



H.F. 3421
(Murphy, M., by request)

S.F. 2969
(Betzold)

Executive Summary of Commission Staff Materials

Affected Pension Plan(s): Various Statewide Retirement Plans
Relevant Provisions of Law: Minnesota Statutes, Chapter 11A
General Nature of Proposal: Revision or dissolution of the Minnesota Post Retirement Investment Fund
Date of Summary: March 27, 2008

Specific Proposed Changes

- If the Minnesota Post Retirement Investment Fund remains sufficiently funded on a market value basis, the bill continues the Consumer Price Index adjustment component, unnames and modifies the investment performance adjustment component, adds a lost purchasing power adjustment component, and provides for additional benefit and funding recommendations in the event of significant future excess funding.
- If the Minnesota Post Retirement Investment Fund becomes insufficiently funded, the current post-retirement adjustment mechanism and fund arrangement is dissolved, retiree assets would be re-deposited in each retirement fund, and a flat 2.5 percent annual benefit increase would replace the current mechanism.

Policy Issues Raised by the Proposed Legislation

1. Unclear conformity with Commission's Principles of Pension Policy.
2. Appropriateness given unclear policy goal for MPRIF modifications.
3. Appropriateness given the proponents' bias in favor of dissolving the MPRIF.
4. Appropriateness of instituting a dissolution trigger and the selection of the particular trigger.
5. Appropriateness of the complexity of the proposed changes in a retained MPRIF.
6. Unlikely prospect for any meaningful increases from proposed "lost purchasing power" component.
7. Appropriateness of the proposed benefit reductions.
8. Unclear application of MPRIF changes to Minnesota Statutes, Section 356.41.
9. Federal tax code compliance issues arising from the proposal.

Potential Amendments

H3421-1A moves MERF-related provisions from the MPRIF law to the MERF law (technical amendment).
H3421-2A makes language and style revisions under current drafting conventions (technical amendment).
H3421-3A eliminates MPRIF dissolution article, requiring legislative determination before any MPRIF dissolution.
H3421-4A, upon MPRIF funding decline, requires fund administrator report rather than MPRIF dissolution.
H3421-5A resets MPRIF dissolution trigger to a lower funding ratio.
H3421-6A adds actuarial gain pool to the "lost purchasing power" adjustment determination procedure.
H3421-7A makes conforming changes to Minnesota Statutes, Section 356.41, the MPRIF adjustment indexation provision.



TO: Members of the Legislative Commission on Pensions and Retirement
FROM: Lawrence A. Martin, Executive Director *LAM*
RE: H.F. 3421 (Murphy, M., by request); S.F. 2969 (Betzold): Minnesota Post Retirement Investment Fund; Revisions and Dissolution Procedure
DATE: March 27, 2008

Summary of H.F. 3421 (Murphy, M., by request); S.F. 2969 (Betzold)

H.F. 3421 (Murphy, M., by request); S.F. 2969 (Betzold) amends Minnesota Statutes, Section 11A.18, and adds new Minnesota Statutes, Section 11A.181, relating to the Minnesota Post Retirement Investment Fund (MPRIF), the post-retirement adjustment mechanism for the various statewide retirement plans, by making the following changes:

- a. Retention (Article 1). If the MPRIF funding ratio is above 80 percent in all future years and is above 85 percent in all future consecutive two-year periods, the following provisions apply:
 - (1) Continuation of CPI Component. The current adjustment based on the annual increase in the Consumer Price Index (CPI), not to exceed 2.5 annually, continues without change;
 - (2) Unnaming and Modification of Investment Performance Adjustment Component. The current investment performance adjustment component is modified by the elimination of the investment performance reference and by the addition of a specific cap that either is the remaining amount by which the CPI adjustment is less than 2.5 percent or is the amount by which the CPI exceeds 2.5 percent, continuing to be payable only if the MPRIF has no deficit and if its investment performance has a net positive margin above 8.5 percent, and, when added to the CPI component after 2010, does not exceed 5.0 percent in total;
 - (3) Addition of Lost Purchasing Power Adjustment. If the MPRIF is at least 90 percent funded, if the MPRIF investment performance for the most recent fiscal year is greater than 8.5 percent, and if the CPI adjustment component is less than 2.5 percent, an increase equal to the amount by which each MPRIF annuitant's past benefit adjustments have failed to match the CPI increase since the June 30 of the year before the first MPRIF adjustment was paid, but not to exceed the difference between the combined amount of the two other prior MPRIF components and 2.5 percent for each person. The adjustment is subject to an additional reduction by the amount needed to maintain the MPRIF at a 90 percent funded ratio; and
 - (4) Addition of Excess Assets Trigger for the Formulation of Additional Benefits and Funding Recommendations. If the MPRIF becomes at least 115 percent funded in a future year, the governing bodies of the retirement plans participating in the MPRIF must jointly prepare recommendations on overall benefits and funding for active members and benefit recipients.
- b. Dissolution (Article 2). If the MPRIF funding ratio is below 80 percent as of June 30 in any one year or is below 85 percent as of June 30 for two consecutive years, the MPRIF dissolves, with no future required reserve transfers as of the December 31 following the triggering event, with no actuarial mortality loss transfers after the triggering event, and with the transfer back of each retirement plan's participation in the MPRIF as of the June 30 of the next year following the triggering event. Upon MPRIF dissolution, an automatic 2.5 percent annual post-retirement adjustment applies to all benefit recipients.

