State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

H.F. 2361 (Murphy, M., by request)

S.F. 1978 (Betzold)

Executive Summary of Commission Staff Materials

Affected Pension Plan(s):	Various Retirement Plans; Accounting and Actuarial Reporting
Relevant Provisions of Law:	Minnesota Statutes, Sections 356.20 and 356.215
General Nature of Proposal:	Implements Recommended Reporting Changes to Accommodate Generally Accepted Accounting Principles
Date of Summary:	April 23, 2007

Specific Proposed Changes

- Makes language clarifications and corrections in accounting and actuarial reporting.
- Eliminates outdated asset value and unfunded actuarial accrued liability reporting requirements.
- Revises actuarial value of assets.
- Provides vehicle for making various economic actuarial assumption changes.

Policy Issues Raised by the Proposed Legislation

1. Appropriateness of language clarifications and corrections.
2. Appropriateness of the elimination of outdated asset value and unfunded actuarial accrued liability reporting requirements.
3. Necessity of revising the manner in which Minnesota Post Retirement Investment Fund assets are valued.
4. Unclear whether the proposed pension plan asset value definition revision actually accomplishes the intended result.
5. Proposed pension plan asset value definition revision may not appropriately apply when the Minnesota Post Retirement Investment Fund does not have a deficit.
6. Proposed asset valuation definition does not account for Minnesota Post Retirement Investment Fund deficit funding mechanism.
7. Appropriateness of the proposed asset valuation definition revision functioning to prejudice future Commission post-retirement adjustment reform options.
8. Continued appropriateness of using an actuarial value of assets rather than the market value of assets.
9. Appropriateness of an explicit change to 8.5 percent post-retirement interest rate assumption for the statewide retirement plans.

Potential Amendments

H2361-1A	(substantive) adds accounting change references to the Minnesota Post Retirement Investment Fund financial reporting provision; clarifies that market-related asset valuation procedure applies to the Minnesota Post Retirement Investment Fund.
H2361-2A	(substantive) clarifies generally accepted accounting principle conformance, but retains current actuarial reporting procedure as supplemental information for setting program contribution rates.
H2361-3A	(substantive) shifts from actuarial value of assets to full market value of pension assets.
H2361-4A	(substantive) resets post-retirement interest rate actuarial assumption to conform with "de facto" assumptions.
H2361-5A	(technical) clarifies reference to Commission-retained actuary.
H2361-6A	(substantive) implements MSRS-General, PERA-General, and TRA economic actuarial assumption changes from 2000-2004 experience studies.
H2361-7A	(substantive) implements economic actuarial assumption changes for PERA-P&F and PERA-Correctional.
H2361-8A	(substantive) implements economic actuarial assumptions changes for the State Patrol Retirement Plan and MSRS-Correctional.

State of Minnesota \ LEGISLATIVE COMMISSION ON PENSIONS AND RETIREMENT

TO:	Members of the Legislative Commission on Pensions and Retirement
FROM:	Lawrence A. Martin, Executive Director LAM
RE:	H.F. 2361 (Murphy, M., by request); S.F. 1978 (Betzold): Various Plans; Implementation of Various Generally Accepted Accounting Principles
DATE:	April 23, 2007

General Summary of H.F. 2361 (Murphy, M., by request); S.F. 1978 (Betzold)

H.F. 2361 (Murphy, M., by request); S.F. 1978 (Betzold) amends Minnesota Statutes, Sections 356.20 and 356.215, the public pension financial and actuarial reporting laws, by making the following changes:

1. Language Clarification and Corrections. The term "chief administrative official" is replaced by "chief administrative officer" and the term "public pension fund" is replaced by "public pension plan." Cross citations are corrected and language style and usage improvements are made (Sections 1, 2, and 3);

2. Outdated Asset Value and Unfunded Actuarial Liability Reporting Requirements Are Eliminated. The current annual financial reporting requirements with respect to the value of pension plan assets and to the unfunded actuarial liability under various liability measures that related to generally accepted accounting principles in force in 1984 and subsequently revised are eliminated (Section 1); and

