Pension Obligation Bond (POB) Pension Reform

SELECT BOARD
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I am not representing the Retirement Board nor the Revenue and Expenditure Taskforce in making this presentation.

Why we are here

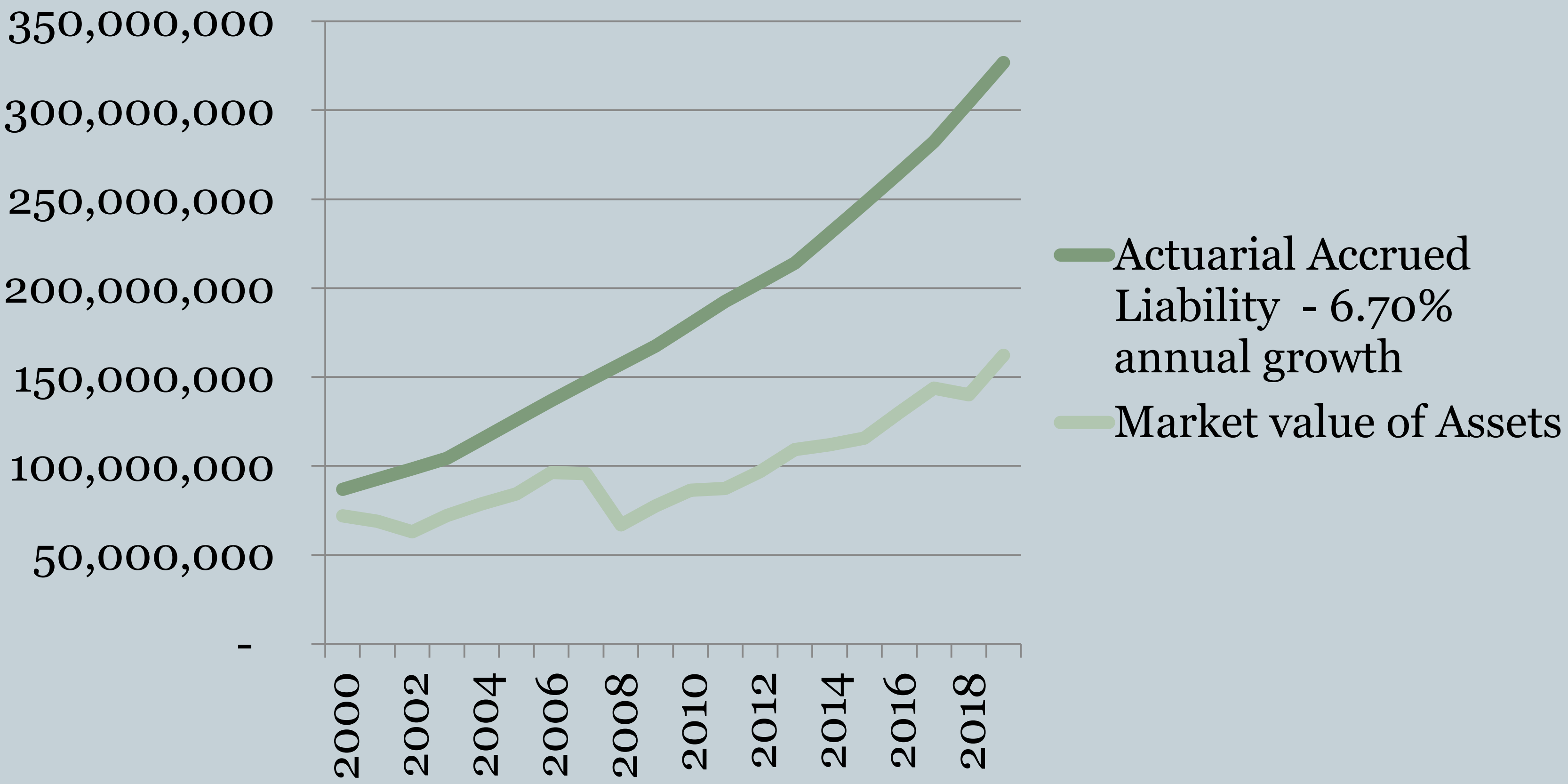
Andover’s ability to pay future pension contributions set by the Retirement Board is unsustainable. It is impossible for Andover to fully fund its pension without massive tax hikes and reduction of services that are implemented solely to allow increases in pension payments. Pension costs should not be allowed to threaten Andover’s ability to provide essential services or require taxation levels that reduce economic growth.

