Blue Ribbon Panel on Pension Reform

Report and Recommendations to Governor Mark Dayton
December, 2016

Executive Summary

In November of 2016, Governor Mark Dayton asked a Blue Ribbon Panel of independent business, legal, academic, and financial professionals to review the status of Minnesota's pension plans and recommend strategies for improvement. Following their review, the Panel made the following recommendations:

- **Support Investment Return and Discount Rate Assumptions at 7.5%**. The Panel believes it is prudent to lower the rate immediately.

- **Support Changes to Improve Plan Funding**. Plan changes designed to put the plans on a positive funding path should be supported as a comprehensive package.

- **Support Funding Needed at the State Level to Support Employer Obligations.** Because the State of Minnesota is both an employer and a partner in the funding of local governments and school districts, the Panel recommends increased pension funding for state agencies and employers.

- **Support Study of Reform Strategies to Mitigate Pension Risk.** In the future, mechanisms to reduce risk in Minnesota's pension plans should be examined.

Introduction

Over the past several years, public pension funding has risen in importance in the minds of elected officials, taxpayers, and plan members. Rating agencies and the Governmental Accounting Standards Board (GASB) have increased their focus on public pension plan funding. While not representative of Minnesota pension plans, reports of dire pension funding situations have heightened awareness of the need for continual review, strong and conservative management, and proactive adjustments to keep pension plans healthy and able provide for the benefits earned by and promised to plan members.

Minnesota pension plans continue to perform above the national average in terms of funded ratios and the percentage of state spending needed to support them. Minnesota's plans provide relatively modest benefits to members who contribute more than the national average towards their own benefit. Minnesota also has a history of proactive management of pension funds, taking a thoughtful approach to pension management and implementing fiscally sound plan changes when needed.

Market conditions, particularly the recent low interest environment, and new actuarial data indicating longer life expectancy for plan members, have impacted Minnesota's pension plans. These economic and demographic trends have lead Minnesota's pension plans to consider changes to ensure continued stability and sustainability.

Charge of the Blue Ribbon Panel on Pension Reform

In light of these challenges, Governor Mark Dayton asked a Blue Ribbon Panel of independent business, legal, academic, and financial professionals to review the status of Minnesota's pension plans and recommend strategies for improvement.

Blue Ribbon Panel

- Professor Colleen Manchester, Carlson School of Management at the University of Minnesota
- Tom Borman, Attorney at Mason Edelman Borman & Brand
- David Crosby, Managing Director at Piper Jaffray
- James Campbell, Retired President/CEO of Wells Fargo
- Brenda Brannan, Chief Wealth Management Officer at North Shore Bank of Commerce in Duluth, MN
- Ambassador Samuel L. Kaplan, Attorney at Kaplan Strangis & Kaplan
- Morrie Lanning, Former MN Representative and former Chair of the Legislative Commission on Pensions and Retirement

The Panel held a series of meetings and consultations in November and December of 2016. The Panel was provided information on the national context of pension funding and reform, Minnesota's pension plans and the funding proposals approved by each pension plan's board of directors. This report contains the Panel's findings and recommended actions.

Background

In general, public employees in Minnesota are covered by either the Minnesota State Retirement System (MSRS), the Public Employees Retirement Association (PERA), the Teachers Retirement Association (TRA), or the St. Paul Teachers Retirement Fund Association (SPTRFA).

In 2015 and 2016, many of the plans completed experience studies (periodic reviews of assumptions used to value pension plans). These experience studies revealed that plan participants are living longer in retirement than had been previously assumed. While that is good news for beneficiaries, this also increases pension liabilities as it extends the amount of time a member will be receiving benefits.

Also during this time period, analysis conducted both nationally and in Minnesota began to look at the assumed rate of return and discount rate used by the plans. In Minnesota, these assumed rates are the same. Given recent market history and an environment of low interest rates, many public pensions reduced their assumed rate of return. This movement to lower assumptions nationally leaves Minnesota with one of the higher investment return and discount rate assumptions in the nation. The Minnesota State Board of Investment (SBI) also conducted an assets and liabilities study that indicated a long term return of 8% would be harder to achieve and is likely not a reasonable rate to assume moving forward. The rate of return and discount rate assumptions are key components of pension valuations, as they drive both the income from investments the plan can expect, as well as dictating how future liabilities will be discounted to evaluate a plan's funded status. Small changes to these assumptions can have a large impact on a pension plan's funded ratio.

