



LETTER FROM THE EXECUTIVE DIRECTOR

We are pleased to present this Annual Report for 2007 detailing the activities of the Public Employee Retirement Administration Commission (PERAC) and the Massachusetts public pension systems during 2007.

Last year, I noted that pension financing has become an increasingly important factor in the overall fiscal health of the Commonwealth and its cities and towns, leading to more intense scrutiny of the activities of our retirement boards. That has certainly been the case as evidenced by the passage of Chapter 68 of the Acts of 2007, which mandates the transfer of assets to the Pension Reserves Investment Trust (PRIT) if funding and investment standards are not met. The Commission did not take a position on the legislation and, as noted in our 2006 Annual Report, at the Public Service Committee hearing on the bill one Commissioner vehemently opposed its passage while the Secretary of Administration & Finance enthusiastically supported its adoption. Nonetheless, the Commission has implemented that law fairly and we believe in a manner sensitive to the retirement boards. More recently, there has been a constant media focus on the benefit and administrative structure of the retirement system.

In the past, I have used this letter to review the actions of the Commission, Courts, Governor, and Legislature that impacted the public pension community in the previous year. This year I would like to depart from that template and provide an overview of where our retirement systems stand and, hopefully, to

confront some of the myths about the public pension world in Massachusetts.

Background

The increasing focus on the public pension system in Massachusetts and across the country has brought forward many opinions about the fiscal condition, benefit structure, administration and investment performance of the trustees responsible for the management of those systems. An equal number of “solutions” to the “crisis” in public pension plans have been put forth, sometimes by well-meaning policy analysts and sometimes by those with preconceived conclusions based on principles that are not relevant to the subject at hand.

Reports assessing the performance and condition of the Massachusetts plans often have leaned to the “half empty” rather than “half full” characterization of the situation. For reasons that will be detailed, the statutory history of these systems mandates that, in many respects, the glass be half full at this point in time. Significant progress has been made in finances since the late 1980’s when boards were authorized to begin the transition to actuarial funding. That progress has been generally acceptable from an actuarial point of view and in some cases extraordinary.

Too often the overall circumstances of all 106 retirement systems have been described on the basis of the circumstances of a limited number of systems. And in those cases, frequently the poor relative fiscal condition of those systems is one component of a

breakdown in all of the functions of a particular jurisdiction. For example, it should not be a shock that retirement systems in jurisdictions that have been under the statutory jurisdiction of a financial control board due to general conditions also have a financial problem in the retirement area.

Similarly, the impression of an overly generous benefit structure for the average employee is fostered by emphasis on anomalies and anachronisms in the law which appear to favor certain employees.

Finally, the investment returns of most retirement systems in Massachusetts have been competitive with similar entities across the country. The extraordinary performance of PRIT has tended to obscure that fact.

One of the most serious distortions in the discussion of the condition of the Massachusetts Public Pension System that has taken place in the last several years is the lack of perspective and context that often accompanies assertions about the system’s shortcomings. This lack of perspective and context is particularly evident when comparisons are made to the private sector, Social Security and other public plans across the country. Any rational discussion of public pension issues and possible policy changes must take place with an accurate awareness of the history of the Massachusetts Public Pension System and how it truly compares to other retirement programs, governmental and private.

The first and perhaps most fundamental fact that

has been ignored to date is that Massachusetts is not a “Social Security” state. Public employees in Massachusetts rely solely on the public pension plan and are not eligible to participate in Social Security. Most other public employees in the country are covered by Social Security and thus the pension plan that is sponsored by the local government supplements Social Security. However, in spite of the supplemental nature of the locally funded and determined benefit in those jurisdictions, Massachusetts benefit structure is not overly generous in comparison and the funded status of the majority of Massachusetts systems compares well with that of those systems.

The second element that has been missing in the discussion of the Massachusetts systems is the historical context for the policy approach adopted to address long-term funding needs. From inception until the early 1980’s, the Massachusetts Public Pension System was financed primarily on a pay-as-you-go basis. Annual appropriations by the governmental unit were set by the cost of the benefits to be paid in that year. Consequently, in the early years this short-sighted approach greatly benefited the governmental unit as few members were eligible for retirement and costs were kept artificially low. The poor overall fiscal condition of the systems was further exacerbated by withdrawing so-called “excess earnings” from the system to actually reduce the amount committed by the governmental unit. Thus, employer contributions to the retirement system often did not even match the amount being paid to retired members in benefits. In fact, for most of the period from 1945 – 1983, retirement boards were legally barred from attempting to secure actuarial forward funding as was required for private sector plans.

In the late 1980’s, legislation was adopted that revised the method for funding our pension systems. The goal was twofold: (1) create a mechanism to transition to the amortization of the unfunded liabilities that had accrued under the pay-as-you-go method and, (2) immediately commence funding current benefits on an actuarial basis.

