TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Susan Lenczewski, Executive Director

SUBJECT: H.F. 2373 (Murphy, by request); S.F. xxxx: Volunteer Firefighter Relief Associations; Recommendations of the Volunteer Fire Relief Association Working Group

DATE: March 12, 2019

H.F. 2373 is the result of the work of the State Auditor's Volunteer Fire Relief Association Working Group during 2018. This group is convened by the State Auditor and meets through the fall and early winter preceding each legislative session. The group's proposed legislation addresses a variety of issues identified by the State Auditor and members of the working group, all of which affect Minnesota's volunteer firefighter relief associations (VFRAs or "relief associations").

Section-by-Section Summary

Section 1: Clarification that Audits include Legal Compliance Audits.

Minnesota Statutes, Section 6.495, Subdivision 1, requires the State Auditor to do an annual audit of volunteer firefighter relief associations and authorizes the State Auditor to do the audits, waive the audit requirement, or contract with an outside auditor to do the audits. Minnesota Statutes, Section 6.65, gives the State Auditor the authority to prescribe minimum procedures and the audit scope for auditing the books of "political subdivisions" in Minnesota. This statute further provides that the minimum scope of such audits "must include financial and legal compliance audits." "Political subdivisions" is a defined term for purposes of Chapter 6 and does not include volunteer firefighter relief associations. See Minnesota Statutes, Section 6.465, Subdivision 2.

The concern the State Auditor is addressing in Section 1 of the bill is the lack of a link between the duty to audit relief associations and the authority to impose minimum audit requirements on political subdivisions. Minnesota Statutes, Section 69.051, Subdivision 1, requires relief associations with assets or liabilities of at least $500,000 to prepare financial reports and financial statements in accordance with generally acceptable accounting procedures (GAAP). These financial reports are subject to the audit requirement under Section 6.495. Subdivision 1, Paragraph (d), requires filing the audited report within 180 days after the end of the fiscal year.

Section 1 amends Subdivision 1, Paragraph (d), to incorporate the requirements of Section 6.65, and thereby ensure that the audits of relief associations include legal compliance, as well as financial reports.

Policy consideration: It would be helpful for the LCPR to understand the scope of "legal compliance audit," as defined by the State Auditor. Legal compliance does not appear to include auditing compliance with all applicable state laws. For example, many relief associations consider themselves qualified retirement plans and subject to the requirements of Minnesota Statutes, Sections 356.001 and 356.635. These statutes incorporate applicable requirements of federal law, specifically provisions of the Internal Revenue Code regarding required minimum distributions, vesting upon plan termination, and the right to elect a direct rollover. It would be reasonable for relief associations to assume and take comfort in the fact that the State Auditor's legal compliance audit includes reviewing whether they comply with these federal requirements, as incorporated into state law. It does not appear that a legal compliance audit includes checking compliance with these requirements.

Another example is the requirement under Minnesota Statutes, Section 356A.06, Subdivision 2, that "investment of plan assets must be diversified to minimize the risk of substantial losses…." The LCPR receives an "Investment Business Recipient Disclosure Form" for many relief associations each year, pursuant to Minnesota Statutes, Section 356A.06, Subdivision 5. Many of these forms report investment of plan assets that appears to violate the diversification requirement. The attached form, with identifying information redacted, is one example among many we receive in the LCPR office showing lack of diversification. This topic does not appear to be included in the State Auditor's legal compliance audit.

<u>Section 2: Threshold for Additional Reporting Requirements</u>.

Investment reporting requirements for volunteer fire relief associations, other local public pension plans, and the State Board of Investment (SBI) are defined in Minnesota Statutes, Section 356.219. As explained by the State Auditor in the materials provided to the working group, the reporting requirements depend on the total market value of the plan and whether the plan is fully invested with the SBI. The current threshold at which additional investment reporting is required is $25 million. The Bloomington Fire Department Relief Association, the St. Paul Teachers' Retirement Fund Association, and the SBI are currently the only entities above the $25 million threshold, and are all significantly above the threshold. The threshold has been adjusted a number of times, and needs to be adjusted again so that relief associations remain under the threshold and maintain their current level of reporting.

Section 2 amends Minnesota Statutes, Section 356.219, Subdivision 3, to replace "$25,000,000" with "$50,000,000" every place it appears.

<u>Sections 3-5: Breaks in Service</u>.

Sections 3 through 5 clarify the treatment of "breaks in service" for various purposes. Section 3 inserts a new definition for "break in service" in the definitions section for Chapter 424A.

Section 4 clarifies the requirements within which relief associations may define, under their bylaws, the treatment of firefighters who return to service after a break in service.

Section 5 addresses concerns regarding the benefit level that applies when a member incurs a leave of absence or break in service at the end of the member's firefighting career, and then, during the leave, resigns or is terminated without resuming active service. The new language clarifies that the applicable benefit level is the level in effect at the earlier of (i) the date of the separation from active service or (ii) the date on which the member begins a break in service that ends when the member separates from active service.

Sections 6 and 8: Vesting.

