To: *Members of the Legislative Commission on Pensions and Retirement*

From: *Susan Lenczewski, Executive Director*

Date: *January 27, 2022*

Subject: *Letter dated December 29, 2021, to the members of the Legislative Commission on Pensions and Retirement from the Public Employee Pension Coalition (PEPC)*

Note: An earlier version of this memo was provided to legislators and the Governor's office, in response to requests for this review. This memo has been revised since this earlier version.

This memo has been prepared upon request and is a review of the letter from PEPC referred to in the subject lines, above. This memo confirms or comments on statements made in the letter and provides context.

The letter makes three primary points:

- PEPC objects to decreasing the investment rate of return assumption until after the quadrennial experience studies for the three largest statewide pension plans have been completed.

- PEPC was persuaded to support the 2018 omnibus pension bill because it was told that the sustainability of the funds was at risk due to the need to change the actuarial assumptions for mortality and investment rate of return. These assumptions, and the assumption for inflation, have turned out, four years later, to be incorrect.

- Cost of living adjustments (COLAs) for retirees no longer track with inflation and should be increased, and the legislature should fund the increase.

The letter concludes that, instead of decreasing the investment rate of return assumption, the legislature should increase COLAs and fund the increase.

The following is an italicized word for word copy of the letter. The paragraphs have been numbered. I have inserted comments, additional facts or data, or context after each paragraph.

1. *The Public Employee Pension Coalition (PEPC) is a coalescence of retiree, member advocate, and labor organizations with interests in our state's public employee pension plans. Each undersigned organization cares deeply about the long-term sustainability of our pension plans as a means for our members to achieve a dignified and fulfilling retirement after deferring compensation throughout their careers in public service. We wish to express our opposition to any proposals which lower the assumed rate of return for our pension funds without first doing a comprehensive analysis and having up to date experience studies.*

A comprehensive analysis of the investment rate of return assumption was performed by the actuaries for the pension funds. For example, see the letter dated June 24, 2021, and the accompanying analysis from the actuary for the Minnesota State Retirement System (MSRS), presented to the MSRS board of directors at its meeting on September 16, 2021: Pages from 9.16.2021 MSRS Board Materials GRS and Horizon reports.pdf. The actuaries are required by the applicable actuarial standards to perform a thorough analysis.

With regard to the statement that this assumption should not be changed without an experience study:

- Minnesota law does not require an experience study to change the investment rate of return assumption. Minnesota Statutes, section 356.215, applies. Subdivision 8 sets forth requirements relating to the investment return, salary increase, and payroll growth assumptions (the "economic assumptions"). Subdivision 9 sets forth requirements relating to all other assumptions (the "demographic assumptions"). Subdivision 9 requires that these "other assumptions" be set at levels consistent with an experience study. An experience study compares actual experience to the assumptions being used in the valuations, so is especially relevant to assumptions that are specific to the particular pension plan, such as plan members' rates of mortality, retirement, disability, and marital status. Subdivision 8, which specifies the investment rate of return assumption to be used by each plan listed, does not require an experience study to change the rate.

- Experience studies for the three largest statewide plans, the MSRS General Plan, the Public Employees Retirement Association (PERA) General Plan, and the Teachers Retirement Association (TRA), are done every four years. The next four-year period begins on July 1, 2018, and ends on June 30, 2022. Based on the time taken to complete prior studies, the next experience study will not be completed until the summer of 2023, after the next legislative session. Since any change in the rate of return assumption can only be made by the legislature, waiting until the completion of the next experience study will mean that the assumption will not be changed until the 2024 legislative session.

- We understand that the analysis done by the actuaries on this assumption is no more rigorous in the experience studies than the analysis done on this assumption every year in the annual valuation reports. The same actuarial standard applies. Compare the analysis in the MSRS actuary's report cited above, dated June 24, 2021 (pages excerpted from the actuary's report to the MSRS board of directors) to the analysis of the assumption in the experience study for the MSRS General Plan, dated June 27, 2019: pages excerpted from the experience study for MSRS General Plan (pdf pages 9-22).

2. *In 2018, after years of analysis, debate, negotiations, multiple executive vetoes and eventually, cooperative good-faith compromise, our coalition supported the omnibus pension bill which is now current law. It was a tremendous all-around effort from the Legislature, executive branch, plan administrators, staff and members of the LCPR, all of our organizations and more which culminated in an omnibus pension bill with two dominant themes: Shared Sacrifice and Promises Made, Promises Kept*.

   No need for comment or context on this paragraph.

3. *The burden of the sacrifices from that agreement fell disproportionately on workers and retirees while the so-called sacrifices shouldered by employers represented long overdue funding increases which could have reasonably occurred independent of any benefit reductions. According to a 2020 issue brief from the National Association of State Retirement Administrators (NASRA), in fiscal year 2018, Minnesota ranked 47th in the nation for "government contributions to pensions as a percentage of all state and local government direct general spending". At 2.3%, Minnesota was contributing less than 45% of the national average*.

