State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Ed Burek, Deputy Director EB

RE: H.F. 1313 (Thissen); S.F. 1141 (Betzold): MERF; Permitting Investing with the State Board of Investment and Transfer Liquidity Flexibility

DATE: February 28, 2007

Summary of H.F. 1313 (Thissen); S.F. 1141 (Betzold)

H.F. 1313 (Thissen); S.F. 1141 (Betzold) amends sections in Minnesota Statutes, Chapter 422A, the Minneapolis Employees Retirement Fund (MERF) chapter, by making the following changes:

1. MERF Authority to Invest with the State Board of Investment. The MERF Board would be permitted to invest some or all of the fund's assets with the State Board of Investment (SBI) through either the Minnesota Supplemental Investment Fund, a mutual fund-like family of investment accounts, or the Minnesota Combined Investment Funds, an investment pool made up of the active member assets of the various statewide retirement plans (Section 1).

2. MERF Internal Transfer Liquidity Flexibility. The transfer of assets between the MERF active member investment account (the MERF Deposit Accumulation Fund) and the MERF retired member investment account (the MERF Retirement Benefit Fund), if the Deposit Accumulation Fund has insufficient assets to make the transfer upon the retirement of an active member, can be made with an internal interest-bearing promissory obligation. The obligation would bear interest at the rate of five percent, plus the percentage increase in the Consumer Price Index over the period, and the interest and the principal of the obligation would be payable first from any balance in the Deposit Accumulation Fund (Sections 2 to 6).

3. Repealer. Minnesota Statutes, Section 422A.101, Subdivision 4, a provision requiring the City of Minneapolis to provide sufficient assets to make required transfers to MERF's retired fund at the time of retirement, is repealed (because it is replaced by the mechanism in 2, above).

These provisions are effective June 30, 2006.

Background Information

1. MERF, In General. Background information on the creation, plan design, benefits, and administration of the Minneapolis Employees Retirement Fund (MERF) is attached as Attachment A.
2. Minnesota Retirement Plan Investment Authority. Background information on the investment authority of MERF as compared to SBI and other major local retirement plans is presented in Attachment B.
3. MERF Post-Retirement Adjustment Mechanism. Background information comparing the operation of MERF's retirement Benefit Fund with the Minnesota Post Retirement Investment Fund operated by SBI is contained in Attachment C.
4. Background Information on State Aid to MERF. Background information on the state aid payable to MERF is set forth in Attachment D.

Discussion and Analysis

H.F. 1313 (Thissen); S.F. 1141 (Betzold) authorizes the MERF Board to invest some or all of MERF's assets with the State Board of Investment through either the Minnesota Supplemental Investment Fund or the Minnesota Combined Investment Funds; and it would authorize use of internal interest-bearing promissory obligations for use in covering transfer requirements between MERF's active and retired member fund when the active fund has insufficient assets to make the transfer upon the retirement of an active member. The interest on the obligation would be five percent plus the percentage increase in the Consumer Price Index over the period, and the interest and the principal of the obligation would be payable first from any balance in the active fund.

The current bill is based on a bill introduced in the House in 2005 by Representative Margaret Anderson Kelliher, H.F. 853. The Commission heard 2005 H.F. 853 (Kelliher) and recommended it to pass, but it was not enacted in 2005. On February 15, 2006, the Commission again recommended various provisions of that bill to pass, but portions of it were removed by the House and again not enacted. The two items that were removed by the House, revised MERF investment authority to allow investing with SBI and permission to use an internal liquidity transfer, are the substance of the current bill. The drafting incorporates technical revisions suggested by Commission staff in 2006.

H.F. 1313 (Thissen); S.F. 1141 (Betzold) raises several pension and related policy issues for Commission consideration and discussion, as follows:

1. Appropriateness of a Continued Separate Plan Administration for MERF and other Minneapolis Pension Funds. The policy issue is the appropriateness of retaining a separate plan administration for MERF. The MERF benefit plan has been closed to new members since 1979 (1977 in actuality, since the MERF Coordinated Program created for all new entrants in 1977 was consolidated into the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General) in 1979). According to the July 1, 2006, MERF actuarial valuation, MERF had only 335 active members (down from 462 a year earlier), and a considerable portion of these remaining active members meet or exceed minimum age and service requirements for retirement. MERF uses outside investment managers to handle its portfolios, and MERF is considering placing some or all MERF assets with the State Board of Investment.

