November 12, 1997
Room 15, Capitol

14th Meeting

LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

MINUTES

Senator Steven Morse, Chair of the Legislative Commission on Pensions and Retirement, called the meeting to order at 9:25 A.M.

Commission members present:
Representatives Mike Delmont, Richard Jefferson, Phyllis Kahn, Harry Mares, and Mary Murphy
Senators Don Betzold, Dean Johnson, Steven Morse, Lawrence Pogemiller, and LeRoy Stumpf

Commission members with an excused absence:
Senator Roy Terwilliger and Representative Steve Smith

3. **Designated Study: Funding and Allocation of Police Pension-Related State Aids (Second Consideration)**
Lawrence A. Martin, LCPR Executive Director, stated that the staff memo would provide information on the state aid provided to pension funds on a fund-by-fund basis. He noted that the memo provided background information on each of the funds and then he referred members to Attachment A. He stated that Attachment A showed the funded status of all the plans receiving Police State Aid. Sen. Morse noted that the unfunded accrued liability figure of $226,167,000 for PERA-P&F should be in parenthesis because that fund is fully funded. Mr. Martin agreed with Sen. Morse's correction. Rep. Delmont questioned the description on page 2, paragraph 2, under State Patrol Retirement Plan which stated employees of the "Department of Public Safety who lacked the power of arrest." Mr. Martin responded that the definition Rep. Delmont referred to is the language provided in statute. Mr. Martin continued to review Attachment A and stated that non-consolidated police pension plans are required by statute to be provided with the full amortization amount annually whereas, statewide plans and consolidated police relief associations have their funding primarily set as a percentage of payroll and the Legislature resets that funding level periodically. Discussion followed.

At this time a quorum was present and Sen. Morse reverted to agenda item one.

1. **Approval of Minutes of the October 7, and October 22, 1997, Commission Meetings**
Senator Betzold moved approval of the October 7, and October 22, 1997 Commission Meetings. **Motion Prevailed.**

Mr. Martin continued with his review of the Funding and Allocation of Police Pension-Related State Aids. He referred members to the charts shown as Attachments B through M and noted that the charts provide a graphic representation of the funding and source of funding received by each of the plans shown in Attachment A. Mr. Martin referred to Attachment B. He noted that police state aid is being phased into the State Patrol and, although it only covers half of the employer contribution this year, next year it will cover virtually the entire employer contribution. This will permit a reduction in the appropriation for the State Patrol Plan. Sen. Pogemiller questioned how a general agency budget item for pension contributions is shown in the budget. Sen. Morse responded that general agency items are not broken out to that level in the budget. Sen. Pogemiller asked how the executive branch was going to reflect this reduction in the general agency requirements in their budgeting process. Phil Kapler, Department of Finance, testified that the police state aid amounts received by the Department of Natural Resources and Public Safety were to be included in their base budgets for the 2000-2001 biennium and will be transferred to the departments. This will make the police state aid allocation numbers from the Department of Revenue unusual since the money that went to local governments will be expenditures and the money that goes to state agencies will be transfers. The money that went to the Department of Public Safety can only be applied to the employer contribution for non-general funded positions. General fund position money must be deposited and canceled back as non-dedicated receipts and will not show up in the

Department of Public Safety base. The Department of Natural Resources was allowed to keep both the general fund and non-general fund position portion of State Aid so it will show up in their base. Mr. Kapler testified that in his opinion, the Legislature may be double paying those departments. Discussion followed and it was agreed that the Executive Branch and House and Senate Finance Committees should be made aware of this funding so that everyone understands the impact.

Mr. Martin continued by reviewing Attachment C, Funding PERA-P&F. He noted that police state aid is the largest single funding amount for PERA-P&F. He moved on to the PERA-P&F Consolidation Account funding chart which showed the many different aid programs providing funding for these plans. He noted that he had forgotten to include the First Class City Fire Surcharge Aid for Duluth and St. Paul police and fire funds so the chart should have one more segment. Sen. Johnson questioned what was amortization aid. Mr. Martin responded that when the Legislature approved phasing-out local police and fire funds in 1980 so that all new members would be going into PERA-P&F, the State established the amortization aid program to assist the funds in paying off their unfunded accrued liability. Mr. Martin continued with his review of the charts. He reviewed MERF funding and Minneapolis police funding. Sen. Morse questioned why on the local police accounts the member contribution is only 8% when the member contribution for PERA-P&F and the PERA-P&F Consolidation accounts is approximately 40% of their normal cost. Mr. Martin responded that as part of the Guidelines Act local police and paid fire plans required a member contribution of 8% as a minimum. Local police and fire plans have not been required to use the 40/60 split which has been a statewide policy for public safety plans and which was formalized in the recent review of the Principles of Pension Policy. Discussion followed.