   The NASRA issue brief cited can be found at Issue Briefs/NASRACostsBrief.pdf. This 2.3% contribution percentage for Minnesota government spending on pensions, as reported by NASRA, is the same percentage reported for Minnesota in 2018 when the omnibus pension bill was considered by the Commission. Commission staff worked with House fiscal staff and the pension fund directors to dig into the data behind this number to verify it and determine whether comparing this percentage for Minnesota to other states was a fair comparison. For several reasons, comparing this percentage for Minnesota to other states is not a fair comparison or, at least, requires further investigation before this percentage can be considered reliable today:

   - The data used in the NASRA study is current through fiscal year 2018 and, therefore, does not include consideration of the contribution and state aid increases enacted as part of the 2018 omnibus bill.
   - Minnesota spends more than many other states on government, making the percentage that it spends on pensions smaller relative to states that spend less on government.
   - Many states, including several of the most populace states, provide public employee pension plans are not coordinated with Social Security, which means that public employees in these states do not receive Social Security in addition to a state pension. See, for example, the rates for California and Illinois. These states will spend more on public pensions to make up for not having to contribute to Social Security for their employees. This skews the average so it is higher than it would be if the large "basic" (not coordinated with Social Security) plans were not included.

4. *Two major motivators of the 2018 pension reforms were recommendations to change actuarial assumptions to account for a shifting economic and demographic landscape. First, we were told assumed rates of return for the various plans were unsustainable. Second, we were told life expectancy was increasing and pensioners would be drawing benefits longer. Since the 2018 pension changes, the actual return on investment has been more than 2.5 times the assumed rate. Of course, the emergence and spread of the COVID-19 virus has impacted life expectancy. According to a study published by Oxford University and the International Journal of Epidemiology, of 29 countries studied, males in the United States experienced the largest loss of life expectancy at birth during 2020, a reduction of 2.2 years. Thus far, the actuarial assumptions used to inform the 2018 changes have missed the mark on both these points*.

   This paragraph notes that two assumptions changed in 2018, for investment rate of return and mortality, turned out to be incorrect. The 2018 omnibus pension bill decreased the investment rate of return from 8% to 7.5% and increased the average age of mortality to reflect that members were

living longer. These adjustments resulted in higher liabilities and, consequently, lower funded ratios, leading legislators to conclude that benefit reductions and contribution increases were needed.

The pension funds, the Commission, and the legislature acted in 2018 on the best information available at the time. That certain assumptions on which changes and funding were based turned out to be inaccurate supports more frequent testing of assumptions, especially in a period of market volatility and a pandemic that is increasing the death rate, and adjustments as circumstances change.

5. *Another assumption, foundational to the 2018 agreement, is no longer consistent with what we're observing: stable, modest inflation. According to the Federal Reserve Bank of Minneapolis (FRBM), the annual percent changes to the Consumer Price Index (CPI) for years 2013-2018 were 1.5%, 1.6%, .1%, 1.3%, 2.1% and 2.4% (averaging 1.5%). The dominating school of thought during the 2018 pension reform negotiations was that these low rates of inflation would continue into the foreseeable future. Similar to the two previous assumptions, this one has not come to fruition*.

   The data presented appears to be accurate, as is the statement that stable, modest inflation is no longer an accurate description of the current rate of inflation. Based solely on the current rate of inflation, retirees and their advocates can reasonably take the position that the current COLA rate of 1% is no longer appropriate. However, the fact that current inflation was not anticipated in 2018 does not invalidate the basis for which the changes and funding were made in 2018. As noted, the pension funds, Commission, and legislature acted in 2018 on the best information available at that time.

6. *The FRBM CPI estimate for 2021 is for a 4.8% increase; Social Security benefits are going up 5.9% in 2022; Xcel Energy proposed a three-year rate increase in excess of 20%; and Medicare premiums are increasing 14.5% on January 1, 2022. Between a lingering pandemic, supply chain challenges, a tight labor market and many unpredictable variables, it is common knowledge that prices are on the rise and no economic oracles exist to assure us this trend will cease anytime soon. The 2018 agreement included an LCPR study on postretirement adjustments; the findings of that study showed significant loss in purchasing power over a retiree's lifetime, even prior to the rise in inflation we're seeing now. The ceiling on COLAs, agreed to in the 2018 pension bill, no longer appropriately tracks with inflation; the dignified and fulfilling retirements, which these benefits are designed to deliver for our members, are in danger*.