   MERF also has a considerably larger administrative expense per plan member (including all active, disabled, deferred, retired, and survivors) than PERA-General ($147.12 per member for MERF compared to $26.07 per member for PERA-General in fiscal 2006). Another way of viewing this is that, on a per member basis, for every $1 PERA spends on administrative expenses, MERF spends $5.65. The two other Minneapolis pension funds, the Minneapolis Fire Relief Association (MFRA), and the Minneapolis Police Relief Association (MPRA) are even less efficient. In the State Auditor's Large Public Pension Plan Investment Report for the Year Ended December 31, 2005, and in a presentation before the Commission last year, State Auditor Patricia Anderson indicated that in 2005, MPRA's administrative expenses were $640 per member and MFRA's administrative costs were $1,047 per member. On a per member basis, for every $1 in administrative expenses spent by PERA to run PERA-General, the MPRA spent about $24.60, while the MFRA spent $40.26.

   At some point pension plans become too small in size, have shifted sufficient functions to outside contractors, and are too expensive in administrative cost to justify continuing separate plan administration. If MERF or other Minneapolis pension funds have reached that point in the opinion of the Commission, there are at least three options that could be considered for reorganizing the MERF and other Minneapolis plan administrations. These options are:

   a. MERF Administration by PERA. The MERF Board either could be authorized to contract with PERA for the provision of plan administrative services for MERF or PERA could be mandated to administer MERF. **Amendment H1313-1A** authorizes the MERF Board to contract with the PERA Board for plan administrative services. **Amendment H1313-2A** mandates that PERA administer MERF.

   b. PERA Administration of the Minneapolis Firefighters and the Minneapolis Police Relief Associations. **Amendment H1313-3A** mandates that PERA administer the Minneapolis Firefighters Relief Association and the Minneapolis Police Relief Association.

   c. Combine Minneapolis Pension Plan Administrations. The plan administrations of two or more of the Minneapolis pension plans could be combined into a single plan administration. **Amendment H1313-4A** would require that the MERF plan administration provide administrative services for the Minneapolis Firefighters Relief Association and the Minneapolis Police Relief Association.

   d. Convert MERF to a Trust Fund Administered by the City. MERF could be converted to a trust fund to be administered by the City of Minneapolis, akin to the situation of the former Eveleth Police Relief Association, the former Eveleth Fire Department Relief Association, and the former Thief River Falls Police Relief Association. **Amendment H1313-5A** converts MERF to a trust fund of the City of Minneapolis to be administered by the city finance director.

   A consideration for any proposal that would have MERF administer one or both of the Minneapolis relief associations is that it would be a second-best solution, and a temporary one. All these organizations are rapidly losing their remaining active membership to retirement and soon will consist entirely of retirees and survivors. It may be more efficient to consider merging all administrative functions into PERA and all investment-related functions into SBI.

2. Appropriateness of Authorizing MERF to Invest with SBI. The policy issue is the appropriateness of permitting MERF to utilize the State Board of Investment (SBI) to invest some or all of the MERF assets, either by purchasing shares in one or more accounts of the Minnesota Supplemental Investment Fund, or in a separately managed account in the Minnesota Combined Investment Fund, the current investment vehicle operated by SBI for the active member funds of the various statewide retirement plans. The five remaining local police or paid fire relief associations (Bloomington Fire, Fairmont Police, Minneapolis Fire, Minneapolis Police, and Virginia Fire) and the 700+ volunteer firefighter relief associations have had authority to utilize the Minnesota Supplemental Investment Fund under Minnesota Statutes, Section 69.77 (enacted in 1969) or 69.775 (enacted in 1971). Last year, the remaining first class city teacher fund associations received statutory authority to use the SBI Supplemental Fund (Laws 2006, Chapter 271, Article 8, Section 2).

   While authority to invest in the Minnesota Supplemental Investment Fund has been granted to nearly all Minnesota public plans, the MERF proposal for the authority to use the Minnesota Combined Investment Funds is without current precedent in any other local Minnesota public pension plan. The proposal also grants MERF discretion to allocate assets to the Minnesota Combined Investment Funds while also granting the SBI discretion as to whether to place MERF assets in fixed income pools or separately managed accounts. The Commission should consider taking testimony from MERF and from the State Board of Investment about how they envision this joint discretion will operate in practice.