In the wake of the adoption of funding legislation in the late 1980’s, state and local officials took actions that, although perhaps necessitated by the general fiscal condition, impeded the transition to actuarial funding.

Following passage of the reforms that required a phase-in of actuarial funding, several jurisdictions sought and received home rule petitions that enabled them to avoid making the full appropriations necessary under the new law. This led to a reduction in funding status and a delay in the transition period.

In 1997, legislation transferred financial responsibility for the cost of cost of living adjustments to local retirees from the Commonwealth to the retirement systems and governmental units.

Early retirement incentives, pension holidays, and other local option statutes often adopted at the behest of municipal officials increased the liabilities of the retirement systems.

These actions reflect the fact that the retirement boards do not operate in a vacuum. Public officials have often used the retirement system to transfer costs from the operating budget to the pension budget, manipulate the pension appropriation, and, in some instances, solve personnel problems through disability retirement. Thus, one element of the difficulties we face is the use of the retirement system for unrelated purposes, some of which are supportable as public policy and some of which clearly are not.

Apples to Apples Comparison

The fact that Massachusetts public employees do not participate in the Social Security System has significant implications not only in terms of the benefit structure, but also on the fiscal condition of the retirement systems and the obligation of the employing governmental units (primarily the state and its cities and towns) to appropriate funds for those benefits. The “normal cost” paid by Massachusetts public employers to cover employee benefits as they accrue is substantially less than the percentage of payroll that, in the absence of the Chapter 32 system, would be paid to Social Security. Furthermore, comparisons between the fiscal condition, benefit structure, and viability of the Massachusetts systems and public and private retirement systems elsewhere must account for the lack of Social Security coverage for Massachusetts public employees. This difference makes any comparison between pension plans that incorporate Social Security and the Chapter 32 system a comparison of apples and oranges.

Non Social Security Systems

State Name	Method	Funding Ratio
1. Texas TRS	Entry Age	87.3%
2. Ohio STRS	Entry Age	75.0%
3. Ohio PERS	Entry Age	93.0%
4. Nevada PERS	Entry Age	74.9%
5. Missouri PSRS	Entry Age	82.6%
6. Maine SRS	Entry Age	77.1%
7. Louisiana TRSL	Projected Unit Credit	67.5%
8. Louisiana SERS	Projected Unit Credit	63.9%
9. Kentucky TRS	Projected Unit Credit	73.1%

10. Illinois TRS	Projected Unit Credit	62.0%
11. Connecticut TRS	Entry Age	68.4%
12. Colorado PERA	Entry Age	73.3%
13. California TRS	Entry Age	86.0%
14. Alaska TRS	Projected Unit Credit	60.9%
15. Alaska PERS	Projected Unit Credit	65.7%
16. Massachusetts SERS	Entry Age	81.5%
17. Massachusetts TRS	Entry Age	67.2%

The financial condition of the Massachusetts systems must be put into the context of similar systems nationwide. This chart is the result of a survey conducted by the State of Wisconsin for 2006. Although the survey included nearly 100 pension systems, these are the systems that are stand alone, that is their members are not covered by Social Security.

The first observation that should be made is that the Massachusetts State Retirement System, with a funded ratio of 81.5%, is one of the better funded of the similarly situated funds surveyed. Out of the 17 funds surveyed, the MSERS places fifth in terms of the ratio of assets to liabilities. Although the Massachusetts Teachers System does not fare as well, it places 13th with a ratio of 67.2%. This is below the mean of 73.3% as well as the average of 74.1%. However, that ratio is not dramatically below either standard. The actuarial valuation of the Massachusetts systems uses the “entry age” method which generally results in greater liabilities than the “projected unit credit” method used in the Alaska and Kentucky plans, with a ratio above that of the Massachusetts Teachers.

The Massachusetts State Employees’ Retirement Funded Ratio improved further since the Wisconsin Study. As of 1/1/08, that funded ratio was 89.4% on an actuarial value basis and 98.8% on a market value basis.

The Massachusetts Teachers’ Retirement System Funded Ratio has also improved since the Wisconsin Study. Although the 1/1/08 Actuarial Valuation is in process, as of 1/1/07, the Teachers Funded Ratio was 71.0%.