Minnesota Statutes, Section 424A.016, Subdivision 3, and section 424A.02, Subdivision 2, specify the vesting requirements that apply, respectively, to defined contribution relief association plans and defined benefit relief association plans. Section 6 and 8 make the vesting requirements identical for each type of plan and clarify how the vesting schedules apply.

Under current law, defined contribution relief associations are permitted to require up to 20 years of active service in order to fully (100%) vest members in their defined contribution plan. The relief association may elect to use graded vesting, which gradually vests a firefighter in his or her account starting at five years of service, with a vested percentage that cannot by law be more than 40%. Over the next five years, the relief association is permitted to increase the vesting percentage by 12% each year, until the member is 100% vested at ten years of service.

Under current law, defined benefit relief associations are permitted to require up to 20 years of active service in order to fully (100%) vest members in their accrued benefit. The relief association may elect to use graded vesting, which gradually vests a firefighter in his or her accrued benefit starting at five years of service, with a vested percentage that cannot by law be more than 40%. Over the next 15 years, the relief association is permitted to increase the vesting percentage by 4% each year, until the member is 100% vested at 20 years of service.

Section 8 amends the requirements for vesting for defined benefit relief associations that wish to use graded vesting, by matching the vesting percentages to the current vesting percentages for defined contribution plans. The relief association may provide in its bylaws that firefighters will gradually vest in their accrued benefit in 12% increments until they are 100% vested at ten years of service.

Other language changes in Sections 6 and 8 are intended to clarify the vesting requirements.

Policy considerations: According to the State Auditor, in the materials provided to the working group, long vesting requirements result in more firefighters forfeiting their benefits when they leave active service. These forfeited benefits contribute to the "turnover gain" that helps fund benefits payable to other relief association members. When a firefighter who is not vested, or is not fully vested, leaves active service the portion of the member's accrued benefit or defined contribution account that is not vested is forfeited. The forfeited amounts are either allocated to the active members in a defined contribution plan or increase the available assets in a defined benefit plan. Shorter vesting requirements reduce this turnover gain.

As the State Auditor also explained, permitting a shorter vesting requirement may help fire departments that are facing challenges in the recruitment and retention of firefighters and recognizes the fact that firefighters appear to be more mobile than in the past, with fewer firefighters staying on a fire department for 20 years.

Comment: While the amendments in the bill make it more likely more firefighters receive their defined contribution accounts or accrued benefits in a defined benefit plan, these vesting requirements might still be considered too long, especially in the case of relief associations whose firefighters are truly volunteer and get no compensation at all for their service, other than the retirement benefit. Even with these changes, a relief association may still elect to use a 20-year cliff vesting schedule. This means that a relief association could require in its bylaws that firefighters will forfeit their entire retirement benefit if they leave active service before 20 years of service. These forfeitures, in the overfunded defined benefit relief associations, simply add to the surplus.

For context, in the private sector, federal law does not permit the imposition of long vesting requirements, to ensure more employees receive a retirement benefit. For example, under generally applicable federal law, the longest vesting schedules permitted are:

- 3-year cliff (0% for first three years, 100% starting in year four); or
- Two to six years graded (20% in Year 2, increasing 20% each year until 100% in Year 6).

Section 7: Technical Correction to Crediting Investment Earnings on an Account in a Defined Contribution Plan.

Minnesota Statutes, Section 424A.016, permit relief associations to provide in their bylaws that the account of a "deferred" member in a defined contribution relief association will be credited with investment earnings on that account during the period between ending active service and turning age 50, which is the earliest age a member of a relief association can receive a pension benefit. The investment earnings are held in the account until distribution of the account. The statute erroneously states that the earnings must be "paid" (or "pay") during the period of deferral, when the intent was that the earnings be "credited" during the period of deferral.

Section 7 replaces "paid" with "credited" and "pay" with "credit" to correct this error.

Section 9: Technical Correction to Crediting Interest on a Deferred Pension Benefit under a Defined Benefit Plan

Minnesota Statutes, Section 424A.02, permits relief associations to provide in their bylaws that the pension benefit of a "deferred" member in a defined benefit relief association will be credited with interest annually during the period between ending active service and turning age 50, which is the earliest age a member of a relief association can receive a pension benefit. The statute erroneously states that the interest must be "paid" (or "pay") during the period of deferral, when the intent was that the interest be "credited" during the period of deferral.

Section 9 replaces “paid” with “credited” and “pay” with “credit” to correct this error.

Policy consideration: Interest is not the same as investment earnings in the defined contribution context, because a member’s accrued benefit in a defined benefit plan cannot actually be set aside and invested in an interest-bearing account. Crediting interest on a deferred member’s accrued benefit in a defined benefit plan is more aptly referred to as “augmentation,” which is no longer permitted under any of the state’s other public pension plans.

This amendment is a reminder that relief associations continue to be permitted to provide augmentation, a fact that may have been overlooked when augmentation was ended for all other public pension benefits. One of the pension reforms included in the 2018 pension bill was to eliminate this benefit for the other public employee pension plans, including the plans administered by MSRS, PERA, and TRA.

