COMMISSION ON PUERTO RICO GOVERNMENT PENSION SYSTEMS REFORM
GOVERNMENT OF PUERTO RICO

October 21, 2010

Hon. Luis G. Fortuño
Governor
Government of Puerto Rico
La Fortaleza
San Juan, PR

Re: Report of Commission on Puerto Rico Government Pension Systems Reform

Dear Governor Fortuño:

In response to your Executive Order #OE-2010-10 of March 12, 2010, we are pleased to submit for your consideration our report on the work of the Governor's Commission on Puerto Rico Government Pension Systems Reform ("the Commission"). We wish to acknowledge the contributions and the efforts of all the Commission's members. They each offered their opinion and provided recommendations on ways to improve the financial condition of the Government Employees, Teachers and Judiciary Retirement Systems.

Introduction

The Puerto Rico Retirement Systems are currently facing a $24 billion dollar funding gap and are expected to reach insolvency within the next 8 to 10 years. This critical situation can be directly attributed to historically inadequate employer and employee contributions and the enactment of benefit arrangements that were not funded.

Puerto Rico is not alone. A convergence of factors is prompting states to reform public sector retirement systems. Historically, retirement benefits have been an important tool for state governments to attract and retain its workforce. But in the last decade, dwindling state and local government revenues have placed extraordinary stress on public retirement funds across the United States, including Puerto Rico. Now the bill is coming due and states have to pay up for benefits promised to its retired employees and the funds are just not there. It has become an increasingly crucial issue affecting the states' fiscal health and economic competitiveness.

The events that have taken place during the last decade have magnified the funding issues facing public retirement funds. As a result, some states have made broad changes to their benefit design. The goal has been to adjust current benefits to improve the financial solvency of the pension plan and enhance the credit rating of the state. Some of the changes that have been implemented are:

- ✓ An increase in employee contribution
- ✓ An increase in employer contribution
- ✓ An extension of the period over which salary is calculated for the purpose of determining retirement benefits
- ✓ An increase in the age or service requirement, or both, for eligibility for retirement benefits
- ✓ Anti-spiking provisions to avoid pension calculation abuses
- ✓ Reductions or greater control over post-retirement cost-of-living adjustments, among others

Historically, the Puerto Rico Retirement Systems have been severely underfunded. In the past, policy makers have often ignored the problem. In fact, in the last eight years, the problem was exacerbated by a series of bad, even irresponsible, policy decisions. The current administration has inherited a significant challenge and its living up to its responsibility of tackling this issue, as you have so forcefully recognized.

Against this background, the purpose of this document is to present a general overview of the main public retirement systems in Puerto Rico and to outline the recommendations from Commission members on how to deal with the problem.

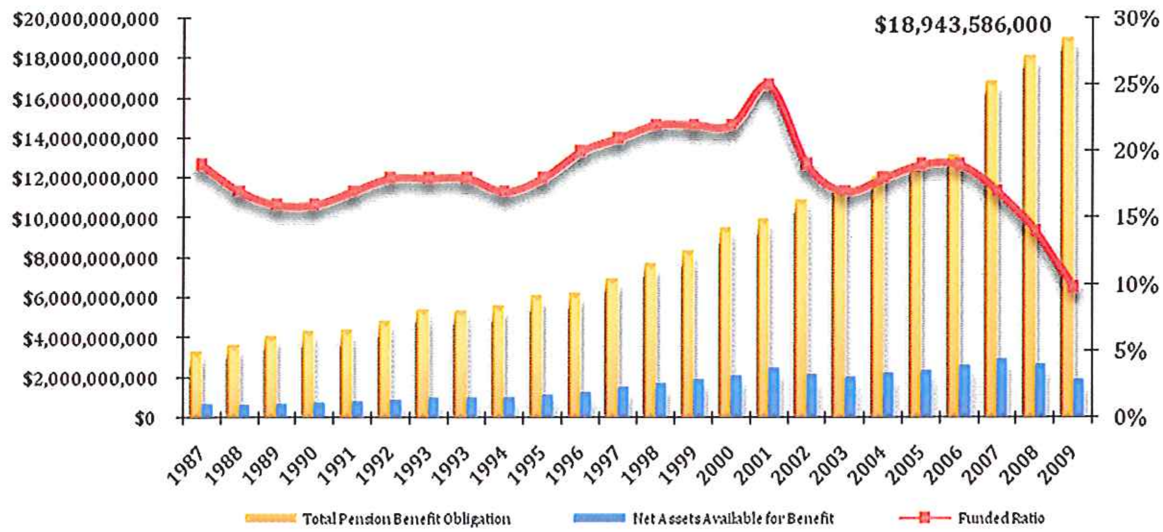
Puerto Rico Government Retirement Systems Overview

