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Evaluation Report Summary / January 2007

Pensions for Volunteer Firefighters

Major Findings:

- In 2004, 713 volunteer firefighter relief associations were responsible for determining eligibility, setting benefit levels, and investing funds for volunteer firefighter pension plans within broad parameters set in state law.
- Most volunteer firefighter relief associations—84 percent—have defined benefit pension plans and make one large "lump sum" payment to retiring firefighters based on their years of service.
- For volunteer firefighters with 20 years of service, these lump sum payments averaged $16,000 in 2004, but ranged from $500 to $140,000—which reflects differences in state aid and, indirectly, differences in the activity levels of individual fire departments.
- In 2004, most volunteer firefighter pension plans had sufficient funds to pay their anticipated future pension obligations.
- However, the vast majority of relief associations—96 percent—would have earned higher rates of return and had lower investment costs if they had invested through the State Board of Investment (SBI) from 1997-2004.
- During fiscal years 2003-2005, less than one-third of volunteer firefighter relief associations invested through SBI; 41 percent of relief association officials responding to an OLA survey said that they were "not familiar at all" with SBI.
- From 1997-2004, volunteer firefighter relief associations paid a higher percentage of their funds on administrative costs than did large public pension plans in Minnesota; however, their costs were not unreasonable given their inability to take advantage of economies of scale.
- Most relief association and local government representatives responding to our survey oppose centralizing volunteer firefighter pension plans at the state level or requiring relief associations to invest through SBI.

Volunteer firefighter relief associations need to achieve higher investment returns.

Key Recommendations:

- The Legislature should require that all volunteer firefighter relief associations invest their pension funds through the State Board of Investment.
- The Legislature should require volunteer firefighter relief associations to develop investment policies that incorporate best practices.

The full evaluation report, *Pensions for Volunteer Firefighters*, is available at 651-296-4708 or:

www.auditor.leg.state.mn.us/ped/2007/pensions.htm

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Today, more than 700 different pension plans cover nearly 20,000 volunteer firefighters statewide.

In 2004, the median lump sum benefit paid out to a firefighter retiring after 20 years of service was $16,000.

Report Summary

Like most states, Minnesota has a strong tradition of relying on volunteers to provide fire protection services. As a reward for their service, the state allows them to receive pension benefits upon retirement. Today, there are more than 700 pension plans covering nearly 20,000 volunteer firefighters statewide. Each plan is administered by a nonprofit corporation known as a volunteer firefighter relief association.

Relief associations must administer pension plans within broad parameters set by state law.

Each volunteer firefighter relief association is responsible for determining eligibility, setting benefit levels, and investing funds for its pension plan. State law requires that a relief association be governed by a nine-member board of trustees, with three of the trustees appointed by the city or town operating the local fire department with which the relief association is affiliated.

In addition to board membership, statutes also regulate maximum levels for pension benefits; minimum requirements regarding vesting and retirement age; allowable investments for association pension funds; local government pension contribution requirements; auditing and reporting requirements; and allowable administrative expenses.

To help pay for pension benefits, the state levies a tax on certain insurance premiums. Other major sources of revenue include investment income and local government contributions—some mandatory and some voluntary.

Benefit levels vary widely, which reflect differences in state fire aid and, indirectly, fire calls.

Most relief associations offer defined benefit "lump sum" plans to retirees. Under such a plan, eligible firefighters receive a set amount of money for each year of service, paid out in one large payment at retirement. In 2004, the median lump sum benefit was $800 per year of service. Thus, a firefighter retiring with 20 years of service would receive one payment of $16,000. Benefit levels ranged from $25 to $7,000 per year of service, resulting in lump sum payments after 20 years of service ranging from $500 to $140,000.

Benefit levels depend on state fire aid as well as local contributions and investment income. We found a strong relationship between state fire aid and the number of fire-related calls a fire department responds to each year. For example, associations that received less than $9,000 in state fire aid in 2004 averaged 7 fire-related calls per year from 1999 through 2004. In contrast, relief associations that received more than $21,000 in state aid responded to an average of 43 fire calls per year.

Most volunteer firefighter pension plans have sufficient funds to cover future liabilities.

"Funding ratios" measure relief associations' net assets as a percentage of their accrued liabilities. In short, they help explain whether pension plans have enough money to cover future spending needs.

Most volunteer firefighter relief associations use a simplified formula set forth in statutes to annually determine their funding ratio. A funding ratio of 100 percent means that a pension fund has just enough assets to pay anticipated future benefits. In 2004, the median funding ratio was 106 percent. Sixty-five percent of relief associations with defined benefit plans had funding ratios of 100 percent or more; 17 percent had funding ratios of less than 90 percent.

From 1997-2004, SBI's Income Share Account earned a 7.7 percent average annual rate of return, compared with 4.8 percent earned by relief associations.

Most relief associations would have earned higher rates of return if they had invested through SBI.

