November 17th and 18th, 1998 24th Meeting
Room 15, Capitol

LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

MINUTES

November 17, 1998 Agenda

Senator Steven Morse, Chair of the Legislative Commission on Pensions and Retirement, called the meeting to order at 1:14 P.M.

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

Commission members absent:
Representatives Mike Delmont and Steve Smith and Senator Roy Terwilliger

Agenda Items Discussed

2. **Commission Interim Topic: Potential Expanded Authority For Prior Military, Unpurchased Interim Military, Out-of-State Teaching, and Maternity Service Credit Purchases (First Consideration)**
Senator Morse noted that the Commission did not yet have a quorum so he would begin with the second agenda item. He noted that this topic is the result of legislation introduced last year and that he had made a commitment to study the issues. The topic has widespread interest and he hoped that the Commission would come up with some recommendations for legislation to be introduced in the next session. He requested that Lawrence A. Martin, LCPR Executive Director, review the staff memo on this topic.

Mr. Martin referred members to two staff memos, one dated September 8th and the other dated November 13 and began to review the earlier memo. He stated that the two memos provided members with background on this topic. He stated that service credit purchases are a phenomenon of defined benefit pension plans since the value that an employee gains is determined largely by their service credit. Minnesota pension plans currently permit some service credit purchases and this study provided an opportunity to discuss expanding authority for service credit purchases. He reviewed the Commission's policy on service credit purchases and noted that the Commission has authorized past service credit purchases on a case-by-case basis. He referred members to Chart 1 which showed the previously authorized service credit purchases by type of service and by plan. He also noted that there was a listing of the Special Law service credit purchase authorizations on page three of the memo. He provided background information on the 1997 study of the actuarial value purchase payment amount which resulted in a new method for calculating that value. The new calculation method passed the Legislature last session. He stated that the previous method of calculating full actuarial value was the worst case scenario and the newly adopted method was less than the worst case scenario and should be less costly for employees. He reviewed the difference between the service credit purchase payment amounts using the two methods and noted that the new method provided smaller purchase payment amounts and in some cases significantly smaller purchase payment amounts. Sen. Morse asked if staff had any information on the purchase payment amounts under the two methods for service credit purchase bills passed in the 1998 Session? Mr. Martin stated that staff would not have numbers for the 1998 service credit purchases until the actuarial valuations were completed. He reviewed the four types of service credit purchases that would have been authorized under the 1998 legislation. The first would permit the purchase of military service which occurred prior to public employment, the second would permit the purchase of uncredited military service which interrupted public employment, the third would permit the purchase of out of state public school teaching service, and the fourth would permit pre-1976 maternity leaves or maternity breaks-in-service. Sen. Morse questioned what might have been the reason an employee would not have purchased their military service credit if that service interrupted their public employment? Mr. Martin suggested that the employee might not have had the money to make the purchase or may not have expected to stay in public employment. Sen. Morse asked what was currently allowed for purchasing military service credit which occurred prior to public employment? Mr. Martin stated that other than a Vietnam War service purchase provision in TRA law that has expired and might have permitted the purchase of prior military service, that type of service is not permitted under Minnesota law. Federal law does require the authority to purchase on-leave military service credit but not prior military service. Discussion followed.

Rep. Mares asked if Commission staff had any numbers on how many employees may be interested in purchasing service under these provisions? Mr. Martin stated that the Commission has some numbers on potential utilization of these service credit purchases included in the November 13th memo. Rep. Mares asked if there had been any discussion of coaching activity becoming part of the high-five computations? Mr. Martin stated that the topic of extracurricular activity pension contributions was studied extensively for about a five year period and is different than this topic because the member received credit for their service but they in effect bought the same credit for a higher price than teachers who did not coach unless the extracurricular service occurred in their high five years. This problem also affects employees other than teachers who may work overtime early in their careers and make higher pension contributions but if it is not a part of their high five years they do not receive any benefit for those higher contributions. The Commission never resolved this issue in a manner acceptable enough to pass the Commission. Mr. Martin referred members to Attachment A, which provided a chronological list of the special law provisions authorizing purchases of prior service and repayments of refunds, and the other attachments to the September memo.

Mr. Martin then referred members to the November 13th staff memo which covered the practices of other states in dealing with prior service credit purchases and also covered the potential number of teachers who would purchase service if S.F. 2798; H.F. 3228 were enacted. He provided an overview of an August 1998 study on purchases of service credit done by the Public Retirement Institute. He stated that the study noted that there is very little research on this topic probably due to the complexity of prior service credit purchase provisions. The study collected data on 147 local government plans and found that 48% allowed the purchase of some service credit. He referred members to the table on page two of the staff memo and gave an overview of the data. He noted that the Institute also surveyed statewide plans and received responses from 93 plans of which 92% permitted some types of service credit purchases. He referred members to pages three and four of the memo and reviewed the tables showing the types of plans that responded and the types of service credit purchases permitted. The primary type of service credit permitted was military service. He stated that he reviewed 72 public pension plan web sites that included information which could be analyzed on purchases of prior service credit. Rep. Mares questioned whether the military service shown in Table 2 was prior military service or on leave military service? Mr. Martin stated that the Institute did not differentiate between types of military service and, since federal law requires plans to provide on leave military service credit, that number probably should be 100%. Mr. Martin noted that the web site sampling did differentiate between the types of military service and he referred members to the tables on page five of the memo and reviewed the data. He noted that Attachment A following the memo provided a table that showed a state-by-state breakdown of the types of service credit eligible for purchase. He referred members to the bar charts between pages five and six of the memo which showed employees in various age and service categories, since purchases of service credit are driven by age and service. Rep. Kahn questioned whether it wouldn't be less costly for persons that might be eligible to buy service credit to buy that service credit at much earlier ages and she questioned whether the pension funds provided an informational packet stating that if an employee had service they might want credit for later, it may be to their advantage to buy it early? Mr. Martin responded that Rep. Kahn was correct but he was not sure what the plans currently provided with regard to counseling on purchases of prior service credit. He continued to review the TRA and first class city teachers age and service charts.

