August 15, 1996
Room 10, State Office Building

20th Meeting

LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

MINUTES

Representative Richard Jefferson, Chair of the Legislative Commission on Pensions and Retirement, called the meeting to order at 12:40 P.M.

Commission members present:
Representatives Richard Jefferson, Bob Johnson, Phyllis Kahn, and Steve Smith
Senators Steven Morse, Phil Riveness, and LeRoy Stumpf

Commission members with an excused absence:
Senators Lawrence Pogemiller and Roy Terwilliger

1. **Approval of Meeting Minutes, Meetings of May 23, 1996 and June 13, 1996**
Rep. Jefferson moved approval of the meeting minutes of May 23 and June 13, 1996. **MOTION PREVAILED**.

2. **Review of 1994-1995 Time-Weighted Rate of Return Investment Reporting Under Minnesota Statutes, Section 356.218**
Edward Burek, LCPR Deputy Executive Director, stated that two memos were included in Commission member packets on this issue. The first memo was an executive summary that discussed the main issues on this topic. The second memo provided more extensive information. Mr. Burek provided background and an overview of the topic. He noted that the material in the second memo is divided into three groups, the major plans, police and paid fire plans, and volunteer fire plans. He then reviewed the total portfolio benchmarks that would be used for all three groups. Mr. Burek noted that 1994 was a bad year for investments because of inflation fears and the federal reserve's increases in interest rates. However, 1995 was a very good year for investments because the federal reserve reduced interest rates. He noted that the MERF returns for the three year period from 1993 through 1995 are comparable to the returns of the other major plans. He further noted that the major plans track the stock and bond benchmarks closely and have not underperformed the markets to any great extent. Mr. Burek reviewed the issues the Commission may want responses to from the appropriate fund directors. The first issue concerned SBI's stock portfolio. SBI's investment goal is to exceed its benchmark, the Wilshire 5000, by a fraction of one percent but for the six year period ending with 1995 they have underperformed their benchmark by .6 percent.

Rep. Johnson asked what was SBI's current dollar asset amount. Mr. Burek responded that SBI has current assets of approximately $30 billion dollars. He noted that .6 percent of the SBI basic fund stock underperformance over the six year period would be approximately $270 million dollars.

Sen. Stumpf restated that it is SBI's benchmark goal to outperform the Wilshire 5000 by a fraction of a percent but they have not succeeded. Mr. Burek agreed with that statement.

Rep. Phyllis Kahn asked if the underperformance estimate took into account the compounding effect. Mr. Burek stated that his estimate did take into account the compounding effect of the six year underperformance.

Mr. Burek reviewed the second issue for which the Commission may want a response. The issue concerned the MTRFA approximately one percent stock underperformance in comparison to the Wilshire 5000 and the S&P 500. He stated that the Commission may want to ask MTRFA what they use for a stock benchmark and what actions they may be considering to achieve better performance.

Rep. Johnson questioned how SBI's underperformance might have affected benefits, employee contributions, and employer contributions. Rep. Johnson also asked if SBI has responded to this document. Mr. Burek stated that SBI did not see this document prior to this meeting since it is Commission policy not to provide staff memos to anyone prior to Commission members receiving them. Mr. Burek further stated that he is sure that there is understanding on the part of the SBI

Investment Advisory Council and some of the SBI Board members that their active stock managers as a group have not added value over the long term. Mr. Burek stated that SBI has a combination strategy. SBI indexes a portion of their stock portfolio to the Wilshire 5000, they also use an enhanced index strategy, and in addition have active managers. Mr. Burek stated that the numbers in this report indicate that the active managers have not added value but have lost value. He also noted that SBI had a strong performance in bonds which helped to offset the underperformance in stock. Discussion followed.

Rep. Kahn questioned whether there was a dollar amount connected with the MTRFA stock underperformance. Mr. Burek estimated the underperformance for MTRFA for the six year time period at $19 million dollars.

