

Statement

from the Executive Director

The last year has been an eventful one for the Massachusetts public pension systems and their members. The reforms instituted by Chapter 306 of the Acts of 1996 began to impact the practices of the retirement boards as the Public Employee Retirement Administration Commission (PERAC) established itself and commenced the implementation of that important statute.

Other legislative initiatives significantly altered the structure of the pension law. Chapter 17 of the Acts of 1997 revised the method of granting Cost of Living Adjustments (COLAs) to retirees and survivors. As a result, in the event the statute is accepted at the local level, the retirement board will be vested with the power to decide each year whether a COLA will be awarded. Financial responsibility for future COLA's will also be the responsibility of the local governmental units, the employees of which are members of the retirement system. Pursuant to Chapter 17, PERAC filed a report with the Legislature on December 30, 1997 which estimated the fiscal effect of this change in the method of financing. In general, the report concluded that, due to recent progress in the funding of overall liabilities, the retirement systems are well positioned to include COLA in modified, but acceptable, funding schedules. As of July 1, 1998, 95 localities have accepted Chapter 17 and in most instances, PERAC has worked with the retirement board to develop a satisfactory funding schedule.

During the course of the year PERAC wrestled with the Early Intervention Program created by Chapter 306. In conjunction with the public pension community, recommendations for amending that aspect of the statute were submitted to the Legislature. In the latter stages of the legislative session that proposal was approved and became law. This represents a major accomplishment achieved after months of effort by PERAC, MACRS, the retirement boards and the members of the EIP Task Force. In addition, the support of Public Service Committee Chairs, Senator Richard Moore and Representative Timothy Toomey and their staffs; the House and Senate leadership; and the Office of Governor Cellucci enabled us to achieve this important goal. This development of a coalition approach to legislative initiatives provides a successful blueprint for future efforts.

PERAC has also moved forward aggressively in the revision of regulations governing the investment activities of the retirement boards and the disability retirement process. The new investment regulations recognize the increased professionalism in the management of system assets and make significant changes

in the regulatory process. The disability regulations focus on the implementation of Chapter 306 and the post retirement monitoring of disabled retirees.

In the past, this report has focussed exclusively on the investment activities of the retirement boards. This year we have instituted a new format that attempts to provide a more comprehensive picture of the condition of our retirement systems. Each system is profiled, enabling the members of that system and other interested parties to assess the overall condition of the system. The Commission believes that by incorporating actuarial and audit information the investment management role of the retirement boards will be placed in proper context, and the interrelated nature of the many different responsibilities of the board members will receive appropriate emphasis.

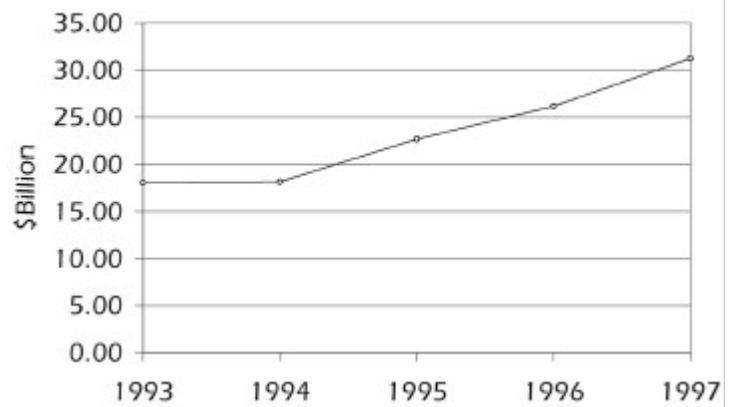
As will be outlined, dramatic progress has taken place in the financial condition of the retirement systems. One of the central contributors to this progress has been the return on investment achieved over the course of the last fifteen years. 1997 was no exception to this record. The average return for 1997 was 18.69%. In the last five years the annualized average return was 13.44%. Since the inception of the independent review of the investment performance of the systems, the annualized average return has been 12.18%.

