

# **Public Pensions in Minnesota:**

## **Re-Definable Benefits and Under-Reported Performance**

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**Executive Summary**

As an area of government spending, public pensions do not receive much attention. However, public pension obligations are growing rapidly around the country. According to the United States Census Bureau, major public pension plans paid out \$78.5 billion in the 12 months that ended in September 2000. By the same period in 2004, pension payouts had grown by 50% to \$118 billion. In 2003, state and municipalities contributed \$46.3 billion to pension plans which was a 19 percent increase over 2002 levels. There is also the issue of unfunded pension liabilities. In September 2005, the Council of State Governments estimated that the liabilities owed by state government-operated retirement plans nationwide exceeded assets by some \$292.4 billion.

Are Minnesota taxpayers being exposed to significant risks from pension liabilities? Or is Minnesota successfully avoiding the problems other state and local governments are struggling with? What are the current and long-term costs of our public pension decision-making? Are there reforms we can pursue to improve both the financial health of the public pension system and the accountability of pension decision-making to state taxpayers? These are the questions addressed in this report.

This report focuses on six major pension plans: the three major independent teacher plans (St. Paul, Duluth, and Minneapolis Teachers Retirement Fund Associations) and the three major statewide public employee plans (MSRS or Minnesota State Retirement System General Plan; PERA or Public Employees Retirement Association General Plan; and TRA or Teachers Retirement Association). Minnesota's public pension system includes many more plans than these six. There are a total of eighteen statewide public pension plans and four other plans that cover the employees of individual cities. There are also several hundred locally administered volunteer firefighter pension plans (mainly operated by townships) and some locally administered plans whose members are police and professional firefighters. However, the plans studied in this report are the three largest statewide public pension plans, accounting for about 80% of the retirement funds under the control of the State Board of Investment, and the three largest city-operated pension plans in Minnesota. The six plans combined cover more than 600,000 active and retired public employees. Even though a review of the status and performance of the other state and local pension plans is beyond the scope of this report, taxpayer risk issues discussed in this study apply to these plans as well.

**Findings on the Current Health and Status of Public Pensions in Minnesota**

- As of June 2005 the six plans comprising this study had reported unfunded pension liabilities totaling \$6.1 billion. Although the funded ratios (defined as total assets divided by total accrued pension liabilities) have mostly improved over the past thirty years, the \$6.1 billion in unfunded liabilities is greater in absolute terms (inflation adjusted dollars) than in 1975.
- The Minnesota Post Retirement Investment Fund (Post Fund), the fund exclusively for the assets and liabilities of existing retirees from statewide pension plans, also has unfunded liabilities totaling \$3.7 billion for PERA, MSRS, and TRA retirees. These liabilities are not reported as part of fund actuarial reports. If these liabilities

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are included, total unfunded pension liabilities in these six funds totaled \$9.8 billion as of June 2005.

- The health of the plans is mixed. None is fully funded. Two of the plans, MSRS and TRA, are above 95% funded. PERA and St. Paul Teachers have less than 80% of the assets needed to pay the benefits owed to active and retired plan members. Minneapolis Teachers Retirement Fund had less than half of the assets needed to pay benefits owed to its plan members.
- Five of the six plans also had contribution deficiencies, which means that too few contributions are being made to close their existing funding gaps. The size of contribution deficiencies for MSRS and PERA are the greatest in 30 years. Since 2002, PERA has added over \$500 million in unfunded pension liabilities as a result of contribution shortfalls alone. The magnitude of contribution deficiencies for all three major independent teachers plans are all greater than the state plans and also are approaching or exceeding 30-year highs. Only TRA had a contribution surplus, which means that progress was being made on reducing their unfunded liabilities.
- Contribution increases are already in law to begin to remedy these shortfalls. However, these increases are not without real cost. If all the approved increases to fix the PERA funding gap occur, local government spending will increase by \$380 million through 2010, in the form of city and county governments' pension contributions (the employers' share only). The employees' share of these increased contributions also create wage increase pressures for local governments to compensate employees for lower net pay.
- Real life divergence from the assumptions actuaries have used to calculate future pension liabilities has had a major influence on reported pension fund health. Changing mortality rates, rates and timing of employee retirement, and related demographic issues added nearly \$4.5 billion in unfunded liabilities to the six funds since 2002.