The public employees of the Government of Puerto Rico and its instrumentalities are covered by five retirement Systems: (1) the Employees Retirement System ("ERS"), (2) the Puerto Rico System of Annuities and Pensions for Teachers ("TRS"), (3) the Commonwealth Judiciary Retirement System ("JRS") (4) the Retirement System of the University of Puerto Rico, and (5) the Employees Retirement System of the Puerto Rico Electric Power Authority.

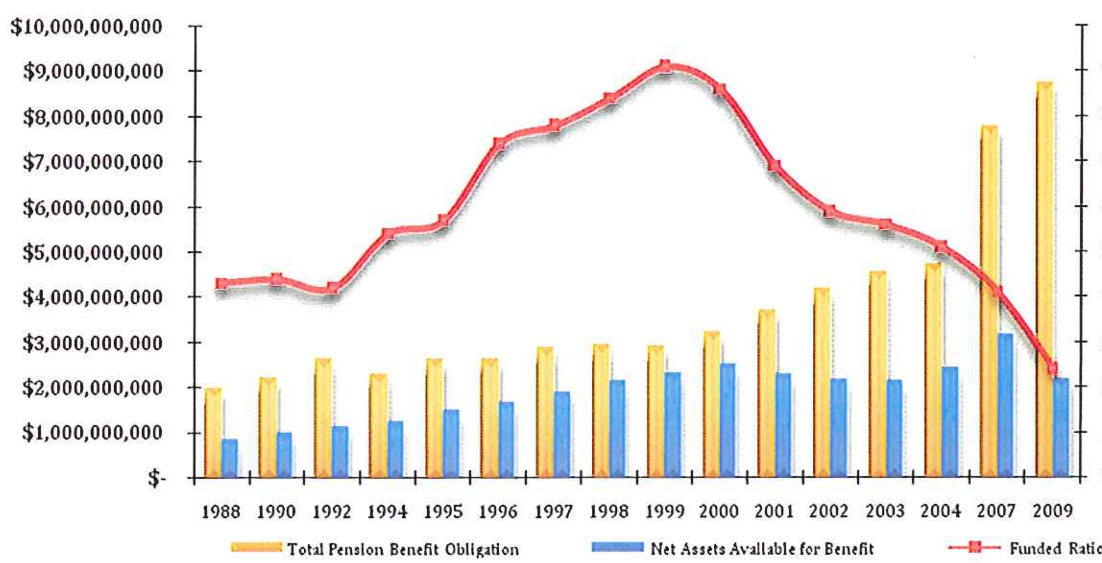
This Commission Report will make recommendations only for the first three retirement systems, collectively referred to hereinafter as "the Systems".

As of June 30, 2010, the total numbers of participants, including active participants and retirees, in the Systems were as follows: ERS, 247,010; TRS, 79,052; and JRS, 759. The three Systems are financed by contributions made by employers and employees and investment income.