Mr. Burek reviewed the third issue for which the Commission may want a response. It concerned MERF's reporting of money recovered through lawsuits. He stated that MERF seems to be reporting lawsuit settlement amounts as capital gains without disclosing this practice in their time-weighted rate of return reports. An extraordinary event should be disclosed to anyone viewing MERF's investment returns otherwise, normally one would assume that the entire return was due to the MERF Board and its money managers actions. Mr. Burek noted that in 1994, when Commission staff first became aware of settlement amounts being reported as capital gains, the effect of one lawsuit raised MERF's total portfolio rate of return by one percentage point. This occurred in a year when most other funds reported returns of zero so MERF's return of 1.89% allowed MERF to be ranked very close to the top of the list for investment returns for 1994. Mr. Burek noted that of even more concern was the $6.5 million dollar fiduciary breach lawsuit settlement against MERF's Board and John Chenoweth. This settlement was also treated as a capital gain and as investment gain, was used to provide a post retirement adjustment for MERF retirees. Mr. Burek stated that although this is not contrary to law, he does not believe it was legislative intent. He further questioned how this settlement was allocated between the MERF retired and active accounts. Discussion followed.

Mr. Burek began his review of investment returns for the non-consolidated police and paid fire plans. He noted that their total portfolio returns trail the benchmarks and the major plans considerably since the last report done by Commission staff in 1994 with data through 1992. He then referred to Tables 5 and 6, the bonds and stock rates of return. He stated that the low 1994 bond returns and the high 1995 bond returns indicate that the funds were probably holding bonds with a longer maturity. With regard to the stock returns most of the funds fall far below the benchmarks and this might indicate that the police and paid fire funds are not well diversified. Rep. Johnson asked how this information might help these funds in the future. Mr. Burek stated that the boards for these funds should be reviewing their past investment history and determining what would be reasonable investment policies for the future. Rep. Johnson stated that he believes the boards are probably doing that but he questioned whether the Commission or Commission staff was suggesting a legislative initiative that would place greater fiduciary responsibilities on trustees. Mr. Burek responded that this Commission staff report is meant only to provide information.

Mr. Burek referred members to the volunteer firefighter returns and stated that as a group they are falling behind the major funds and the police and paid fire funds. In 1994, heavy weighting toward bonds with longer maturities contributed to their losses. These funds also substantially underperformed the stock market. Discussion followed.

Mr. Burek referred members to Table 10 which attempted to show in dollar terms the amount each of the funds reporting added or lost to their portfolio in comparison to a conservative, passively managed portfolio comprised of 10% cash, 60% bonds, and 30%. He noted that all of the major funds gained value in comparison to the benchmark fund, seven out of the nine police and paid fire funds lost value in comparison to this benchmark fund, and only six of the volunteer fire funds gained value while the majority lost considerable value compared to the benchmark. He noted that this showed a considerable opportunity lost for a substantial number of the funds reporting in comparison to a benchmark portfolio that was itself an underperformer.

Mr. Burek moved on to compliance issues and stated that non-compliance continues to be a problem. Some funds do not file returns and many funds that do file returns use incorrect methodologies or their returns contain obvious errors in the computations. He stated that over 50 letters to fund administrators noting errors were sent as a follow-up to the 1994 returns and so far 23 of the 1995 returns have been identified as problematic. Discussion followed. Mr. Burek recommended that because of the problem with non-filers and erroneous computations, the Commission may wish to consider adding a penalty in law for non-compliance. He further stated that data quality is a real issue. He stated that if the Investment Task Force established by the Commission recommends simplifying the reporting requirements for pension funds, the Commission may want to assure that sufficient information is provided either through the volume of data required or asset class information or by creating a requirement that the funds send in the raw data (actual market value, and cash flow information), so that the numbers can be computed at the state level. Mr. Burek noted that otherwise the database would be of a very poor quality and would not be useful for drawing conclusions.

Rep. Johnson requested that Howard Bicker comment on the State Board of Investment's .6% underperformance of its benchmark, the Wilshire 5000 Stock Index, over a six year period.

Howard Bicker, SBI Executive Director, testified that he is accustomed to looking at investment performance in five year periods rather than six. He further testified that SBI has three long term goals which are to exceed inflation, to exceed the TUCS median over a five year period, and also to exceed, over a five year period, a composite index of securities that the SBI has chosen to invest in. He stated that over a five year period SBI has exceeded the indexes noted on the total portfolio table. He agreed that over a five year period the SBI has underperformed its stock index. He testified that over the long term, SBI will sometimes underperform and sometimes outperform the market but he believes the bottom line is how has the total fund done and he testified that the total fund has outperformed its benchmarks. He further testified that managers have more difficulty outperforming in strong markets than in weak markets. Discussion followed regarding the timeframes for looking at investment returns and SBI's underperformance in its stock portfolio.

