

2008 PUBLIC PENSION INSTITUTE



By Sarah Kelly
Communications & Education Director

In August, PERAC was pleased to welcome members, administrators, and administrative personnel from Massachusetts public employee retirement boards to the 2008 Public Pension Institute at the University of Massachusetts at Amherst. Nearly



Leslie A. Kirwan, Secretary, Executive Office for Administration and Finance

200 participants from the boards came together to focus on a wide ranging set of course offerings presented by guest speakers and PERAC staff members.

Leslie Kirwan, Secretary of the Executive Office for Administration and Finance, was our keynote speaker. Secretary Kirwan reviewed recent budget deliberations pertaining to pension policy, voiced concern regarding the possible adoption of a referendum question eliminating the state income tax, and discussed short and long-term fiscal challenges facing the state. "The participation of Leslie Kirwan, the 'deputy governor', demonstrates the important role our pension systems play in the Commonwealth," noted PERAC Executive Director Joseph E. Connarton. "I'd like to extend my thanks and those of the Commission to Leslie for taking time out of her busy schedule for this event."

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ORIGINS OF THE FINANCIAL CRISIS

By Robert Dennis
Investment Director

At the beginning of 2007, few of us had even heard the term "subprime mortgage". Now, after more than a year of financial market turmoil that has evolved into the most serious upheaval in a generation, we all know what subprime mortgages are. In rapid succession over the past year, we have also become familiar with CDOs (Collateralized Debt Obligations), CLOs (Collateralized Loan Obligations), SIVs (Structured Investment Vehicles), MBIA and Ambac (major municipal bond insurers), and auction-rate securities. We have seen major rating agencies Moody's and Standard & Poor's lose

credibility after their failure to correctly assess the risk in securitized mortgage products. We saw venerable Wall Street firm Bear Stearns fail in March, major mortgage bank IndyMac collapse in July, and many other prominent financial companies lose most of their equity value after suffering staggering loan write-offs. We saw both retail and institutional investors trapped as the resale market for auction-rate securities ground to a halt. We saw the Federal Reserve take a series of unprecedented and aggressive actions, including opening its lending window to Wall Street firms, in hopes of preventing an even worse financial meltdown. Unfortunately, all these events and actions proved to be just preliminary to

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- Audit Follow-up Letters Now Being Posted on Web

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Joseph E. Connarton
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By Michael DeVito
Director of Strategic Planning,
Management, and Public Affairs

A recap follows of some of the actions taken by the Massachusetts General Court on pension issues before the 2007-2008 session was concluded:

PERAC BOARD GOVERNANCE LEGISLATION

Foremost on PERAC's agenda for the 2007-2008 session was the pension board governance legislation, H. 4011. The bill did not advance to passage but it received strong consideration this session from the Legislature as it was again favorably reported by the Joint Committee on Public Service, chaired by Representative Jay Kaufman (D-Legislation) and then Chairman Benjamin Downing (D-Pittsfield) who has since been replaced as Chairman by Senator Anthony Galluccio (D-Cambridge).

H. 4011 was developed after extensive negotiations with the Joint Committee on Public Service, the Massachusetts Association of Contributory Retirement Systems (MACRS), the Retired State, County and Municipal Employees Association of Massachusetts, and PERAC. In these sessions, PERAC made significant concessions to arrive at a version of the bill to which all parties could agree. Upon referral to the House Ways and Means Committee, a redraft (H. 4801) was created, reported favorably, and referred to the House Committee on Steering, Policy and Scheduling. After deliberations in Steering and Policy, the bill was recommitted to House Ways and Means and subsequently reported favorably with changes as H. 5048 (an amendment pending to H. 4011) on July 31, 2008 prior to the end of the Legislature's formal session. PERAC worked until the last hours of the session to try to enact H. 4011, the draft PERAC and MACRS

agreed to, but as of this writing, it has not yet been achieved.

H. 4011, if adopted, would provide for significant board governance upgrades in several important policy areas, including:

- Competitive bidding requirements for retirement boards, which while required as a component of a board member's fiduciary duty, are currently exempt in statute;
- Ongoing educational requirements for retirement board members;
- Updating of the statute governing investments by boards, including elimination of the waiver process;
- Financial disclosure by retirement board members;
- Local option authority to increase board compensation; and,
- Authority for PERAC to debar individuals and firms in certain cases of illegal action or other misconduct.