Mr. Martin reviewed the final chart, Attachment M, and the table following it, Attachment N, which showed the jurisdictions that only had PERA-P&F covered members. He noted that the general trend shown in the table is that police state aid has increasingly covered the employer pension obligation going from 83.80% coverage in 1991 to 97.72% coverage in 1997.

Sen. Morse questioned how the aid works. Mr. Martin responded that the aid a municipality received in 1997 will reimburse them for their 1996 expenditure for police pension costs. Sen. Morse questioned the degree of confidence there is that the State is not paying out more money than a municipality is actually contributing to the pension fund. Mr. Martin responded that there is a potential for loose administration of the program beginning with the certification of police officers. He stated that in 1996 he reviewed the number of POST certified police officers in a jurisdiction, the number of police officers PERA listed in that same jurisdiction and the number certified to the Department of Revenue and, in several cases, the numbers did not match. Municipalities certify to PERA how many full-time police officers they have and the preliminary aid distribution is made on that basis up to the actual PERA employer obligation. There is the potential that the numbers could be overstated. Sen. Morse restated the process noting that municipalities make a contribution to the state, then certify what they paid, and then the State sends a check to reimburse the municipality. He stated that the Commission will study this topic further at another meeting.

2. Results of Time Weighted Rate of Investment Return Reporting by Larger Minnesota Public Pension Plans

Mr. Edward Burek, LCPR Deputy Executive Director, referred members to the three pieces in their packets, the staff memo, Table 3, and the appendices. He noted that due to changes in the law last session, this is the last time the LCPR staff will be providing this report based on information reported to the Commission by relief associations with assets greater than $500,000. In the future, the time-weighted return data as well as the investment attribution data will be provided to the State Auditor. The Auditor will be computing total portfolio returns for all public pension plans and will be computing asset class returns for plans with over $10 million in assets. Mr. Burek then began to review Table 3. He stated that Table 3 provided the one year and three year total portfolio growth rates for all the funds that provided usable data to the Commission for 1996 and that the remaining columns in the table provided an example of the dollar impact of those returns in comparison to a low-end standard, the Composite Fund, and in comparison to the State Board of Investment Combined Fund. He stated that there is a wide range between plans for the one year and three year growth rates and that the Major Funds' returns are higher than the Police and Paid Fire returns and the Police and Paid Fire returns are higher than the Volunteer Fire returns. Mr. Burek stated that the returns for all these funds are the result of two factors, the asset mix the plans select and the success that the plans have in earning market returns for the given asset mix. He then reviewed the indices in Table 1 on page 5 and the pie charts in Table 2 on page 7 of the memo. He referred members to the appendix items and specifically to appendix page 5. He noted that the Wilshire 5000 Stock Index annual returns are provided in the first column and going across the annualized returns are provided. Mr. Burek stated that the major plans for the most part are able to capture market returns for stock, the police and paid fire plans are not doing as well, and the volunteer fire plans stock performance is noticeably below the police and paid fire plans and are quite erratic. Based on the Lehman Aggregate Bond Index, the bond returns for the police and paid fire plans show many of them slightly below the index, the major plans' bond performance is higher than the police and paid fire, and the volunteer fire plans' bond returns are below the police and paid fire plans. Mr. Burek referred members to Table 3 on page 10 of the memo and reviewed the makeup of the Composite Fund which the Commission has used as an index since it began reviewing the time-weighted rate of return data. He stated that the Composite Fund is a very conservative fund made up of 30% stock, 10% cash, and 60% bonds. He stated that Table 3 provided a relevant comparison for each of the three groups of funds and that he did not realize when he put the table together that SBI would have the highest returns. He further noted that the comparison of these funds to SBI is reasonable since there has been past discussion of consolidating the first class city funds with the statewide funds while police and paid fire funds are already authorized to consolidate with PERA so those portfolios would then be invested by SBI. Volunteer fire funds do not have an option to consolidate but they do have an option to invest in supplemental funds SBI offers.

Sen. Morse asked how many volunteer fire funds invest with SBI. Mr. Burek stated that the information is available in the SBI annual report and that the last time he checked, 40 volunteer fire fund portfolios were invested in SBI supplemental investments.

Mr. Burek continued with his review of Table 3 and noted that the table provided a method of tracking a $1 million investment gain or loss relative to both the Composite Fund and the State Board of Investment Combined fund at each fund's three year growth rate. He reviewed each group of funds' gain or loss and the impact the gain or loss had on each fund's portfolio. Mr. Burek stated that all of the major funds have lost considerably over the last three year period compared to the SBI returns that might have been achieved. He noted that the most cynical conclusion that could be drawn from these results is that the direct state aid provided by the Legislature has not made the hoped for impact.