3. Appropriateness of According MERF Full Discretion on the Amount of Its Assets Allocated to the State Board of Investment. The policy issue is the appropriateness of letting the MERF Board determine the amount of its assets to be invested with SBI. Under the authority, the MERF Board could increase or reduce the amount of its assets invested with SBI month to month or year to year as it saw fit. Allowing this much discretion reflects a continuing commitment to local pension plan autonomy.

4. Question of Whether to Amend Bill to Mandate the Investment of MERF Assets by SBI. The policy issue is whether the bill should be revised to mandate the investment of MERF assets by the State Board of Investment. Until 1969, MERF was responsible for investing all of its assets, but when the predecessor to the Minnesota Post Retirement Investment Fund (Post Fund) was established in 1969, MERF retired member assets were moved to that SBI fund and invested by SBI. Then, in 1981 or 1982, MERF retiree assets were transferred back to MERF and a MERF Retirement Benefit Fund statute was enacted as a virtual copy of the SBI Post Fund provision, using identical procedures for generating post retirement increases. The only difference between the MERF and SBI provisions of any significance was who did the investing of MERF retiree assets. That legislation required that the investing be done by MERF rather than SBI. If the Legislature in the early 1980s had not decided to copy the SBI system for determining post-retirement increases into MERF law and had not transferred MERF retiree assets back to MERF, SBI would at the current time be investing nearly all MERF assets, because currently nearly all MERF assets are retiree assets. As of September 30, 2006, MERF had total assets of $1.638 billion. Of that amount, 89 percent of the assets were in the MERF Retired Fund, another 8.5 percent of assets were in a survivor benefit account to pay survivor annuities, and only two percent of assets were in the active member (deposit accumulation) fund.

   As Appendix B indicates, over the long term through calendar year 2003, MERF investment performance has not been more advantageous than SBI, potentially arguing for a change in MERF's investment authority. The information in this appendix reflects the data available when Commission staff last systematically reviewed pension plan investment performance. **Amendment H1313-6A** would transfer the investment authority with respect to all MERF assets to SBI, effective July 1, 2007.

5. Appropriateness of Permitting Transfers of Internal IOUs Instead of Cash to the MERF Retirement Benefit Fund. The policy issue is the appropriateness of replacing the obligation for MERF to transfer cash or assets from the Deposit Accumulation Fund to the Retirement Benefit Fund with authority for an interest-bearing internal transfer payable. As indicated in Appendix C, the MERF Retirement Benefit Fund was established to replace and to parallel the Minnesota Post Retirement Investment Fund, which requires the transfer of the full actuarial required reserves for a retirement annuity upon the retirement of an active member from the active member investment account to the retired member investment account. Currently, the MERF Deposit Accumulation Fund has nominal assets that will not support many full required reserve transfers and the City of Minneapolis has had large and increasing additional contributions required under Minnesota Statutes, Section 422A.101, Subdivision 4, to maintain solvency in both funds, necessitating the City of Minneapolis to issue bonds to fund the liquidity transfers. The proposed addition of internal IOU transfer authority would alleviate the need for the current practice of bonding for liquidity transfers, but as the remaining 335 active members actually retire with an individual required reserve transfer amount that averages almost $350,000,

there is considerable potential that the internal IOUs could represent a large percentage of the Retirement Benefit Fund assets. The Minnesota Post Retirement Investment Fund and the MERF Retirement Benefit Fund have been portrayed to annuitants as beneficial because the full funding of the retired member investment account provides the security of tangible assets to them. Internal IOUs meet an accounting and a financing difficulty, but do nothing to maintain this sense of full funding security, replacing tangible assets with a promise of future city funding that is still based on actuarial assumptions and using an amortization period (i.e., until 2020) that was chosen by MERF to moderate the fiscal impact of resolving the investment losses inherited from the John Chenoweth era in 1991, but did not reflect the actual investment markets, historic salary increase practices, or the remaining working lifetime of MERF active members.