PERAC's Executive Director Joseph E. Connarton commented on the bill:

While we are disappointed that the bill has not reached the Governor's desk this session, we are not discouraged. On the positive side, we were pleased that we were able to reach an accommodation with MACRS and its representatives on language that all could accept. This development is welcome and we look forward to a continued positive working relationship with MACRS on this and other issues. We clearly understand that the passage of significant reform legislation is not an easy undertaking; yet we hope that the General Court will continue its serious consideration of this bill and the reforms it offers and will pass it as soon as possible.

Mr. Connarton also expressed his thanks to House Public Service Chairman Jay Kaufman and Senate Public Service Chairs Benjamin Downing and Anthony Galluccio, Chairman Paul Donato of Steering and

Policy, and Chairman Robert DeLeo of House Ways and Means for their consideration of H. 4011 this session.

OTHER MAJOR ITEMS OF INTEREST:

COLA INCREASE VETOED

The General Court, as part of their FY'09 budget, originally passed an increase in the COLA base for State employees and Teachers to \$16,000 and extended the funding schedule to 2026 from the previous 2023. The Governor sent back that proposal with a recommendation that the increase in the base be limited only to those with pensions of less than \$40,000. The General Court rejected that amendment, but passed a version (H. 4959) that would limit the increases to persons receiving an annual retirement allowance, pension, or annuity of less than \$40,000 for only FY'09 -- after which the increased base would be available to all members of the State Employee and Teachers systems and the Boston teachers (who were added). The extension of the funding schedule to 2026 was also sent back to the Governor. However, on August 8, 2008, the Governor returned H. 4959 to the Legislature unsigned (i.e. vetoed it) and since the Legislature had recessed their formal session for the year, it is unlikely that an override of this veto will occur during the remainder of the session.

BUYBACK INTEREST CHANGES

The General Court also passed changes to Chapter 32 that would change certain buyback interest situations. In some buyback cases, the buyback interest rate replaced the regular interest rate and in one other case, it replaced the assumed actuarial interest rate. PERAC has informed the boards of these changes in Memorandum #28 of 2008.

PERAC AUDIT FOLLOW-UP LETTERS NOW BEING POSTED ON WEB

The audit follow-up letters issued by PERAC six months after the completion of certain audits are now being posted on the PERAC Web page (www.mass.gov/perac). Several years ago, in accordance with the State Auditor's recommendations to PERAC, a process was instituted to return to retirement systems whose audits reflected significant findings and to document their current status. This process was initiated to better monitor the board's efforts to institute changes suggested by PERAC auditors for the improvement of the administration and record keeping of the system.

These follow-up letters can be found with the original audit report under the "Board Profile" section and under "Audit Unit/Audit Reports" section. Posting of these documents began with letters issued after January 1, 2008.

By James Lamenzo
Actuary

Two charts from the January 1, 2008 Commonwealth actuarial valuation report are presented on this page. The bar chart shows the unfunded actuarial liability (UAL) since 1990. The UAL represents the actuarial accrued liability less the value of plan assets. As of January 1, 2008, the actuarial liability was \$56.6 billion and the actuarial value of plan assets was \$44.5 billion. The difference of \$12.1 billion is the UAL, which represents a \$1.2 billion reduction from the 2007 valuation. When there is no UAL, the system is said to be fully funded.

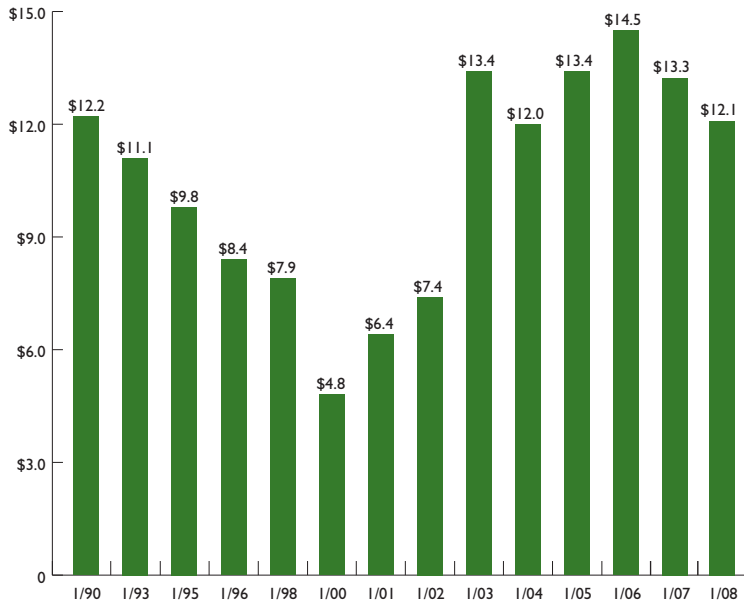
It is important to note that plan assets have grown much faster than plan liabilities since 1990. As of January 1, 1990, the actuarial accrued liability was approximately \$20.0 billion and assets \$7.8 billion resulting in a \$12.2 billion UAL. Since 1990, the actuarial liability has grown by 2.8 times while assets have grown by almost six times. For this reason, the funded ratio represents a better measure of the plan's funded progress. The funded ratio equals the actuarial value of plan assets divided by the actuarial accrued liability. When the funded ratio reaches 100%, a system is fully funded. The funded ratio chart shows the significant progress made by the Commonwealth in the past 18 years.