Background Materials

Background material relevant to the proposed legislation is attached, as follows:

- A. Attachment A presents background information on the current statutory provisions of the Minnesota Post Retirement Investment Fund (MPRIF).
- B. Attachment B presents background information on the development of the MPRIF.
- C. Attachment C presents background information on the requirements for the transfer of retirement fund assets to and from the MPRIF.
- D. Attachment D presents a comparison of the percentage rates of post-retirement adjustments provided by the various Minnesota statewide and major local retirement plans over time, including the MPRIF.

- E. Attachment E presents a comparison of federal Consumer Price Index increases with post-retirement adjustments from the MPRIF.
- F. Attachment F presents information on the past funded ratio of the MPRIF and its predecessor for the period 1979-2007.

Technical Amendments

1. **Technical Amendment H3421-1A** simplifies the revised Minnesota Post Retirement Investment Fund governing statute by moving the provisions in Minnesota Statutes 2006, Section 11A.18, applicable to the Minneapolis Employees Retirement Fund (MERF) to the applicable MERF statutory provision.
2. **Technical Amendment H3421-2A** makes various language style and usage revisions to gain greater conformity to the current drafting conventions.

Document H3421-E3 is a draft engrossed version of the bill with both technical amendments, for ease in ascertaining the impact of those amendments.

Analysis and Discussion

H.F. 3421 (Murphy, M., by request); S.F. 2969 (Betzold) establishes a trigger for the dissolution of the Minnesota Post Retirement Investment Fund (MPRIF), the current statewide retirement plans' post-retirement adjustment mechanism, replaces the MPRIF with an automatic annual 2.5 percent adjustment upon a future MPRIF dissolution when the poor funding trigger occurs, and adds two potential additional adjustment components to the MPRIF if the dissolution trigger event is not met, a lost purchasing power component payable if the MPRIF is less than fully funded, but at least 90 percent funded, and if the Consumer Price Index (CPI) component adjustment is less than 2.5 percent, to be funded from that difference, and an excess asset benefit modification report and joint retirement plan recommendation if the MPRIF is at least 115 percent funded.

The proposed legislation raises several pension and related public policy issues for Commission consideration and potential Commission discussion, as follows:

1. Unclear Conformity with Commission's Principles of Pension Policy. The policy issue is the extent to which the proposed revision or dissolution of the Minnesota Post Retirement Investment Fund (MPRIF) conforms with the Principles of Pension Policy formulated by the Commission over the years. Principle II.C.8., relating to post-retirement adjustments, indicates that:

II.C.8. Postretirement Benefit Adequacy

- a. The retirement benefit should be adequate during the period of retirement.
- b. Postretirement benefit adequacy should function to replace the impact of economic inflation over time in order to maintain a retirement benefit that was adequate at the time of retirement.
- c. The system of periodic post retirement increases should be funded on an actuarial basis.
- d. In order to replace inflation, the post retirement adjustment system should follow a valid recognized economic indicator.

Based on comparisons of the annuity and benefit amounts for the various retiree cohorts in Attachment E, annuitants and benefit recipients have kept pace with inflation in their current benefit amounts, but as a review of the annual patterns of each cohort or of the chart accompanying Table 2, the match between the MPRIF adjustments and the cost of living as measured by the federal Consumer Price Index (CPI) has generally not been very close. The proposed additions to the MPRIF, pending its dissolution, would increase post-retirement adequacy based on valid recognized economic indicator, the CPI, but only during periods of very low inflation, which would not remedy the current flaw in the MPRIF of a poor correlation between adjustments and inflation during all periods but those with exceptionally low inflation. Upon a dissolution of the MPRIF, the proposal would replace the current mechanism with a flat 2.5 percent annual increase completely untied to the CPI.

2. Appropriateness Given Unclear Policy Goal for MPRIF Modifications. The policy issue is the appropriateness of the proposed modifications in the Minnesota Post Retirement Investment Fund (MPRIF) when there is no clear explicit or implicit policy goal underlying the changes. The proposal represents the result of a joint committee drawn from the boards of the Minnesota State Retirement System (MSRS), the Public Employees Retirement Association (PERA) and the Teachers Retirement

Association (TRA). The joint committee had 11 meetings, considered ten alternatives, and arrived at this proposal. The announced guiding principles for the joint board committee in developing the proposed legislation were:

Guiding Principles	
Primary Principles	
<ol style="list-style-type: none"> 1. The post-retirement increase mechanism will provide some form of inflation protection for retirees and will have long-term financial sustainability. 2. The post-retirement increase mechanism will result in less funding volatility and less volatility in annual increases than the current method. 3. The committee's focus will be on finding solutions for the Post fund. 	<ol style="list-style-type: none"> 2. Any component that is paid in addition to some inflation protection should avoid increasing benefits that later could result in significant unfunded liabilities. 3. The new adjustment mechanism should function in alternative economic scenarios. 4. The underlying inflation protection would be the same for all plans, but any incremental increases in addition to inflation, may differ for various plans.
Post Fund Mechanism	
<ol style="list-style-type: none"> 1. Post retirement increases should have some tie to the rate of inflation. 	Funding <ol style="list-style-type: none"> 1. The post-retirement changes will minimize additional cost to the plan. 2. Any funding solutions will be based on reasonable actuarial assumptions.

Those guiding principles are contradictory in practice and do not resolve themselves into a clear policy goal. The retirement plan sponsors of the proposal should be provided an opportunity to clarify what policy goal or goals they believe are forwarded by the proposed legislation.

