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## LETTER FROM THE EXECUTIVE DIRECTOR



Last year, as we prepared to publish our *Annual Report*, the Honorable Domenic J.F. Russo had recently assumed the Chairmanship of PERAC. Under his leadership, the Commission has achieved the accomplishments outlined in this *Report*. On behalf of the staff and the Massachusetts pension community, I would like to extend our thanks for his efforts. We all look forward to continuing our work with him.

Other changes have taken place at the Commission in the last year. These include the appointment of Henry Brauer by Governor Romney to the investment position. Commissioner Brauer replaces Chris Alberti who, after several years of service, found it necessary to devote all his energies to private pursuits. Commissioner Brauer spent 14 years with TA Associates Realty, the last 12 as a partner. During his tenure at TA Associates, he served as the portfolio manager for the firm's two largest separate accounts: Los Angeles County Employees Retirement Association and PRIM. In the short time that Commissioner Brauer has served on the Commission, he has already brought his extensive expertise to bear and we look forward to his contributions in the years ahead.

### Today's Environment

In many ways the pension community seems to be constantly reacting to events. We all have been suddenly thrust into a controversy, often generated by me-

dia coverage, that focuses on aspects of the retirement law or the retirement system. Frequently, those controversies arise because of perfectly legitimate and long-standing practices that, in a certain light, are portrayed as overly beneficial to employees, inconsistent with some private sector standard, or centered on a non-retirement purpose. Nonetheless, whether it's the termination benefit under Section 10 of Chapter 32, the structure of the benefits available to dual members, or other aspects of the pension law, cries for reform and accusations of lax management become part of the controversy.

Most recently, national controversies have begun to impact the policy discourse regarding public sector retirement. The principles of defined contribution plans have become an integral part of the federal discussion of Social Security. The governor of our most populous state, California, proposed a dramatic change in the benefits available to public employees by shifting from a defined benefit structure to a defined contribution structure. It is not the purpose of this introduction to debate the merits of the various proposals or the validity of the assumptions on which such proposals are based. The important lesson to draw is that, as I indicated last year, our pension plan will be the center of attention due to these and other trends.

In addition to these general concerns, public pension funds in a number of

jurisdictions have found themselves in the middle of significant controversies associated with fiscal distress, moderating investment returns, and unfortunately, in some instances, corruption.

The City of San Diego Pension Reform Committee concluded that the city faces a major unfunded liability problem due to investment performance, under-funding by the city, use of plan earnings for unrelated benefits, net actuarial losses, and benefit improvements.

Investment performance was determined to be the least significant factor; nonetheless, the Committee concluded that the market bubble of the late 1990's overshadowed other problems. Because of the positive rates of returns during those years, the City increased benefits and reduced its appropriation to the pension fund. Interestingly, when the market finally adjusted downwards, the focus on investment impact also tended to obscure poor decisions, particularly the reduction in appropriation levels.

San Diego, not unlike many Massachusetts municipalities, finances its pension system on an actuarial funding schedule basis that does not result in a payment that is sufficient to prevent the plan's unfunded liability from growing. Appropriating less than required under the schedule exacerbated this trend.

These two aspects of the San Diego crisis are reflected in Massachusetts—several years of excellent investment returns lead to a change in attitudes about the fiscal stability of the retirement systems and the failure to appropriate a sufficient amount for pension purposes.

Non-investment related actuarial losses were also a major contributor to the San Diego crisis. Deviations from the assumptions included low employee turnover, salary increases, retirement rate, and service purchases. This underscores the importance of establishing and maintaining a realistic set of assumptions to avoid these losses and the accompanying increase in appropriations.

The San Diego Committee made recommendations ranging from the need to immediately increase contributions to the fund to more aggressive amortization of gains and actuarial losses. Included were a series of benefit reductions for new hires and governance reforms, such as changes in the retirement boards' composition and a revision in the way that disabilities are awarded.

In Houston, voters decided in a referendum to exempt the city pension plan from the provision in the Texas Constitution that required pension promises to be kept by the employer. The action took place after revelations that changes in the plan, particularly the adoption of a DROP Plan (Delayed Retirement Option Plan), had jeopardized the fiscal condition of the system. Retroactive applicability of some aspects of benefit increases also played a role in the fiscal crisis and, perhaps more importantly, in the public attitude towards the pension system. Similar financial concerns have arisen in Philadelphia, Milwaukee, and other jurisdictions. In Milwaukee, seven county supervisors were removed from office in a recall election as a result.

San Diego and Houston are jurisdictions that have confronted a serious problem, primarily due to the failure of the employer to meet its financial obligations while enhancing benefits. Other pension systems are confronting different problems.