COMPOSITE FUNDED RATIO

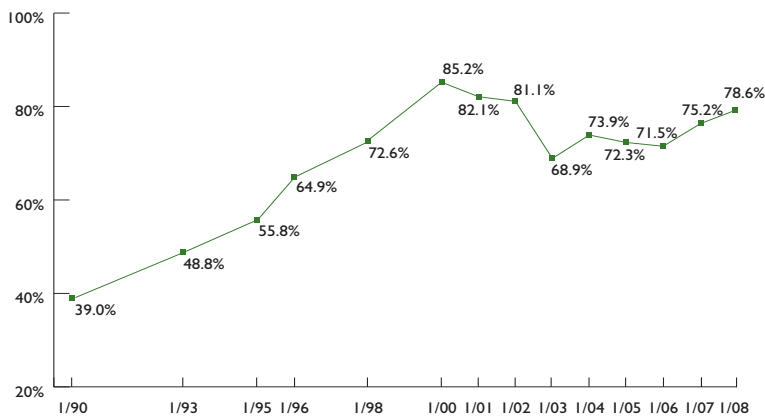
By James Lamenzo
Actuary

In the article above, we show the Commonwealth's funded ratio history since 1990. We have developed a similar exhibit for the local systems. The composite funded ratio is determined by taking the ratio of total local systems assets to the total local actuarial liability. Our graph reflects the composite funded ratio for each year based on the most recent valuation for each system. Since most systems perform valuations every two years, the liabilities and assets for a system for a given valuation are included in the composite for two years. For example, a January 1, 2006 valuation for a system will be reflected in the January 1, 2006 and the January 1, 2007 composite funded ratios. The shape of the composite graph is similar to that of the Commonwealth graph and it shows the significant progress that has been made over the past 18 years by the local systems as a group.

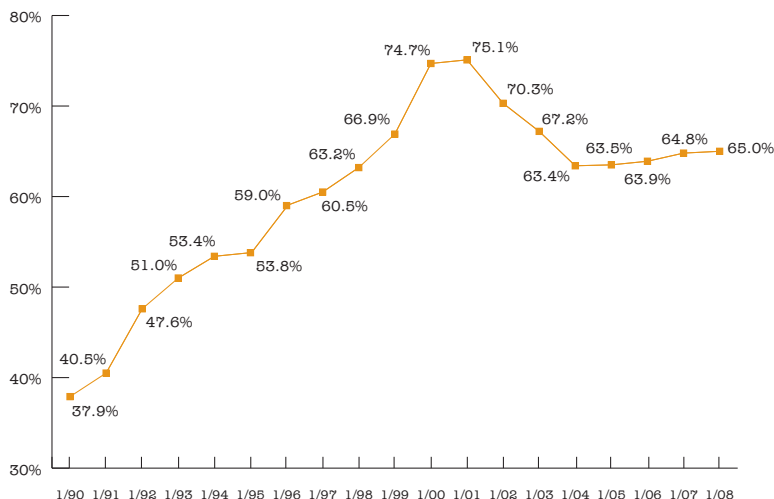
COMMONWEALTH UNFUNDED LIABILITY
(in billions of dollars)



COMMONWEALTH FUNDED RATIO



LOCAL SYSTEMS' COMPOSITE FUNDED RATIO



UPDATED ACCOUNTING MANUAL INTRODUCED AT PERAC EDUCATIONAL INSTITUTE PERAC TO SEEK INPUT FOR FINAL VERSION

*By Frank Valeri
Deputy Director*

A revised version of the PERAC Accounting Manual was presented to the participants at the 2008 Public Pension Institute recently hosted by PERAC at the University of Massachusetts Amherst. The document was included in the packet of educational materials given to those who attended the “Basic Level” curriculum. It was also distributed upon request to other retirement board participants. The accounting manual was originally developed by PERA, our predecessor agency. An attempt to update it last occurred in 1999. Based on the input of the PERAC Audit staff, the Commission determined that an update of this core document was long overdue.