3. Appropriateness of the Proposal's Bias In Favor of Dissolving the MPRIF. The policy issue is the appropriateness of the proposed legislation when the proposal has a clear bias in favor of a future dissolution of the Minnesota Post Retirement Investment Fund (MPRIF). From the materials provided to the Commission from the joint boards committee on the MPRIF, there was strong interest from the outset of the project to either permit some retirement plans to withdraw from the MPRIF or to dissolve the MPRIF entirely. The final proposal, although described in materials as reserving the dissolution option to a future scenario where the funding level of the MPRIF falls to an unacceptable level or fails to make funding progress over an appropriate period, sets the unacceptable level for one year at 80 percent funded and sets the funding progress failure over an appropriate period at 85 percent funded over two years. The setting of those levels was apparently the last issue settled by or on behalf of the joint committee, reportedly based on a number of actuarial studies, but that body of information has not been provided to the Commission. Other than to recite unsubstantiated figures about the improbability of the MPRIF becoming fully funded in any one year, the proponents of the proposed legislation have not indicated what policy or practical disaster will follow if the funded ratio of the MPRIF should fall below 80 percent during the course of some future recession, panic, or depression and why that disaster would not occur with the proposed mixing of the retiree asset value decline with the asset value decline that would also be felt on the active member assets. Without some clear indication of the harm that would occur from a funded ratio setback in the MPRIF, providing for a dissolution of the MPRIF at an arbitrarily funded ratio figure seems premature.
4. Appropriateness of a Dissolution Trigger; Trigger Selection. The policy issue is whether or not it is appropriate to have an automatic dissolution of the Minnesota Post Retirement Investment Fund (MPRIF) if a triggering event happens rather than leaving the MPRIF dissolution to the Legislature based on a careful consideration of the circumstances at hand and the implications involved and, if an automatic trigger is appropriate, is the proposed trigger appropriate. The primary reasons usually given for an automatic trigger is that a timely response is needed for an emergency event that cannot be delayed to the next legislative session or that there is such clarity on what constitutes an emergency and on what the response should be that the program can be put on automatic pilot. It is not clear that a simple economic or market decline constitutes a sufficiently clear emergency for which a sole response is indicated, especially when the decline will also impact on the balance of the retirement plan assets in a comparable fashion. The past history of the MPRIF and its predecessor has indicated that relatively wide swings in the funded condition of the investment fund have occurred and logic suggests that those savings could be expected again. While the MPRIF had its most sustained period of underfunding in its history during the period since 2000, the investment fund has had underfunded years in the 1980s and has numerous instances where the fund has had changes in its funding ratio from year to year greater than five percent.

If the Commission has doubts about the wisdom of an automatic MPRIF dissolution based on a triggering event or a set of triggering events, **Amendment H3421-3A** would eliminate the dissolution article, leaving the decision on the dissolution of the MPRIF to a future legislature.

If the Commission views the current MPRIF deficit with concern and wishes to foster an earlier future discussion on the MPRIF if there is a future erosion in market value, **Amendment H3421-4A** converts the proposed trigger consequence from an automatic dissolution of the MPRIF and automatic benefit change to a mandated report and recommendations from the affected retirement plan administrators upon that future market value decline.

If the Commission believes that the proposed trigger (funded ratio falling to 80 percent in any one year or two consecutive years of funded ratio results of 85 percent or less) are not sufficiently dramatic to warrant an MPRIF dissolution, **Amendment H3421-5A** would reset the conditions to require a greater market decline for a longer period of time (less than 75 percent rather than less than 85 percent for three consecutive years rather than two consecutive years or less than 70 percent for two consecutive years rather than less than 80 percent for one year).

5. Appropriateness of the Complex Proposed Changes in the Current MPRIF. The issue is the policy and administrative appropriateness of the proposed changes in the current Minnesota Post Retirement Investment Fund (MPRIF), with the “unnaming” of the former investment performance component and the addition of the complex lost purchasing power component. The current investment component would continue without much substantive change other than dropping a reference to investment component, apparently in an attempt to create a perception that it is no longer connected to investment performance. This “unnaming” attempt simply makes the adjustment component more difficult to reference in statute or common parlance. The “lost purchasing power increase” establishes an individualized annual determination of the extent that past post-retirement adjustments have lagged past inflation and a potential increase for those who had lost past purchasing power. Once all potential lost purchasing power adjustments have been calculated, the actual adjustments to be paid must be further modified if their payment would cause the overall MPRIF funded ratio to fall below 90 percent. The additional increase is obviously an attempt to address the vocal complaints of recent retirees who have fared less well from the MPRIF than longer term retirees have found. If the preconditions for the payment of the increase exist, the new adjustment component will require individualized calculations and determinations for the current 123,524 MPRIF-covered retirees annually. It is unclear that the retirement systems have the hardware, software, and personnel in place to implement the new adjustment or to communicate it to the various retirees. While addressing vocal complaints from recent retirees has an attraction, the new adjustment is unlikely to make any significant actual headway on recapturing lost purchasing power (see issue #6) while appearing to provide a more significant benefit than it actually will provide and creating more recent retiree dissatisfaction compared to longer duration retirees.
6. Unlikely Prospect for Any Meaningful Lost Purchasing Power MPRIF Increases. The policy issue is the appropriateness of creating another whole increase component within the Minnesota Post Retirement Investment Fund (MPRIF) when the preconditions for the increase are so stringent and the effective cap on the increase is so modest that either no lost purchasing power increase will be paid or any lost purchasing power increase will be so nominal in any year that it would hardly justify the administrative expense to provide it. The proposed lost purchasing power increase is only payable if the MPRIF is at least 90 percent funded, that the MPRIF had earned at least one dollar of investment return in excess of 8.5 percent for the fiscal year and the Consumer Price Index (CPI) adjustment component provides an adjustment of less than 2.5 percent in that year. The proposed lost purchasing power increase is limited to the difference between the CPI adjustment component and 2.5 percent for each recipient and is further subject to a downward adjustment if the increase is calculated to cause the MPRIF funded ratio to fall below 90 percent. The lost purchasing power increase does not redistribute any portion of the difference between the CPI adjustment component and 2.5 percent for those retirees who have not suffered any lost purchasing power, so any perceived or actual inequity in treatment between long-term retirees and more recent retirees will not quickly be reversed.