6. Appropriateness of the Internal IOU Interest Charge Calculation Procedure. The policy issue is the appropriateness of the formula proposed for calculating the interest on the internal transfer payable amounts credited to the MERF Retirement Benefit Fund. The internal IOUs are required to be credited with interest at a rate that is unrelated to the actual investment return of the plan, which could affect future investment performance component post-requirement adjustments. The interest rate to be credited on the internal IOUs is five percent plus the percentage increase in the Consumer Price Index during the fiscal year, without a maximum. While the credited interest rate would cover the potential minimum post-retirement adjustments (i.e., the five percent baseline post-retirement interest rate actuarial assumption plus up to a 3.5 percent increase in the Consumer Price Index), the rate does not cover lost investment returns during bull market periods (i.e., investment returns in excess of 8.5 percent) and will overstate actual investment returns during bear markets if there is moderate or high inflation. Inflation and investment returns are not well correlated[1], so when the interest crediting procedure would produce a high rate (five percent plus a high CPI increase percentage), actual MERF Retirement Benefit Fund performance is unlikely to also be high, meaning that the proposed interest crediting procedure will work to actually produce a higher investment performance component adjustment that is unreflective of what the situation would have been without internal IOUs. Similarly, in periods of nominal inflation and high investment returns, the internal IOUs authority will work to depress investment performance component adjustments.

7. Appropriateness of Creating a Priority for Redeeming Internal Transfer IOUs Interest Over Principal. The policy issue is the appropriateness of the proposed manner in which any future internal transfer IOUs and their interest charges will be redeemed when the MERF Deposit Accumulation Fund receives additional revenue. The proposed legislation would redeem the interest on the internal transfer IOUs first, before redeeming the principal. Given the large differential between the actuarial funding required under Minnesota Statutes, Section 422A.101, Subdivision 1, and the liquidity funding required under Minnesota Statutes, Section 422A.101, Subdivision 4, internal transfer IOUs are likely to be considerable and payment of the contrived interest charge on the IOUs instead of the principal of the IOUs could artificially increase future MERF unfunded actuarial accrued liability that drives the amount of the state contribution to MERF. MERF officials or Minneapolis city officials should be requested to disclose any projections that they have prepared that would shed some light on the magnitude of the anticipated internal transfer IOUs, IOU interest charges, city contributions, and the state's support of MERF.

8. Appropriateness of the Use of IOUs on Future State Aid to MERF. The policy issue is the impact on future state aid payments to MERF under Minnesota Statutes, Section 422A.101, Subdivision 3, of the proposed internal IOU transfers between the MERF Deposit Accumulation Fund (Active Account) and the MERF Retirement Benefit Fund (Retired Account). Rather than the aid ending when the last MERF active member retires, which is expected to be well before 2020, under this proposal the aid is likely to continue until that 2020.

   The state makes annual contributions to MERF to help retire its unfunded liability. Based on the most recent actuarial study, the state is expected to contribute $9.0 million in the coming year to help retire MERF unfunded liability by the 2020 full funding date. If the deposit accumulation fund does not have enough assets to meet asset transfer requirements when individuals retire, Minnesota Statutes, Section 422A.101, Subdivision 4, requires the city to provide any additional funding necessary for these transfers. The City of Minneapolis has issued municipal bonds to meet this and other pension obligations. Under existing laws given the expected retirement dates for MERF's remaining active members, that requirement in Section 422A.101 will cause MERF to be fully funded well in advance of 2020, and the state aid to MERF will end when that full funding date is reached..

[1] See Frederick Novomestky, "Geometric Brownian Motion Model for U.S. Stocks, Bonds and Inflation: Solution, Calibration and Simulation", 2001, p. 30.

In contrast, under the current proposal the state aid to MERF is likely to continue until 2020. Under this proposal, when the deposit accumulation fund as insufficient assets to make transfers, the retiree fund may not receive real assets. Instead, it will receive IOUs, declaring that the real assets will be provided at a later time. The IOU transfers are internal, they do not constitute actual assets of MERF, and they do not increase its funding ratio over time. The real funding, plus the additional interest required due to the delay, will be provided through the amortization process in law, which is geared to fully retiring all unfunded liability by 2020, not sooner.

9. Appropriateness of Retroactive Effective Date. The issue is why the effective date of these provisions should be July 1, 2006, rather than being prospective. The two issues covered by the bill is the issue of whether to use the State Board of Investment to invest some or all MERF assets, and whether to permit IOUs to be deposited in the retired fund, rather than requiring the City to immediately obtain sufficient assets to make the transfers by taxing or by borrowing. It does not seem that either of these could occur retroactively, so the retroactive effective date seems to have no purpose. **Amendment H1313-7A** would make the bill effective July 1, 2007.