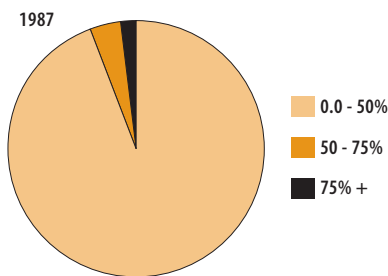
Funding History

For the first time, legislation in 1987 allowed retirement boards to seek financing on an actuarial basis. The unfunded liability confronting the systems at that time was not the responsibility of the retirement board or the benefit structure in place; it was entirely due to the method of financing that had for years artificially masked the true cost of the pension systems. This failure to finance pension costs properly for the shortsighted temporary freeing of resources for use on other priorities, regardless of the value of those expenditures, is the true cause of the financial crisis that

culminated in the reforms in funding and investment and with which we are struggling today. Reform legislation recognized the financial impossibility of an immediate commencement of actuarial funding on a level amortization payment basis. For the same reasons, the law called for a maximum time period in which systems must retire unfunded liabilities. This responsible approach insured that systems would ultimately adopt a full funding approach while providing the flexibility for systems, on a case by case basis, to be as aggressive as circumstances of the individual governmental units allowed. The mandate that full funding be achieved by 2028 and the authorization of a 4.5% annually increasing amortization payment reflects the clear expectation that a transition period would be necessary to commence full funding.

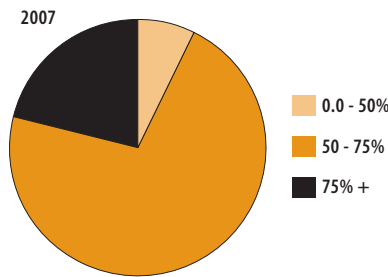
For many systems, the transition period is now or will soon be ending. The increase in unfunded liability that was the result of the flexibility has now ended in many systems and we are beginning to see scheduled appropriations leading to annual decreases in the unfunded liabilities. As of FY 08, 47 systems will experience a decline in unfunded liability as a result of appropriation. By FY 13, that number will reach 90. Each appropriation will result in a net reduction of unfunded liability. This is in addition to the 3 systems that are already 100% funded. In the next 5 years, 93 retirement systems will either be fully funded or will be reducing unfunded liability through annual appropriation. That is precisely the process that was envisioned when the Funding Reform Legislation was passed in 1987.

The following chart illustrates the status of the systems at the inception of actuarial funding:



100 of the 106 Massachusetts' public pension funds were less than 50% funded in 1987. At that time, only two had a funded ratio above 75% and an additional four were funded at a level greater than 50%, but less than 75%.

This chart reviews that status as of the most recent period:



Now the situation is essentially reversed, with 96 systems funded at a ratio greater than 50% and 28 funded at a level above 75%. Only ten systems are funded at a ratio below 50%.

Future Progress

As we have seen, the statutory structure created in the late 1980's to address the unfunded liabilities of the Massachusetts public pension systems anticipates a term of years before those liabilities are fully amortized. Funding schedules adopted pursuant to that statute indicate that today there are three fully funded systems (MassPort, Wellesley, and Minuteman). An additional 17 systems will be fully funded by 2020 (Berkshire – 2016, Adams - 2013, Arlington - 2019, Brockton - 2020, Cambridge - 2015, Concord - 2012, Dedham - 2020, Fairhaven - 2019, Greater Lawrence - 2018, Leominster - 2015, Lexington - 2015, MHFA - 2013, Milton - 2016, Montague - 2015, Stoneham - 2020, Watertown 2017 and Winthrop - 2019). Twenty-three more will be fully funded by 2023 (Weymouth – 2021, Plymouth – 2022, Northbridge – 2022, Chicopee – 2021, Boston – 2023, Bristol – 2023, Marblehead – 2023, Shrewsbury – 2022, Woburn – 2022, Needham – 2021, Dukes – 2023, Attleboro – 2022, Marlborough – 2022, Maynard – 2023, Melrose – 2021, Quincy – 2023, Saugus – 2022, Somerville – 2022, Taunton – 2022, Winchester – 2021, Worcester – 2023, State – 2023 and Teachers – 2023).

Forty-three of the Massachusetts public pension plans, including several of the largest (Boston, Cambridge, State and Teachers), will be fully funded within 15 years, well before the maximum time period allowed by law of 2028. All Massachusetts public pension systems will be fully funded by that deadline.

A recent study, by Alicia Munnell of the Boston College Center for Retirement Research, concluded that of the factors that affect the funded status of a plan, "The

key issue is whether the sponsor has a funding plan and is sticking to it."

The message from this data is clear – stay the course and be as aggressive as possible. The statute is working as it was designed.

Comparison to Actions of Other Jurisdictions

In Massachusetts, several benefit structure changes have taken place that have added liability to the pension system while contributing to other governmental goals. These have included early retirement incentive programs, Retirement Plus, and pension holiday legislation. However, in comparison to the action of other jurisdictions, the Massachusetts experience has been one of restraint and measured progress.