To demonstrate the difference in the individual versus pool basis for adjustments, for an average MPRIF retiree who has one percent cumulative lost purchasing power, if the CPI adjustment component in a future year was 2.25 percent, the lost purchasing power increase limited on an individual basis as proposed would be \$3.38 per month, while the lost purchasing power increase for the same circumstance using a pool basis would be limited to \$35.76 per month if 20 percent of all retirees had lost purchasing power and \$71.52 per month if ten percent of all retirees had lost purchasing power.

If the Commission desires to improve the lost purchase power increase within the confines of the actuarial gain obtained when the CPI adjustment component does not reach 2.5 percent, **Amendment H3421-6A** creates a pool from that actuarial gain from all retirees rather than handling the gain solely

on an individual-by-individual basis and allocates it to retirees with lost purchasing power in proportion to their prior purchasing power loss.

7. Appropriateness of the Proposed Benefit Reductions. The policy issue is the appropriateness of the benefit reductions that are included in the proposed Minnesota Post Retirement Investment Fund (MPRIF) legislation, whether the MPRIF is retained or dissolved. If the MPRIF is retained, the former investment performance component adjustment, first made subject to a five percent annual maximum in conjunction with the Consumer Price Index (CPI) adjustment component in 2006 legislation, effective in 2010, would further be subject to the maximum of the difference between the CPI increase and 2.5 percent. If the MPRIF is dissolved, the sole post-retirement adjustment payable would be a flat annual 2.5 percent increase, irrespective of CPI increases or the investment performance of the retirement fund in excess of the interest rate actuarial assumption. The benefit reductions would be accompanied, if the MPRIF is retained, by the creation of a “lost purchasing power increase” and an unspecified potential adjustment alone or in combination with active member benefit modifications as part of joint retirement plan recommendations to be forwarded to the Commission if the MPRIF becomes at least 115 percent funded, and if the MPRIF is dissolved, by the potential for the payment of a full 2.5 percent adjustment when the CPI is less than 2.5 percent and there is no investment performance in excess of 8.5 percent. A benefit reduction is inconsistent with the Commission’s Policy Principles unless combined with a benefit increase implementing sound pension goals, and may be found unconstitutional in subsequent litigation.

Based on Christensen v Minneapolis Municipal Employees Retirement Board, 331 NW2d 740 (1983), the Minnesota Supreme Court treats public pensions as quasi-contracts under a promissory estoppel doctrine, thus barring most or all legislative diminutions as violative of the non-impairment of contract clause of the U.S. Constitution. Based on Sylvestre v State, 214 NW 2d 658 (1973), and Anderson v State, 214 NW2d 668 (1973), the Minnesota Supreme Court may permit the reduction of one pension benefit when accompanied by another beneficial legislative change, especially if the conjoining of a reduction and an increase are the result of formal or informal bargaining. In AFSCME Council 6 v Sundquist, 338 NW2d 560 (1983), the Minnesota Supreme Court suggested in dicta that it accepted the doctrine developed in other states that actuarial necessity could justify benefit modifications. It is unclear whether the benefit limitations or eliminations included in the proposed legislation are offset to a great enough degree by the benefit increase modifications to allow them to be upheld in future litigation.

The Commission may wish to take testimony from the retirement plan administrators on the nature of the legal advice they received when assembling the proposed legislation and to seek guidance from the House Research Department and Senate Counsel lawyers with public pension subject matter responsibilities.

8. Unclear Application of Proposed Changes for Benefit Recipients Indexed to the MPRIF Increases. The policy issue is the manner in which the proposed changes in the Minnesota Post Retirement Investment Fund (MPRIF) will apply to those benefit recipients who have their adjustments indexed to the MPRIF increases. Minnesota Statutes, Section 356.41, currently provides the same increase annually to all benefit recipients of the Elective State Officers Retirement Plan, all survivors and annuitants since 2002 of the Legislators Retirement Plan, and disabilitants and survivors of the General Employee Retirement Plan of the Public Employees Retirement Association (PERA-General), the Public Employees Police and Fire Retirement Plan (PERA-P&F), the Local Government Correctional Employees Retirement Plan of the Public Employees Retirement Association (PERA-Correctional), and the Teachers Retirement Association (TRA). While the MPRIF adjustments remain a single annual percentage increase, Minnesota Statutes, Section 356.41, will operate as anticipated. With the proposed changes, especially the proposed “lost purchasing power increase,” MPRIF adjustments will differ depending on the initial benefit payment date and that change is not contemplated by the current language of Minnesota Statutes, Section 356.41.