According to the most recent actuarial valuation of the ERS, as of June 30, 2009, the total pension benefit obligations of the system were $18.944 billion. The unfunded pension benefit obligations of the ERS as of the same date were $17.092 billion, representing a funding ratio of 9.8%.



For the TRS, as of June 30, 2009, the accrued actuarial liability of the System was $8.722 billion and the value of its assets amounted to $2.158 billion, representing a funding ratio of 24.7%, and the resulting unfunded accrued liability was $6.564 billion.



According to the most recent actuarial valuation of the JRS as of June 30, 2009, the total pension benefit obligations of the system were $324.6 million. The unfunded pension benefit obligations of the JRS as of the same date were $273 million, representing a funding ratio of 15.6%.

Cash Flow Situation

During the last decade benefit payments have consistently exceeded contributions, creating a negative cash flow situation.

Employees Retirement System

A cash shortfall for fiscal year 2004 was covered with a loan received from the Treasury Department. Balances owed to the Treasury Department and other pending working capital needs through fiscal year 2005 were refinanced through a repurchase agreement with a financial institution in an amount of $138 million, collateralized with ERS assets. The cash shortfall for fiscal year 2006 was approximately $70 million. This shortfall was covered with a line of credit provided by a private financial institution and collateralized with ERS assets. The cash shortfall for fiscal year 2007 was covered by the receipt of the proceeds from the sale of the Puerto Rico Telephone Co., stock that Puerto Rico Telephone Authority held for the benefit of the ERS. These proceeds were also used to pay off the balance of the 2005 repurchase agreement and the 2006 line of credit used to cover the respective year's cash shortfalls. For fiscal years 2008, 2009, and 2010 the System was able to cover its annual cash flow needs from various non-recurring sources of income, the sale of investment portfolio assets, and proceeds from the issuance of pension obligation bonds.

Teachers Retirement System

With respect to the TRS, the cash shortfalls for fiscal years 2007, 2008, 2009 and 2010 were $40 million, $75 million, $110 million, and $157 million respectively. Investments were liquidated to cover these shortfalls. For fiscal year 2011, the TRS expects to have a cash shortfall of approximately $185 million.

Factors Contributing to the Actuarial Liability Cash Flow Problem

- ✓ Since the inception of the Systems, the Government of Puerto Rico has never made the full actuarially required contribution (ARC), i.e., it has never funded its Systems according to actuarial requirements.
- ✓ Creation of merit-based pension without a corresponding increase in contributions.
- ✓ The payment of benefits for part-time and non-government work.
- ✓ The number of years considered for the calculation of average salary was lowered from 5 to 3 years.
- ✓ Liberal pension benefit laws approved without the required actuarial analysis and due diligence.
- ✓ Special Laws were approved without the required permanent funding.
- ✓ Actuarial contributions were established though a statutory basis, not an actuarial methodology.
- ✓ Plans have reached a mature stage where less active workers are carrying a bigger load of pensioners. Longer life expectancy has resulted in longer mortality tables.
- ✓ Early retirements programs have proliferated over time.

- ✓ Failure to properly discharge sound fiduciary duties in the governance of the Systems on the part of its Trustees and Administrators has resulted in lack of action on pressing problems.

Establishment of Special Commission for the Reform of the Puerto Rico Retirement Systems

Puerto Rico's two largest pension funds, the ERS and the TRS, are expected to reach insolvency within the next 8 to 10 years when they will have exhausted all of their liquid assets. Thereafter, the Government of Puerto Rico will have to assume the payment of pension benefits over the current employer contributions.

Puerto Rico's pension systems are not alone in this matter; according to recent studies no U.S. state pension system will be sustainable past 2042. According to the studies, Oklahoma and Louisiana could become insolvent as soon as 2017; New Jersey, Connecticut and Illinois could follow suit in 2018.

Puerto Rico could face additional revenue needs by having to fund "a pay as you go" system when its retirement systems run out of liquid assets. Given such scenario, a solution must be identified. It was with this objective that the Commission was created to present viable alternatives to these issues.