Sen. Morse stated that if the major funds' portfolios had been invested by SBI for the last three years, their assets would have increased by $54 million, the police and paid fire assets would have increased by $40 million, and the volunteer fire fund assets would have increased by approximately $20 million. This adds up to approximately $113 million over three years. Sen. Morse then asked, historically, how has SBI compared to the other funds? Mr. Burek stated that, for the major fund group, we cannot assume that SBI would be the top performer. He noted that if we had provided this table last year for the 1994 and 1995 two year period, some of the major funds would have shown a gain relative to SBI.

Rep. Kahn noted that on appendix page 5, SBI lagged behind the S&P 500 Index and questioned whether SBI might perform better if it simply invested in stock index funds rather than employ its money managers. Mr. Burek responded that SBI has changed its approach and now invests 1/3 of its stock assets with active managers, 1/3 in index funds, and 1/3 in enhanced index funds.

Sen. Morse stated that some of the results are disturbing since the low returns can result in additional or continuing state aid. Discussion followed.

Sen. Betzold questioned the poor performance of the 1996 Spring Lake Park returns. Mr. Burek stated that Spring Lake Park bond returns tend to swing much more than the market returns. When the bond market returns are up, Spring Lake Park returns are very high, but when the bond market returns are down, Spring Lake Park returns are very low. He said that indicates that their portfolio may have bonds with maturities that are much longer than market maturities. Long term bonds tend to be heavily impacted by any change in interest rates. Spring Lake Park's stock returns are not even close to tracking the market. The bond and stock performance may be acceptable if they create some stability in the portfolio or higher returns than could be achieved if they took a more conservative approach but instead, they have great variability in bonds and stocks and total portfolio returns that are far below what could be expected.

Mr. Burek then reviewed the major funds in more detail and noted that some years they may outperform the SBI and some years they may underperform SBI, but they merit watching. He stated that the MERF Total Fund showed a $32 million loss in assets that would have been available for post retirement increases when compared to SBI. This may be due to the MERF Post Fund having a more conservative asset mix than the SBI Post Fund and still having some drag from the weak investments that MERF held in the late 80's and early 90's. Mr. Burek noted that last year he had commented on the SBI and MTRFA stock performance. The SBI stock performance has shown improvement this year but MTRFA has not and the early 1997 MTRFA stock portfolio performance was very weak. This may have a significant impact on the MTRFA fund and should be watched.

Mr. Burek noted that the police and paid fire plans average returns are considerably below the major plans. Austin Fire, Crookston Police and Fairmont Police did not beat the low-end Composite Fund benchmark and all of the police and fire funds showed sizable losses compared to SBI. The police and paid fire plans are authorized to consolidate with PERA and, in view of the returns the local plans have provided, leaving them as freestanding associations is the more costly alternative. He then reviewed six of the police and paid fire funds in more detail. He specifically cited Minneapolis Fire and stated that their total portfolio returns have been higher than other funds' returns mainly due to extremely high 1991 stock returns. He stated that they could be vulnerable to a considerable downturn if they continue to use the strategy that produced such high returns. He further noted that their more recent stock returns have not been on a par with their previous performance and they would have been better off if they had indexed. Minneapolis Police stock and bond returns for the last year have been close to the market returns but long term their returns have been weak compared to the major plans.

Mr. Burek began to review the volunteer fire plans and he noted that over the three year term their average is lagging behind the police and fire and major plan returns. He stated that half of the plans are underperforming the Composite Fund and over the three year period all of the plans are underperforming the SBI Combined Fund Portfolio. None of the volunteer fire plans has been able to achieve a 12% three year return. He specifically noted that Cottage Grove and Bloomington have stronger 1996 returns but weaker returns over the longer period. The implication is that the fire state aid is not being efficiently used. If an arrangement can be found which creates a higher level of investment performance for these plans, the same level of pension benefits could be paid with far less state aid or, alternatively, pension benefits far in excess of those currently being paid could be paid using the same amount of state aid. The conclusion is that the current arrangement does not seem to be in the best interest of the volunteer firefighters or the state.

Rep. Kahn stated that she is concerned that the LCPR will no longer be producing this analysis since the simplification of the reporting law last session provided that the State Auditor will be the recipient of investment performance data from the pension funds in the future. She asked if anyone from the State Auditor's office could provide information on the commitment the State Auditor's office has made to provide this kind of analysis. Deno Howard, State Auditor's Office, testified that the State Auditor plans to provide whatever information is required by the law that passed last session. Mr. Burek stated that the State Auditor will be computing total portfolio returns so Table 3 would still be able to be produced, however, asset class information for plans with assets less than $10 million will not be available and this may impact those plans since they will have less information to work with.