Mr. Martin referred members to pages six and seven of the memo which included data from the Minneapolis and St. Paul teachers plans as a result of his request that the four teacher plans survey their members on this issue. He noted that he received information from the Duluth teachers plan an hour prior to the beginning of this meeting so it was not included in the staff memo and that TRA had not yet conducted its survey. He reviewed the survey data he had received and noted that the largest contingent of employees expressing interest in purchasing service were interested in out-of-state teaching service, which is currently available to Minneapolis teachers.

Sen. Morse asked whether the Minneapolis teachers had included the 1977-1981 maternity period in addition to the other maternity period because they did not allow the purchase of maternity service credit until 1981? Mr. Martin responded affirmatively. Mr. Martin concluded by stating that it would be difficult to get conclusive numbers for the total number of potential employees who might purchase these service credits if authorized because of the self-selective nature of the service. He stated that at the next meeting on this topic, the staff memo would provide a policy analysis of the issues raised. Sen. Morse asked if the Legislature passed legislation authorizing these purchases of service credit for the teacher plans wouldn't other public plans also want that authorization? Mr. Martin responded affirmatively and stated that was one of the policy issues raised when the Commission discussed this legislation last session since the issue is broader than just the teacher plans.

Senator Stumpf questioned whether the military service credit included prior military service as well as on leave military service? Sen. Morse responded that both types of military service credit were included. Mr. Martin stated that federal law requires the provision of on leave military service credit. Sen. Stumpf agreed with the purchase authorization of on leave military service but stated that it would be hard to justify authorizing prior military service credit purchases since private sector employees do not have that option.

1. Approval of the Minutes of the Commission Meeting of September 29, 1998, and the MERF Subcommittee Meeting of October 1, 1998

Sen. Morse noted that since a quorum was present, he would entertain a motion for adoption of the minutes. Rep. Mares moved adoption of the minutes of the meeting of September 29 and the MERF Subcommittee meeting of October 1, 1998. **MOTION PREVAILED**.

Sen. Morse then asked for testimony from interested parties on the purchase of service credit issue.

Rose Hermodson, Education Minnesota, introduced Larry Jensen who was particularly interested in the purchase of prior military service credit.

Larry Jensen, a Kimball area school teacher, testified in support of the authorization to purchase prior military service credit for Vietnam era veterans whose college education's were interrupted by military service. He testified that without this authorization, teachers who did not serve, avoided service, or had their teaching service interrupted by military service will be able to retire two to three years earlier than those who served prior to public employment. He stated that many Vietnam veterans were exposed to agent orange and may not have as long a life expectancy which makes the opportunity to retire earlier more desirable. He testified that Vietnam veterans are willing to contribute to the purchase amount. Sen. Morse asked Mr. Jensen how long he served? Mr. Jensen responded that he served for two years and seven months and will not receive any retirement benefit for that service other than Social Security. Sen. Morse asked Mr. Jensen how he would respond to Sen. Stumpf's concern that providing this benefit to public employees would create a disparity between public employees and private employees? Mr. Jensen stated that he is speaking for Vietnam era veterans who were the last veterans subject to the draft. He testified regarding employees who seem to have been rewarded for being draft dodgers and stated that the Vietnam war was so unpopular that even today those veterans do not get the respect given to other war veterans. Sen. Betzold noted that Vietnam era veterans did receive special benefits under the GI Bill and many veterans were educated and became teachers as a result of their military service.

Rose Hermodson testified that many people who were not veterans also received financial aid to pay for college expenses related to teaching careers because there was such a need for teachers in the late 1960's and early 1970's. She also testified in support of authorizing purchases of service for prior military service.

Rep. Murphy asked Mr. Jensen for the timeline for his college, military service, and entry into teaching. Mr. Jensen responded that he interrupted his freshman year in college (1965-1966) to enter the military, reentered college in the fall of 1969, graduated in 1972, and began teaching in the fall of 1972. Sen. Johnson asked how many people might be interested in purchasing prior military service? Mr. Jensen was not sure. Ms. Hermodson also testified in support of maternity leave and out-of-state teaching service purchases.