3. Revised Actuarial Value of Assets. The actuarial value of assets is redefined as the market value of assets as of June 30, 2007, for the July 1, 2007, valuations, and the current actuarial value of assets definition, which is the market value of assets reduced by portions of the difference between the expected value of assets using the interest rate actuarial assumption, for up to four prior years, apparently including the assets of the Minnesota Post Retirement Investment Fund, and renames the term "current assets" as the "actuarial value of assets" (Section 2).

Background Information

Background information on relevant topics attached is attached:

- **Attachment A** contains background information on the actuarial reporting requirements of Minnesota public pension plans;

- **Attachment B** contains background information on the manner in which pension plan assets are valued for actuarial reporting purposes;

- **Attachment C** contains background information on the statewide retirement plan common post-retirement adjustment mechanism;

- **Attachment D** contains background information on the current difference between the market value of assets and the actuarial value of assets of the Minnesota Post Retirement Investment Fund;

- **Attachment E** contains background information on the discussion of the disclosure of Minnesota Post Retirement Investment Fund liabilities and assets in recent reports by the Minnesota Taxpayers Association and by the Program Evaluation Division of the Office of the Legislative Auditor; and

- **Attachment F** contains background information on the results of the 2000-2004 quadrennial experience studies for the General State Employees Retirement Plan of the Minnesota State Retirement System (MSRS-General), the General Employees Retirement Plan of the Public Employees Retirement Association (PERA-General), and the Teachers Retirement Association (TRA) and the subsequent recommendations for assumption changes.

Discussion and Analysis

H.F. 2361 (Murphy, M., by request); S.F. 1978 (Betzold) modifies the public pension plan financial and actuarial reporting laws, Minnesota Statutes, Sections 356.20 and 356.215, by eliminating pension liability and funding ratio reporting requirements that are no longer mandated by public pension plan generally accepted accounting principles and by revising and updating the actuarial value of assets definition in the statutory actuarial valuation requirements.

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

1. Appropriateness of Language Clarifications and Corrections. The policy issue is the appropriateness of the proposed language clarifications and corrections contained in the proposed legislation. The replacement of the reference to "fund" with a reference to "plan" and of the reference to "chief administrative official" with a reference to "chief administrative officer" are more consistent with current drafting conventions and appear to be appropriate because they do not appear to have any substantive change in the provisions while making the provision more readable.

2. Appropriateness of the Elimination of Outdated Asset Value and Unfunded Actuarial Accrued Liability Reporting Requirements. The policy issue is the appropriateness of the proposed elimination of Minnesota Statutes, Section 356.20, Subdivision 4, Paragraphs (b) and (c), which represent generally accepted accounting principle requirements that were in force in 1984 and have been subsequently supplanted as the governing accounting principles. Minnesota Statutes, Section 356.20, governs the annual financial reporting requirements applicable to public pension plans in Minnesota. The financial reporting requirement has been in statute since 1965, when there were few or no public pension plan-specific financial reporting requirements in force. Since the development of the Financial Accounting Standards Board (FASB), primarily applicable to the non-governmental sector, and the development of its governmental sector counterpart, the Governmental Accounting Standards Board (GASB), the general practice in Minnesota has been to reflect the regulation that has been determined to be "generally accepted accounting principles." While the retention of outdated reporting requirements does not cause any harm, unless the requirements function to supplant more recent reporting requirements, the retention decision should be made based on its merits rather than on inertia. It would appear that the continued existence of Minnesota Statutes, Section 356.20, Subdivision 4, Paragraphs (b) and (c), is a result of inaction by any interested public pension plan party, chiefly the accounting sections of the various retirement plans, the State Auditor's Office, and the Legislative Auditor's Office. It is unclear that the reporting items proposed for elimination have provided any additional valued information to public pension plan personnel, the Legislature, the Department of Finance, or any outside consumer of public pension information, which argues for the elimination of the items. The Commission should provide any interested party an opportunity to discuss the analytical value of the reporting information proposed for elimination.