Asset growth is a product of a number of factors including employee contribution rates, appropriations, and investment return. Although in this report we are not able to isolate the impact of each factor, on a statewide basis, assets increased from \$26.2 billion at the end of 1996 to \$31.3 billion at the end of 1997. In the five years from 1993–1997 assets have increased from \$18.1 billion to \$31.3 billion.

In this report we have included the actuarial assumptions for investment return used in the most recent actuarial valuation of each retirement system. To the extent that actual return exceeds that assumption the funding condition of the system has improved beyond the expectation. Also provided in the following tables is the funded ratio of each system as of its most recent actuarial valuation and as of its prior actuarial valuation. The funded ratio is a measure of the financial condition of the system based on the ratio that system assets bear to system liabilities. Thus a 100% funded ratio indicates a fully funded retirement system.

The purpose of setting forth the actuarial assumptions for the investment return and the systems' funded ratios is to put investment activity in its proper context. Raw investment return numbers provide only limited insight into the management of the retirement system. That return is a product of the asset allocation and risk inherent in the portfolio. As systems improve in their funded status, the goal of investment activity should be to achieve the actuarial assumed rate of return.

Five Year Statewide Asset Growth



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This may lead to asset allocation decisions that do not seek to attain returns in excess of that assumption. As a result, a retirement board may, in fact, be managing assets in the best interest of members and beneficiaries although its comparative performance may be different from its peers.

Retirement boards across the Commonwealth are bound by a fiduciary duty to manage the system in the best interest of the members of the systems and their beneficiaries. Essential to that role is to insure that resources exist to finance the hard-earned benefits that are guaranteed under Chapter 32. In this capacity the boards rely on actuarial analysis of the assets and liabilities of the system to determine funding needs. As can be seen in the funded ratio information, great progress has been made in the fiscal condition of the systems. This accomplishment is made more impressive by the fact that, until the late 1980s, contributions to the systems were determined by the “pay as you go” funding method which did not address the cost of future benefits. Ironically, this is the same method of financing that has jeopardized the Social Security System which federal policy makers are attempting to mandate on Massachusetts and its cities and towns.

Pursuant to Chapter 32 of the General Laws PERAC conducts an audit of each retirement system on a three-year cycle. That audit reviews the system’s compliance with the provisions of statute as well as regulations pertaining to financial accounting and record keeping established by the Commission. In this year’s report we have not included audit information. However, in future years, that information will be an integral part of the PERAC Annual Report.

In addition, we have made changes in the manner in which audit results are presented to retirement boards. PERAC Auditors will now review each audit finding directly with each retirement board. This process should enable boards to fully understand concerns raised and to respond expeditiously in clarifying information or in correcting any deficiencies cited in the audit. Also, over the course of the next year, the Commission would like to see an expanded role for the private audit community in conducting retirement board audits on an annual basis.

Similarly, PERAC conducts triennial actuarial valuations of the retirement systems. The PERAC Actuary will also begin to review each valuation personally with each retirement board to assure that the implications of the valuation results are fully understood. Those valuations form the basis of the funding schedules that set forth the payments necessary to finance retirement benefits. Over the course of the last year, the PERAC Actuary has worked with the private actuary community in developing funding schedules designed to cover the local assumption of COLA costs. The Commission firmly believes that an actuarial valuation of each retirement system should be conducted each year; if not, no less than every two years. This course of action allows for retirement systems to maintain more accurate data and insures that funding schedules are in fact accurately addressing system liabilities.

Conclusion

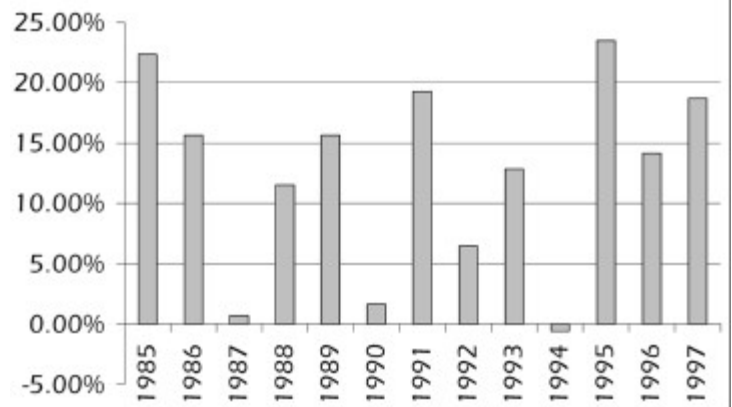
Recent history has proven that the environment in which the Massachusetts public pension systems operate is constantly changing. Throughout the 1980s and 1990s major legislative reforms have transformed the statutes embodying our pension law. In fact, retirement boards are being called upon to fulfill responsibilities such as child support enforcement that are unrelated to the primary function of managing the retirement systems.

It appears that this will continue. Today we are confronted by the specter of mandated Social Security coverage at the federal level, and the difficult task of implementing Return to Work and Pension Modification provisions of Chapter 306. In March, PERAC, at the request of the U. S. General Accounting Office, completed a study of the impact of mandated Social Security coverage on Massachusetts public employers and public employees. The conclusion of that report is that such a mandate would be a disaster for the state and its cities and towns as well as public employees. The progress retirement boards have made in the last two decades to insure the financial security of employee benefits and moderate the impact of pension costs on public budgets would be negated by the imposition of greater costs to finance diminished benefits. PERAC has estimated that for new employees only, the employer cost of Social Security coverage will be from \$210 to \$400 million. That expense would be doubled in order to establish a supplemental benefit structure to attract and retain qualified employees. This is necessary because Social Security benefits, depending on salary, pay out between 45% and 75% below the amount paid out under the current Chapter 32 system. The Commission is committed to opposing the mandate of Social Security coverage on Massachusetts' public employers and public employees and will convene a task force to coordinate our efforts with impacted employer and employee groups.

A major challenge for retirement boards as well as the world economy in general is the Year 2000 problem. Computer software developed in past years did not account for dates ending in 00. Consequently, in order to avoid a shutdown of programs and loss of data, boards must insure that software is Year 2000 compliant. To that end, PERAC invited the State Year 2000 Coordinator to make a presentation at the June 1998 MACRS Conference. That presentation introduced those who were unaware to the problem and outlined the steps that should be taken to achieve compliance.

Aside from these considerable challenges, retirement boards may be faced with a capital market environment that provides lower returns on investment than experienced over the last few years. The Asian Crisis has blunted further growth in

State Average Annual Return (%)



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that area of the world and its impact has been felt in other developing economies. Slowing demand in Asia and other parts of the world has begun to pinch profits of multi-national corporations whose securities form the backbone of many investment portfolios. Many observers believe the U.S. stock market is overvalued. Other signs such as the Federal budget surplus and possible privatization of some aspects of Social Security paint a more positive picture. In any event it is unlikely that future experience will mirror the recent past. In fact, during the last month the markets have retreated from record highs.

This uncertain future comes at a time when many Massachusetts retirement systems have made great progress in funding status. PERAC has been discussing with the private actuarial community the transition from use of a market value of assets to using an actuarial value of assets in the development of funding schedules. Actuarial valuation of assets is a technique that attempts to smooth the volatility that can result from the use of market value. Assets are valued at some level below market value. Thus, actuarial value will provide systems with a cushion to guard against declines in the value of assets caused by a change in the capital market environment.

As these new issues arise, Retirement Board Members are being asked to maintain and expand upon the substantial progress already achieved in improving the financial condition of the retirement systems. We are confident that the dedication, professionalism, and expertise of the Members of the retirement boards will enable those boards to meet these challenges. The Commission, as always, stands ready to assist the boards in that effort.

Robert F. Stalnaker, *Executive Director*