Lloyd Belford, Legislative Chair for the Retired Educators Association of Minnesota, testified in support of authorizing these purchases of service credit opportunities even though the result may be a shortage of teachers because improving benefits may be an incentive to draw more young people into the teaching profession. Sen. Morse asked whether the retirees were hoping that by improving active member benefits it might also result in improving retiree benefits. Mr. Belford responded negatively.

Gary Austin, TRA Director, testified that he graduated from college in 1966 and enlisted in the military. He also commented that TRA is still getting responses to their survey and have received approximately 1,000 to date with 676 female and 310 male respondents. Of the respondents, 55% support authorization of the purchases of service which are being studied this interim. He also noted that the comment section of the survey showed that many people are interested in the purchase of private school service. Discussion followed.

J. Michael Stoffel, DTRFA Executive Secretary, referred members to the letter from the Duluth Teachers Retirement Fund Association in response to the survey request and clarified that the Percent Reporting column in the table which showed 3.6% were interested in military service might be misleading. The 3.6% figure was considering the 1000 teachers that received the survey but 16% of those responding to the survey expressed interest in military service credit, 28% were interested in pre-76 maternity leave credit, and 57% were interested in out-of-state teaching credit.

Eugene Waschbusch, StPTRFA Executive Secretary, testified in support of authorizing these purchases of prior service. He testified that the military service credit proponents from his membership believe that unfairness stems from their being drafted. He testified that members of the StPTRFA were not eligible to purchase maternity leave of service until 1989 and they are very interested in purchasing that credit.

Karen Kilberg, MTRFA Executive Secretary, testified that her members have the authority to purchase out-of-state teaching service credit at full actuarial value under the old method, as stated in law, but the cost is prohibitive and they have only had three or four members purchase that kind of service credit. Sen. Morse questioned whether MTRFA would seek a change in the law to permit this service credit to be purchased using the new calculation? Ms. Kilberg responded that if a purchase of service credit bill was passed using the new calculation she would hope that MTRFA would be included. Sen. Morse asked if the authorization to purchase out-of-state teaching credit is a useful recruiting tool? Ms. Kilberg responded that teachers seeking a position with the Minneapolis school system ask if the opportunity to purchase out-of-state teaching service is available but very few inquire further. Discussion followed regarding whether the current military service credit authority was only for members who were drafted. Mr. Martin stated that federal law requires the authorization to purchase interrupted military service credit regardless of whether a member was drafted or enlisted. Rep. Murphy asked who provided the comments shown on the last page of Mr. Martin's memo? Mr. Martin responded that those comments came from StPTRFA. Rep. Murphy asked if the authority to purchase maternity service credit being considered was only for maternity leaves that interrupted teaching careers and not for maternity periods that occurred prior to public employment? Mr. Martin responded affirmatively since the current authority requires teaching service both before and after the maternity leave period.

3. Commission Interim Topic: Potential Revisions In The Minimum Volunteer Firefighter Aid Portion of the Fire State Aid Program (First Consideration)

Sen. Morse introduced this item of the agenda and noted that he suspects that the minimum fire state aid program may be modified during the next legislative session.

Edward Burek, LCPR Deputy Executive Director, referred members to the staff memo dated November 12, 1998. He stated that the issue has arisen because the language in the law that passed in the 1996 Session based the count for allocating the minimum state aid on the 1993 membership of volunteer firefighter relief associations. He noted that because of the 1993 membership requirement, relief associations organized after 1993 are not eligible for the minimum fire state aid program. Mr. Burek provided background on the fire state aid program. He then reviewed the process for allocating the minimum fire state aid. He referred members to Mr. Martin's February 23, 1996 memo to Sen. Morse and specifically to the tables after the memo. He noted that Column 10 showed the projected minimum state aid for approximately half of the 700 volunteer firefighter relief associations in Minnesota. He stated that the minimum fire state aid will increase as police and paid firefighter relief associations achieve full funding and no longer qualify for amortization and supplemental amortization aid causing an increase in the unallocated portion of these aids which is the funding source of the minimum fire state aid program. He reviewed possible changes the Commission may want to make in the minimum fire state aid program. Some revisions might be to require recipients to follow all State Auditor report filing requirements, to reset the historical year to allow relief associations established after 1993 and before the reset base date to be eligible for the minimum state aid program, to reduce the 70% amount of unallocated amortization and supplemental aid that currently goes to the first class city teacher funds. Mr. Burek then reviewed the table showing the 1997 minimum floor fire state aid. He noted that the total minimum floor state aid for 1997 was $667,615 and for 1998 is $974,078. Mr. Burek stated that we do not have an estimate of how many relief associations have been established since the 1993 base year.

Sen. Stumpf asked Mr. Burek to elaborate on the aid withheld from relief associations by the State Auditor. Mr. Burek responded that state aid would only be withheld if the associations were out of compliance with the financial reporting requirements in state law.