In response to this new information and current pension environment, each of these pension plans developed proposals to adjust benefits, contributions, and other features. The plans also discussed lowering the assumed rate of return and discount rate used in valuing the plans from 8.0% to 7.5%. Following study and deliberation by each of the respective plans' board, each board forwarded a recommendation for changes. The goal of these proposals is to improve the funding ratio of the plans, and continue the strong and proactive management of Minnesota pension plans to continue to maintain their long term health and sustainability.

Proposed Changes

The board of each pension plan is proposing changes specifically tailored to their needs and situation. Plans also engaged their stakeholders with a goal to come up with a proposal that could be supported by all those impacted. Generally, the proposals put forward included a combination of the following elements:

- Increased regular employee contributions
- Increased regular employer contributions
- Increased supplemental employer contributions (designed to address past unfunded liabilities and address the reduced investment return and discount rate assumptions)
- Reduced annual post-retirement benefit increases (commonly referred to as cost of living adjustments or COLAs) and elimination of automatic future COLA increases
- Reset the amortization period (the time period over which unfunded liabilities are paid for) to 30 years
- Requests for additional state aid to fund unfunded liabilities

The impacts of these proposed changes will be shared among plan participants, and will vary based on the current plan structure and the specific funding needs of the plans. In the case of TRA's proposal, employers will bear 47% of the impact, active members 28%, and retirees 25%. For MSRS's General Plan proposal, employers will bear 54% of the impact of the proposed changes, active members will bear 26%, and retiree/inactive members 20%. For the changes proposed to the Correctional and State Patrol plans, the employers will bear a larger portion of the impact - 72% and 88%, respectively – with the remaining portion being shared between active and retired/inactive employees.

An appendix with a summary of the changes proposed by all of Minnesota's pension plans is included with this report.

Findings

The Panel was presented with information on each of the pension plans' proposed changes. The Panel was also provided information on national pension trends, including the fact that many public pension systems continue to lower the assumed rate of return and discount rate assumptions.

After reviewing the information provided by Minnesota Management and Budget and each of the pension plans, the Panel made the following findings:

MN Pension Plans are Currently Underfunded. Minnesota has a history of proactive pension reform, and the state pension plan systems have developed proposals to continue on a path towards full funding. But, because contributions and investment earnings have been lower, Minnesota pension plans are increasingly underfunded.

An Assumed Rate of Return and Discount Rate of 8% is Too High. Given the information available, the Panel agrees that the current assumed rate of return and discount rate of 8% is too high. This rate is not a realistic assumption to use going forward. Other states are recognizing the need to reduce these assumptions, and Minnesota is becoming an outlier among public pension plans.

An Adequately Funded Pension Plan is in the Best Interest of the State. Healthy pension funds are a significant component of state fiscal management. As such, appropriately funded pension plans are beneficial to the state's credit rating. In addition, the pension systems provide retirement support to their members that fulfills the promises made to public sector employees in Minnesota. Nearly 185,000 recipients received over $3.9 billion in pension payments statewide in fiscal year 2015.

Action is Needed Now to Improve Pension Funding in Minnesota. Inaction will only exacerbate current underfunding, and will burden future generations of Minnesota taxpayers and public employees. It is important to address past unfunded liabilities and to facilitate the reduction in the assumed rate of return and discount rate now.

Recommendations

The Panel respectfully submits the following recommendations:

- **Support Investment Return and Discount Rate Assumptions at 7.5%**. The Panel believes it is prudent to lower the rates immediately. The Panel also supports future study to refine these assumptions, as well as to examine the investment return versus discount rate assumptions independently of each other. This is a first step, as additional reductions to the rate will likely be needed in the future.
- **Support Changes to Improve Plan Funding**. The Panel supports pension plan changes that exhibit a shared sacrifice among all stakeholders, including increased contributions, reduced COLAs, elimination of automatic future increases to COLAs, and more realistic investment return and discount rate assumptions. Changing only the discount rate does not achieve the goal of improving the plans long term financial health.
- **Propose Funding Needed at the State Level to Support Employer Obligations.** Because the State of Minnesota is both an employer and a partner in the funding of local governments and school districts, the Panel recommends increased funding for state agencies and school district employers. These costs are not insignificant, and it would not be reasonable to ask employers to absorb the costs without financial assistance.
- **Support Study of Reform Strategies to Mitigate Pension Risk.** In the future, mechanisms to reduce risk in Minnesota's pension plans should be examined. The Panel supports exploring options to direct positive