Sen. Morse questioned whether the returns are shown net of fees and whether they are calendar year or fiscal year. Mr. Burek responded that except for Table 10, the indexes are not net of fees and the returns shown are all on a calendar year basis because that is the requirement specified in law.

Sen. Morse questioned Mr. Bicker's testimony with regard to SBI's managers outperforming the index in a weak market and referred to the years 1990 and 1994 when SBI's stock performance was considerably under its benchmark? Mr. Bicker stated that historically his statement is true. Sen. Morse asked what benefit the state derives from active manager investment. Mr. Bicker stated that realistically over various periods of time the active managers have not added value but also realistically, if the entire stock portfolio was passively managed, the portfolio would underperform the index because there are costs to run a passive portfolio. Mr. Bicker further stated that only one-third of SBI's stock portfolio is now actively managed.

Dick Nelson and Brian Rice, representing the Minneapolis Police Relief Association, testified regarding the reduction in the required contribution by the City of Minneapolis to the Minneapolis Police Relief Association due to the enactment of the thirteenth check legislation. He testified that the City of Minneapolis will levy $3.5 million dollars this year as compared to $16.2 million in 1988. Mr. Nelson provided background on the Minneapolis Police Relief Association's investment policies and noted their assets have grown to $330 million dollars. He testified that their main objective is to reach full funding by 2010. He further testified that prior to 1994, Minneapolis Police Relief Association's investment portfolio was heavily weighted toward bonds but they have since reallocated their portfolio.

Rep. Kahn asked for an explanation for the high loss by the Minneapolis Police Relief Association compared to a very conservative benchmark fund as shown in Table 10. Mr. Rice responded that Table 10 looks at only a two year period. He referred members to Table 4 and testified that Minneapolis Fire, over a six year period, exceeded the TUCS although Minneapolis Police did not. He testified that as a result of these reports, the two Minneapolis relief associations have reviewed their investment policies and made adjustments. He further recommended that the Commission provide an opportunity for the funds to comment on the returns shown in this report. He also testified that the Minneapolis police and fire funds are diversifying. They now have invested in international funds and have also invested in real estate within the City of Minneapolis.

Judy Johnson, MERF Executive Director, testified regarding the treatment of lawsuit settlements in the MERF time-weighted rate of return reports. She testified that in 1992 she was General Counsel at the State Auditor's Office and the State Auditor's Office, at that time, required MERF to have some of their investments revalued and written down since the valuations on the books for those investments were inaccurate. Under generally accepted accounting principles the rule is to use the lesser of market or book and MERF was required to take about $70 million dollars in losses. Generally accepted accounting principles also say that if any of those losses are recovered, either through a restoration of market or any other means, the gains should be taken into income and cannot be considered contributions. The losses directly impacted retirees' benefits and so do the gains. She will disclose the impact of any gains due to lawsuit settlements or other extraordinary occurrences in future time-weighted return reports from MERF.

Rep. Kahn asked Ms. Johnson if the fiduciary lawsuit settlement was appropriate to use in providing a post retirement adjustment to retirees. Ms. Johnson testified that it was the thinking of MERF's actuaries and accountants that the investment losses decreased the post retirement adjustment retirees received so the settlement should be part of the gains used to increase retirees' post retirement adjustment. Ms. Johnson agreed to provide the Commission with a memo showing how the investment losses impacted MERF's retirees.

3. Mandated Commission Study: Defined Contribution Pension Plans and Defined Benefit Pension Plans (Second Consideration)

Lawrence A. Martin, LCPR Executive Director, began his review of the second staff memo on this topic. He stated that this is the end of the staff work on this topic and at the end of the memo he has provided some options for the Commission's consideration regarding recommendations and legislation. Mr. Martin began his presentation and noted that the purpose of the study was to determine which employees could be characterized to be the most benefited by each of the two types of plans. He further noted that public pension plans in Minnesota are predominantly defined benefit plans and, for the most part, defined contribution plans are a more recent development.