In Ohio, legislation recently became law that dramatically altered the operations of

the state pension funds. The reform was an outgrowth of scandals that engulfed several retirement fund trustees. A member of the Ohio Police and Fire Pension Board was indicted for accepting travel and other gratuities that improperly influenced his work at the Board. The indictment accuses the member of receiving "dinners, golf, alcoholic beverages, tickets to sporting events, hotel costs and incidentals, boat rental/fishing trips, holiday parties, transportation, and gifts that total thousands of dollars."

The climate created by the missteps of the few can alter the legal and regulatory environment that applies to all board members. This is no less true in Massachusetts than it is in Ohio.

The Ohio Legislation, passed in the wake of that scandal, requires board members and select employees to file annual ethics disclosure statements, requires that vendors who attempt to influence fund investment decisions comply with the state lobbying laws, changes board composition, and requires each board to conduct regular financial and performance audits.

Similar controversies have taken place in Milwaukee, where eight Milwaukee County Pension Board members paid civil penalties related to receiving "perks" from money management firms.

All of these developments call unwanted attention to the issues of pensions and pension fund management. Public policy makers facing difficult budget times will be scrutinizing the fiscal implications of pension costs and also will focus on pension fund management. Such controversies, arising in the middle of a national debate about alternative approaches to existing pension plans, could lead to the end of the system that we have known for many years.

Increased scrutiny by regulators and the public has also taken place with regard to the role of consultants and other parties in the decision making process of pension funds. The US Securities and Exchange Commission (SEC) is in the process of reviewing several aspects of the marketplace including conflict of interest, marketing practices, and disclosure.

Some of the concerns were raised in a *New York Times* article last year. The lead of that article stated, "A small but growing part of the \$2 trillion in state and local pension funds is being steered into high-risk investments by pension consultants and others who often have business dealings with the very money managers they recommend. After making such investments, a few of these pension funds have come up short, forcing governments to draw on tax dollars."

The paper noted that there is a "web of intermediaries—marketing agents, lobbyists, brokers and world leaders between pension funds and the investments they choose." Instances where funds lost substantial amounts include the Arkansas teachers' pension fund that, through a consultant, became involved with Andrew Fastow, chief financial officer of Enron. Arkansas committed \$30 million to an investment in one of Enron's off balance sheet entities and may have lost it all. Louisiana, a client of the same consultant, due to losses resulting from an allocation of 42% of assets to "alternative investments", incurred an increase of \$147 million (more than 20%) in its appropriation to the fund.

In 2002, Hawaii discovered that its consultant had recommended 16 money managers—14 of whom were paying the consultant for services.

PERAC disclosure forms now require that consultants and money managers reveal any such arrangements. Boards must review these disclosures carefully in assessing the merits of a prospective manager or consultant. The process by which a manager has been recommended and selected must be competitive and objective. Failure to closely monitor this area will, especially in light of the attention now being paid to these issues, inevitably result in controversy and provide ammunition to those who do not possess the same commitment that you and I do to the existing pension system in Massachusetts.

#### **Reform**

The Commission, from the outset, has believed that assisting the pension community in becoming proactive, and working with you to provide accurate information about the law and the retirement system

to policy makers, are key aspects of its role. As outlined, the need for such an approach has never been more critical.

PERAC sees several areas of concern that will inevitably raise the level of scrutiny on pension practices. Recent discussion at the Commission has been conducted regarding narrowing the areas of focus and initiating a conversation with retirement boards about how best to address these concerns, before the public controversy arises and the pension community is once again reacting to events outside our control. A select Reform Initiatives Advisory Committee, chaired by former Attorney General Scott Harshbarger, is reviewing several general issues. The Committee has sought the views of the Public Pension Advisory Group, a group comprised of board members and administrators that meets regularly with PERAC to discuss various aspects of the legal and regulatory framework.

The Harshbarger Committee has focused on the following:

First—In light of the fact that the investment regulatory environment in which boards operate has remained essentially the same for the last 20 years, changes should be considered that grant boards greater flexibility while insuring that assets are protected.

The Committee believes that the “waiver/exemption” process should be reviewed with an eye towards making it less onerous. This will enable the Commission to increase emphasis on competitive process and fiduciary compliance. Such a reform may require more extensive statutory or regulatory guidance to the boards relative to the competitive process for use in selecting vendors. This could take the form of something analogous to Chapter 30B that is required for government procurement at the local level.

The expansion of existing disclosure requirements relating to payments associated with obtaining business from a retirement board and enhanced penalties for failure to disclose should also be reviewed. The annual filing of disclosure forms, and the delineation of all payments from or to any source relative to services provided to

a retirement board, could be components of such a change.

PERAC would retain the ability to prohibit a particular investment if such an investment is not in the best interest of the system.

Second—In the event a retirement system is in fiscal or administrative jeopardy that necessitates quick (perhaps temporary) action to protect assets or to ensure the members’ rights are secure, PERAC should be able to act.