3. Necessity of Revising the Manner in Which Minnesota Post Retirement Investment Fund Assets Are Valued. The policy issue is the extent that the proposed revision in the actuarial value of assets definition of Minnesota Statutes, Section 356.215, Subdivision 1, Paragraph (f), is necessary. The revision reflects the resolution assembled by David DeJonge, Assistant Director for Finance and Information Systems of the Public Employees Retirement Association (PERA), and by John Wicklund, Assistant Director for Administration of the Teachers Retirement Association (TRA), to address a problem of illegal noncompliance in the annual financial reporting of the statewide retirement plans with Governmental Accounting Standards Board (GASB) Statement No. 25 because the assets of the Minnesota Post Retirement Investment Fund are valued on a liability basis rather than on a market value-related basis. Since the predecessor to the predecessor of the current Minnesota Post Retirement Investment Fund was established in 1969, the value of the assets in the post-retirement adjustment mechanism and investment fund has been equated to the required reserves of the retirement benefits payable from the mechanism. Generally accepted accounting principles for public pension plans, to the extent that it existed at all in 1969, as reflect in Minnesota Statutes 1969, Section 356.20, carried pension plan assets at their book value. If the actuarial work of the various statewide retirement plans does not conform with GASB Statement No. 25, the consequence is that the audits by the Office of the Legislative Auditor will have a qualified opinion by the auditor indicating the nature of the noncompliance to put third party users of the information on notice of the deviation. That qualified audit opinion on the annual financial reporting of the retirement plans, which apparently does not carry into the financial reporting of the state as an employer and pension plan sponsor, could cause municipal board rating agencies to downgrade the state's credit rating and could cause reduced demand for state bonds.

4. Unclear Whether the Proposed Pension Plan Asset Value Definition Revision Actually Accomplishes the Intended Result. The policy issue is whether or not the proposed revision in the pension plan asset valuation definition accomplishes the intended result. The current definition of the actuarial value of assets, Minnesota Statutes 2006, Section 356.215, Subdivision 1, Paragraph (f), does not apply to the equity in the Minnesota Post Retirement Investment Fund, which is valued as equal to the required

reserves of the statewide post-retirement adjustment mechanism, presumably because there is a special financial reporting provision in Minnesota Statutes, Section 11A.18, Subdivision 7, and nothing in the revised definition overrides Minnesota Statutes, Section 11A.18, Subdivision 7, or clarifies that the revised actuarial value of assets definition applies to the participation in the Minnesota Post Retirement Investment Fund as well as the assets in the statewide retirement plan not transferred to the Minnesota Post Retirement Investment Fund. If the Commission wishes to augment the language of the proposed legislation to make the legislative intent of the revision clear, **Amendment H2361-1A** adds additional language to clarify the application of the proposed legislation.