From January 1997 through December 2004, pension funds invested by relief associations earned an average annual rate of return of 4.8 percent. Earnings ranged from a loss of 2.7 percent per year to a gain of 13.7 percent per year. During the same time frame, the State Board of Investment's Income Share Account—a "medium" risk account consisting of stocks, bonds, and cash equivalents that relief associations can invest in—had an average annual rate of return of 7.7 percent.

Data suggest a variety of reasons that might explain relief associations' low rates of return, including poor stock selection, inconsistent investment strategies, and excessive investments in cash equivalents. In our survey of volunteer firefighter relief associations, many representatives from associations earning low or average rates of return said that they needed more investment-related training.

Although volunteer firefighter relief associations have the option of investing some or all of their pension funds through SBI, less than one-third did so in fiscal year 2005. Part of the problem could be lack of knowledge. In our survey of relief associations, 41 percent said that they were "not familiar at all" with the investment options offered through SBI.

SBI has lower management and investment fees than most mutual funds.

In addition to its "proven track record" in terms of investment performance, SBI charges low investment fees. Most mutual funds usually charge annual management fees and operating expenses that total between 1 and 2 percent of assets. For 2006, the State Board's fees for the Income Share Account were 0.01 percent of assets; none of the SBI accounts open to volunteer firefighter relief associations had fees exceeding 0.25 percent.

Though high, relief associations' administrative costs are not unreasonable.

Between 1997 and 2004, pension benefits made up over 90 percent of relief associations' total annual disbursements, with administrative expenditures ranging between 6 and 9 percent of total disbursements. In 2004, 7 percent of relief association expenditures, or 0.42 percent of total pension assets, went for administration.

This level of spending is significantly higher than those for the state's three largest pension funds. Administrative expenses made up 0.07 percent of the Public Employee Retirement Association's total fund assets in fiscal year 2004. Administrative expenses for the Teacher's Retirement Association and the Minnesota State Retirement System were 0.08 and 0.07 percent of assets, respectively, for fiscal year 2004.

At the same time, relief association spending on administration has not been excessive. In 2004, 53 percent of relief associations' administrative expenditures were for actuarial, audit, and legal services. Fifty-eight percent of the associations did not spend anything on board salaries and 19 percent reported no administrative expenses at all. Given the need to keep accurate records to determine eligibility, calculate pension benefits, and comply with state auditing and reporting requirements, economies of scale likely explain why larger pension plans spent proportionately less on administration than did volunteer firefighter relief associations.

Maintaining some elements of local control has advantages over complete centralization.

Minnesota's decentralized pension system for administering volunteer firefighter pensions creates problems and challenges, especially in relation to

Some elements of local control should be maintained.

investments. To address these problems, we considered several options that ranged from maintaining the status quo to completely centralizing all pension-related responsibilities at the state level.

There are several reasons for maintaining some elements of the current local control framework. First, relief associations have been generally conservative in setting benefits and most have sufficient resources to cover anticipated future liabilities. Second, the Legislature has implemented a system of checks and balances that appears to be working—pensions are funded and paid according to law. Third, local control may produce other benefits, such as increased community involvement, personal service, and civic pride. Fourth, there is little support for widespread structural changes among the relief associations and local governments that we surveyed. Finally, the primary purpose of offering pensions to volunteer firefighters is to reward them for community service, not to provide retirement income. It is generally assumed that firefighters will rely primarily on other sources of income to finance their retirement.

The Legislature should require volunteer firefighter relief associations to invest through SBI.

However, requiring relief associations to invest through SBI would likely increase their rates of return and lower their investment costs.

Minnesota statutes currently allow, but do not require, volunteer firefighter relief associations to invest some or all of their pension funds through SBI. To improve overall investment performance, the Legislature should make investing through SBI mandatory.

Doing so has several advantages. First and foremost, almost all relief associations could likely expect higher rates of return and lower investment costs. We estimated that relief associaions would have earned about $56 million more had they invested almost all of their pension funds through SBI in 1997-2004. The additional revenue could be used to increase pension benefits or decrease mandatory contributions by local governments. Second, relief associations would still have some input in how they invest their funds. The State Board of Investment offers a variety of investment options that allow relief associations to design portfolios that reflect their individual needs. Third, the change would simplify association reporting requirements somewhat and reduce board members' need for investment-related training. Fourth, because SBI already has procedures in place for relief associations to use, requiring the associations to invest through SBI should not increase state costs.

Despite the obvious advantages to investing through SBI, relief associations and local governments express little support for doing so. In our surveys, 5 percent or less of respondents said that relief associations should be required to invest through SBI.

If the Legislature does not adopt this recommendation, we think that, at a minimum: (1) the State Board of Investment should provide more outreach and assistance to relief associations, including participating in investment-related training, and (2) the Legislature should require that relief associations provide annual "report cards" to their membership that summarize association investments relative to certain benchmarks.

Finally, regardless of whether relief associations are required to invest through SBI, the Legislature should require that associations develop long-term investment policies that incorporate industry best practices, and associations should use them. Our review of relief association investment policies found that most policies did not contain performance benchmarks or an overall strategy for achieving association goals.