



Letter from the EXECUTIVE DIRECTOR

The Commission and its staff are pleased to release this Annual Report on the Massachusetts Public Employee Retirement Systems for 2012 which marked the first year of implementation of the most ambitious set of reforms to our public pension system in history. Chapter 176 revised the benefits available to present and future members of the retirement systems, regulated the interaction between collective bargaining agreements and the pension law and dramatically impacted the corporate governance law applicable to the retirement boards. In 2012 PERAC embarked on the initial stages of a multi-year effort to ensure that new practices were adopted by the public pension community without undue burden. These pages detail the fact that retirement board members have complied with not only the letter but also the spirit of the law. This willingness to greet major change with equanimity and cooperation should make a significant contribution to putting to rest concerns about procurement practices, educational standards, and transparency that have contributed to the clamor for fundamental changes in the very nature of Massachusetts' public pension funds and the benefits available to public employees in the Commonwealth.

Staff Changes

Staff changes took place during the year as PERAC Director of Communications and Education Sarah Kelly retired after thirty four years of state service. Sarah initiated a wide range of programs designed to inform, educate and, at times, entertain the Massachusetts public pension community. Her leadership enabled the recruitment of top notch professionals in the design and drafting of Commission publications, the

development and maintenance of the PERAC Website and the coordination of countless educational sessions. One of her lasting contributions has been the establishment of an unrivaled in-house publication capability that has significantly reduced dependence on contracting with outside sources. In addition Sarah was instrumental in the establishment of PERAC's successful Chapter 176 Education Program as she employed her experience in overseeing and planning PERAC's Annual Emerging Issues Forum and PERAC's Educational Institute at UMass Amherst. Sarah has set a high bar for her successor Natacha Dunker to meet. Natacha recently assumed the role of Director of Communications and Education and has already begun to build on the solid foundation left by Sarah.

As was noted in last years' Report, Barbara Phillips retired after serving as PERAC General Counsel for over twenty-five years. Over the course of the last several months she has been assisting new PERAC General Counsel John Parsons as he transitioned into the position as well as helping as the Commission implemented the reforms of Chapter 176. Recently Barbara decided that the time had come for her to reduce that role. It is impossible to review all of the issues with which she dealt, the wise counsel that she dispensed, and the professional example that she provided. No one has contributed more to the well-being of our retirement systems and the members and beneficiaries of those systems than Barbara.

A third stalwart of PERAC, Barbara Lagorio, also has decided to move on from her post retirement role of assisting the PERAC Disability Unit. Barbara virtually created the PERAC Disability Unit, including a

sophisticated computerized Disability Application Tracking System which ensures smooth functioning of the Medical Panel Process, the Comprehensive Medical Evaluation Process and PERAC's Return to Service Program.

Emerging Issues Forum

In September, 2012, PERAC held its eighth Emerging Issues Forum at the College of the Holy Cross. Three hundred and eleven people participated, the highest number of attendees in the program's history. Retirement board members received three education credits under the educational mandate of Chapter 176. As has become a custom, Lieutenant Governor Tim Murray delivered opening remarks and best wishes from Governor Deval Patrick. This year's focus was sustaining public pensions and post-retirement benefits. Linda Bournival, Consulting Actuary from KMS Actuaries, provided a country-wide and state by state assessment of pension reform and plan design. PERAC Actuary Jim Lamenzo, an annual star at these events, focused on the Massachusetts experience highlighting the major provisions of Chapter 21 of the Acts of 2009, Chapter 131 and Chapter 188 of the Acts of 2010 and Chapter 176 of the Acts of 2011. The former receiver of financially troubled Central Falls Rhode Island, Judge Robert Flanders detailed his experience in leading that city through the Chapter 9 bankruptcy process. As a result the city was able to eliminate a \$6 million structural deficit. Rosemary Booth Gallogly, Director of Revenue for the State of Rhode Island, made a presentation on the RI Study Commission on Locally Administered Plans. She noted that in the Central Falls collapse retiree pensions were cut by 55%.