As noted above, the Wisconsin Study reviewed 85 public pension plans, 68 of which also participate in Social Security. Benefit comparisons with Massachusetts systems must recognize that fact. The benefit formula is: years of service x formula multiplier x final average salary. In Massachusetts, for a Group 1 employee retiring at 65, the multiplier is 2.5%. It is reduced .1% for each year between 55 and 65. However, it is critical that policymakers understand that in the 68 plans that also provide Social Security benefits, the formula multiplier varies from 1.3% to 2.1%. Thirty-two of the 60 Social Security plans that are not money purchase plans or in which the employer determines the formula, provide a multiplier of 1.9% or greater. Thus, the benefit provided in addition to Social Security in the majority of those plans is virtually as generous as the benefit provided without Social Security to the average Massachusetts employee at age 60. Under some circumstances, the multiplier is as high as 3.5%.

The Study also underscores the difference between our system and those surveyed in employee contribution rates, limitations on benefits, vesting, and COLAs. Again, keep in mind, that most of the systems surveyed provide Social Security coverage as well as the defined benefit.

The Massachusetts contribution rate for new hires is greater than that of all systems surveyed with the exception of Missouri PSRS (12%) and Illinois TRS (9.4%). Factoring the 2% extra contribution on an amount in excess of \$30,000 makes our contribution rate higher than all but Missouri PSRS. Florida FRS, Michigan SERS, Missouri SERS, Tennessee CRS, Utah SRS, and Milwaukee County require no employee contribution. Twenty-eight of the plans require a contribution rate that is at or below the level made by Massachusetts employees hired prior to 1975 (5%).

Massachusetts caps the retirement benefit at 80% of final average salary. In the majority of plans surveyed in

the Wisconsin Study, there is no maximum benefit limit imposed. In 13 systems, the limit is 100% of the final average salary.

In order to be eligible for a retirement benefit (vest) in Massachusetts, an employee must have 10 years of creditable service. In the systems surveyed, 67 of the 85 have vesting requirements lower than that of Massachusetts and 63 have a requirement of 5 years or less.

Another element of the plan in which Massachusetts is dramatically less generous than most other systems is cost of living increases (COLAs) after retirement. Again, the Social Security component of the benefit in 68 of the plans surveyed will receive a COLA under Social Security. Thirty-eight of the 85 plans provide an automatic COLA indexed to the CPI. Another 23 plans have an automatic increase. In Massachusetts, a COLA is ad hoc based on the annual actions of the Legislature or the retirement board. However, most significantly in Massachusetts, the COLA is capped at a maximum of 3% of the first \$12,000 in the retiree's benefit. According to the study, Massachusetts is the only plan with such a limit.

Beyond these structural differences which clearly demonstrate that the Massachusetts plan is not overly generous, other jurisdictions have taken recent actions that established a level of benefits far in excess of that available in the wildest imagination of the most vociferous critic of the Massachusetts system.

Houston, San Diego, and Milwaukee County are a few of the jurisdictions that adopted so called "DROP" (Deferred Retirement Option Plan) plans for their employees. Under such a plan, a member can freeze his or her benefit at a certain level and continue working. During the period between the freezing of the benefit and retirement, the retirement benefits are paid into a separate account and upon retirement, the employee receives a lump sum as well as a regular retirement benefit going forward.

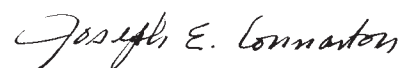
In Milwaukee, the DROP account was credited with a 2% annual COLA and 9% interest compounded monthly. In several instances, this arrangement provided for lump sum payments in excess of a million dollars. In addition, Milwaukee provided a 25% pension bonus for employees hired prior to 1982.

In San Diego, pension trustees, in exchange for reducing the City's annual appropriation, established a DROP plan. Ultimately, the plan was made permanent. In addition, changes were made that allowed retirement benefits to exceed 100% of salary and employees were allowed to purchase up to five years of creditable service. The latter benefit, that is purchasing additional service without having been employed during the years purchased, is available in other jurisdictions as well. Criminal prosecutions are ongoing as a result of the San Diego Board's actions.

Conclusion

Although this review represents a departure from previous practice, it is my hope that it will provide context and perspective for those who may not be familiar with the reality and the history of the public pension system in Massachusetts. The Commission is not blind to the need to make changes in our retirement law. It has sponsored legislation to reform the administration of the system to increase transparency, assure accountability, and improve management (House 4011). In addition, the Commission has adopted regulatory amendments to address confusion relative to regular compensation, supported enhancement in the COLA, and taken strict action in cases where board members have violated the trust of the system members. We acknowledge that, in some areas, the law may be unclear or anachronistic, and we will work with those that seek responsible and appropriate reforms. However, as this review points out, the core of the retirement system is fair not only to employees, but to taxpayers as well.

Sincerely,



Joseph E. Connarton
Executive Director