The accounting manual was issued in a loose-leaf binder designed to minimize the effort involved in circulating changes, updates, and revisions as the science of accounting evolves. Future changes will likely involve the insertion or removal of pages, similar to a subscription service.

It is not an easy task to develop an instructional manual applicable to all retirement boards whose demographics, geographics, financial status, and organizational structure vary significantly. In view of the complexities of pension system accounting, the Commission will be conducting a process to gather comments and suggestions about the manual from board members and staff. A presentation about the manual is currently scheduled for the October MACRS conference in Springfield. In addition, this agency intends to hold regional meetings (including the PERAC offices) to accept input on revisions.

Systems should begin to use the accounting manual now. Readers will find that most of the accounting tasks are unchanged. However, some of the new items (described later) will be topics of further discussion and adherence to them will only be required at a later date.

The Capitalization Policy has been designed to address situations where

systems have purchased buildings, office condominiums or similar property for the activities of the system. As required by GASB #34, systems will be required to capitalize the cost associated with the purchase and amortize the asset over time through depreciation. Systems are encouraged to formulate a “capitalization policy” in keeping with their evaluation of the useful life of similar assets owned.

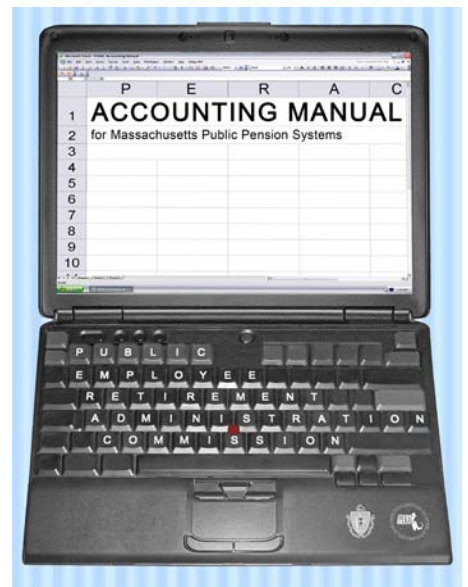
PERAC’s procedure for buyback agreements establishes a protocol for adjusting the value of assets at each year-end for the un-recovered cost of buyback arrangements that include a formal agreement for regular periodic scheduled payments. The proposed process involves utilizing Accounts Receivable with an offset that increases the closing Annuity Savings Fund (ASF) value, but doesn’t add the unfunded balance to anyone’s ASF balance because it hasn’t yet been paid. The adjustment is to be reported as a single cumulative number on the Annual Statement on one line at the end of the ASF supplemental schedule. Statutory interest only accrues on the funded portion of a member’s ASF contributions.

This process is intended to recognize past service cost liability on the balance sheet. Since the financing of public retirement systems has moved from “pay as you go” to a funding schedule mechanism, a methodology to better identify the assets and liabilities of the system under a member’s right to buy back creditable service at a given time is essential.

In addition, it may improve the collection of funds that are due the system, but which are not invested over the course of a member’s tenure. This would enhance internal control. It may also fundamentally change the way members are counseled about their options to purchase prior creditable service. This approach obviously entails a higher level of record keeping and involves the creation of subsidiary records where few exist currently. For all these reasons, it is a very sensitive accounting proposal.

Other changes involve including what

were previously recognized as subsidiary accounts within the actual trial balance. These accounts correspond to the several sources of investment income and the multiple categories of pension benefits paid. This may be accomplished by adding distinctive digits to numbers in the existing chart of accounts. Additional specific general ledger account numbers were assigned



for Workers’ Compensation settlements, hedge fund investments, and professional services.

The goal is to ensure that PERAC’s proposed accounting changes become workable solutions for most retirement systems. If you are interested in commenting, please contact Harry Chadwick, PERAC’s chief auditor, at 617 666-4446, Ext. 924. Everyone is encouraged to read the manual and provide constructive suggestions.

For additional copies of the accounting manual, please contact the PERAC Communications Unit at 617-666-4446, ext. 970.

I would like to thank Deputy Chief Auditor Jim Tivnan and Auditor Jim Ryan for their efforts in drafting the manual and the Communications Unit staff members who provided technical assistance with the layout and design of the document.