Mr. Burek reviewed the volunteer fire plans in more detail. He specifically reviewed Lakeville, Mendota Heights, and Plymouth Volunteer Fire as funds that had three year returns under 5%, which is a return that could have been received by simply investing in cash markets. He noted that Lakeville was involved in some poor investments several years ago and has not shown any signs of recovering. Mendota Heights stock performance for 1995 and 1996 was half of the market return. Plymouth's 1995 stock return was negative 3% when the market provided returns of 36.5% which means that Plymouth's returns for that year were approximately 40 percentage points under market. Spring Lake Park's stock returns have been very volatile and for 1996 their stock return was 3.59%. This indicates that they may not be broadly diversified and are very vulnerable to fluctuations in the market.

Sen. Morse directed Commission staff to send a letter to all of the funds with investment returns which are less than one-half of the SBI returns and ask them to provide an explanation.

Brian Rice, a Best & Flanagan lobbyist for Minneapolis Police & Fire, provided a handwritten sheet with a table that he compiled using the data from Mr. Burek's report. He reviewed his table which showed the one year, three year, and seven year total portfolio, stock and bond returns for SBI, Minneapolis Police and Fire, and the first class city funds. He testified that the variation in performance for these funds is small. Mr. Rice continued his testimony and referred members to page 6 of Mr. Martin's previous memo. He noted that PERA-P&F has total assets of $1.6 billion, takes in $62 million in contributions, and pays annuities of $37 million annually which is about 2% of their assets. Minneapolis Police has $320 million in assets, takes in $10 million in contributions, and pays benefits of about $19 million annually. PERA is paying out half as much as they are taking in while Minneapolis Police is paying out about twice as much as they are taking in. PERA is paying 2% of its assets in benefits, Minneapolis Police is paying out 6% of its assets in benefits, and MERF is paying out 8% of its assets in benefits so the asset allocation strategy is a big factor in closed funds.

Sen. Morse questioned whether Mr. Rice was making an argument against closed funds. Mr. Rice responded negatively. Mr. Rice continued with his testimony.

5. Designated Study: Purchase of Prior Service Credit Authorizations and Payment Amount (Second Consideration)

Mr. Martin began his review of the staff memo on this issue by briefly referring members to several items in their packets on this issue, a November 6th memo, a November 10th memo, and a table designated Attachment A. He noted that this was the second time the Commission was considering this topic during the interim. He stated that he had requested the various pension funds to calculate some hypothetical prior service credit purchases. The fund directors substituted fewer and less varied hypotheticals which were determined to be sufficient to provide the Commission with an understanding of the factors involved. Mr. Martin stated that he hoped to provide Commission members with information on current purchase of service credit calculations so that they would understand what the result would be if the method for calculating prior service credit were changed. Mr. Martin briefly reviewed the Minneapolis Teachers Coordinated Program hypotheticals shown on page 3. He then briefly reviewed Attachment A. Mr. Martin then reviewed the supplemental memo and graphs. He stated that the hypothetical calculations in Graph #1 show the sensitivity of the purchase amount to the age of the person when they purchase the service. He then reviewed Graph #2, which showed how the amount of service the person has accrued affects the purchase payment amount at different ages. Graph #4 showed the sensitivity to the amount of service credit being purchased especially if the "Rule of 90" is involved. Mr. Martin continued with his review of the graphs. He referred members to page 4 of the November 6th memo which showed the types of service which may be authorized as a result of this study. He stated that the next time this issue was on the agenda, TRA planned to provide an alternative purchase payment calculation procedure and staff would request that Mr. Tom Custis, Milliman & Robertson, Inc., provide the actuarial valuation result of using that alternative purchase payment procedure.

Rose Hermodson, representing the Minnesota Federation of Teachers, testified regarding buybacks dealing with maternity leaves. She provided a copy of the Rules and Regulations of the Board of Education of the City of Duluth from 1960 which showed under VI. J. the maternity policy of that school district. She testified that Mary Lou Wicklund is an example of the situation in the 60's and 70's and provided details of Ms. Wicklund's case. Ms. Hermodson testified that the first collective bargaining agreements went into effect in September of 1971 and were not much different than the board policies. Women who were impacted by these board policies are requesting an opportunity to purchase the service credit that they lost.

The meeting adjourned at 1:05 P.M.

Jean A. Liebgott

Jean Liebgott, Secretary