### **Findings on the State of Minnesota's Performance in Managing Public Pension Liabilities**

The Minnesota legislature determines the cost of public retirement programs by 1) making decisions that determine how future pension costs will be paid for; and 2) establishing pension benefit levels. With respect to paying for future pension costs, the legislature adopts an assumed rate of investment return and determines employee and employer contributions to the plans. With respect to benefits, the legislature sets the formula for determining retiree benefit levels and determines the size of any post retirement benefit increases.

#### ***Findings Regarding Legislative Decision-Making in Paying for Future Pension Costs***

- To determine whether or not a pension fund will have enough assets to meet the liabilities owed to current and future retirees, the state makes an assumption about what annual average rate of return it will earn on its investments in perpetuity. The 8.5% assumed rate of return that the Minnesota legislature has adopted is among the

highest assumed rates of return used by any state managed pension fund in the nation. Of 127 state managed funds surveyed by the National Association of State Retirement Administrators in 2004, 85% assume more conservative rates of return. Only 2 funds reported using a higher assumed rate of return.

- Reported pension fund health is very sensitive to changes in assumed rates of return. If Minnesota used an 8% assumed rate of return—the norm for most state managed plans—PERA’s reported funded ratio would decline to 70.03%, which translates into an additional \$1.02 billion of unfunded pension liabilities.
- From 1985 to 2001, pension funds made steady progress toward reducing unfunded liabilities by consistently out-performing the 8.5% assumed rate of return. However, the market downturn beginning in 2000 and the post 9/11 economic environment took its toll on fund health. In only four years, the three state funds added back over 50% of the unfunded liabilities they had managed to reduce through investments over the previous sixteen years (1985-2001). Over the same time period, all of the reductions in unfunded liabilities from investment gains made by the Minneapolis and St. Paul Teachers Funds were reversed.
- The effects of failing to achieve assumed rates of return—and the resulting taxpayer exposure—can in part be seen in the contribution rates of struggling pension funds. In the Minneapolis and St. Paul Teachers funds, employees contribute 5.5 percent of their salary to the pension fund, more than the three state funds. However, taxpayers in those school districts contribute over 8% of salary through school district employers. This employer contribution rate is more than twice the percentage state taxpayers contribute to the statewide MSRS fund.

### *Findings Regarding Legislative Decision-Making on Pension Benefits*

- In the last twenty years, the legislature has approved two primary formula multiplier increases; the first in 1989, the second in 1997. These changes have resulted in an estimated additional \$1.728 billion in benefits paid since 1985, or 7.64% more than provided for by 1985 law. However the costs of formula changes are not felt immediately and increase in the future. As more employees retire with these higher benefits, the post-1985 increased portion grows. Increases due to the 1989 changes may have fully taken effect. However, increases from the 1997 changes may just now be taking effect.
- The state has no empirical or quantifiable method for determining whether increases in pension benefits are justified. Currently employees in each of the six plans with 30 years of service can earn 51% of their pre-retirement income from their pensions. When Social Security is included, the average wage employee receives between 77.5% and 89.9% of their pre-retirement income (\$36,610 - \$67,117) depending on the plan.
- Post retirement benefit increases come in two forms, an annual inflation adjustment of a flat 2.0% or actual inflation up to 2.5% depending on the fund, and periodic benefit increases based on investment performance exceeding 8.5%. Both types of increases become a permanent part of the base pension benefit. From 1994-2006,

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the three state managed plans (MSRS, PERA, TRA) dedicated \$3.52 billion of assets toward cost of living benefit increases and \$4.87 billion toward investment performance benefit increases. If other State Board of Investment managed funds are included, \$5.73 billion in assets was dedicated to investment performance benefit increases during this period.