gains to the pension plans towards reducing risk in the plans. Policies to consider could include maintaining plan reserves even after funding levels exceed 100% or reducing the discount rate assumption as plans achieve full funded status. These kinds of changes are the first steps in the ongoing mitigation of pension risk, and the Panel supports future analysis to identify potential future discount rate adjustments.

Appendices

Appendix A: Summary of Changes as Submitted by Each Pension Plan's Board of Directors

Increased regular employee contributions

- MSRS General – 5.5% to 6%, 0.5% increase
- MSRS Correctional – 9.1% to 9.6%, 0.5% increase
- MSRS Patrol – 14.4% to 15.4% - 1.0% increase
- PERA Police and Fire – 10.8% to 11.8%, 1.0% increase [1]
- TRA, SPTRFA – no change

Increased regular employer contributions

- MSRS General – 5.5% to 7%, 1.5% increase
- MSRS Correctional – 12.85% to 14.4%, 1.55% increase
- MSRS Patrol – 21.6% to 23.1%, 1.5% increase
- TRA – 7.5% to 9.5%, 2.0% increase [2]
- PERA Police and Fire – 16.2% to 17.7%, 1.5% increase [1]
- SPTRFA – 6.5% to 9.5%, 3.0% increase

Increased supplemental employer contributions

- MSRS General – add 1% supplemental contribution
- MSRS Correctional – add 4.45% supplemental contribution
- MSRS Patrol – add 7% supplemental contribution
- PERA Police and Fire, TRA, SPTRFA – no change

Reduced annual post-retirement benefit increases (commonly referred to as cost of living adjustments or COLAs)

- MSRS General – From 2% to 1.5% annual increase
- MSRS Correctional – From 2% to 1.5% annual increase
- TRA – From 2%, reduce to 1% for 5 years, then 1.5% annual increase thereafter
- MSRS State Patrol, PERA Police and Fire, SPTRFA – no change to COLA rates [2]

Elimination of automatic future COLA increases

- All plans include elimination of automatic future COLA increases

Reset the amortization period

- All plans include extension of the amortization period to 30 years

Assumed Rate of Return/Discount Rate

- MSRS General, Correctional, and Patrol; SPTRFA; PERA Police and Fire – from 8% to 7.5%
- TRA – from 8% to 7.5% for a period of 3-5 years, returning to 8% thereafter

Requests for additional state aid to fund unfunded liabilities

- PERA Police and Fire - $9 million annually
- SPTRFA - $5 million annually
- MSRS General, Correctional, and Patrol; TRA - no state aid requested

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[1] PERA Police and Fire employer/employee rates and proposed changes were placed under the wrong headers. Corrected 1/30/17.
[2] Originally indicated that TRA's employer contribution would go from 7.0% to 9.0% and that TRA has no COLA changes. Corrected 1/30/17.

Appendix B: Estimated Funding Need for Employer Contribution Increases and State Aid Costs

Pension Proposals Cost Summary

$s in Millions

	FY18-19	FY20-21
General Fund		
MSRS General	$ 19.42	$ 33.53
MSRS Correctional	$ 17.92	$ 29.51
MSRS State Patrol	$ 0.88	$ 1.81
TRA	$ 67.50	$ 157.00
SPTRFA	$ 25.60	$ 25.60
PERA Police and Fire	$ 18.00	$ 18.00
General Fund Total:	**$ 149.31**	**$ 265.46**
Other Funds*		
MSRS General	$ 46.91	$ 81.02
MSRS Correctional	$ 1.05	$ 1.73
MSRS State Patrol	$ 4.97	$ 10.29
Other Fund Total:	**$ 52.92**	**$ 93.04**
Other Employers**	**$ 21.90**	**$ 37.82**

*Other funds include funds such as the Trunk Highway Fund, Federal Funds, and other dedicated revenue funds.

**Other employers (ex. - U of M and Met Council) participate in MSRS but are not part of the State of MN payroll system.