POBs accompanied by pension reforms are required to assist Andover in funding future pension promises without putting an undue burden on taxpayers and ensuring basic benefit promises to current employees and retirees are kept.

Current state

- The Andover retirement plan has one of the lowest funding ratios (49%) in the State and one of the lowest in the country (public plans nationally average 72%).
- Andover (the town and sponsor) incurred operating losses of ($12.3 million) for FY 2018 and ($760,000) (1) for FY 2019. Losses are likely to continue going forward.
- Andover's negative net position (liabilities exceeding assets) was ($48.5 million) at 6/30/19. Continued losses noted above will balloon Andover's negative net position to over ($100 million) in 5 to 10 years, or less.
- 1/1/2020 actuarial valuation report shows the town's annual contributions will increase by 357% over the next 17 years from $12 million for FY 2021 to $42.9 million in FY 2037. Town revenues, assuming 4% annual increases, will increase at approx. half of town's annual pension contribution % over the same period.

We need to slow down the growth in actuarial accrued liability



FY 2020 pension cost (2)

	Amount	%of payroll	
Employer normal cost	3,999,681	8.89%	Normal cost should be significantly higher (>20%) to reflect the guaranteed nature of pension benefits.
Payment of unfunded actuarial accrued liability	8,026,029	17.85%	Town bears all market risk if pension investments underperforms. This payment represents the town's required 2020 payment for investment underperformance for past 20 years. This payment grows at approx. 10% annually.
Actuarially determined contribution (ADC)	12,025,710	26.74%	This is what is the town is minimally required to pay. The amount is used for the annual budget.
Pension expense	20,910,097	46.49%	This is the actual pension expense for the year and reflected in the town's audited financial statements. Changes in assumptions makes up the difference between ADC and pension expense.
Projected payroll	44,974,764		Reflects only town employees and non-teachers in the school department.

Recommended Reforms

1. Establish an Investment Committee
2. Change pension eligibility from part-time to full-time for new employees
3. New part-time employees will not be allowed to purchase past service rendered with the town upon becoming a full-time employee
4. Offer retirement options to new full time employees

Since employees and retirees will benefit from the issuance of POBs, they need to support and endorse pension reforms.

Important – none of the above reforms will have any impact on the town's existing unfunded pension liabilities. These reforms will only stop digging the hole deeper.

Investment Committee

If the town goes forward with POBs, the Retirement Board will have $345 million + in investable assets (POB - $185 million plus current plan investments of $160 million).

Management of pension fund assets will be critical for a successful POB program.

Recommendation: Establish an Investment Committee having decision making responsibilities over the investment process. Final investment decisions should be the result of an agreement between the Investment Committee and the Retirement Board.

Asset Allocation
Approach should start with risk

Set Risk

- Set the maximum affordable risk level

Find Return

- Then find the maximum achievable return from possible asset allocation options

Set Discount Rate

- Set discount rate

Asset Allocation
Process used by Retirement Board

Discount rate

- Set discount rate

Find Return

- Then find the maximum achievable return from possible asset allocation options

Investment Committee

- The higher the assumed return, the lower the contributions by the town. This is attractive in the public sector as governments sponsoring pension plans, elected officials, unions and others, would prefer to use scarce resources for other purposes. Higher contributions would possibility lead to layoffs, cuts in services and higher taxes.
- To assume a higher return, pension plans must invest in risky assets to justify high returns. The Retirement Board has increased its allocation to riskier investment over the past twenty years.
- Taxpayers bear the risk of pension fund investments but have no say on asset allocation. Retirement Board has responsibility for asset allocation.
- Retirement Board said plan assets would earn 8% past 20 years but only earned 4.86%. Retirement plan assets would be $100 million+ greater if 8% was achieved.

Investment Committee

The investment committee will be responsible for:

- Setting the strategic asset allocation ranges
- Performance monitoring
- Establishing investment objectives and guidelines
- Directing the Investment consultant on investment decisions
- Stress testing and risk constraints
- Setting the annual long term rate of return/discount rate used for the actuarial report.

