk to reach high yields. Minnesota is not alone in moving from a conservative investment policy to one that is "inherently risky", according to the report. It goes on to note that because pensions are guaranteed even if the funds run short, operating budgets for core services bear an unacceptable level of risk. The authors warn of a "crowding out" scenario where operating budgets are strained and cut to meet pension obligations. That scenario is playing out in cities and states across the country. If the State of Minnesota does not come to the rescue of the Duluth Teachers fund, we would see it played out there. I mention this so that you will see that this "crowding out" scenario has already arrived in our great state. (Given Rockefeller's suggestion that our actuaries have understated the Duluth liabilities, perhaps the Duluth school district, St. Louis County and the City of Duluth as the immediate beneficiaries of Duluth schools, should join the state in discussion on how to make TRA truly whole if it is to be merged.)

It would be tragic if Minnesota fails to heed this warning and misses the earliest possible opportunity to fix the problem.

Lax rules—and absence of rules---allows underpayment of contributions. Here the authors note that long amortization periods like Minnesota's 30 year rule---which we reset each year-- allow the plans to put off the pain of funding promises—and they describe the practice of missing actuarial payments as "insidious." ***Minnesota has not paid the full contribution since 2008 and missed required contributions in the last three years by almost a billion dollars; $252 million in 2011, $360 million in 2012 and almost $400 million in 2013. That is a billion dollars that is not being invested by the State Board of Investment but has been promised to public employees.*** Imagine what that billion dollars could have earned in the market (though perhaps at high risk) these last few years.

Perhaps we could prevail upon the governor to consider paying some of the surplus into the pension funds as part of a reform package. I would also suggest passing legislation that requires the state to fully fund the actuarial required contribution just as it would pay any other debt obligation on time and in full.

The risks and potential consequences of these funding flaws are greater now than ever before. The authors note that as unfunded liabilities grow, they are making up a greater share of the economy and at the same time are taking on a greater investment risk profile. The danger this poses to our economy and local and state governments cannot be overstated.

The Rockefeller Institute report outlines detailed steps Minnesota could take to get a much more accurate valuation of local and state liabilities, reduce the risk of pensions for taxpayers and public employees, but all with an eye toward saving the defined benefit system.

My favorite quote from the report is "the future does arrive." (Page viiii of the Executive Summary)

Others have concluded that we have already reached a point of no return and that it would be more prudent to replace a defined benefit with a defined contribution plan (or some kind of hybrid). I note, for example, that Sweden moved from a defined benefit to a defined contribution plan in the 1990's because it knew the funds would be bankrupt in 20-25 years. (See, http://pensionconference.chicagofedblogs.org/archives/2006/03/notional_pensio.html)

I think that if Minnesota's public employees, employers and taxpayers were asked to actually fully fund a defined benefit system as suggested by Rockefeller, they would conclude that a defined contribution not only offered greater upside to employees but less risk to employers and taxpayers.

- For a good discussion on pension reform and why hybrids should be rejected because they do not solve the problem, see Richard C. Dreyfus, Manhattan Institute Fixing the Public Sector Pension Problem: The True Path to Long-Term Reform (rejects hybrids---yes! But we can talk about them and why we think it is a mistake to keep a DB) http://www.manhattan-institute.org/pdf/cr_74.pdf

- For a helpful discussion on how Minnesota can move from a DB to a DC, see Josh B. McGee. Ph.D., Arnold Foundation March 2013 The Transition Cost Mirage---False Argument Distract from Real Pension Reform Debates

http://www.arnoldfoundation.org/sites/default/files/pdf/LJAF_Transition_Cost_Policy_Brief.pdf (argues that we can pay off debt early) ;

- And also see, Robert M. Costrell, Arnold Foundation May 2012 "GASB Won't Let ME"---A False Objection to Public Pension Reform http://www.arnoldfoundation.org/resources/%E2%80%9Cgasb-won%E2%80%99t-let-me%E2%80%9D-%E2%80%93-false-objection-public-pension-reform (Minnesota's actuary and 2011 legislative study are called out as being in error pages 13-14)

- For some clarifying news on how we measure retirement income, please see Sylvester Schieber and Andrew Biggs, "Retirees aren't headed for the poor house" where they explain that a commonly cited measure of retirement income ignores at least 60% of the money that seniors receive. http://online.wsj.com/news/articles/SB10001424052702304603704579329012635470796

Introduction to the Pension Crisis in the US and Minnesota

- Andrew Biggs AEI http://www.aei.org/article/economics/when-it-comes-to-public-pensions-theres-funding-and-then-theres-funding/
- Report of the State Budget Crisis Task Force July 2012 Richard Ravitch and Paul Volker Co-Chairs (Alice Rivlin and George Schultz) summary: http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Summary.pdf
- full report http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf