



Letter from the EXECUTIVE DIRECTOR

We are pleased to present this Annual Report for 2008 which provides a review of the activities of the Public Employee Retirement Administration Commission (PERAC) and the Massachusetts public pension systems.

Pension Reform

It is not an exaggeration to state that we issue this Report at a time when the Chapter 32 retirement system is at a crossroads. In the last several publications, as well as various forums, the Commission has made it clear that the administrative, investment, and benefit structure of the Massachusetts Public Pension Plans has been receiving unprecedented scrutiny by policy makers, the media, and taxpayers. Recognizing the need for change, the Commission has, on a number of occasions, filed legislation to improve the governance practices of the retirement boards. The Governor has signed into law a proposal that will alter substantive benefits provided under Chapter 32 for the first time in memory. At the same time, a Special Commission to Study the Massachusetts Retirement System is preparing its recommendations which may be far-reaching and transform our pension plan in a manner that will make it virtually unrecognizable to those familiar with its present provisions. The Commission and, I believe, the entire pension community, is prepared to support reasonable reforms that improve the system. However, if necessary, we must band together to oppose any suggestion that the basic benefit structure of our law be changed in a knee-jerk response to controversies related to archaic aspects of the statute that have limited applicability.

Recently approved legislation has instituted pension reforms that:

- (1) Eliminate the one day – one year whereby elected officials receive a year of creditable service

for one day of service in a calendar year;

- (2) Repeal eligibility for a Section 10 termination benefit for those who fail to be nominated, re-elected, or do not become candidates for nomination for re-election;
- (3) Increase the vesting period for elected officials from six to ten years;
- (4) Eliminate creditable service for library trustees;
- (5) Repeal the provision allowing unpaid selectman, alderman, school committee members, or town moderators directly elected by the people prior to 1/1/86 to receive creditable service for their service in those positions;
- (6) Change the definition of “regular compensation” to remove certain compensation from being included in retirement benefit calculations;
- (7) Provide that a municipal, county, or state employee receiving compensation of less than \$5,000 annually will not receive creditable service for serving in a position paying that amount.
- (8) Preclude an individual from working two full-time positions at the same time and, as a result, establishing membership in two retirement systems and combining the salaries received from those positions to determine the regular compensation on which the retirement benefit is based;
- (9) Change the method for calculating accidental disability benefits;

- (10) Authorize a retirement board to require direct deposit of benefit payments to members;

- (11) Authorize a retirement board to require a retired member to assign an amount to pay subscriber premiums for health insurance at retirement;

- (12) Add language to Section 91(b) of Chapter 32 which clarifies that earnings limits will apply to employment with an “authority” and will also limit service as a consultant to a public entity.

Legal Concerns

The new law contains language overriding the contract language of Section 25 of Chapter 32 resulting in the benefit changes applying to active members of the system. Although legal challenges can be anticipated to these provisions, the Legislative intent is clear and unless and until the courts rule otherwise: that is the law.

Myth versus Reality

On a substantive basis, a clear picture of the actual benefit available to employees as it compares to other similar jurisdictions and the method of financing is critical to a sober and fair assessment of proposed changes to Chapter 32.

The assertion that public employee pension benefits are too generous in Massachusetts is now so commonplace in our public discourse as to possess a credibility that is not warranted. New employees in the most common group classification generally finance their own benefit over their working lives. In other groups, a significant percentage of the benefit for new members is self-financed. The total percentage of retirement benefit available to Massachusetts public retirees is capped at 80% of their three-year average annual rate of regular

compensation. This maximum is not supplemented by Social Security. This contrasts with a retiree from another jurisdiction such as New York that provides a defined benefit plan in conjunction with Social Security. In that system, an employee with 30-40 years of public service receives a state pension between 60% and 75% of salary in addition to Social Security. As a result, many New York public employees retire with a benefit in excess of the salary they received while working.

Earlier this year, PERAC released its *State of the Pension System 2009*, a publication designed to provide a status report on the Massachusetts public pension systems. That document reviewed the funding history of the 106 retirement systems and attempted to place the experience of 2008 in context.

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 – even though some funding and investment reforms have been enacted – continues to confront us 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 ensured 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 their 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.

Prior to 2008, the transition period was coming to an end for many systems. Based on pre-2008 schedules, sixty-three systems would have experienced a decline in unfunded liability as a result of appropriation immediately and by FY 2013, nearly all systems would begin seeing such a decline. This was precisely the process envisioned in 1987 when funding legislation was adopted.

One hundred of the one hundred and six Massachusetts public pension funds were less than 50% funded in 1987. At that time, only two systems had a funded ratio above 75%, and four were funded at a level greater than 50%, but less than 75%.