Phil Kapler, representing the Office of the State Auditor Pension Division, stated that when they received the data from Revenue, 148 relief associations were out of compliance and the final date to come into compliance is November 30th, 1998. He also testified that, as of this time, only 11 funds are out of compliance. Sen. Morse asked what happens to the state aid money withheld from non-compliant relief associations? Mr. Kapler responded that he believed the money canceled back to the General Fund but he will research that question. Sen. Pogemiller asked whether there are any tables which show all the revenue sources and dollar amounts the relief associations receive? Mr. Martin responded that the State Auditor's Office does a compilation of volunteer fire funds that includes all the funding sources for the special fund. The most recent report the Commission has is 1996 and he would be able to produce a report that provided the information Sen. Pogemiller requested. Sen. Pogemiller stated that currently there is no correlation between the funding of the relief associations and the need for funding. There is the potential for some funds to get more money than they need. Discussion followed.

Rep. Kahn asked why the State Auditor does not withhold state aid from relief associations that do not file their Economic Interest Statements? Mr. Kapler responded that he does not believe there is a certification process set up between the Ethical Practices Board and the Department of Revenue.

Jim Hanson representing MARAC, the Minnesota State Fire Departments Association, and Minnesota State Fire Chiefs Association, testified in support of the minimum floor fire state aid program as a recruitment and retention tool. He also testified in support of the current distribution formula.

4. **Commission Interim Topic: Police Pension State Aid Revision/PERA-P&F Consolidation Account Amalgamation (Second Consideration)**

Mr. Martin noted that this topic combined and continued two topics studied last interim and he provided background. He noted that the objectives of the topics were to provide a better understanding of the source and distribution of police state aid and to resolve what to do with the growing number of police and fire consolidation accounts that are fully funded. Mr. Martin referred members to the staff memo dated September 25, 1998. He briefly reviewed the fire state aid programs which consist of fire state aid, the first class city fire insurance premium tax surcharge, amortization state aid, supplemental amortization aid, and additional amortization state aid. He then referred members to the colored flow charts covering both fire and police state aid. He noted that most of the money for these programs comes from the dedicated insurance premium taxes. He continued to review the other charts. He noted that 1997 legislation changed the allocation of excess police state aid to include the highway patrol and DNR conservation officers. Sen. Morse provided background on the 1997 legislation with regard to the Department of Finance's actions to guarantee that they met their projections by taking a set amount rather than a percentage but he also noted that after the year 2000 distribution, the formula reverts to the pre-1997 distribution method. Mr. Martin stated that the reduction in the PERA-P&F employer contribution rate that will occur as required by law will produce significantly more excess police aid. Discussion followed.

Mr. Martin referred members to the results of actuarial surveys over various years and how relief associations funding has changed over time. He then referred members to pages nine and ten of the staff memo for factors identified as having helped improve the funded condition of various police and paid fire relief associations. He stated that when the 1998 actuarial work is completed, he will provide the Commission with updated information on the consolidated accounts' funding status to enable the Commission to consider restructuring the aid programs and how the aid programs are administered. Sen. Morse noted that it is an increasingly complicated system and he believes that it should be simplified.

Brian Rice, from Best and Flanagan and representing Minneapolis police and fire relief associations, testified that his understanding of the policy behind the additional aid programs was to pay off the unfunded liability of the relief associations as quickly as possible because once the plans are fully funded, the aid programs drop off. He also testified that with regard to Mr. Martin's charts, all of the money shown going to Minneapolis police and fire does not go to the relief associations. Some of that money goes to pay PERA-P&F employer contributions for Minneapolis public safety employees hired after 1980. Mr. Rice also testified that he does not believe the revenue in the aid programs will grow quite as much as was projected on the charts because adding the state patrol and conservation officers cost more than expected. He testified in support of continuing the aid programs until all relief associations are fully funded.

Terry Haltiner, representative of the City of St. Paul, testified in support of increasing the amortization aid for consolidated relief associations because some of the funds that were fully funded may fall below when PERA-P&F contribution rates are reduced.

The meeting adjourned at 4:55 P.M.

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Senator Steven Morse, Chair of the Legislative Commission on Pensions and Retirement, called the meeting to order at 8:55 A.M.

<u>Commission members present:</u>
Representatives Richard Jefferson, Phyllis Kahn, Harry Mares, Mary Murphy, and Steve Smith
Senators Don Betzold, Steven Morse, Lawrence Pogemiller, and LeRoy Stumpf

<u>Commission members absent</u>:
Representative Mike Delmont and Senators Dean Johnson and Roy Terwilliger

<u>Agenda Items Discussed</u>

November 18, 1998 Agenda

4. Commission Interim Topic: Potential Improvements in Local Correctional Employee Benefit Coverage (Second Consideration)

Edward Burek, LCPR Deputy Executive Director, referred members to the two memos in their packets and began to review the June 15, 1998, staff memo on this issue. He reviewed the background on this issue and noted that last session a bill was introduced that would have provided pension coverage for local correctional officers using the MSRS-Correctional Plan as a model. He stated that the bill did not pass as introduced but an enhanced duty disability benefit for local correctional officers did pass with an agreement to study the issue over the interim. He then reviewed background on the MSRS-Correctional Plan benefit provisions. He reviewed the differences between the benefits provided by the MSRS-Correctional Plan and the MSRS-General Plan. He also reviewed the enactment and repeal of the PERA local correctional plan. Mr. Burek referred members to the attachments to the staff memo which included a copy of the law regarding the certification procedure for employees who request coverage under the MSRS-Correctional Plan, a copy of the repealed PERA Local Government Correctional Service Plan, actuarial work on various plans, the list of counties that employ the 1647 employees who are seeking a local correctional plan, and the staff memo and bill introduced last session that would have established a local correctional officers pension plan. He commented on the high number of public pension plans already established in Minnesota and stated that it might be better to include the local correctional officers in the MSRS Correctional Plan rather than to establish another plan. He noted that the accrual rate in the original bill introduced last session was set at 2% because of the higher cost of the 2.4% accrual rate which the MSRS-Correctional Plan has.