Amendment H3421-7A attempts to make the necessary adaptation in Minnesota Statutes, Section 356.41.

9. Federal Tax Code Compliance Issues Connected with the Proposed Changes. The issue is whether or not the proposed modifications in the Minnesota Post Retirement Investment Fund (MPRIF) comply with the applicable federal Internal Revenue Code provisions. In 2006, when the Commission recommended the proposal forwarded by the joint retirement plan administrators to impose a five percent annual adjustment maximum on MPRIF increases, the maximum provision was given a delayed effective date until 2010 because the retirement plan administrators indicated that they needed

that amount of time to get a private Internal Revenue Service (IRS) determination letter that the change did not violate the federal Internal Revenue Code and regulations. The proposed legislation makes additional changes in the MPRIF, with some additional maximums and some additional potential increases, with a June 30, 2008, effective date. No document has been forwarded to the Commission related to the IRS private letter request with respect to the 2006 MPRIF benefit limit by any of the affected retirement plans and no delay in the proposed legislation is being requested by the retirement plan administrators, although the issue appears to be identical this year as in 2006. The retirement plan administrators should be requested to provide an update on the progress of the private letter ruling request with respect to the 2006 MPRIF benefit maximum and to provide any legal opinion that they may have that indicates that there is no federal Internal Revenue Code compliance issue with respect to this proposed legislation.

Attachment A

Background Information on the Minnesota Post Retirement Investment Fund: Summary of Current Provision

Minnesota Statutes, Section 11A.18, Subdivision 1, Establishment. The Minnesota Post Retirement Investment Fund serves as an investment vehicle for the reserves of the various retirement annuities payable by the included plans. The Minnesota Post Retirement Investment Fund was indicated to be a continuation of the Minnesota Adjustable Fixed Benefit Fund in existence on January 1, 1980.

Minnesota Statutes, Section 11A.18, Subdivision 2, Assets. The assets represent the reserves for the retirement annuities which have been transmitted to the Minnesota Post Retirement Investment Fund.

Minnesota Statutes, Section 11A.18, Subdivision 3, Management. The State Board of Investment manages the fund.

Minnesota Statutes, Section 11A.18, Subdivision 4, Investment. The Minnesota Post Retirement Investment Fund assets must be invested consistent with the State Board of Investment investment authority provision, Section 11A.24.

Minnesota Statutes, Section 11A.18, Subdivision 5, Deferred Yield Adjustment Account. A deferred yield adjustment account exists which is to be increased by the sale of debt securities at less than book value and decreased by the sale of investment securities at more than book value. At the end of each fiscal year, a portion of this account's balance is offset against the investment income for that year, with the offset being proportional to the reciprocal of the average remaining life of the bonds sold. In any fiscal year in which the gains on the sale of debt securities exceed the discounts on these securities, the excess is used to reduce the balance of the account. If the balance of deferred yield adjustment account is zero, all excess gains are available for the calculation of postretirement adjustments.

Minnesota Statutes, Section 11A.18, Subdivision 6, Participating Plans, Transfer of Required Reserves. The full actuarial reserves for an annuity are required to be transferred to the Minnesota Post Retirement Investment Fund no later than the last business day of the month in which the benefit begins to accrue. If the exact amount of the necessary reserves is unknown, the transfer must be based on the best estimate by the Teachers Retirement Association (TRA) or Public Employees Retirement Association (PERA) plan administrations, which ever is applicable, and may be base on the best estimate for other participating funds. Any necessary adjustments are to be made in later transfers, with interest paid on any deficiency at the pre-retirement interest assumption rate for the applicable plan.

Minnesota Statutes, Section 11A.18, Subdivision 7, Participation and Financial Reporting in Fund. Each participating retirement plan has an undivided interest in the Minnesota Post Retirement Investment Fund. The participation on any valuation date is determined by revising the previous participation amount by any funds transferred by the applicable plan into the Minnesota Post Retirement Investment Fund, six percent interest on the plan's prior participation amount, and the reserves for any benefit adjustment made as of the current valuation date, adjusted for mortality gains and losses.

Minnesota Statutes, Section 11A.18, Subdivision 8. Withdrawal of Money. The State Board of Investment is permitted to sell securities to raise cash to transfer back to the applicable plan administration to cover benefit payments.

Minnesota Statutes, Section 11A.18, Subdivision 9. Calculation of Post-Retirement Adjustment. An annual permanent increase in annuities is payable matching inflation, not to exceed 2.5 percent, based on the fiscal year change in the Consumer Price Index for urban wage earners and clerical workers. (The full capped increase is payable to annuitants retired at least one year, with those retired less than one year receiving a prorated increase.) To determine if an additional investment-return based increase can be paid, the State Board of Investment is required to determine the required reserves for the Minnesota Post Retirement Investment Fund annuities as of June 30, including reserves needed for the capped inflation match. This total is to be subtracted from the Minnesota Post Retirement Investment Fund market value. The difference, positive or negative, is allocated equally to five yearly accounts, representing the current year and the next four years. The State Board of Investment will determine the amount in the current year's account, given the amounts allocated to this account this year and in prior years. If the net amount is positive, the State Board of Investment determines the percentage by which annuities can be permanently increased given these additional reserves. If the amount in the current yearly account is

negative, no investment performance based increase is payable, and this negative amount rolls forward to the next year's account.