The 2008 Institute featured two curriculum tracks: basic and advanced. The basic level curriculum was designed to provide comprehensive education in the fundamentals of pension administration for administrators and members who were brand new or relatively new to the field. Key aspects of public pension administration were explored in a set of eleven classes including: guidelines for board meet-



ings, actuarial concepts and data maintenance, disability retirement, benefit calculations, accounting for retirement boards, budgeting, 91A processing, and the full gamut of membership issues. The advanced level curriculum was designed to meet the need of more experienced board members and administrators with a concentration on important discretionary functions. In this set of thirteen classes, participants reviewed what has changed in Massachusetts & federal retirement law since 2002; enhanced their coping skills for the investment markets; considered internal controls and gained a deeper appreciation for the risks faced by every retirement system. Actuarial concepts were revisited with a walk-through of a valuation report. A Section 15 forfeiture mock hearing was presented with a focus on the board responsibilities that can come into play when a public employee has been charged with a crime. The Pension Protection Act of 2006 was discussed and IRS Determination Letters were reviewed. With the assistance of several retirement board members and administrators, various mock audit exit conference scenarios were presented.

PERAC distributed more than 40 different documents to conference participants. The documents included 16 different slide show handouts, book-

lets of assorted styles and formats, forms in folios and on a CD, and two newly updated lengthy manuals: the Accounting Manual for Massachusetts Public Pension Systems, and Disability Retirement: PERAC's Complete Guide to the Process.

It is the Commission's hope that these documents, which have also been posted on PERAC's Web site (mass.gov/PERAC) and distributed to those retirement boards that were not represented at UMass Amherst, will serve as helpful reference materials for retirement board members and employees.

The 2008 Public Pension Institute marked the first time PERAC presented exemplary operations awards to select public retirement boards. PERAC Executive Director Joseph E. Connarton presented certificates of achievement to boards that had no audit findings in audits issued by PERAC between January 1, 2007 and August 8, 2008. These boards include Andover, Arlington, Clinton, Concord, Danvers, Fitchburg, Framingham, Gardner, Gloucester, Greenfield, Leominster, Marlborough, Massachusetts Turnpike, Methuen, Milford, Northbridge, Reading, Shrewsbury, Southbridge, Wakefield, Weymouth, and Worcester. These awards will be issued on an ongoing basis for audits published after August 8, 2008.

PERAC dedicated many staff members' time for the better part of a year to the development of the curriculum and presentation materials. This effort was well rewarded when retirement board attendance exceeded the Commission's projections. The strong turnout clearly demonstrated that retirement board members and administrators share the agency's strong commitment to the development of pension administration expertise.

The evaluations completed by 62 retirement board participants were generally very positive. The topics were generally found to be very relevant or relevant; the quality of the majority of the presentations was

judged to be excellent or good, and the overall quality of the written materials received high marks.

A representative sampling of the evaluations includes the following comments, "Well done. High marks overall... Overall this was a great idea. It gave me the tools to work better.... Kudos for a job well done.... Great job. Well planned & informative... I think the conference is an excellent resource for learning and networking... I got some great suggestions to bring back to my board... Very straight forward. Dry material covered well... Jam packed with info and they... they made it interesting and in some cases funny....



I am so happy I came, as usual very educational and a good price... a credit to all...Our system [will] benefit from this...It can only help with the relationship between boards and PERAC."

Executive Director Joseph E. Connarton noted, "We were most gratified by the turnout and by the enthusiastic response from the retirement boards. The classes were well attended and the participants were fully engaged. The give and take that went on in the classes was terrific. UMass Amherst Conference Services team provided excellent support and contributed greatly to the success of the Institute. As an organization, PERAC was committed to providing an educational experience that would merit the time and attention of the dedicated men and women who are the members and administrators of the Massachusetts public pension systems. We believe we met that goal and look forward to hosting additional events in the future."

the epic month of September, when capitalism as we've known it changed forever.