Change pension eligibility for new employees from part-time to full-time

One of the few reform measures available to a retirement board is the discretion to determine membership eligibility for the retirement system. M.G.L.c.32, 3(2)(d).

Current Andover regulation: Any individual who is permanently employed (20) or more hours per week by the Town of Andover, Andover Public Schools, the Andover Housing Authority or the Andover Retirement Board shall become a member of the Andover Retirement System. In addition to the foregoing, an individual or elected official must earn at least $5,000 per year in regular compensation to be eligible for membership. Elected officials are not required to satisfy the 20 hours per week minimum criteria.

Change pension eligibility for new employees from part-time to full time

Local towns requiring part-time employees to work more than 20 hours to participate in pension plan.

- **Reading** – Anyone employed by the town of Reading or the Reading Housing Authority, whose total service for their primary position equals or exceeds 1,690 scheduled hours per year shall be enrolled in the Reading Retirement System. The primary position is defined as the position with the highest number of hours. It may not be combined with any other position.
- **Wakefield** – All permanent employees who are employed on a regular work week for not less than 30 hours within such work week, shall become members of the Wakefield Retirement System.
- **Methuen** – The criterion for eligibility for membership is that the individual works a minimum of 30 hours a week, for a minimum of forty weeks a year.

Change pension eligibility for new employees from part-time to full time

An alternative to Social Security is permitted by the federal Omnibus Budget Reconciliation Act of 1990 (OBRA).

- Part time, seasonal or temporary employees not eligible to participate in the employer's retirement program are required to participate in a Massachusetts deferred compensation plan. Andover uses a 457 plan with ICMA-RC.
- Employees contribute at least 7.5% of their gross compensation to the plan.
- Contribution is deducted on a pretax basis.
- Additional contributions above the mandatory contribution of 7.5% are allowed.

Recommend – Change pension eligibility for new employees from part-time to full-time. Town will contribute 3% for new part-time employee (20 hours or more) into the 457 plan. This would minimally save 6% (see normal cost on page 4) and likely significantly more as the town no longer has any market risk. Contributing 3% would make this attractive in hiring qualified staff.

Change pension eligibility for new employees from part-time to full-time

Changing the eligibility for participation in the retirement plan also affects participation in OPEB. In order to qualify for OPEB, an employee needs to be in the retirement plan. This would mean new part time employees would not be eligible to participate in OPEB.

Stone Consulting, Andover's actuary for OPEB, was asked to prepare an analysis (3) showing the impact to Andover by limiting eligibility to full time (35 hours a week). The results are:

- The town's full funding schedule for OPEB would be reduced from 45 years to 38 years.
- The present value of 50 year cash flow payments by the town would be reduced from $302.3 million to $271.9 million.

New employees will not be eligible for purchasing past service rendered

- The Retirement Board has the authority to set policy on whether or not employees can purchase past service rendered.
- State law does not allow the Retirement Board to prohibit employees from purchasing past service rendered at another governmental unit within the Commonwealth of Ma.

Recommendation: New employees, upon joining the pension system, will not be eligible to purchase past service rendered while employed with the town of Andover. Employees eligible to purchase past service while working at other governmental units will have such service prorated based on 35 hours being the equivalent of a week of service.

Retirement options for new full-time employees

A defined benefit plan, like Andover, offers two main drawbacks:

1. It leaves the town holding all the risk. Andover promises to pay out a certain income each year to retirees, regardless of the performance of the plan's pension investments in the market.
2. Defined benefit plans distort personnel decisions by creating job lock. Pension plans are slow to vest and are not portable outside the public sector in Massachusetts. Employees have less flexibility to leave for a new job or to retire before they are fully vested and potential employees who might join the public workforce later in life are forced to forgo most pension benefits.

Changes in the labor markets have changed the demand for fixed pensions versus flexible, portable retirement benefits, as well as preferences for a higher salary today over better long-term benefits. Offering retirement options to new full time employees expands the potential pool of workers for Andover.

Retirement options for new full time employees

Recommendation – Create a defined contribution plan with faster vesting and more portability providing workers more flexibility and equips the town to better attract a talented workforce.