10. Question of Local Approval. The question is whether a local approval clause should be added, if the proposal is viewed as placing additional funding responsibility or risk on the city. The Commission may wish to hear brief testimony on this matter. The bill seems quite favorable to the city in the short run, by reducing its need to quickly inject assets into MERF to cover transfer requirements. The long run impact is less clear, but still seems favorable. Some of the need to make payments to the fund to cover obligations is shifted to the more distant future, and some portion of that will be picked up by the state. But there is some risk to the city because the interest rate to be paid on the IOUs is a function of inflation, which is unknown, and a current or future Legislature might decide to limit state aid to MERF, leaving the city with a larger share of the financing responsibility. **Amendment H1313-8A** would add a local approval clause.

Attachment A

Background Information on the Minneapolis Employees Retirement Fund (MERF)

The Minneapolis Employees Retirement Fund (MERF) was established in 1919 and is governed by Minnesota Statutes, Chapter 422A. MERF was closed to new entrants in 1979. The membership of MERF is largely composed of employees of the City of Minneapolis and Special School District No. 1. Police officers employed by the Metropolitan Airports Commission before June 30, 1979, are members of MERF and are entitled to receive retirement benefits under either the MERF benefit Plan or the law governing PERA-P&F. Metropolitan Airports Commission firefighters employed before June 30, 1979, are also covered by MERF.

MERF is a defined benefit pension plan and is not coordinated with the federal Social Security System. For most MERF members, the retirement annuity is calculated based on the member's final average (highest five successive years) salary and a two part (2.0 percent for each of the first ten years; 2.5 percent for each subsequent year) benefit accrual rate. The normal retirement age is age 60 or any age with 30 years of allowable service. Police officers and firefighters covered by MERF receive the retirement benefit payable under the PERA-P&F benefit plan if that benefit plan produces a larger benefit than the MERF retirement benefit. Post-retirement adjustments are provided through the Retirement Benefit fund, modeled on the pre-1997 Minnesota Post Retirement Investment Fund law. MERF also provides disability and survivorship benefits.

MERF's two primary funds are the Deposit Accumulation Fund and the Retirement Benefit Fund. The Deposit Accumulation Fund, also called the Active Fund, accumulates and invests active member assets. At the time of retirement, the full reserves needed to pay the retirement benefits for the expected remaining lifetime of the new retiree transfer to the Retirement Benefits Fund. From the Retirement Benefit Fund, MERF pays the retirement benefits, and individuals receive increases composed of a partial inflation match and an investment-based increase. In addition to MERF's Active and Post Fund, MERF has two minor funds, a survivor benefits fund and a disability benefits fund. These are largely accounting constructs and the assets are merged with other MERF assets for investment purposes.

The state makes large annual contributions to MERF to help that fund retire its unfunded liabilities. The level of unfunded liabilities that currently exist in MERF is partially due to MERF's very weak investment performance under John Chenoweth, a former state legislator who was MERF's Executive Director for a period during the 1980s and very early 1990s, and the MERF Board at that time. MERF received several million dollars from an insurance policy as settlement of a fiduciary breach lawsuit, stemming from the activities of John Chenoweth and the Board. Losses, however, as measured by the difference between MERF assets and the assets that would have been generated for the fund under competent investment management was much higher than the recovery from the insurance policy. That opportunity loss, as measured by MERF staff during the early 1990s, ranged from $60 million to as high as $130 million, depending upon the exact time period under study. Some of that opportunity loss impacted MERF retirees in the form of lower post-retirement adjustments. The rest impacted the state and employing units through an increased need for state aid and employer contributions.

MERF is managed by a governing board of seven members, of which five are elected by the members of the Minneapolis Employees Retirement Fund Association, the mayor or the mayor's designee, and a Minneapolis city council member selected by the council. In addition to maintaining records and determining benefit amounts, the MERF governing board is the investment authority for the assets of its various funds, although the MERF Board is required to use independent professional investment firms.

In fiscal year 2006, MERF received total contributions of slightly over $46.7 million (76 percent from the city, 19.3 percent from the state, and 4.7 percent from the employees), received net investment income of almost $122 million, paid total retirement benefits of almost $134.7 million, and paid administrative expenses of slightly more than $792,000 (59 percent for personnel, 19 percent for conferences and professional services, and 12 percent for communications, office rent, and other expenses).