Bob Johnson, representing Teamsters Local 320, testified in support of establishing benefit improvements for local correctional officers and stated that it is their intention to have a bill introduced next session. He noted that Rep. Mares and Mr. Martin toured the Hennepin County jail and that he was working on setting up a tour of the Dakota County jail for interested Commission members to get a first hand look at conditions in a relatively new facility. He testified that the local correctional officers are asking for prospective coverage only under a local correctional plan. They believe that PERA would be the appropriate administrator of this plan. The bill they plan to have introduced in the 1999 session would include an age 55 normal retirement age, a 1.9% or 2% accrual rate, and it would limit membership to essential employees with at least 75% inmate contact. Sen. Morse asked what were the reasons to set up a new plan rather than put these employees in MSRS-Correctional. Mr. Johnson stated that the cost of the 2.4% accrual rate in the MSRS-Correctional Plan would be prohibitive for the counties involved. He also noted that PERA already has payroll information on these employees. Sen. Morse noted that the MSRS-Correctional employees contribution rate is 5.5% and the PERA correctional officers rate is 4.96% which is not a large jump. Mr. Johnson stated that the local correctional officers have an unfunded actuarial accrued liability that would also have to be considered if they moved to the MSRS-Correctional Plan.

Rep. Mares commented that he participated in the Hennepin County jail tour and he agreed that it is a dangerous occupation. He asked for clarification of the statement on page 3, the second paragraph, "however, ... the process has not been properly followed." Mr. Martin responded that in June, the Commission dealt with certifying employees who were added to the MSRS-Correctional plan without following the procedures established 20 years earlier in Minnesota Statutes. Mr. Martin also noted that about 50 employees have been transferred to MSRS-Correctional without complying with the procedure shown in statutes. Sen. Morse noted that the Commission would be reviewing additional employees seeking certification at the next Commission meeting.

Mary Vanek, PERA Executive Director, testified that the local correctional officers covered by the duty-related disability benefit enacted last session pay a 4.96% contribution rate while PERA-General members pay 4.75%. She further testified that according to actuarial work prepared last session, if local correctional officers had benefits that duplicated the MSRS-Correctional Plan benefits with a 2.4% multiplier, their contribution would need to be increased to 7.5% and the employer contribution rate would be 11.3% compared to the employer contribution rate of 7.7% for the MSRS-Correctional Plan. Sen. Morse asked if those contribution rates reflected starting a new plan rather than adding these employees to the MSRS-Correctional Plan. Ms. Vanek responded affirmatively but testified that if these employees were added to the MSRS-Correctional Plan the cost would be higher. Sen. Morse stated that he would be interested to know what the cost would be to add these employees to MSRS-Correctional rather than spend several sessions establishing a duplicate program at PERA.

Sen. Morse then recommended that members try to go on the Dakota County jail tour that will be coordinated through the Pension Commission office. He also noted that MSRS-Correctional had a 113% funding ratio and a $29 million surplus as of the last actuarial valuation.

3. Commission Interim Topic: Potential Revisions in the Method for Establishing the Actuarial Value of Pension Fund Assets (Second Consideration)

Lawrence A. Martin, LCPR Executive Director, began his review by stating that after the 1996 quadrennial experience studies, the Commission actuary, Thomas Custis (Milliman & Robertson, Inc.) proposed changing the way the actuarial value of assets was determined. He noted that the current method of valuing assets has been used since 1984 and takes the book value of assets plus 1/3 of the difference between the book value and the market value of assets. He noted that the Commission's first consideration memo is dated June 16, 1998, and the second consideration memo is dated July 28, 1998. He stated that the July memo provided members with a range of the results that would be obtained by using different methods of valuing assets as identified by Mr. Custis. He referred members to the bar graphs on pages two through five which indicated the different results using the methods identified as book value, current value, market value, and Mr. Custis's proposed method. He stated that attached to the memo are four bill drafts reflecting the four methods shown. The memo included a summary of each of the bill drafts and the policy issues raised by each. Sen. Morse questioned why the Custis proposed method in the bar charts showed assets lower than the book value of assets.

Thomas Custis, Milliman & Robertson, Inc., testified that the relationship of book value to market value is driven by how fast the investment manager turns over the assets. The method identified as the Custis method unlocks the recognition of asset performance from book value. It is designed to track market value over time while smoothing the volatility that might be seen if a full market value of assets method was used. He stated that this method would be like the post fund mechanism and would spread recognition of gains and losses over a rolling five year period.