- Most of the post retirement benefit increases based on investment performance are actually the result of market volatility. Between 1990 and 2004, the Post Fund returned an average of 9.34% annually. If the Post Fund had realized a consistent 9.34% return each year over that period (a straight line increase) only \$1.52 billion would have been dedicated for investment performance benefit increases, some \$4 billion less than was actually dedicated.
- The policy of turning investment gains into permanent benefit increases has had significant negative impact on the health of public pension funds:
  - The state Post-Retirement Fund's position changed from a \$4.3 billion surplus in 1999 to a \$4.1 billion *deficit* in 2005. Even if the investments in this fund return 9% annually going forward, it will take until the year 2033 for this fund to be restored to full funding. The permanent benefit increases also hindered the ability of the Basic Funds to achieve fully funded status because transferred assets were used to pay post retirement increases.
  - It has created major fairness and equity problems among public employee retirees. Those who were fortunate to have benefited fully from the 1990s markets have retirement benefits today often in excess of their working salary. The story is completely different for public employees retiring recently under much different market and fund conditions. Those in the three state plans have little hope of seeing anything other than inflationary adjustments – especially since the Post Fund for retirees will have unfunded liabilities for years to come. The “winners” under this system have been persons who retired between roughly 1981 and 2001, and the “losers” have been those persons retiring since 2001.
  - It has exposed taxpayers to significant risk. If the state's pension fund managers are unable to realize returns of at least 8.5%, retirees do not have any risk of reductions in benefits. Because public employee retirees no longer make contributions to the funds, governments—and by extension taxpayers—will be liable for any long-term deficiency that threatens benefits.
  - It has resulted in rates of pension payment growth far exceeding national averages. In 2002 Minnesota spent nearly 27% more per capita on state and local employee retirement payments than the national average, with a national ranking of 5<sup>th</sup> highest in the country. In 1992 our per capita rank was only 25<sup>th</sup> highest and our payments from retirement funds per capita were near the U.S. average.

### Findings Regarding Accountability in Public Pension Asset Management

- Current reporting requirements on pension fund performance fall short in several ways. There is no requirement to translate funds' annual rates of return into actual dollar values gained or lost; no quantification of value added or lost as a result of investment decisions, and no ability to see the cumulative value added effects of decision making over time.
- Value added performance auditing is an important and complementary method to current performance reporting methods based on time weighted rates of return. Value added performance auditing increases levels of transparency and accountability in pension fund asset management.
- Applying value added performance auditing methods yields insights into the current situation faced by the Minneapolis Teachers Retirement Fund. Between 1982 and 2005 approximately \$1.78 billion of investment returns were available through efficient investment in its own policy. However, \$667 million of this total was not realized due to poor investment decision-making. In other words, 68% of the current \$972.5 million deficit plaguing the Minneapolis Teachers Retirement Fund (according to the 2005 actuarial report) could have been avoided with better investment management of the fund's assets.
- Past efforts to adopt value added performance auditing in Minnesota were first championed then resisted by the Office of State Auditor. Future attempts to institute this methodology may require moving the performance auditing function into a state agency less subject to the political pressures of elected officials.
- The type of investments made by public pension funds can also introduce accountability problems. Growing interest in "alternative investments" – such as private equity funds – is being fueled by returns superior to those offered by investments traded publicly on organized exchanges. However, investment performance in these vehicles comes at the expense of transparency and accountability. Alternative investment managers don't price their assets as often—and only they know if that pricing is accurate. Often the valuations are merely estimates.

### Recommendations

Our objectives in these recommendations are:

- to preserve the integrity of a defined benefit pension system for public employees
- improve and ensure the continued health of these funds
- concurrently reduce taxpayer risk and exposure, and
- encourage a greater transparency regarding the costs and risks for an open debate of their priority vis-à-vis other public spending.

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### *To improve the Monitoring and Reporting of Pension Health and Spending in Minnesota:*

- Require Governors' proposed budgets to list pension contribution costs separately.
- Report funded ratios and unfunded liability totals for both the basic and post funds independently.
- Initiate value-added performance auditing to monitor public pension fund performance in Minnesota.
- Consider removing the responsibility for monitoring public pension funds in Minnesota from the State Auditor's Office to an agency with personnel not directly elected by the voters.

### *To Improve the Design and Function of Minnesota's Defined Benefit Pension System*

- Permanently end benefit increases based on superior investment returns and provide only capped inflationary adjustments.
- Develop quantifiable standards of replacement income to be achieved through pension benefits.
- When the Basic Funds are under-funded and the Post Fund is fully funded, transfer only the fractional reserves necessary to keep the Post Fund "whole."
- Should conditions return that result in surpluses for both the Basic and Post Funds, give first priority to reducing employee and employer contributions, then possibly to providing for self managed accounts or "13<sup>th</sup> checks" for retirees, but only when an established "maximum funded ratio" in the Post Fund is exceeded.