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TRANSCRIPT

Testimony before the Joint Committee on Public Service of the General Court of the Commonwealth of Massachusetts Regarding the Fiscal Condition of Local Retirement Systems

by Iliya Atanasov

Thank you, Chairman Brownsberger, Chairman Michlewitz and Committee members, for the opportunity to speak before you today. My name is Iliya Atanasov and I am senior fellow on finance at Pioneer Institute.

The subject of this meeting – defined-benefit pensions and other postemployment benefits for public employees in Massachusetts – will cast a growing shadow on the fiscal health of the commonwealth for the foreseeable future.

The main risks associated with maintaining retirement systems are related to salary or healthcare-cost growth and investment returns. Under further scrutiny, these concerns translate into lack of fiscal discipline and poor management processes in the retirement system.

The general outlook for the coming years is bleak. Repeated revisions of funding schedules will be needed to increase payments and/or extend funding deadlines further into the future. This expectation is driven by several concomitant trends in federal and state policy:

1. Assumed rates of return (ARRs) on pension-fund assets are being lowered from their pre-crisis highs. The Public Employee Retirement Administration Commission (PERAC) has been steering pension systems towards a gradual reduction of the return assumptions they use to value their obligations. We expect these assumed rates of return to reach an asset-weighted average of 7.5% by 2018, down from about 8% in 2012.

Iliya Atanasov is Pioneer's Senior Fellow on Finance, leading the research tracks on pension portfolio management, infrastructure and municipal performance. Iliya is a PhD candidate in Political Science and Government and MA candidate in Statistics as well as a former Presidential Fellow at Rice University. He also holds BAs in Business Administration, Economics and Political Science/International Relations from the American University in Bulgaria.

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2. Governmental Accounting Standards Board (GASB) Statements 68 and 71 come into force beginning in fiscal 2015. Under the new rules, unfunded liabilities will be discounted using a much lower government-bond rate than the assumed rate of return on a plan's assets. Thus, the average discount rate for pension liabilities may be substantially below the ARR. This impact will be disproportionately stronger with systems that are less funded, which have higher current return assumptions and whose liabilities are of the greatest duration. The systems in the worst financial condition will be the worst-affected by the new accounting rules.

3. Bond yields and, consequently, discount rates under the new rules will remain low for the next five to seven years. The Federal Reserve's forward guidance and current yields on bond futures suggest that the zero interest rate policy will likely continue through mid-2016; a more normal yield of at least 2% on the short end of the curve can be expected around fiscal 2019. Thus, the lower bound on the discount rates will rise by little and only too slowly after the initial shock of GASB 68 implementation.

4. Accommodative monetary policy has helped paper over many of the structural problems that preceded the financial crisis; because the excess debt was not restructured, the next recession is likely to be severe. We do not expect recessionary conditions to return before 2017, but the extended period of smooth sailing in the US economy is usually predictive of more severe and longer downturns with more precipitous market drops.

5. Little is being done to advance-fund OPEB.

Taken together, these five major policy concerns militate forcefully against a sustainable decline in the size of unfunded liabilities for retiree healthcare and pensions. For most systems, especially the worst funded ones, required contributions can be expected to jump within the next three fiscal years considerably above the levels budgeted in current funding schedules. Many systems will not be able to withstand any subsequent economic shock leading to a substantial decline in asset prices.

We consider the following retirement systems to be in critical condition based on the most recent data made available by PERAC:

Springfield
Everett
Lawrence
New Bedford
Fitchburg
Hull
Middlesex County
Gloucester
Worcester County

Systems whose condition is severely impaired include:

Lynn
Fall River
Swampscott
Pittsfield
Methuen
Quincy
Arlington
Peabody
Athol
Hampden County
Southbridge
Haverhill
Andover
Webster
Amesbury
Salem

Without changes in current policy, we can expect that about a dozen of these communities will go through bankruptcy in the period 2017-2023.

This is, in part, because the current legal framework for public-employee retirement benefits provides local communities little control over their obligations. They can reduce meaningfully the cost of the benefits only through reductions in payroll (by salary or employment cuts) or by much more aggressive funding of the accrued liabilities. Both of these are rather blunt instruments which are largely out of reach, particularly for the systems in the worst condition.

This panel may consider certain measures which will have an immediate albeit limited effect on the cost of retirement benefits:

A. Cap annual cost-of-living adjustments (COLAs) by the rate of inflation using a benchmark such as the consumer price index (CPI). Currently, systems can adopt an arbitrary percentage up to the 3% annual bump allowed by law.

B. Prohibit systems funded under 80% from providing COLAs.

C. Segregate the accounts of individual communities in the pooled county systems and devolve decisions on local options to the communities' legislative bodies rather than the advisory boards of the county retirement systems.

D. Require that OPEB be funded under the same general framework as public pensions are and, to the extent possible, use the existing institutions to manage those funds.

E. Require communities to map out not only their schedules for pension payments, but also cash flows for OPEB and outstanding debt at least biennially. Making this information publicly available is indispensable in deciding between funding retirement obligations and spending on government services.

F. Allow further regionalization to achieve administrative efficiencies. Towns and cities can be allowed to form larger systems by ballot initiative or a majority vote of their legislative bodies. The assets in such systems ought to be maintained in separate accounts, with decisions over local options being reserved for the individual member communities.

G. Create further restrictions on double-dipping. For example, income from continued employment after retirement can be subtracted from the overall benefit.

These measures will likely be insufficient to make the systems sustainable in the long run, but they are an important first step towards improving their fiscal condition for the time being. A longer list of necessary improvements in the transparency, governance, risk management and cost controls of retirement systems in the commonwealth is attached as an appendix to these remarks.

Thank you.

Appendix. Possible Avenues for Further Improvement of the Condition of Local Retirement Systems in Massachusetts

Risk Management

- Authorize PRIT to handle hedge option positions for participating systems to reduce market risk for the underwriting communities. Options are more effective than interest rate swaps for hedging pension liabilities.
- Disallow the issuance of debt to fund retirement liabilities – more leverage increases the risks associated with the pension obligations (interest rate risk on the bonds + market performance of the pension fund's portfolio)
- Refinance local debt before Fed normalization using annuities rather than vanilla bonds, but avoiding underwriting by major investment banks
- Prohibit funds from owning debt issued by public authorities within the state

Administrative and Credit Costs

- Make all systems with assets under $200mn PRIT participants
- Cut costs of investment management by putting a ceiling on fees or pension funds' aggregate expense ratios

Governance

- Make all retirement board contracts publicly available online
- Make PERAC publish boards' annual reports and investment managers' quarterly statements
- Make retirement board members' SFIs public
- Prohibit sealed legal settlements with third-party vendors

Benefits

- Introduce ceiling on maximum benefit using cumulative CPI to adjust
- Compute pensionable salary on entire period of employment rather than just a segment of it
- Prohibit early-retirement programs
- Require reinstated members to sign an affidavit that they will transfer to the retirement schedule coming into force in 2012

PIONEER INSTITUTE
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185 Devonshire Street, Suite 1101, Boston, MA 02110
T: 617.723.2277 | F: 617.723.1880
www.pioneerinstitute.org