Sen. Riveness questioned why all unclassified employees were not eligible for the Unclassified Employees Retirement Plan. Mr. Martin responded that the Unclassified Plan was established for employees who hold positions with the potential for high turnover because their positions are politically sensitive.

Mr. Martin stated that a large number of defined contribution plans throughout the country are supplemental deferred compensation plan arrangements. He briefly reviewed the five reasons defined contribution pension plans are established as noted in the staff memo. Mr. Martin referenced a 1995 Forbes magazine article which favorably discussed defined contribution pension plans replacing underfunded and overgenerous defined benefit pension plans.

Rep. Kahn questioned whether the pension plans that have changed from defined benefit plans to defined contribution plans apply to new hires only. Mr. Martin responded that the information provided in the articles on this topic are not very specific but his belief is that they apply largely to new hires.

Mr. Martin continued his presentation with a review of federal taxation issues that specifically deal with defined contribution or defined benefit pension plans. He cited the principle difference in tax treatment between defined benefit and defined contribution plans from a federal tax code standpoint are the section 415 limitations. There are limits on benefit amounts that apply to a defined benefit pension plan under section 415 and there are limits on contributions that apply to a defined contribution pension plan under section 415. Mr. Martin reviewed the characteristics of the two types of plans with regard to contributions, coverage, funding, investment risk, and administration. He then reviewed the characteristics of which broad groups of employees would benefit from each of the two types of plans. Mr. Martin reviewed the considerations of an employer in determining whether to establish a defined benefit or defined contribution pension plan. He referenced the proposed reformulation of the pension policy principles in which Rep. Jefferson suggested that a purpose for the state's public pension plans be included as well as a general preference for defined benefit pension plans over defined contribution pension plans. Mr. Martin concluded his presentation with the options staff identified for completing the mandated study of defined benefit and defined contribution pension plans.

Rep. Johnson questioned the staff memo's statement that a defined contribution pension plan is cheaper than a defined benefit plan. He stated that it was his understanding that the Unclassified Plan and IRAP are quite expensive. Mr. Martin responded that the Unclassified Plan employee contribution was only changed in recent years to correspond to the MSRS General employee contribution and the employer contribution has not changed for several years while MSRS General's employer contribution has been reduced. Rep. Johnson asked if mobility is as much of an issue among public employees as in the private sector? Mr. Martin stated that he has not seen any good studies concerning public employee mobility versus private employee mobility. He stated that while the Commission was studying actuarial assumptions it was noted that there is a very high turnover probability for younger and shorter service employees. He stated that the probability of an employee entering state or local government service at age 25 and still being there at age 55 or 60 is very slight, somewhere between two and ten percent while for teachers the probability is fifty percent that they will remain until retirement.

Rep. Kahn suggested a direction for the Commission on this topic. She stated that the Commission should make it clear that the three major plans should always remain defined benefit plans. She also would prefer the word "consideration" rather than "recommendation" for options d and e on page 16 of the staff memo. She would like to see further analysis of the problems involved when employees are given choices between defined benefit and defined contribution pension plans.

Sen. Riveness agreed with Rep. Kahn that the major plans should remain defined benefit plans. He also stated that although one of the purposes of a pension plan is to retain staff, it should not be a fence that holds people back that should move out of public service. He suggested looking at the changing dynamics in the work force. Sen. Riveness requested on his and Sen. Morse's behalf that the Commission continue to review this topic (Sen. Morse had to leave this meeting early due to another commitment).

Sen. Stumpf also requested on his and Sen. Pogemiller's behalf that discussion on this topic continue (Sen. Pogemiller's father died so he was unable to attend this meeting). Sen. Stumpf stated that he is interested in the federal regulations that affect what can and cannot be done at the state level. The ability to earn after retirement and part-time retirements are issues that will come up in the future and he would like to have discussion on those topics.

Rep. Jefferson agreed that the broadness of this topic does require additional review. He also stated that he believes there is a need to provide more portability for public employees than what is currently available in law.

The meeting adjourned at 4:15 P.M.

Jean Liebgott

Jean Liebgott, Secretary