“Augmentation” or, as referred to in the relief association statutes, “interest,” is an automatic annual increase in the pension benefit accrued by a member who is no longer in public service, but has not yet reached retirement age. These members are sometimes referred to as deferred vested members because, while they have a vested pension benefit, they are having to “defer” starting their pension benefit until they reach retirement age.

A few reasons augmentation was eliminated for last year for all the state’s large public pension plans:

- With the scrutiny applied to public pension plans and the funded levels of those plans, eliminating a benefit that provided no benefit to current employees or current retirees was a relatively painless way to reduce benefit costs for the plans.

- Augmentation benefits former employees (firefighters, in this case) without regard to why their service ended. Reasons for that could include termination because of poor performance, inappropriate or unprofessional behavior, or worse.

- With one exception (in South Dakota), no other governmental pension plan nation-wide provides this benefit. For context, augmentation is an unknown concept in the private sector: private sector defined benefit pension plan do not pay cost-of-living adjustments (interest, in this case) on deferred vested benefits.

- Augmentation does not encourage portability, if “portability” is defined as the ability of an individual to terminate service and take his or her retirement benefits to the next position. Augmentation, in fact, inhibits the transfer of pension benefits, because doing so means no more interest payments.

Section 10: Benefit Level Applicable to Disability and Survivor Benefits.

Members of relief associations receive a pension benefit equal to the number of years of service multiplied by a benefit level set in the relief association’s bylaws. A benefit level is a dollar amount from $10 to $10,000, which depends on the “average amount of the available financing per firefighter." This average is based on fire state aid, supplemental state aid, municipal contributions, and the amount of surplus assets. The benefit level in effect at the time an active firefighter becomes disabled or dies is the benefit level to be used when calculating the disability or survivor benefit.

Section 10 addresses the question of what benefit level applies when a deferred member becomes disabled or dies. A "deferred" member is a former or inactive firefighter who has accrued a benefit but is no longer active and earning additional service credit. Since the member has not yet reached age 50, the earliest age a member can receive a pension benefit from a relief association plan, his benefit is "deferred."

Section 10 amends Minnesota Statutes, Section 424A.02, Subdivision 9, to insert language that states that, for deferred members, the amount of a disability or survivor benefit is calculated using the benefit level in effect on the date of separation from service, unless the relief association bylaws provide differently.

Section 11: Filing Requirement for Bylaws Amendments.

Section 11 of the bill clarifies language in Minnesota Statutes, Section 424A.02, Subdivision 10, regarding the entities that would approve a bylaws amendment that must be filed with the State Auditor. The clarifying language indicates that only one municipality would have approved a bylaws amendment for its directly associated relief association or the approval may have been done by an "independent nonprofit firefighting corporation," if applicable.

Section 12. Supplemental Benefits to Survivors.

Under Minnesota Statutes, Section 424A.10, when a relief association pays a lump sum survivor benefit to a surviving spouse or to a surviving child or children, the relief association is required to also pay a supplemental survivor benefit. The supplemental survivor benefit is equal to 20% of the lump sum, up to a maximum of $2,000. The intent of the supplemental benefit is to help the recipient pay state income taxes on the distribution.

Under current law, if the survivor benefit is paid to a designated beneficiary or to an estate, the designated beneficiary or estate is not entitled to a supplemental benefit. As explained by the State Auditor in the materials provided to the working group, relief associations have occasionally paid a supplemental benefit that resulted in benefit overpayments when it was determined that the supplemental benefit was paid to individuals other than a surviving spouse or children. Designated beneficiaries and individuals who receive a distribution through an estate likely have the same tax concerns or obligations as other recipients of a service pension or survivor benefit.

Section 12 amends Minnesota Statutes, Section 424A.10, Subdivision 1, to authorize the payment of supplemental survivor benefits to a designated beneficiary or to an estate if there is no surviving spouse and there are no surviving children.

INVESTMENT BUSINESS RECIPIENT DISCLOSURE FORM

Pursuant to Minn. Stat. § 356A.06, subd. 5, the chief administrative officer of a Public Pension Plan (Plan) shall annually list all the recipients of investment business with respect to investments made by the Plan. This disclosure document must be prepared within 60 days of the close of the fiscal year of the Plan, by the association president, and must be made available for public inspection during regular office hours at the office of the Plan. Within 90 days after the close of the fiscal year of the Plan, a copy of this completed form must be filed with the **Executive Director of the Legislative Commission on Pensions & Retirement, 55 State Office Building, St. Paul, MN 55155.**

COMMERCIAL BANKS	TYPE OF INVESTMENT	AMOUNT
1.		
2.		
3.		

INVESTMENT BANKERS	TYPE OF INVESTMENT	AMOUNT
1. R State Bank	CD's	$231,299.00
2. R State Bank	Saving's	$550.50
3. R State Bank	General Fund Checking	$24,397.97
4. R State Bank	Special Fund Checking	$10.00

BROKERAGE ORGANIZATIONS	TYPE OF INVESTMENT	AMOUNT
1.		
2.		
3.		

OTHER INVESTMENT MANAGERS	TYPE OF INVESTMENT	AMOUNT
1.		
2.		
3.		

Signature of Relief Association President

ASSN

Relief Association Name

01/31/2019

Date