Minnesota Statutes, Section 11A.18, Subdivision 10. Payment of Post-Retirement Adjustment. The State Board of Investment certifies the percentage increase for Minnesota Post Retirement Investment Fund annuities to the plan administrations. These plan administrations begin paying the higher annuities (with applicable prorating for annuitants retired for less than one year on the June 30 determination date) on January 1. The revised annuities are paid automatically unless an annuitant files a written notice with the applicable plan administration that the increase should not be paid.

Minnesota Statutes, Section 11A.18, Subdivision 11. Adjustment for Mortality Gains and Losses. As of June 30, annually, the actuary retained under Minnesota Statutes, Section 356.214, is required to determine the required reserves representing any Minnesota Post Retirement Investment Fund mortality gains or losses for each participating plan. If the amount is a gain, the State Board of Investment is required to sell sufficient securities to transfer applicable amounts to the plan administrations and if a mortality loss occurred, the applicable plan must transfer the necessary additional reserves to the Minnesota Post Retirement Investment Fund. The amount of the transfers must be determined before any postretirement benefit adjustments are computed. All transfers are to be made by December 31 for the preceding June 30 without interest, or with interest at the applicable pre-retirement interest rate for any transfers after December 31.

Minnesota Statutes, Section 11A.18, Subdivision 12. Appropriation of Required Amounts. Amounts needed to pay annuities, including post-retirement adjustments, are appropriated from the Minnesota Post Retirement Investment Fund as needed.

Attachment B

Background Information on the Development of the Minnesota Post Retirement Investment Fund

- A. Development of the Minnesota Adjustable Fixed Benefit Fund. Prior to creation of the Minnesota Post Retirement Investment Fund in 1980, benefits were adjusted during retirement through the Minnesota Adjustable Fixed Benefit Fund (MAFB), which was created in 1969 (Laws 1969, Chapter 485, Section 32). The plans participating in the Minnesota Adjustable Fixed Benefit Fund include the Minnesota State Retirement System (MSRS) (Laws 1969, Chapter 893, Section 9), the Public Employees Retirement Association (PERA) (Laws 1969, Chapter 999), and Teachers Retirement Association (TRA) (Laws 1969, Chapter 485, Section 31) plans, plus the Minneapolis Employees Retirement Fund (MERF) (Laws 1969, Chapter 914, Section 2). In 1981 (Laws 1981, Chapter 298, Sections 5-10), MERF was permitted to invest and manage the assets of its retirees in a separate investment fund invested by MERF, which was set up to be identical to the Minnesota Post Retirement Investment Fund in structure and operation.

At least in theory, the Minnesota Adjustable Fixed Benefit Fund had a post-retirement adjustment process that allowed retiree benefits to increase or decrease during retirement, depending upon investment results, although the benefit amount was not permitted to go below that received at the time of retirement. In practice, the Minnesota Adjustable Fixed Benefit Fund developed differently. By periodically amending the benefit floor language after 1969 in connection with the general benefit improvements, the Legislature in fact never permitted benefits to fall below the most recent levels during the history of the Minnesota Adjustable Fixed Benefit Fund through 1980.

Each retirement fund taking part in the Minnesota Adjustable Fixed Benefit Fund transferred sufficient reserves to permit level annuities to be paid to retirees, if the post-retirement fund continued to earn at least the actuarial interest requirement. The Minnesota Adjustable Fixed Benefit Fund annuities could be revised through an adjustment mechanism relying on a two-year average total rate of investment return measure compared to the actuarial rate of return. The use of an averaging period presumably was intended to add some stability. The total rate of return included dividends, interest, and realized and unrealized gains or losses. Annually, a "benefit adjustment factor" was computed. This was calculated by dividing the quantity one plus the two-year average total rate of return, by the quantity one plus the actuarial rate of return. If the fund was not meeting the actuarial investment return requirement, the calculated ratio or benefit adjustment factor would be less than one. The calculated ratio would be equal to one if the return equaled the actuarial return, and, if the return exceeded the actuarial return, the calculated ratio would be greater than one. Benefits could be increased if the benefit adjustment factor was greater than 1.02, providing that annuity stabilization reserve requirements, discussed below, were met. If the benefit adjustment factor was less than .98, a benefit decrease was required, but at no time could the retirement payments drop below the level received at the date of retirement.

Sizable post-retirement benefit increases occurred during the 1970s, but most of these were ad hoc changes authorized by the Legislature to address inadequate benefit amounts provided to certain older retirees, or to compensate the retired group for legislated changes in the post-retirement interest rate actuarial assumption, which would have the effect of lowering future increases. This interest rate assumption was revised from 3.0 percent to 3.5 percent in 1969 and from 3.5 percent to 5.0 percent in 1973. The benefit increases actually granted as a result of the operation of the Minnesota Adjustable Fixed Benefit Fund were rare and minimal, due in part to the poor investment climate during the 1970's and to annuity stabilization reserve requirements that were part of the Minnesota Adjustable Fixed Benefit Fund adjustment process. Benefit increases above four percent could not be paid unless the annuity stabilization reserve contained enough assets to cover 15 percent of the past year's benefit payments. If the reserve was insufficient, part of the new investment earnings were added to the reserve rather than being paid out as benefits. Benefit increases above four percent required correspondingly higher annuity reserves. The poor performance of the Minnesota Adjustable Fixed Benefit Fund during the mid- and late-1970s, in part due to the investment climate during the period and in part due to the design of the adjustment mechanism, led to pressure to revise the system. This undoubtedly led in 1980 to the creation of a revised mechanism in the form of the Minnesota Post Retirement Investment Fund.