Members of the Special Commission for the Retirement System of Puerto Rico

The following is the list of Commission members:

Hon. Miguel Romero, Labor Secretary
Commission Chairman

Roberto Aquino, CPA, President, Retired Government Employees Assoc.
Representing the Retirees

Ángel Febus, Executive Director
Representing the Retirement Systems Permanent Commission

Brian W. Klopp, Labor Economist, AFSCME
Representing the Employees

Aida Díaz de Rodríguez, President, PR Teachers' Association
Representing Teachers

Luis Felipe Navas, Esq.
Representing the Legislature (Senate of Puerto Rico)

Annie Rivera Vicentí, Esq.
Representing the Legislature (House of Representatives of Puerto Rico)

Glenn D. Bowen, FSA, EA
Representing the Employers

William B. (Flick) Fornia, FSA, EA
Representing the Employers

Hon. Sonia I. Vélez Colón, Esq., Courts Administrator
Representing the Judiciary

Manuel Iglesias Beléndez
Executive Director

Potential Pension Reforms to Attain System Solvency

The members of the Commission considered a wide array of measures that could be undertaken to assure the future solvency of the Systems. The following is a list of the most significant alternatives recommended by Commission members:

<u>Benefits Reductions</u>

- ✓ *Increase the Retirement Age to 65 years.*
- ✓ *Eliminate Merit Pensions of 75% of salary.*
- ✓ *Put a cap on pensions: $60,000 for Employees; $36,000 for Teachers*
- ✓ *Prohibit all future early retirement programs that are not actuarially positive to the system.*

<u>Contribution Increases</u>

- ✓ *Increase employer contribution rates by 1% per year for 10 or 15 years.*
- ✓ *Increase employee contribution rates by 0.25% for each 1% contributed by the employer or increase employee contribution rates proportionately to salary scale.*

<u>Post-Employment Benefits Reductions</u>

- ✓ *Eliminate most Special Laws: Christmas bonus, Summer bonus, medicine allowance.*
- ✓ *Compensate minimum pension recipients by a proportionate increase in minimum levels, but dedicate the remaining funds as a special contribution to the plan.*

<u>System Cash Flow Measures</u>

- ✓ *Eliminate personal loans or substantially reduce the maximum amount of loans made.*
- ✓ *Do not allow loan renewals until one year before final maturity, or allow only after two years of payments.*

- ✓ *Create other revenue sources: Special Lottery drawings, special tax on government contractors, etc.*
- ✓ *Make special legislative appropriations yearly from the general fund.*
- ✓ *Establish legislation to disallow late payments by Employers: special collections from CRIM, stiff penalties for late payments.*

Summary of Special Commission Recommendations

The following is a summary of the specific recommendations made by members of the Commission. For purposes of clarity we have grouped them in major topics as follows:

1. Contributions:

In general, all members of the Commission agreed that there has to be an increase in employer contributions. Some members did not assign a specific amount. Some members recommended increasing only the employer contribution while other members recommended increasing both contributions (employer and employee).

Those members with expertise in the actuarial field provided specific numbers that would lead the Systems to barely achieve solvency (in combination with other remedies). They recommended that employer contributions be increased by 1% per year until they reach 21% for ERS in 2021 and 22.5% for TRS in 2024.

The AFSCME representative agreed that there should be increases in employer contributions (but none by employees) until no negative cash flows are experienced. The Permanent Commission representative proposed a smaller increase of 8.275 percentage points and divided it up between employers and employees, using annual increases of 1% per year, until 2013. The Pensioners Association representative suggested overall increases of 4.225 percentage points to be split between employer and employee as well. The Teachers Association representative, on the other hand asked that employers contribute 1% for each 0.25% contributed by teachers until a sound funding level is reached. The Senate representative recommended that increases be legislated, and the House of Representatives representative recommended that employer contributions be based on salary scales.