5. Proposed Pension Plan Asset Value Definition Revision May Not Appropriately Apply When the Minnesota Post Retirement Investment Fund Does Not Have a Deficit. The policy issue is whether or not the revision of the actuarial value of assets definition in the proposed legislation will appropriately apply to the Minnesota Post Retirement Investment Fund assets when the current deficit in the post-retirement adjustment mechanism is retired and the mechanism has assets in excess of the required reserves for benefits currently in force. When the Minnesota Post Retirement Investment Fund accrues investment returns in excess of 8.5 percent (the combination of the post-retirement interest rate actuarial assumption of five percent and the 3.5 percent potential Consumer Price Index-related annual post-retirement adjustment), if there is no deficit in the mechanism, that excess investment return amount is allocated into five equal amounts (one credited to the current year and the remaining four credited to the four subsequent years), and the current year portion of the current year's return and the current year portion of the previous four years' returns are totaled and the net result, if positive, funds an investment performance-related post-retirement adjustment (subject to a five percent annual maximum in combination with the CPI-based adjustment amount, separately capped at 2.5 percent annually) on the following January 1. While the revised actuarial value of assets definition, when fully implemented, recognizes varying fifths of current and prior years market value change compared to the expected asset value based on the pre-retirement interest rate actuarial assumption of 8.5 percent, that similar calculation is not identical to the Minnesota Post Retirement Investment Fund excess investment return crediting that produces benefit increases and additional liabilities. The end result, whenever the Minnesota Post Retirement Investment Fund funding situation again returns to a deficit-free situation, will be to overstate assets and the retirement plan funding ratio by recognizing some assets that fund benefit increases in the pipeline and future liabilities against then-recognized liabilities. The overfunded, over-recognition of assets as a funding resource, under-recognition of total liabilities situation that will occur if the definition revision is enacted and the Minnesota Post Retirement Investment Fund retires the existing $4 billion deficit, a situation that does not occur under current law, will arguably misrepresent the total financial condition of the various statewide retirement plans.

6. Proposed Asset Valuation Definition Does Not Account for Minnesota Post Retirement Investment Fund Deficit Funding Mechanism. The policy issue is the appropriateness of the actuarial valuation of assets definition revision proposed in the bill since the revision does not recognize the current law Minnesota Post Retirement Investment Fund deficit funding mechanism. Separate from an alleged failure to comply with the requirements of the Governmental Accounting Standards Board (GASB) Statement No. 25 for market value-related asset values, the recent report by the Program Evaluation Division on Post-Employment Benefits dealt largely with retirement plan issues rather than the developing policy area of "other post-employment benefits" (OPEBs), criticized the statewide retirement plans for improperly reflecting their actual financial condition because retirement plan actuarial work does not include Minnesota Post Retirement Investment Fund deficits, and recommended that the Legislature take additional steps to fund those Minnesota Post Retirement Investment Fund deficits after revising the post-retirement adjustment mechanism. Although the Legislative Auditor's report acknowledged that the Minnesota Post Retirement Investment Fund has a mechanism for retiring its current deficit by withholding any future investment performance post-retirement adjustments until the deficit is fully funded, the reporting promptly dismissed that statutory provision arguing for the creation of a different statewide retirement plan post-retirement adjustment mechanism. Minnesota Statutes, Section 11A.18, Subdivision 9, Paragraph (c), Clauses (5) to (9), provide that no post-retirement adjustment is payable from the Minnesota Post Retirement Investment Fund if the post-retirement adjustment mechanism has a deficit (i.e. market value of assets less the required reserves for benefits covered by the mechanism). The discontinuation of post-retirement adjustments when the Minnesota Post Retirement Investment Fund has a deficit provides the mechanism for retiring any deficit, which occurred in the early 1980s, when the Minnesota Post Retirement Investment Fund last had a deficit before 2000-2001. If the Minnesota Post Retirement Investment Fund deficit is recognized in the actuarial valuation and annual financial report of statewide pension plans, as proposed in the legislation, the post-retirement adjustment mechanism will be added to the unfunded actuarial accrued liability of the retirement plan and to the plan's amortization requirement to be met by ongoing contributions, without reflecting the statutory

mechanism for retiring the deficit. In addition to providing reliable information to outside investors and other parties, Minnesota public pension plan actuarial valuations are intended to assist Minnesota policymakers in setting and revising member and employer contribution rates to insure adequate plan funding. If the Minnesota Post Retirement Investment Fund deficit is simply lumped together with the retirement plan unfunded actuarial accrued liability, any alleged accuracy gained by bond raters and potential bond purchasers would be offset by the inaccuracy in funding measures for policymakers that also would result. **Amendment H2361-2A** attempts to disclose the Minnesota Post Retirement Investment Fund deficits or surpluses in the actuarial and financial work without losing the accuracy of the actuarial work in assisting policymakers to determine member and employer contribution rates by continuing to additionally require actuarial reporting in the same fashion as the current actuarial valuation work is performed.