Henry Dormitzer, Chair of the Special Commission on Retiree Healthcare and other Non-Pension Benefits brought the audience up to date on the OPEB's Commission's work. This session was particularly prescient as recently Governor Patrick has submitted legislation based on the Commission's efforts. Comptroller of the Commonwealth Marty Benison brought an accounting perspective to the issues of OPEB liabilities and GASB reporting requirements. In addition he outlined the details of the recently issued GASB pension reporting rules. Continuing on the health care theme, Bob Johnson, retired Deputy Director and Chief Operating Officer of the Group Insurance Commission, talked about the Commission's history and its expanding role in the administration of health care benefits for local employees and retirees. The concluding address was made by Treasurer and Receiver General Steven Grossman. Treasurer Grossman spoke about the challenges and achievements of the Pension Reserves Investment Management Board and reaffirmed his steadfast commitment to a defined benefit plan and fulfillment of the Commonwealth's pension obligations to its public employees.

Section 23B

Chapter 176 inserted Section 23B into Chapter 32 and throughout 2012 and into 2013 the Commission has been conducting analysis, disseminating memoranda and responding to questions in an effort to assist retirement boards and vendors. One of the major challenges raised by Section 23B has been the application of its provisions to investment allocations, products and complex legal structures that often are an integral part of alternative investment. PERAC issued Memorandum #51/2012 which contained specific recommendations as to how the contract term, indemnification, disclosure and fiduciary duty aspects of Section 23B could be met in the context of limited partnerships and similar entities.

The Commission also provided guidance through memoranda that outlined the impact of Chapter 176 on PERAC Investment Regulations. This action, in conjunction with the advisory mentioned above, has enabled a generally seamless transition to investing assets under the new law.

One element of Section 23B which we are presently dealing with is the requirement that vendors annually disclose payments made or received and conflicts of interest to the retirement boards and PERAC. We are reviewing and following up on submissions received to date. Already significant information has been gleaned from these filings including the use of sub-advisors, payments through the designation of a party as a "special limited partner" and the obtaining of services through "soft dollars".

Enforcement

In the spring of 2012 PERAC Auditors uncovered serious irregularities at the Maynard Retirement Board centering on the activities of Executive Director Timothy McDaid. The Commission immediately notified the Maynard Retirement Board which removed McDaid. An investigation was commenced by the Middlesex District Attorney who, with PERAC's assistance, ultimately developed sufficient evidence for an indictment. Recently McDaid pleaded guilty to charges of larceny over \$250, uttering a false check and forgery in connection with the theft uncovered by the PERAC Auditors.

In the interim the Commission acted to prohibit McDaid from serving a retirement board in any capacity based on a previous conviction for financial crime.

During this period the Commission also issued a Temporary Order assigning Deputy Chief Auditor James Tivnan and Compliance Counsel Derek Moitoso to monitor the Maynard Retirement System and ensure its smooth functioning.

Legal Issues

Two legal matters that drew considerable attention during 2012 were the application of the new Anti-Spiking provisions of Chapter 176 and the regular compensation status of payments made in lieu of taking vacation leave. Due to the nature of the anti-spiking statute, PERAC's Legal and Actuarial Unit worked tirelessly and ultimately produced an eight page memorandum that not only reviewed the legal framework but also set forth several examples as to how the statute works in practice. The Commission grappled for several meetings with the regular compensation status of vacation buy-back payments. Ultimately the Commission decided that such payments could be classified by the retirement board as regular compensation if that conclusion was reached after a careful analysis.

Waivers of Filing Requirement for 91A Filings Successful

Legislation proposed by PERAC and adopted as part of Chapter 176 authorized the Commission to waive the Annual Statement of Earned Income filing requirement for certain disabled retirees. After assessing the earnings history of all disabled retirees (a number that exceeded 15,000) PERAC issued over 2,200 waivers for the 2012 filing season to retirees who had been retired for twenty years and had reported no earnings in the last ten years. Over 2,100 of that number returned affidavits certifying that PERAC will be notified of any future change in

earnings status and these members are no longer required to file an Annual Statement of Earned Income. This represents a reduction of close to 14% in the number of disabled retirees required to file these statements.

Chapter 176 Impact on Members Taking a Refund

We would like to take this opportunity to once again remind retirement boards that the benefit changes in Chapter 176 can impact existing members in one particular scenario. Retirement boards must make sure that those who were members on or before April 2, 2012 are aware of the ramifications of taking a refund of retirement contributions in the event they leave service. Such an action will terminate membership in the system and if he or she later returns to service having taken such a refund, that individual will be considered a new employee and will be subject to the post-April 2, 2012 benefit structure. Benefit changes will include a new age factor table requiring a longer work period before achieving the same or similar benefit available to pre-April 2 members; an increase in the period for determining regular compensation from three to five years; and an increase in the minimum retirement age.