Mr. Martin reviewed the policy issues raised by the methods and stated that the Custis proposal seems to be driven by volatility that would last longer than one year and less than six years. The issue is whether that method was solving a problem that doesn't exist, it provided an asset value that is less than book value, and it is difficult to understand. He reviewed the policy issues raised by the full market value method. The issue is that the method exposes funding requirements to the full volatility of the market, the investment style of some plans may cause problems, the method is relatively simple to understand. The partial market/partial expected value of assets method issue is that it takes out volatility but fails to recognize a significant portion of the increase in asset values. He reviewed the market value adjusted by the recognition of gains or losses method. Mr. Martin noted that DTRFA and MTRFA sent letters supporting Mr. Custis' method and they are included in members' packets.

Mr. Custis provided a handout and testified that it showed the dollar-weighted rates of return for each of the funds involved using the old method and his proposed new method. He noted that the third column indicated the asset value using the current method of valuing assets and the fourth column indicated the asset value using his proposed method as if it had been adopted last year and implemented with the first year of transition as he had proposed. He stated that the current method is particularly sensitive to investment management decisions and style. Both Minneapolis Teachers and MERF changed investment managers this year, so the funds held by those managers were liquidated and their returns measured on cost were substantially in excess of market returns. The opposite is true of DTRFA and StPTRFA because they continued with their same manager. The new methodology for the statewide funds produced a significantly lower recognized rate of return in the current year even though their market value indicated that they did better than the other funds. Mr. Custis explained that because this year produced such dramatic returns, the proposed smoothing method recognized only 20% of the excess return over the assumed return. Sen. Morse asked what would happen if the market value of assets were selected as the method? Mr. Custis responded that volatility in the market could cause swings in contribution requirements for smaller employers or a closed group which could cause budgeting problems for those employers.

2. **Commission Interim Topic: Minnesota Public Pension Fund Investment Policies and Performance (Second Consideration)**

Mr. Burek referred members to the August 17, 1998, memo on this topic and stated that it included the investment policy statements of the funds included in this review. He stated that his analysis pointed out weaknesses in the investment policy statements. He stated that the September 25, 1998, staff memo reviewed the investment performance of the ten funds from 1990 to 1997. He referred members to the table on pages two and three of the September memo and noted that an X in the box indicated that the item was covered in the investment policy statement for that fund. Mr. Burek reviewed the concepts and indices used in this report. He then referred members to Table 1, which showed the gain or loss these funds experienced using a four year return when compared to the SBI Combined Fund and the Composite Fund. He noted that all of the funds, except for Minneapolis Fire, showed returns measurably below the return earned by the SBI Combined Fund. Minneapolis Fire's return was slightly higher than SBI's. This table indicated the impact of even small performance differences in the rates of return for these funds given the large amount of assets the funds are managing. He noted that MERF's assets over the four years would have grown by an additional $78 million if SBI had managed their portfolio. He noted that the four year opportunity loss for the first class city teacher funds was $91 million, the loss was $206 million for the combined Minneapolis funds, and the total opportunity loss was $251,383,819 for all of the funds involved in this study compared to SBI. He then briefly reviewed the eight year total portfolio, stock, and bond returns for the funds in the study.

Mr. Burek then reviewed each of the funds individually. He noted that SBI has a fairly aggressive asset mix but it is not out of line with what other funds are doing. The returns show that SBI exceeded its benchmarks for bonds, domestic and foreign stock in 1997. Sen. Morse asked what the rate of return was for SBI's alternative assets. Mr. Burek referred members to the commentary on page 13 and stated that the resource pool return was 92.4% but that accounts for only 1.4% of the Basic fund and is a very small portion of SBI's portfolio. He referred members to Table 6 which indicated all of SBI's domestic stock managers, the dollar amount and percent under each of their management, and the type of management they provide for SBI. He stated that the approach SBI uses keeps it well diversified, allows it to lock in the Wilshire 5000 return, and enables SBI to avoid the market risk that some of the other funds expose themselves to.

Mr. Burek reviewed MTRFA and noted that the asset mix is quite close to SBI's but the returns are low. MTRFA underperformed its domestic stock benchmark by 7.82%. He stated that MTRFA used one equity manager that runs an S&P 500 stock index fund, they manage almost 50% of the MTRFA stock assets, and that fund did slightly outperform its benchmark. However, MTRFA's active stock managers greatly underperformed their benchmarks. He stated that MTRFA has an investment advisory council that recommended that MTRFA invest one-third of its equity portfolio actively, one-third passively, and one-third semi-passively, but the MTRFA Board rejected that advice. Mr. Burek referred members to Table 10 and stated that the State has provided MTRFA with sizable additional funding over the last few years amounting to $30.91 million, to address the unfunded liability in that plan. However, the investment opportunity lost in the MTRFA stock returns for 1997 amounted to $29.65 million when compared to the Wilshire 5000 return and $37.56 million when compared to the S&P 500 return. He stated that improving MTRFA's investment returns might be more beneficial than legislative efforts to provide additional aid since their investment shortfall virtually wiped out two years worth of additional state aid. Sen. Morse clarified Mr. Burek's statements concerning MTRFA and stated that SBI's active stock managers had an investment return of about 30% and the MTRFA stock return ranged from a high of 26% to a low of 4.5%.