- B. Minnesota Post Retirement Investment Fund: Creation. The Minnesota Post Retirement Investment Fund was created by Laws 1980, Chapter 607, Article 14, Section 16, to be the successor to the Minnesota Adjustable Fixed Benefit Fund. Similar to the Minnesota Adjustable Fixed Benefit Fund,

the Minnesota Post Retirement Investment Fund included a benefit adjustment mechanism intended to offset, to some degree, increases in living costs. One difference was that while the old system based adjustments on total investment return, which includes unrealized gains, the original version of the Minnesota Post Retirement Investment Fund provided adjustments based solely on realized investment income. Minnesota Post Retirement Investment Fund procedures also ignored unrecognized gains and losses in determining whether the Minnesota Post Retirement Investment Fund's reserves were sufficient to sustain the existing benefit levels for the expected remaining lifetime of the benefit recipients. Another difference was that the Minnesota Post Retirement Investment Fund contained no provision to reduce benefit levels below that most recently received in the event of subsequent poor investment performance. Benefits could go up, but they could not go down. Third, the original Minnesota Post Retirement Investment Fund based adjustments on a single year's realized investment return, rather than using the average investment return for a multi-year period.

To determine adjustments, at the end of each fiscal year (June 30), the required reserves were calculated. The required reserves were the actuarially determined amount of assets needed to pay the present stream of annuity payments to be paid to retirees over time, assuming that the assets earned at least five percent, which was the Minnesota Post Retirement Investment Fund actuarial interest assumption at that time. The total reserves were multiplied by five percent to determine the amount of investment income needed that year to sustain the current benefit level. By subtracting this assumed interest amount from total realized investment earnings, excess investment earnings, if any, were calculated and this were the amount of earnings which could be used to create a permanent increase in retiree benefits. The fiscal year excess earnings were used to determine the amount of increase, if any, payable the next January 1, the effective date of any benefit change. To determine benefit increases payable as of January 1, the excess investment income and the required reserves must be projected forward to that date. This requires increasing the excess investment income by 2.5 percent, the return which those funds must earn for the six month period in order to meet actuarial requirements, and estimating the total required reserves on January 1 for those eligible for a post-retirement adjustment.

If Minnesota Post Retirement Investment Fund assets had a book value that was less than the required reserves, a portion of any increase that would otherwise be paid was retained, to help build up the fund's asset value. Book value was defined in the provision as the cost of equity investments plus the amortized cost of fixed income investments. If book value, after adjustments for mortality gains or losses, was less than the required reserves, then 25 percent of the excess investment income must be retained, with the remaining 75 percent used to increase annuities. The retention of part of the excess reserves if the total required reserves is greater than book value would help address Minnesota Post Retirement Investment Fund unfunded liabilities. However, the fund could have a market value in excess of the required reserves and have a book value that was less than the required reserves. In this case, some of the excess earnings would be retained despite the excess of the fund's market value compared to book value. This system, in determining excess income and the level of existing assets, placed no reliance on unrecognized gain (any increase in the market value of an asset since the asset was purchased, but which has not been captured or recognized by selling the asset).

The original 1980 version of the Minnesota Post Retirement Investment Fund exposed the State Board of Investment to certain potential pressures, a consequence that may not have been foreseen or intended. Because post-retirement increases excluded any unrecognized gains, the size of any post-retirement adjustment was in part determined by the State Board of Investment's willingness to sell appreciated assets. Retirees want post-retirement increases. If the State Board of Investment were influenced by that pressure, it might sell certain appreciated securities although these sales were not in the best long-term interests of the fund and of retirees. If these securities were worth retaining, the State Board of Investment might buy them back, resulting in the same portfolio composition but with higher transaction costs.

C. Minnesota Post Retirement Investment Fund: Post-1980 Modifications.

1. 1981 Changes; Laws 1981, Chapter 208, Section 2, and Laws 1981, Chapter 158, Section 1. Laws 1981, Chapter 208, Section 2, provided a clarification providing that when projecting required reserves from June 30 to January 1, the State Board of Investment must assume that all eligible individuals alive on June 30 remain alive on the following January 1. Laws 1981, Chapter 208, Section 2, and Chapter 158, Section 1, both revised excess investment income retention procedures. However, the Revisor of Statutes did not try to blend the two laws into a single provision. The Revisor incorporated the Laws 1981, Chapter 208, Section 2, change into

the Minnesota Statutes 1981 Supplement version of Minnesota Statutes, Section 11A.18, Subdivision 9, which stated that rather than retaining 25 percent of excess investment income if book value was less than the required reserves, as specified in the 1980 provision, the retained amount would be 25 percent or any amount sufficient to cause the book value to equal the required reserves, whichever is less. That same provision as it was changed by Laws 1981, Chapter 158, Section 1, appeared in a footnote. In that footnote, if the book value was less than the required reserve, the retained amount would be 5 percent rather than 25 percent, or any amount sufficient to cause the book value to equal the required reserves, whichever is less