Statement of Financial Interests Filing

In accordance with Chapter 176 retirement board members are required to file Statements of Financial Interests by May 1st of each year. These submissions are not subject to release pursuant to the public records law. I would like to commend the retirement board members for their willingness to meet the requirements of the new law.

The Commission has in place Security Protocols to ensure that the information remains confidential. The staff at PERAC with access to the filings is strictly limited. Initially only the Compliance Officer and Compliance Counsel have access. In the event that an issue arises regarding compliance, the General Counsel and Executive Director as well as the Commission, in certain circumstances, will also be able to review a filing. If a Commissioner wishes to access a filing in the absence of those circumstances he or she must notify the Chair and may review the information in the presence of the Compliance Officer or Compliance Counsel. In the event that a Commissioner does so or if the Commission does so in the circumstances described above the retirement board member will be notified. Statements will not be copied or scanned electronically with the exception that a copy may be made in order to provide the retirement board member with a date stamped receipt.

The Compliance Review takes place in several stages and retirement board members are provided ample opportunity to establish that compliance with the statute has taken place or to bring the submission into compliance if necessary.

The 2011 filing season was completed with nearly 100% of retirement board members submitting Statements of Financial Interests. Only one board member was removed from office for failing to file. The 2012 filing season is in full swing and PERAC's Compliance Officer, Tom O'Donnell and Compliance Counsel Derek Moitoso are in the midst of reviewing submissions. The Statement of Financial Interests was modified for 2012 in an effort to simplify and streamline the process. Thus far we have experienced a high rate of compliance.

Again, I would like to express the thanks of the Commission to retirement board members whose cooperation and commitment have enabled the implementation of this mandate to proceed smoothly.

Education Update

2012 marked the first year of mandatory training for retirement board members. Chapter 176 required that during each member's term on the retirement board, the member must complete 18 hours of training. As of March 1, 2013 over 96% of retirement board members are in compliance with educational requirements. We are now proceeding with the 2013 schedule of educational events.

Educational sessions have been held from the Berkshires to Cape Cod. In the first year and a half of the program hardly a month has gone by in which no offering was available to retirement board members. Events have been held in the evening in an effort to accommodate busy schedules. A key element has been the cooperation between MACRS and PERAC in providing a stimulating and diverse program of presentations at the Spring and Fall MACRS Conferences. In 2012 topics at these Conferences included Securities Litigation, Section 15 Forfeiture, benefit calculations, actuarial valuations, Anti-Spiking, the Legislative Process, Pension Board Governance, and Legal Issues. At the Spring 2013 Conference credit will be given for participation in a pre-conference two day new trustees program as well as for sessions during the main conference.

PERAC has also conducted numerous training events throughout the state concerning Annual Statements, Disability, Audits/Earnings Reports, Pre/Post Chapter 176 Benefit Structure, Actuarial Basics and Funding Strategies, Financial Controls for Retirement Systems, and Review of Vendor Disclosures/Competitive Process. Credit has also been granted for attending PERAC's Annual Emerging Issues Forum.

In 2013 PERAC has expanded its efforts to enable retirement board members to obtain credit by completing on-line courses. We now grant credit for the State Ethics Commission On-Line Conflict of Interest Law Training, the Office of the Inspector General's Bidding Basics Course and the Office of the Attorney General's Open Meeting Law Course. These steps have facilitated the ability of retirement board members to comply with the education requirement

PERAC has also authorized credit for participation in programs sponsored by other organizations. Those attending the National Conference on Public Employee Retirement Systems (NCPERS) Trustee Educational Seminar, the NCPERS Program for Advanced Trustee Studies, the National Council on Teacher Retirement (NCTR), International Foundation of Employee Benefit Plans (IFB) New Trustees Institute/Advanced Trustees Institute and the PRIM Investors' Conference will receive credit.

Actuarial Reminders

PERAC has noted for several years that both nationally and locally our defined benefit plan has been under attack. Frequently those challenging the existing structure are ill-informed and, sometimes ill-intentioned. This Annual Report is a convenient forum to remind everyone dependent on or impacted by our pension plan of a few simple facts.