- New full-time employees will be given option of joining the current DB or DC plan.
- Employees joining the DC plan will contribute 7.50% and the town will match with 7.50% contribution.
- Employees opting for the DC plan will continue to participate in OPEB and not allowed to buy back past service rendered if they later decide to go with the DB plan.
- Current full-time employees will be given the option to leave the DB plan and have the actuarial present value of their accrued benefits transferred into the new DC plan. POB proceeds will be used to pay for this buyout.
- All of the above will require State approval.

Retirement options for new full-time employees

- DC plans are more transparent to workers and taxpayers because the town must fund pension expense (town's contribution) at time the obligation is incurred, requiring it be expensed currently in town budget.
- Pension cost for DC plans are not understated through questionable actuarial assumptions.
- DC plans are always fully funded since size of pension fund and retiree benefits owed are the same.
- Shifting to a DC plan provides particular benefits to younger workers. They appreciate a benefit with the portability and flexibility and choice a DC plan offers.
- DC plans align risks and reward of savings and investing for retirement with employees rather than require taxpayers to bear all the investment and actuarial risk like a DB plan.
- DC plans will save Andover money by ensuring unfunded liabilities do not accrue on new employees. The town's contribution of 7.5% is less than the current normal cost (8.89%) and considerably less than the 46% the town is reflecting in pension expense for FY 2020.

Other actions to consider

- **Pension Buyout** – The town would offer plan participants a lump sum early rather than have them wait until they retire to receive benefits. The town would issue bonds to fund the buyouts. **Will require State approval.**
- **Risk assessment/stress test Andover's retirement system** – Risk evaluation requires an analysis of potential future outcomes under different scenarios such as a low return scenario and an asset price shock simulating a recession. This analysis would assess how future retirement system costs will affect the town's budget as a result of market volatility and underperformance. By understanding these impacts, the town can develop funding policies and practices to better manage volatility and ultimately lower costs. The Retirement Board should factor in the town's risk tolerance as asset allocation for plan assets are determined. New Actuarial Standards requires additional information on risks. Stress testing would be performed by a consultant. **The Retirement Board and the town could work together on this.**

Other actions to consider

Wisconsin Retirement system – Has the best funded public pension system in the country. Key success factors:

- Employer and employee contributions to the plan are adjusted based on investment returns and changes in life expectancy. This is known as an auto-triggers (risk sharing) approach.
- Retiree liabilities are discounted at a conservative 5%.
- Contribution rates are set annually to ensure full funding of future benefits.
- Contribution rates are generally split evenly between employees and employers.
- Unlike most other public pension plans, employees and retirees bear most of the investment risk.
- COLAs depends on investment performance and can be reduced or increased based on investment returns.

Penn., Rhode Island, Tenn., Utah, Arizona and Kentucky have shifted new employees to a risk sharing plan.

Will require State approval

Other actions to consider

- **Adopt a level dollar amortization approach** -This would pay down the debt by a consistent, fixed amount each year rather than backing ending payments the town can't realistically afford to pay. The result would significantly increase the town's annual contribution. **The town and Retirement Board would have to approve.**
- **Annual actuarial valuations should be performed** - Currently, valuations are performed every two years. Annual valuations would provide more timely information on plan performance. This would allow contribution rates be set annually to ensure full funding of future benefits. **Retirement Board approval is required.**

Other actions to consider

- **Establish control policies regarding Pension/OPEB participation** – Processes for controlling participation in the pension/OPEB system and data provided to the actuary needs to be developed, if they don't already exist. Well designed and maintained internal controls will provide reasonable assurance benefits are provided only to eligible employees/retirees. **The town is responsible.**
- **Adopt a comprehensive compensation model reflecting true employee costs –** The town should implement a compensation model that factors in the value of its benefit programs. For example – normal cost uses unrealistic assumptions which has shown over time cost for new employees have been understated. **The town is responsible.**
- **Review the composition of the Retirement Board to insure it possesses the necessary skill set consistent with its mission –** A joint study group should be formed between and among the Retirement Board, town employees/retirees and the Board of Selectmen to develop a matrix of skills Retirement Board members should possess. Actuarial experience is an example of a skill the present board lacks. Current board members should be evaluated against this matrix. **Retirement Board, Town Officials and employees/retirees would be responsible.**

References

1. Before extraordinary gain from Columbia Gas settlement
2. Data from 1/1/20 Actuarial Valuation Report
3. Stone Consulting letter dated April 15, 2020