

## Recommendations

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### Recommendations

There are sound policy reasons for providing government employees with defined benefit plans, such as their usefulness as a recruiting and retention tool and to protect against indigence in old age with its corresponding public costs. There are also risks to these plans. Defined benefit systems are complex, confusing, and Byzantine in their technical intricacy and complexity. They are built upon actuarial science with its indecipherable mathematical models, accounting formulas, and layers of assumptions about what life and the economy will look like in the future. The full cost to taxpayers and degree of taxpayer exposure is not realized immediately but evolves over time as the difference between anticipated reality and actual experience unfolds. For these reasons, a premium needs to be placed on introducing the highest levels of accountability and transparency possible with respect to decision making regarding these plans.

The following recommendations have been developed based primarily on this study of the three largest retirement plans included in State Board of Investment oversight, and the three independent teachers' plans of Minneapolis, St. Paul, and Duluth. In the course of conducting this study, we became aware of additional issues regarding other public pension plans and funds not covered here. We believe many of the recommendations should apply to all public pension plans in the state, but some are specific to the plans included in this study.

*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.*

#### ***Recommendations Regarding the Monitoring and Reporting of Pension Health and Spending***

Monitoring funds' health is an important part of administering public pension plans. Reporting that health to the public is just as important a part of keeping the ongoing costs and risks of public pension plans in front of taxpayers who are helping to pay for significant portions of the benefits and who ultimately bear the risks of lower investment returns.

- **Require Governors' proposed budgets to list pension contribution costs separately.** Current pension oversight rests primarily with the Joint Legislative Commission on Pensions and Retirement, consisting of five legislators from each legislative body. While this allows a smaller number of legislators to become experts on the intricacies of public pensions, it does not provide leadership for pension reform and monitoring. Such leadership should appropriately reside in the Governor's office, regardless of who is Governor, since the Governor represents the whole state and is responsible for proposing state budgets.

The current practice of combining pension costs with compensation for employees does not facilitate their inclusion in specific public policy discussion on the priority of providing the current level of pension benefits for public employees.

The Governor's membership on the State Board of Investment (SBI), reinforces the logic of making public pension costs a visible part of the Governor's proposed budgets. As an SBI member, the Governor is in a better position to know the health of the funds under state management.

- **Develop and report funded ratios and unfunded liability totals for both the basic and post funds independently.**

The current practice of reporting a combined funded ratio for both the basic and post funds yet treating them as separate funds results in a misleading indicator of fund health and understates Minnesota's pension liabilities. As an example, PERA was reported as having a funded ratio of 74.53% for the fiscal year ending June 30, 2005, a number that covers the basic and post-retirement funds combined. This number assumes the post fund is fully funded when the post fund funded ratio is actually only 82%. PERA's basic funded ratio is not reported anywhere. Our calculation is that the funded ratio for PERA's basic fund is 56.84% rather than 74.53% as currently reported. We believe all three ratios should be reported: the 56.84% for the basic fund, the 82% for the post-retirement fund, and the 74.53% for the two funds combined.

Reporting of the post fund funded ratio is especially important because it is the source of funds for current retiree benefits. Retirees, future retirees, legislators, and taxpayers need to know that because investment gains were used to fund permanent post retirement benefit increases, only 82 cents in assets currently exist for every pension dollar current retirees have been promised. Even though under current law the government is not required or permitted to pay off any unfunded post fund obligations, both practically and politically we can be certain these unfunded liabilities would be paid off at taxpayers expense if expected investment returns fail to materialize.

Likewise, actual dollar amounts of unfunded liabilities should also continue to be reported for both basic and post funds. The resulting reporting will communicate a much more complete and understandable picture of pension fund health to pension beneficiaries and other state taxpayers.

- **Initiate value-added performance auditing to monitor public pension fund performance in Minnesota.**

Value added performance auditing is an important and needed complement to current pension fund performance auditing based on time weighted rates of return.

SBI already monitors the investment performance of retirement fund money under its oversight using the method described and recommended in this study. However the results are not published in a value added format which would be more understandable to the public.

Value added performance auditing uses data that Minnesota statutes already require all state and local pension funds to submit to the State Auditor's office. Turning this raw

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data into useful information on the actual dollars of pension value gained or lost as a result of investment decisions is the step currently missing.

The benefits of this type of monitoring include the ability to evaluate the performance of both the policy set by the investment boards of the funds and the performance over time of those hired to try to “beat the market returns” of that policy. Such visibility of performance would result in greater accountability in investment decision-making and help flag problem situations before they turn into crisis situations.

- **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.**

This recommendation stems directly from the results of the 1994 campaign for State Auditor. Because public pensions are so complex and politically charged, the large numbers of voters who either do or will receive public pension payments are a potentially powerful voting block subject to candidates’ misrepresentations.

Most agency employees are not appointed by the Governor and are thus several steps removed from direct election by voters, which could help ensure its on-going availability and usefulness for monitoring investment performance.