Employee/Employer Share of the Chapter 32 Retirement Benefit

The basic question is whether an employee's contributions accumulated with expected investment earnings over the working career are sufficient to pay the calculated retirement benefit for the remainder of the retiree's lifetime. In other words is the accumulated value of an employee's contributions at retirement age greater than the present value of the future retirement payments?

A measure of the general principle is as follows: If an employee is in Group 1, is hired after 7/1/96, and serves for over 20 years, the employee pays most, if not all of his or her superannuation retirement benefit provided that the plan's investment return assumption is met.

The employee share of the benefit varies depending on age, service, age at hire, age at retirement and pay. However, if all of the above criteria are met, many of these employees are paying more than 100% of the benefit. Due to the benefit reductions in Chapter 176 a Group 1 member hired after April 1, 2012 who meets the above criteria will likely contribute over 100% of his/her superannuation benefit.

Investment Return Assumption

The investment return assumption is the most commonly discussed pension plan actuarial assumption.

For over 15 years, the "standard" PERAC investment return assumption (assuming a reasonable investment allocation) has been 8.0%. For those of you who can recall the go-go investment returns of the 1990's, during that period the argument was made that this assumption should be increased because of the excellent returns achieved by the systems. PERAC resisted pressure to make such an increase. Over the course of the last several years the reverse has been true as pressure has been applied to reduce the investment assumption based on recent returns. We have been ahead of the curve as five to ten years ago we concluded that an 8.5% assumption was too high. More recently PERAC went further and indicated we believe that 8.25% is too high. We will be considering reducing the 8.0% assumption to 7.75% in 2013 actuarial valuations.

The record reflects the Commission's foresight. In 2003, about half of the systems used an investment return assumption above 8.0%. Today there are only 12 such systems and none use an assumption above 8.25%. In 2003 only 3 systems used an investment return assumption below 8.0%. Currently there are 25 such systems.

While the investment return assumption gets all the press, the salary increase assumption also makes a significant contribution to a plan's liabilities. PERAC's existing standard salary increase assumptions are somewhat conservative. Over the longer term, the investment return and salary increase assumptions should move in tandem as both have an inflation component. Fifteen-to-twenty years ago, PERAC required that the spread between these two assumptions be no more than 2.0%. It is important to note that the impact of a reduction in the investment return assumption may be partially (or fully) offset by a reduction in the salary increase assumption.

The current salary increase assumptions are based on job group and service. The rates of increase are the highest in the earliest years of employment and grade down to an ultimate rate (for example, 4.75% for Group 1 members in local systems). Again, since our salary assumption has not been adjusted to the experience of the past 3 to 5 years, recent actuarial valuations have produced conservative results. PERAC is wrapping up an Experience Study for the State Retirement System and the Teachers' Retirement System which will determine a revised salary assumption.

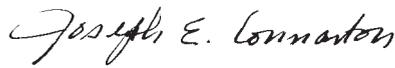
Actuarial assumptions are designed as a package. Focusing solely on the investment return assumption is counterproductive. Other assumptions (namely the salary increase assumption) also make a significant contribution in determining plan liabilities.

Conclusion

It is time now for all those involved in the Massachusetts public pension community to take a deep breath and assess recent history. After the devastating collapse of the capital markets, the ensuing slow down of the economy and the nearly annual statutory changes in our pension law we can safely say that none of us ever before experienced such challenges. Although, perhaps Chapter 176 had the most dramatic impact, other developments may, in the long run, have a greater role in the survival of the defined benefit system in Massachusetts. Foremost among these has been the steady progress made in overcoming the fiscal strain created by the failure of the capital markets in 2008 and the choppy economic recovery since then. Retirement boards have balanced the need to ensure that liabilities

are addressed over time with the recognition that state and local budgets must meet a variety of needs. All systems are meeting responsible funding schedules tailored to the specific circumstances of the governmental units involved. As the investment results detailed in this report underscore, the returns achieved by Massachusetts' funds remain competitive with those of other pension investors nationwide. Long-range returns support the conclusion that retirement boards have responsibly managed system assets. Finally, retirement board members have once again displayed their dedication and professionalism in complying cooperatively and enthusiastically with Chapter 176. For that response, as well as their day-to-day, year in and year out efforts on behalf of system members, beneficiaries and taxpayers, I offer the Commission's heartfelt thanks.

Sincerely,



Joseph E. Connarton
Executive Director