   The precipitous rise in the rate of inflation is well-publicized and these statistics appear to be accurate. As noted in the prior response, the 1% COLA currently provided on public pensions under Minnesota law does not keep up with the current rate of inflation. COLAs are due to automatically increase from the current 1% to 1.5% beginning January 1, 2024, for the MSRS General Plan and, for TRA, in .1% increments each year beginning January 1, 2024, until the COLA reaches 1.5% for 2028 and future years. For the PERA General Plan and the PERA Correctional Plan, the COLA is tied to inflation, but capped at 1.5% and 2.5%, respectively. In a modest way, these PERA plans are currently tracking with inflation, albeit at the lower levels permitted under the caps.

As for the COLA study report, please see pages 57 and 58 of the report at this link: Pages_from_MN.LCPR.COLA.Study.Report.Submitted.pdf. The following excerpts the conclusion in the COLA report as relevant to the statement in the letter:

> We considered how well the postretirement adjustment mitigates the effects of inflation and concluded the following:
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> - For the St. Paul Teachers Retirement Fund Association (SPTRFA) and the statewide plans other than the PERA Correctional Plan, governing statutes prescribe a postretirement adjustment that provides some protection from the loss of purchasing power due to inflation. However, members of those plans will experience erosion of their purchasing power if actual inflation matches the assumed rate of inflation.
> - For the PERA Correctional Plan, governing statutes provide for a postretirement adjustment that is likely to substantially or completely offset future inflation if inflation assumptions are met.
> - A subset of the statewide plans, PERA's Police and Fire Plan and MSRS' State Patrol Plan, are most vulnerable to loss of purchasing power because they are not coordinated with Social Security.
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> Whether the protection against inflation provided by these postretirement adjustments is sufficient is a political question for the Legislature.

7. *The Legislative Commission on Pensions and Retirement Principles of Pension Policy (LCPR Principles) states "Retirement benefits should be increased during the period of retirement to offset the impact of economic inflation over time in order to maintain a retirement benefit that was adequate at the time of retirement" and that "Ad hoc postretirement adjustments should be funded separately from the regular defined benefit public pension plan financing and should not be added to the unfunded actuarial accrued liability of the defined benefit public pension plan." The LCPR Principles clearly outline the solution: The Legislature should authorize additional spending on our public pensions to fulfill the promises to retirees. Addressing this problem should top the list for any changes to the 2018 pension agreement*.

   The two sentences quoted from the Principles are accurate. These statements in the Principles were the subject of much debate in the Commission when it considered the COLA study report and no consensus was reached as to their meaning. The Principles have not been updated since 2009 and may no longer accurately reflect current circumstances or the will of the Commission and the Legislature. Until the changes to COLAs for the two PERA Plans (General and Correctional) made in the 2018 omnibus pension bill, COLAs under Minnesota's public pension plans have not been tied to inflation since the mid-1990s. See the description of the COLAs for the PERA Plans in the comments to paragraph 6, above.

8. *In "Appendix A: Investment Return Assumption by Plan" of a different NASRA issue brief, this one titled, "Public Pension Plan Investment Return Assumptions," you can see Minnesota's rates are equal to, lower than, or within .1% of 26.9% of the 130 plans listed. Our assumed return rates are not outliers when compared to counterparts from other states and there is no pressing need to lower the assumption rates as a solitary adjustment to our pension framework prior to a full analysis*.

   The NASRA issue brief cited can be found at NASRAInvReturnAssumptBrief.pdf. Stated another way, the 26.9% statistic reported by PEPC means that over two-thirds of the 130 public pension plans in the NASRA data use an assumed rate that is lower than Minnesota's. Perhaps more relevant to this issue is the trend of the rates nationwide, which can be seen in the graph on page 3 of the brief. The brief makes the following statement:

   > Among the 130 plans measured, 101, or 78 percent, have reduced their assumed rate of return since fiscal year 2017, and all but five plans (96 percent) have done so since fiscal year 2010. These reductions have resulted in a decline in the average return assumption from 7.53 percent in FY 17 to 7.18 percent in FY 21.

9. *The next round of experience studies, which are scheduled to be completed next year, will provide updated data and analysis on life expectancy, the impact of inflation, various demographic assumption changes and more. We encourage policymakers to proceed with extreme caution when considering any deviations to the assumed rate of return without the full 2022 experience study completed. The focus should be on the most pressing concern, additional state funding to address the lost purchasing power of retirees' pension benefits and keeping our promise of a dignified, fulfilling retirement*.

   As noted on page 2 of this memo, an experience study is not required to change the assumption for investment rate of return. The review the actuaries do every year to check the reasonableness of the investment rate of return assumption is sufficient basis for adjustments and provides no less certainty or thoroughness than an experience study. If the Legislature accepts this advice and waits for completion of quadrennial experience studies for the three largest statewide plans, the earliest the Legislature will be able to address a change in the investment rate of return assumption is the 2024 legislative session.

Legislative Commission on Pensions and Retirement

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