### *Recommendations Regarding Managing Public Pension Liabilities*

The Legislature’s role in deciding how to pay for future pension costs (the mix of employee/employer contributions and the adoption of actuarial assumptions including the assumed investment rate of return) cannot be easily separated from its role in determining the level of benefits. That is because any increase in benefits has to be weighed against resistance to increased employee/employer contributions and risks of failing to meet needed rates of return on investments. Increased pension benefits are inextricably linked to how to pay for them. Because of that link, our recommendations regarding the management of public pension liabilities are made together, not split between benefit levels and paying for future costs.

We are not completely convinced of the value of separate accounts within pension funds for active employees and current retirees. (i.e. a basic fund and a post fund), such as that which exists for the three state managed funds. Although we can appreciate the logic and rationale for creating such a system, we believe the benefits may be outweighed by the reduced transparency of pension fund health while creating significant potential for generational inequities in which the interests of current retirees conflicts with the interest of future retirees. In an attempt to accommodate two “sets” of retirees, we believe the taxpayer is subject to greater risk and exposure.

Nevertheless, this bifurcated system is in law and unlikely to be changed. The two design changes listed below apply to all pension funds, including those that do not separate active and retired employees. The recommendations that apply to specific fund conditions are based on the continued existence of the basic and post fund system.

*Recommended Changes to the Design of Minnesota's Defined Benefit System*

- **Permanently end benefit increases based on superior investment returns and provide only capped inflationary adjustments**

Paying these benefit increases over the majority of the last 12 years has had harmful affects on Minnesota public pension plans:

- *They have increased liabilities for the plans as a whole with a corresponding increase in taxpayer risk.* The amount paid to current retirees in benefit increases due to investment returns above 8.5% in the last 12 years for the three statewide pension plans in this study almost exactly matches the amount of unfunded liabilities for those plans. Every “investment performance bonus” is permanently built into a retiree’s benefit base and creates obligations for the life of the recipient or the recipient’s spouse, and can only be paid for by significant investment returns on the retiree’s assets that are transferred into the fund. Moreover, when basic funds have unfunded liabilities as they do today, the transfer of assets into the post retirement fund comes at the direct expense of the health of the basic fund. This increases the likelihood of needing additional contribution increases from taxpayers and employees.
- *They have contributed to generational inequity among retirees.* Those retiring in the 1980s and 1990s have enjoyed significant increases in their pensions benefits. No performance bonuses have been paid out since 2002, so that anyone retiring in 2001 or later has not received the increases of retirees in the previous two decades. The fact that the post-retirement fund is only 82% funded means they will not likely receive any such increases for at least 10 years.

The current legislative proposal to continue permitting investment-based benefit increases while subjecting them to a cap may reduce the severity of the problem in the future, but the use of investment gains to provide permanent benefit increases is still bad public policy.

- **Develop quantifiable standards of replacement income to be achieved through pension benefits.**

Currently there is no empirical or quantifiable standard used to evaluate the adequacy of pension benefits or planned benefit increases. Policy makers should develop target replacement income standards from public pensions which factor in the availability of other income sources such as social security and supplemental retirement savings.

Future benefit increases should be evaluated against these measurable standards as opposed to the political opportunism created by fund surpluses or from examining what public employees in other states have convinced their legislatures to support.

*Recommendations That Apply to Specific Pension Fund Conditions:*

*When Both the Basic and Post Funds Have Unfunded Liabilities:*

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Such is the condition today and all indications are that these conditions will continue for some time to come. Our recommendations do not functionally deviate from the effects of current law since post retirement benefits are currently based only on inflationary adjustments with Post fund deficits.

*When Basic Funds are Under-funded and Post Fund is Fully Funded:*

- **Upon an employee's retirement, transfer only the fractional reserves necessary to keep the Post Fund "whole."**

If retirees are being kept whole (or more than whole) in the Post Fund, there is no need to transfer all of a new retirees actuarial reserves to a place where they are not needed. By transferring only the amount necessary to keep the Post Fund whole, assets can remain in the basic funds restoring them to health sooner.

*When Basic Funds have a surplus and the Post Fund is Underfunded*

- **Upon an employee's retirement, transfer full actuarial reserves to the Post Fund and focus attention on reducing contribution rates in the Basic Fund**

*When Basic Funds and the Post Fund Have Fund Surpluses*

Although a return of these conditions cannot be expected anytime soon, the discipline created by the previous recommendations would speed the restoration of pension fund health. If these conditions return:

- **Focus attention on the reduction of employee and employer contribution rates**  
By focusing on contribution rate reductions in times of fund surpluses, the benefits of sound pension fund management can be shared by taxpayers as well as employees.
- **Provide for self managed accounts or "13<sup>th</sup> checks" when an established "maximum funded ratio" in the Post Fund is exceeded**  
Since the post fund has no contributions other than investment income, large accruing surpluses should be distributed to retirees. We recommend developing a maximum funding ratio for the post fund which, if exceeded, would trigger benefit increases to retirees. However, we recommend these benefit increases be provided in the form of one time lump sums (otherwise known as "13<sup>th</sup> checks") or in the creation of self managed investment accounts to avoid creating any new permanent obligations on state taxpayers.

As stated above, our objectives in these recommendations are to preserve the integrity of a defined benefit pension system for public employees and help ensure that there is enough information readily available to taxpayers to participate in discussions of how high these plans are to be on the list of public spending priorities.