Mr. Burek reviewed DTRFA and referred members to Table 11 and noted that the top number in the last column should be +.42 rather than +4.2. He noted that the 15.5% total portfolio return for DTRFA is the same as the MTRFA return. He stated that the cause of that return was their high weighting in bonds which is several percentage points above the SBI and MTRFA weighting. They did exceed their bond benchmark but since stock outperformed bonds that high bond weighting provided a total return considerably below the SBI return and their stock return underperformed their benchmark. Sen. Morse asked what percentage of the DTRFA stock return is actively managed? J. Michael Stoffel, the DTRFA Executive Secretary, responded that 15% of the DTRFA total portfolio is passively managed in domestic equities. Sen. Morse asked why DTRFA invests such a large portion of their portfolio in bonds? Mr. Stoffel stated that DTRFA is more conservative in their investment approach and the nine member board sets the DTRFA asset allocation based on advice from their investment consultant.

Mr. Burek reviewed the StPTRFA returns and noted that their asset mix is similar to DTRFA. They have a higher allocation to domestic stock and produced a higher return on their stock than DTRFA but still underperformed their own benchmark considerably. Sen. Morse asked what percentage of the StPTRFA stock return is actively managed. Eugene Waschbusch, StPTRFA Executive Secretary, responded that 25% of their domestic stock portfolio was passively managed.

Mr. Burek reviewed MERF returns and noted that they are producing returns close to their benchmarks. He stated that their total portfolio return of 18.49% is somewhat below SBI's 21.5% return because of their weighting in mid-cap and small cap stocks. He also noted that MERF relies more heavily on indexed funds for both stocks and bonds.

Mr. Burek stated that Fairmont Police was unable to provide investment return information which indicated that they may be relying on the State Auditor to provide rate of return information. He stated that this means they will get limited rate of return information and it will not be timely. This hampers their ability to make investment related decisions. Mr. Burek stated that Virginia Fire does not have any active members and was unable to provide us with any information.

Mr. Burek stated that Minneapolis Police did not provide data in the manner requested by the Commission so Table 15 was put together using the data they provided and their investment policy statement to determine the benchmarks Minneapolis Police used. He noted that Minneapolis Police provided inconsistent quarterly and annual rates of return for their emerging market and venture capitol portfolio. Minneapolis Police domestic equity return is consistent with the other funds returns but they seem to have a major shift out of bonds from the beginning of the year to the end of the year toward stock which should have improved their total portfolio return but did not. Minneapolis Police had serious problems in every segment of its portfolio and underperformed all of its benchmarks. He stated that Minneapolis Police has indicated that they are prudent, conservative investors but Mr. Burek stated that a review of their activity in 1997 and earlier, showed that their investment actions are inconsistent with those of conservative investors. He stated that a review of their investment performance and investment policy statement, with its lack of well specified policies, indicated that the association does not exercise care. Minneapolis Police seems to be using a market timing strategy, which is a high risk strategy, and they have been unsuccessful. He stated that both Minneapolis Police and Minneapolis Fire give considerable discretion to their balanced fund managers. The information provided in Table 16 by Minneapolis Police indicated that since their managers did not know what their other managers were investing in they may have canceled each others market shifts as evidenced by IAI and Mitchell Hutchins changes in asset allocation from 12/31/96 to 12/31/97. Mr. Burek stated that the Minneapolis Police Board gave IAI, which no longer invests for Minneapolis Police, 52% of its total assets and IAI invested them in two accounts, a balanced account and an international account. Mr. Burek stated that when a Board gives such a large percentage of its assets to one company and that company has problems, it has a large negative effect on the total portfolio. Because the Minneapolis Police Board used so few investment managers and gave one manager such a high percentage of its assets to invest, they exposed the fund to considerable manager risk and it was costly for them. He noted that IAI managed assets for both Minneapolis police and SBI but SBI minimized manager risk by broadly diversifying across their managers and achieved a return in excess of their benchmark. Sen. Morse asked who was affected by the Minneapolis police's $70 million lost investment opportunity? Mr. Burek stated that it affects the City of Minneapolis because it may have to make larger contributions and it affects the State of Minnesota because Minneapolis police will require the various state aid contributions it receives for a longer period than would have been necessary if the Minneapolis police investment returns had been better. Sen. Morse stated that the state amortization aid programs focus money on relief associations that continue to have an unfunded liability until those liabilities are paid off. Sen. Morse asked if Minneapolis police representatives could tell him what the difference was between Domestic Stock and Equity Funds in Table 15 on page 24. Brian Rice, representing Minneapolis police, introduced Gerald Bridgeman. Mr. Bridgeman testified that he believes the equity funds are indexed funds. Sen. Morse asked Mr. Bridgeman to follow-up in writing when he verified the information on what exactly was the difference between the domestic stock and equity fund. Sen. Morse then asked what percent of the total portfolio was passively managed and what percent was actively managed. Mr. Bridgeman testified that approximately 25% of the portfolio has been indexed since they discharged IAI and they are moving toward further indexing. Sen. Morse requested that Mr. Bridgeman provide more detailed information on what percent of their stock portfolio is actively or passively managed and whether it is invested in domestic stock for the time period covered by this report. Mr. Rice testified that his understanding was that the equity funds were domestic stock indexed funds and the funds listed as "Domestic Stock" are the actively managed portion of the portfolio at the end of the year. He referred to Table 17 on page 28 and testified that the ANB fund is an indexed fund and the others are actively managed. He agreed to provide Sen. Morse with a letter providing the detail requested.