In terms of employee contributions, the Employers representatives recommended no change; the Senate representative recommended that the cap on contributions be removed so that if employees wish to contribute more they can do so.

The House of Representatives representative suggested a salary-based scale. The Teachers Association representative would recommend an increase only if all of their requests have been met; the Pensioners Association representative recommended a gradual increase up to 10%, and an increase in Coordinated Plans to 6% in the first $550 and to 10% thereafter.

2. *Special Laws*

Special laws have been added from time to time to provide additional benefits to members of the Systems. These laws were enhancements to retiree benefits, but they were never a part of the original design of the retirement plan. The management of the special laws funds has been an administrative burden to the Systems. Half of the commissioners did not submit comments regarding Special Laws. The remaining four commissioners made comments regarding this matter. The House of Representatives representative suggested the elimination of the Summer bonus, and a review of all other Special Laws. The Teachers Association representative suggested that a payment plan be set up to increase collections of Special Laws funds.

The actuaries suggested using part of the Special Law funds to increase the minimum pension. They made a calculation that converted the total sum of those benefits into an increase for those receiving the minimum pension to $6,800 annually. The remaining amount of the funds from the Special Laws should be used to capitalize the Systems.

3. *Benefit Structure*

Most Commissioners agreed that acquired benefits should not be changed for existing retirees. Going forward, most of them agreed that merit pensions should be eliminated. They also agree that some sort of cap should be put on pension benefits and that the five year average salary should be used to calculate the final pension payment, rather than the three year average salary. The Employers representatives tested the impact on the Systems of capping pensions at the suggested levels ($36,000 for Teachers and $60,000 for ERS and JRS employees). They found the impact to be statistically insignificant. The caps would have to be set at much lower levels, closer to the average salaries of $22,000. Both Employers representatives recommended that shifting Law 447 employees into Law 1 type benefits makes sense.

4. *Retirement Age*

Since the ERS was enacted by law in 1951, life expectancy has grown from 58 years of age to 75. Retirement age has not been adjusted to reflect this trend. Around the world, most retirement systems are increasing the age of retirement, as people want to work for a longer period of time. In line with this trend, half of the commissioners thought that the highest benefits should only be paid to those retiring at age 60, rather than at age 55. The Senate representative, the Permanent Commission representative and the Employers representative agreed on this. The remaining commissioners did not comment on retirement age.

5. *Early Retirement Program*

Two members of the Special Commission, the Senate and the Teachers Association representatives, agreed that, for the moment, early retirement programs should be stopped. They understand the drain on resources that these programs create for the Systems. The remaining Commissioners did not comment on this issue.

6. *Mortgage Loans and Personal Loans*

In terms of personal, cultural and mortgage loans, opinions were varied among Commissioners. The actuaries believe that loans should be phased out or totally eliminated, since the loans are not liquid and cannot be quickly converted into cash needed to pay benefits. A couple of other commissioners suggested extending the rollover dates to 18 months (the House of Representatives representative) or 24 months (the Teachers Association representative), from the current 12 months. The Senate representative suggested that rollovers to be done only within one year of maturity, and that they be restricted as much as possible.

It is important to mention that if we compare the Puerto Rico Retirement System to other pension plans, ours is one of the few to offer this type of loan program. Additionally, in Puerto Rico, during the past five years the amount of funds allocated to this type of activity has increased exponentially and has resulted in a reduction of liquid assets of $600 million.

7. *Governance*

Governance is the activity of exercising authority to manage resources. It relates to decisions that define expectations, grant power, or verify performance. Pension plan oversight has always been important, but perhaps never more so than today. More than a few public and private retirement programs are in financial trouble, the regulatory environment is rapidly changing, "breach of duty" lawsuits are on the rise and market volatility is a constant. The consequences of incomplete or poor oversight are far from trivial.