First, concerns over the solvency of the mammoth government-sponsored mortgage agencies Fannie Mae and Freddie Mac led to a surprising and costly federal takeover of these agencies on September 8. Then, Black Monday on September 15 saw the stock market have its worst day since immediately after September 11, 2001, as Lehman Brothers declared bankruptcy, Merrill Lynch was forced to sell itself to Bank of America, and AIG, one of the world's largest insurers, teetered on the brink of insolvency (largely due to their straying from their basic insurance business into massive trading of derivative instruments) before the Fed engineered an \$85 billion bailout. Even seemingly safe money market funds were not immune from credit losses. As the turbulent, historic month neared an end, the era of large, lightly regulated investment banks came to an end as Goldman Sachs and Morgan Stanley became bank holding companies (giving them greater access to Federal Reserve credit), the seizure of Washington Mutual represented the largest bank failure in US history, and Wachovia, the nation's fourth largest bank, sold its banking operations to Citigroup, the largest. After a week of tense and politically charged negotiations, Congressional leaders agreed on an historic plan for a bailout fund that would acquire about \$700 billion of troubled, illiquid loans from financial institutions in hopes that the restored capital bases of the participating institutions would help them to begin borrowing and lending at reasonable terms once again. When election-year politics and taxpayer opposition led to the House's unexpected defeat of this proposal on September 29, the stock market plummeted with the largest one day point drop ever and the largest percentage drop (the Dow off 7%, the S&P 500 off 9%) since the 1987 Crash. As the Administration, Treasury, and Congress went back to the drawing board amid serious concerns about the crisis' effect on the economy, it was no surprise that a widely followed measure of the market's volatility, sometimes referred to as the "fear index", reached its highest level in 28 years.

The full story of what happened and what

is unfolding is, of course, exceedingly complex but the most basic origins of the crisis may be relatively simple to comprehend. In ideal markets, greed (grasping for extraordinary profits) and fear (aversion to risk) offset each other, but for several years earlier this decade, circumstances were ripe for greed to dominate.

In a widely held view, the seeds of the current crisis were sown in the aftermath of September 11, 2001, when the Federal Reserve pumped so much money into the system that it distorted the financial incentives for decision-making for everyone involved in the system. Money was so plentiful that banks and other financial intermediaries had more incentive to lend than borrowers had to borrow. As the normal factors of supply and demand were transformed, the lenders began taking on more and more risk for less return. Thus began the surge in subprime mortgages and similar products where traditional income and asset-based credit standards for borrowers were lowered to virtually nothing. With encouragement from Congress and others in government, subprime loans went from being 2% of the mortgage market in 2002 to about 30% in 2006. With loan syndication and Wall Street's increasingly lucrative business of securitization, the incentives to lend increased even further since many of the new loans would not stay on the lenders' books for long. With lenders desperate for business and real short-term rates so low that they were essentially negative, borrowers of all types had great incentive to borrow even if they didn't really need the money. The market for the esoteric mortgage-related instruments created by Wall Street was facilitated by absurdly high ratings give to them by the major rating agencies, whose revenues derive from fees paid by the borrowers whom they rate. With interest rates low, money plentiful, and profits from trading mortgage-related instruments high, firms like Lehman Brothers employed leverage to the extent that borrowings were over 30 times the size of its capital. As long as housing prices kept rising and the economy was robust, the system was working well for everyone. Hardly anyone worried about all the loans being made to borrowers who shouldn't have been borrowing.

But, as always happens, equilibrium and rationality began to gradually return to the markets. By the spring of 2007, housing prices began to weaken and concerns began to be raised about rising delinquencies among subprime borrowers. The financial system began to show cracks and, after months of increasingly shocking developments and hundreds of billions in losses from shaky loans, the system was essentially broken by the fall of 2008. Banks that had been granting mortgages to applicants without regard to income or assets were now wary of lending, even overnight, to other banks. As it became apparent that the capital bases of many major lending institutions were insufficient to weather a period of falling asset prices, the viability of these institutions began to be questioned. For a while, sovereign wealth funds and private equity funds made sizeable investments in some troubled US institutions, but these sources dried up as it became apparent that these companies' downward spirals were continuing. The downgrading of the bond insurers resulting from their ill-fated foray into structured finance (much of it in mortgage-related instruments) led to further write-downs on the balance sheets of large banks and brokers with large holdings of insured CDOs. While easy money and lax regulation had allowed greed to dominate for several years, fear was now firmly in control. With major US stock indexes having declined 19% this year through September 30 and housing prices continuing to fall nationwide, there was increasing concern over the ramifications for the economy. With so many of our major financial institutions in need of new capital, much of it expected to come from foreign sources, the US itself seemed at risk of becoming the world's largest subprime borrower. The face of Wall Street has changed forever as has the very nature of capitalism in our country. Whatever the final shape and fate of the government's rescue plan, the worst may not be over. At a huge price, we've painfully learned what subprime mortgages are and, in the process, have realized the folly of neglecting the basic principles of risk and return in the financial markets.