Mr. Burek stated that Minneapolis police has been cooperative recently but in the early 90's the Commission staff tried to obtain board meeting minutes from the larger pension funds in the State. The Minneapolis police and fire relief associations would not comply with the request unless Commission members directed them to comply. The Commission did make a motion requesting that information and Minneapolis police did send meeting minutes for a brief period but Minneapolis fire never did send copies of their meeting minutes. He stated that it would be helpful if Commission staff could begin getting copies of meeting minutes on a regular basis. Sen. Morse requested that Minneapolis police and fire provide Commission staff with copies of their meeting minutes and that staff advise him at the next meeting as to whether that has occurred.

Mr. Burek reviewed Minneapolis fire investment returns and stated that long term, they had the highest returns of any public pension fund covered in this report including SBI. He stated that there was a concern with their investment operation. Their investment policy statement is abbreviated and does not provide information on any of their benchmarks. He noted that Minneapolis fire provided investment return information for stocks and bonds and that the bond returns are lower than the Lehman Aggregate benchmark that many funds use. They have 60% of their assets in domestic stock and their return at 38.4% is higher than the S&P 500 return. Minneapolis fire has placed a large percentage of their stock portfolio with one large cap growth manager which has been a rewarding investment style for the past several years. The problem this creates is that this strategy exposes them to considerable risk when that investment style is no longer rewarding, since they are not well diversified and have 91% of their assets with two investment managers. Sen. Morse asked what percentage of Minneapolis fire's stock portfolio was actively or passively managed. Brian Rice responded that the total stock portfolio was actively managed.

Mr. Burek reviewed Bloomington Volunteer Fire investment returns and stated that they provided incomplete and confusing data. They did not provide rate of return information for any asset groupings but did provide rates of return for their Total Return Internal Account at 20.77% and their Total Return Total Fund at 19.67%. Mr. Burek stated that he believes Bloomington fire segregates their investments by internal and external accounts. The internal account may be managed at the discretion of the board and the external account he believes is managed by outside managers. He stated that Bloomington fire would have improved their bond portfolio returns by buying the bond market without any effort to change the weights reflected towards long term, short term, etc. The information Bloomington fire provided in their Standards Valuation report seemed to indicate that they were getting the same bond return as the Lehman Aggregate but the data they provided does not support that claim.

Mr. Burek then referred members to Tables A-1, A-2, and A-3 which showed eight years of investment return information for the funds reviewed in this report broken out by total portfolio, bonds, and stocks.

Rep. Kahn asked if the members of these funds were totally shielded from the effects of the investment decisions their boards make. Mr. Burek responded that the members of these funds are shielded. Depending on the plan, the employer is somewhat impacted if investment performance is poor but the State is most affected either directly or through state aids. The investment decision-makers on the boards of these funds do not bear the risk of their actions.

Sen. Morse stated that he would like Mr. Burek to provide a table for each of these funds showing their asset mix and another table for each indicating the breakdown for active and passive managers for domestic stocks by the next Commission meeting.

Robert Wetherille, a trustee of the Minneapolis Fire Relief Association, testified that he and two other trustees at this meeting had never heard, prior to this meeting, that the Commission had requested minutes of their board meetings. He promised to provide Commission staff with minutes from the last five years of meetings by Monday. He testified that they have a high percentage of assets with Alliance Capital because Alliance has produced very good returns. They have been advised by the State Auditor's Office and the Minneapolis Finance Director to hire a consultant to help the Minneapolis fire board with investments. The Minneapolis fire board is also searching for a new actuary. He testified that the Minneapolis fire investment return is the best in the state and he believes that the board is doing a good job. Sen. Morse agreed that the Minneapolis fire returns have been very good but he is concerned that the fund is not adequately diversified and their strategy is risky.

Brian Rice, representing Minneapolis fire, testified that Minneapolis fire has 60% of their portfolio in domestic stocks but they have the lowest percentage of equity investments of all of the funds included in this review because all the other funds have 10% to 15% of their assets invested in foreign stock. He further testified that Minneapolis fire has 39% of their assets in fixed income, which is a very conservative strategy. He also testified that the highest percentage of SBI's equity portfolio is invested with Alliance Capital. Alliance has been an investment manager for Minneapolis fire for 18 years.

Sen. Morse commented that this report indicated that there has been a foregone gain of a quarter of a billion dollars over this four year timeframe which is significant. He stated that there is a fundamental structural problem in the fact that the individuals making the investment decisions do not bear the consequences of their actions. The State, for the most part, is picking up the downside of those decisions and he wants the Commission to spend more time considering ways to maximize the public return for the public dollars spent.

Sen. Morse stated that the next meeting will be December 16, 1998, and he requested that Commission members keep the whole day open for that meeting.

The meeting adjourned at 12:35 P.M.

Jean A. Liebgott

Jean Liebgott, Secretary