The Senate representative commented that continuous changes to the position of Administrator are not beneficial to the System's long term objectives. The Senate representative also recommended that more members who are participants of the Systems should be included on the Board of Trustees. Others commented on the fact that, in the past, the Board of Trustees did not appear to be governed as rigorously as it should have been.

8. Other Ideas

Other ideas suggested by the several commissioners, which are not specifically related to the main topics expressed above, were the following:

The Teachers Association representative recommended that all schools that are not currently in use should be sold off, and the revenues generated used to fund the TRS. They also recommended that all vacancies be filled, so that more constituents contribute to the System.

The Pensioners Association representative recommended that the ERS be allowed to collect directly from the CRIM for those Municipalities that are in arrears with the ERS. The Permanent Commission representative also supported this idea. The Pensioners Association also recommended that 1% be assigned annually to the ERS from the General Fund to reduce old debt.

The Senate representative recommended assigning 15% of the existing lottery revenues to the Systems. He also recommended imposing a new 1% tax on all government contractors. He proposed to open up the Systems for independent employers to sign up with the Retirement System's programs. He also would like to sell off expropriated properties that currently belong to the government. Revenues would be used to fund the Systems.

The House of Representatives representative recommended that $30 million be assigned annually to the three Systems. She recommended penalizing agencies that do not pay the Systems within a reasonable period of time. She would endorse any legislation that would improve the financial health of the Systems.

The Permanent Commission representative recommended that a special tax of 8% be levied on those retiring at 55 years of age and 30 years of service during the next 3 years.

One of the Employers representatives recommended–although it is currently not a financially feasible alternative--that the Central government should have a plan to be achieve funding of the ARC (Actuarial Required Contribution), thus: $480 million for TRS and $860 million for ERS.

Most commissioners recommended that education for retirement planning should be given on a regular basis to employees.

9. Selected Key comments from Some the Members of the Commission

Aon

"The solution that is most apparent from actuarial reports is for the government to simply fund the actuarially required contribution (ARC). The Commonwealth is under severe financial pressure and paying the full ARC is not viable options. After review of benefit adequacy and competiveness discussed with TRS/ERS and other government officials, we present a package of shared sacrifice: increased contributions and reduced benefits."

AFSCME

"Although currently in use, the Government should not be using System 2000 employee contributions to pay out current retirement benefits. Instead the System 2000 benefits should be held in a separate trust in order to maintain proper system governance."

Puerto Rico Teachers Association

"Once all other previous recommendations have been put into place, the Teachers then will be willing to increase their contributions in a 3:1, three referring to the employer contribution"

Milliman

"While each of these changes is significant in its own right, on an individual basis none completely provides for continued solvency. In combination, these change are expected to provide continued solvency. Future investment returns and demographic changes, as well as any benefit changes beyond those presented here, could cause future results to be more or less favorable than anticipated."

Puerto Rico House of Representatives

"Taking the Systems' current outlook into consideration, drastic, dramatic and serious decisions have to be made, some of them might be unpopular because the will impose a sacrifice on all, but all are necessary in order to save the Systems and ensure financial solvency and stability for future generations."

Conclusion

As of June 30, 2009 the Puerto Rico Central Government and Municipalities, the Judiciary, Teachers, and Public Corporations faced a collective actuarial liability of more than $28 billion in pension and other retirement benefits promised to their public sector employees. They have only $4.1 billion in available assets to pay for those promises. This nets a shortfall of more than $23.9 billion.

After reviewing the Commission members' recommendations, it is clear that the Government of Puerto Rico is facing an historic challenge. The recommendations presented in this report should be thoroughly reviewed by all interested parties to develop a suitable long term solution for the financial viability of Puerto Rico's Public Retirement Systems.

Working from the recommendations of the Commission, I respectfully request the opportunity to personally lead an effort conducive to presenting consensus legislation to address this important historic challenge during the year 2011.

Respectfully submitted,

Miguel Romero
Chairman