Prior to the 2008 market collapse, the situation had been essentially reversed with 99 systems funded at a ratio greater than 50%, and 38 funded at a level above 75%. Only seven systems are funded at a ratio below 50%.

Fifty of the Massachusetts' public pension plans including several of the largest (Boston, Cambridge, State and Teachers) would have been fully funded within fifteen years, well before the maximum time period allowed by law (2028).

Funding in the Post 2008 Era

PERAC recognizes that 2008 has dramatically altered the short and long-term prospects for pension funding. With that reality in mind, we asked that actuaries who provide services to the retirement boards assess alternative funding methodologies that will assist the state and its cities and towns in fulfilling their financial commitment to employees and retirees in a responsible and equitable manner. A number of suggested approaches have been submitted for consideration and the Commission expects to submit legislation to implement a new standard for pension funding in the near future.

Obviously, 2008 has now made the achievement of the full funding goal on the timetable outlined less likely. However, as solutions are crafted to address the economic and budgetary crisis confronting the Commonwealth and its cities and towns, one goal should be to assure that, when the economy rebounds, the responsible and timely meeting of our pension obligations takes place smoothly and, as far as practicable, on the same basis as was the case when the crisis hit.

As noted, in aspects of the benefit plan from member contribution rates to cost-of-living allowances for retirees, the Massachusetts plan lags those available in other states and localities. This does not argue for enhancing these benefits but it does serve as a reminder that it would be tragic from a fiscal and human point of view to tear up this system and put in its place an alternative that is neither affordable nor sufficient to meet the needs of retired employees. The Social Security alternative would substantially increase costs to the state and other public employers while diminishing the benefit to retirees. The defined contribution alternative must be deemed virtually ludicrous in the wake of the 2008 investment experience.

Today the Massachusetts plan is transitioning to an employee funded defined benefit plan. In the years ahead, as we recover from the 2008 experience, the wisdom of holding firm will be rewarded with a resumption of progress towards full funding and a reduction in the level of public resources that must be used to pay pension costs.

National Developments

Each day seems to bring new allegations of "pay to play"

or other unsavory actions in the investment of public pension funds across the country. New York Attorney General Cuomo recently indicted several former officials of the State Comptroller's office as well as so-called "placement agents" and managers for participation in a scheme that extracted "kickbacks" from firms seeking to manage assets of the New York State Common Retirement Fund. These cases involve "sham finder or placement agent fees" totaling in the millions. General Cuomo's investigation has expanded to the New York City Pension Funds and sparked inquiries in New Mexico, California, New Jersey, Texas, and Connecticut.

PERAC has once again filed its Governance Reform Legislation which seems more relevant than ever. In the area of transparency, it would:

- (1) Authorize PERAC to debar firms from doing business with Massachusetts retirement systems if the firm has been convicted of a crime involving public contracts; has been found to supply false information in an effort to obtain a contract; has submitted an inaccurate disclosure statement to the Commission or a board; or has failed to disclose to a board or the Commission compensation provided to any person in relation to attempting to obtain a public contract. This would enable the Commission to proceed against firms which have violated these provisions elsewhere in the country. For the first time, sanctions could be applied in Massachusetts in circumstances such as those uncovered in New York;
- (2) Codify disclosure requirements mandating that all vendors annually inform the Commission and the board of any compensation arrangements to be received or to be paid in relation to the services provided, as well as to annually disclose any conflicts of interest that may exist;
- (3) Require vendors to submit a sworn statement that a good faith proposal has been made without collusion or fraud; and
- (4) Establish civil penalties, including double damages for violations of competitive process and disclosure requirements.

In addition, numerous good governance practices are set forth:

- (1) The establishment of an explicit open and competitive process to be followed by boards when soliciting investment, actuarial, legal or accounting services;
- (2) Require board members to file statements of financial interests;

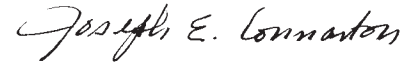
- (3) Prohibit vendors, contractor, employees or others receiving remuneration from a retirement board or anyone doing business with a retirement board from serving on a retirement board;
- (4) Require board members to submit a sworn statement that, to the best of his or her knowledge, any proposal made as part of a competitive process is submitted in good faith and without collusion and fraud; and
- (5) Mandate relevant education for board members.

Conclusion

In last year's report I stated, "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 . . . 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." The Governor and Legislature have worked to produce a reform of a number of these anomalous aspects of Chapter 32, focusing on elected officials' membership and creditable service, Section

10 allowances, dual membership, and the definition of regular compensation. PERAC has been pleased to offer its assistance to policy makers as they confront these issues and we pledge our cooperation as the reform process continues.

Sincerely,



Joseph E. Connarton
Executive Director