2. 1982 Changes; Laws 1982, Chapter 424, Section 1. The 1982 change took the version that had appeared in a footnote in the 1981 Supplement, and placed in the revised statute. If book value was less than the required reserves, the portion of excess income retained amount would be five percent, rather than 25 percent, or an amount sufficient to cause the book value to equal the required reserves, whichever is less.
3. 1983 Changes; Laws 1983, Chapter 324, Section 4 to 6. The 1983 Legislature made two changes. First, some revision was made to the deferred yield adjustment subdivision. Second, the Minnesota Post Retirement Investment Fund mortality gain and loss subdivision was revised by requiring all reserve adjustments due to mortality gains and losses in a fiscal year to be completed by the following December 31, or interest will be assessed.
4. 1987 Changes; Laws 1987, Chapter 259, Section 3 to 5. Minnesota Statutes, Section 11A.18, Subdivision 6, dealing with the transfer of required reserves to the Minnesota Post Retirement Investment Fund, was revised by specifying that transfers occur no later than the last business day of the month in which the annuity commences, rather than the date the benefit commences, by requiring that the transferred amounts be determined under procedures specified by the Commission-retained actuary, and by allowing "best estimate" transfers if the exact amount has not been determined, with interest required on any required transfer amount that is later determined to be deficient. The interest rate was the applicable pre-retirement interest rate or the average short-term interest rate, whichever is greater. Minnesota Statutes, Section 11A.18, Subdivision 9, the provision specifying the post-retirement adjustment procedure, is revised by specifying that all reserve amounts must be determined by the Commission-retained actuary; and language is added specifying that a Social Security-leveling option annuity must be treated as the sum of a period certain annuity and life retirement annuity for purposes of any post-retirement adjustment. Any post-retirement increases granted on the period certain retirement annuity terminate when the period certain retirement annuity terminates.
5. 1989 Changes; Laws 1989, Chapter 319, Article 14, Section 1 to 3. The 1989 change allowed individuals who were receiving an annuity for less than one year as of June 30 to receive a partial post-retirement adjustment. Previously, individuals had to be receiving an annuity for at least one year to be eligible for any adjustment.
6. 1990 Changes; Laws 1990, Chapter 570, Article 9, Section 1. If the exact amount of a required transfer to the Minnesota Post Retirement Investment Fund was not known at the time of the transfer, the estimated transfer had to continue to be based on the best estimate if made by the Teachers Retirement Association (TRA) or the Public Employees Retirement Association (PERA), but the Minnesota State Retirement System (MSRS) was given more flexibility. Its estimated amount "may" be based on the best estimate. Also, the applicable interest rate on shortfalls would be the pre-retirement interest rate, rather than the pre-retirement interest rate or the actual average short-term rate, whichever if greater.
7. 1992 Changes; Laws 1992, Chapter 530, Sections 1 to 3. This chapter made significant changes, fundamentally changing the Minnesota Post Retirement Investment Fund post-retirement adjustment procedures, as follows:
 - a. Nature of Post-Retirement Increases. Post-retirement increases would be based on total investment performance, not just realized gains, and for the most recent five-year period, rather than for a single year;
 - b. Inflation Match Component. An annual post-retirement increase matching inflation, as measured by changes in the Consumer Price Index, but not to exceed 3.5 percent, was created; and

- c. Additional Investment-Based Increase. An additional investment-performance based increase was permitted based on investment performance in excess of 8.5 percent total returns over five-year periods.

The use of five (five-year) accounts for accumulating any excess reserves (the current year plus the next four), creates a form of averaging or smoothing. A very large return in a single year will not immediately impact benefit levels because a majority of it is allocated to future years, helping to provide future increases despite weaker investment returns. However, if there is a string of very good investment years, a prolonged period of very high benefit adjustments could occur. This did occur in the late 1990s. Similarly, if there is a prolonged period of low investment returns, there can be a prolonged period of no investment-performance based increases above the capped inflation match, even for several years after the return of good investment years. Also, the Minnesota Post Retirement Investment Fund is required to be fully funded before any positive asset amounts can be allocated to the yearly accounts. A period of weak investment returns can create a less than fully funded Minnesota Post Retirement Investment Fund, which must be recouped through investment performance before any positive asset amounts can be allocated to the annual accounts.

8. 1992 Changes; Laws 1992, Chapter 539, Section 8. This section revised the mortality gains and losses subdivision, requiring any delinquent charges or credits to include interest at the pre-retirement interest rate of the applicable fund, rather than at the short-term rate earned by the Minnesota Post Retirement Investment Fund.
9. 1994 Changes; Laws 1994, Chapter 604, Article 1, Section 6. The 1994 change clarified procedures for computing required reserves.
10. 1995 Changes; Laws 1995, Chapter 186, Section 6. In a Revisor's bill, a reference to a repealed provision is removed from the post-retirement payment provision.
11. 1997 Changes; Laws 1997, Chapter 233, Article 1, Sections 5 and 58. The inflation match was revised downward to 2.5 percent rather than 3.5 percent, and at the same time (in Section 58) the Minnesota Post Retirement Investment Fund investment return assumption was revised from five percent to six percent. Raising the Minnesota Post Retirement Investment Fund investment return assumption from five percent to six percent lowered expected future annual increases by approximately one percent. In other law enacted that year, the annuities of existing retirees were revised to offset this effect on average.
12. 2001 Changes; First Special Session, Chapter 10, Article 3, Section 2. In an administrative change, language is added stating that fair market value must be computed consistent with generally accepted accounting principles.
13. 2002 Changes; Laws 2002, Chapter 396, Article 11, Section 52. In an administrative change, some cross-references are revised to be consistent with a Minnesota Statutes, Chapter 356, recodification.
14. 2006 Changes; Laws 2006, Chapter 277, Article 1, Section 1. Post-retirement increases in any year may not exceed five percent, effective July 1, 2010.