We can all envision circumstances in which a municipality has failed to make contributions, or rogue investment managers have adopted a strategy that threatens the stability or even the viability of the system. In addition, the prospect that the benefits available under Chapter 32 will be administratively infringed upon is not as unlikely a possibility in light of the examples of San Diego and Houston.

Consequently, in conjunction with the expansion of board authority and the reduction of regulation in the investment area, mechanisms to allow for speedy remedial action, as well as to deter any threat to system assets, must be contemplated.

Third—There are governance issues that have recently come to the forefront that should be addressed. Board employees and vendors serving on boards clearly raise problems of governance. There has been much discussion about the role of corporate directors and the need to avoid conflicts and insure independence in the management of American corporations. Similarly, restrictions may need to be placed on board membership to avoid real or perceived conflicts.

Fourth—Proxy voting is the primary tool for shareholders to impact the behavior of corporate management. Recent corporate scandals have spotlighted the issue of the shareholders’ responsibility to not only monitor corporate decision making, but also to assess whether the investment in a particular company is at risk due to conflict of interest, lack of director independence, or more serious misbehavior on the part of corporate officers. All retirement boards should establish a process for exercising these important rights.

Fifth—In light of the some of the circumstances outlined above relative to vendors and disclosure of conflicts, the disclosure requirements for vendors and board members may need to be changed.

Sixth—Along these lines, there may be a need for financial disclosure by board members and key staff, similar to the financial statements that must be filed by state policy makers. The amount of assets under management by boards and the complexities of the marketplace make the establishment of such disclosures a necessary tool. The goal would be to not only address possible conflicts before they arise, but also to remove the perception of conflict of interest among system members, policy makers, and the public.

Seventh—Disciplinary action may need to be taken when a firm or individual providing services to the retirement boards is convicted of a crime related to procurement, or engages in practices that undermine public confidence in that firm’s ability to provide services. This would enable necessary action to take place while safeguarding the rights of those involved through the creation of a clear statutory process.

In the months ahead, the Commission will review the Advisory Committee recommendations. As part of this process, boards will be afforded ample opportunity to comment. Regardless of the outcome, all of us should be aware that, in the absence of a willingness to make constructive changes ourselves, others will be more than willing to make changes that may not be constructive at all.

#### **2004 Reforms**

The General Court was very active last session in the pension area. PERAC made several recommendations that were adopted and form phase one of the reforms that we hope to build on.

Section 15, relating to the termination of benefits due to conviction on various charges, has been a source of some controversy in recent years. PERAC, after reviewing the process for enforcement of these provisions, concluded that the greatest source for problems was the lack of communication between the law

enforcement community and the retirement boards. Some past criticism of the boards has been grossly unfair, as boards could hardly be expected to terminate benefits if no one informed them of the conviction in the first place. Consequently, PERAC proposed and the Legislature and Governor approved legislation that requires employers to notify boards of relevant convictions and also requires that the Attorney General and all District Attorneys notify the Commission of such convictions.

Standardization of the age to which surviving children can receive benefits was also adopted as a result of a PERAC recommendation. This eliminated anomalies in the law whereby certain retiree surviving children were eligible for the supplemental dependents allowance until the age of 22, if in school, while others could receive the benefit only until age 18.

In addition, legislation was approved that provides that those who fail to file earnings statements pursuant to Chapter 32, Section 91A would lose benefits for the period of non-compliance.

The retirees association advanced and the Legislature approved a measure to direct PERAC to conduct a study of the cost associated with increasing the COLA base from \$12,000 to \$22,000. The study will detail the impact of increases in \$1,000 increments, thereby providing analysis of options available between \$12,000 and \$22,000. Jim Lamenzo, our actuary, is in charge of that project, and we anticipate concluding the study in the near future.

The Fiscal Year 2005 State Budget also directed PERAC to establish new actuarial equivalent factors to be used in the calculation of retirement allowances. These included the development of a new mortality table and interest rate to be used in determining those factors.

The new actuarial equivalent basis is the RP-2000 Combined Healthy Table with 50% male and 50% female rates and an interest rate of 7%.

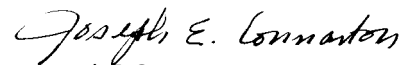
#### **Conclusion**

The tone and tenor of this letter has deviated from those that have introduced previous editions of the *PERAC Annual Report*. The purpose of these comments

is to underscore the seriousness of the circumstances that confront the Massachusetts public pension community. Now is not the time to hope that the tide of change will pass us by or will lead to little substantive difference.

The public pension community in Massachusetts may be on the verge of an exciting but challenging period. Fiscal crises, national events, and the activities of the SEC as well as other regulatory bodies have increased the scrutiny of the pension law and those who must administer it. The Commission believes that the most effective way to meet this challenge is to be proactive in recognizing that change may be coming, and to act to shape that change in a manner that is in the best interest of current and future beneficiaries of the retirement systems.

Sincerely,



Joseph E. Connarton  
*Executive Director*