7. <u>Appropriateness of the Proposed Asset Valuation Definition Revision Functioning to Prejudice Future Commission Post-Retirement Adjustment Reform Options</u>. The policy issue is the appropriateness of the proposed legislation redefining assets to include the participation in the Minnesota Post Retirement Investment Fund valued in a market-related manner when that change could have unintended effects on the ongoing deliberations over the appropriate manner in which to revise the current Minnesota Post Retirement Investment Fund. Currently, because of the sizable deficit in the Minnesota Post Retirement Investment Fund, no investment-related post-retirement adjustments are likely to be paid for years, perhaps decades, and adjustments are effectively limited to 2.5 percent annually, the limit on the Consumer Price Index-related post-retirement adjustments. Until the $4 billion deficit in the Minnesota Post Retirement Investment Fund is retired, post-retirement adjustments will be significantly constrained and the burden of those constraints will be borne by the current retirees. If attempting to conform to some regulation promulgated by the accounting trade results in either the perception of or the reality of the conversion of the current Minnesota Post Retirement Investment Fund deficit into an unfunded actuarial accrued liability to be funded by either the employers, the active plan membership, or both, the proposed legislation could inappropriately advantage current retirees at the expense of current active members and future active members. While not wholly adequate to ward against this potential liability shift, **Amendment H2361-2A** would provide the Commission some basis to argue against the liability shift.

8. <u>Continued Appropriateness of Using an Actuarial Value of Assets Rather Than the Market Value of Assets</u>. The policy issue is whether or not it is better to value Minnesota public pension plan assets at an actuarial value of assets that approximates market value changes, the current law, or to value Minnesota public pension plan assets at their unadjusted market value. The assets of statewide and major local Minnesota retirement plans have never been valued at unadjusted market value. The current actuarial value of assets definition was enacted in 2000, at the recommendation of the consulting actuarial firm then retained by the Legislative Commission on Pensions and Retirement, Milliman & Robertson, which argued that the recommended actuarial value of assets formula would limit the volatility-related shifts in asset values and would insulate the State Board of Investment and other retirement fund investment authorities from actuarial concerns in undertaking investment transactions. The market value of assets was the second choice of the consulting actuarial firm if the Commission did not endorse the actuarial value of assets definition. The Commission staff observed in 2000 that the historic pattern of volatility in the equity markets has been over a period shorter than one year and over periods longer than five or seven years, which both fall outside the current actuarial value of assets formula. No actual evidence of actuarial concerns in investment transactions was ever represented on the part of retirement plan investment authorities that the current actuarial value of assets formula allegedly attempts to relieve. With the possible exception of the Minneapolis Employees Retirement Fund (MERF) among the statewide and major local retirement plans, no plan actually has its contributions in the following year directly affected by a change in asset values because all other plans have statutory contribution rates requiring legislative action to change. The use of the actuarial value of assets confuses rather than clarifies pension funding, since in up markets, interested parties all know the market value of plan assets and use those higher market values to argue for benefit modifications and rely on the actuarial value of assets in down markets to minimize policymakers' concerns, even when those concerns are well-founded. If the Commission wishes to shift to an unadjusted market value for retirement plan assets, **Amendment H2361-3A** would make that change.

9. <u>Appropriateness of an Explicit Change to 8.5 Percent Post-Retirement Interest Rate Assumption for the Statewide Retirement Plans</u>. The policy issue is the appropriateness of updating the post-retirement interest rate assumption for the various statewide retirement plans and resetting the post-retirement actuarial rate actuarial assumptions, both pre-retirement and post-retirement, in the actuarial valuations of the statewide retirement plans is 8.5 percent, although the interest rate actuarial assumptions for the statewide retirement plans in Minnesota Statutes, Section 356.215, Subdivision 8,