CENTER FOR THE NEW ECONOMY

CENTRO PARA LA NUEVA ECONOMIA

POLICY BRIEF

Puerto Rico's Pension System: *Knocking on Heaven's Door*

Introduction

The Employees Retirement System of the Commonwealth of Puerto Rico (the "ERS") is a trust created by Act 447 of May 15, 1951 to provide pension and other benefits to retired employees of the government of Puerto Rico and its instrumentalities. According to the Management's Discussion and Analysis included in the ERS's most recent financial statements, the system "since its inception lacked proper planning."[1] The problem was (and to a certain extent still is) that the level of both employer and employee contributions was relatively low and was not actuarially determined, while the level of benefits was statutorily defined and bore no relation to employee contributions or to the investment yield of the systems assets.

In 1973 the benefit structure was "enhanced" without enacting a corresponding increase in contribution levels. As government employment increased in the mid-to-late 1970s, partially in response to the general economic slowdown, the gap between the assets available to pay benefits and the actuarial obligation began to widen.

In 1990 the Puerto Rico legislature enacted Act 1 of 1990, which reduced some benefits and increased the retirement age from 55 to 65 in order to provide a more affordable structure. In addition, contribution levels were increased and Act 447 was amended to provide that any future proposals to increase benefits be supported by an actuarial analysis and include a financing source.

Notwithstanding these changes, by the year 2000 the large accrued unfunded actuarial liability of the system required further action. As a result, the defined benefit plan was closed to new plan members joining after January 1, 2000. Government employees hired after that date would participate in a defined contribution plan known as System 2000, which is funded solely from employee contributions. Under System 2000 employer contributions continue at the same level but are applied to partially fund the accrued actuarial liability of the defined benefit plan that was closed in 2000.

Therefore, the ERS currently consists of three different benefit structures that are administered pursuant to their respective statutory requirements.

1. Act 447 of 1951

- *Type of Plan* – Contributory, defined benefit plan.
- *Eligibility for Membership* – Employees of the Government of Puerto Rico (except teachers); employees of public corporations (except employees of (i) the Puerto Rico Electric Power Authority and (ii) the University of Puerto Rico); municipal employees (including mayors); employees of the Puerto Rico Police Department; employees of the Puerto Rico Fire Department; and irregular personnel fulfilling the requirements of a regular employees, who were hired prior to April 1, 1990.

[1] Employee's Retirement System of the Government of the Commonwealth of Puerto Rico, *Basic Financial Statements for the Year Ended June 30, 2009,* April 2010, p. 8.

- *Retirement Age* – Age 55 with 25 years of accredited service or age 58 with 10 years of accredited service.
- *Standard Benefit* – 1.5% of the average compensation for the 3 highest years of compensation received multiplied by years of accredited service up to 20 years of service, plus 2% of the average compensation for the 3 highest years of compensation received multiplied by years of accredited service in excess of 20 years of service. Maximum benefit is 75% of the average compensation for the three highest years of compensation received.
- *Employee Contribution* – Plan members make contributions equal to 8.275% of their salary.
- *Employer Contribution* – Employer contributions are statutorily set at 9.275% of the employee's salary.

2. Act 1 of 1990

- *Type of Plan* – Contributory, defined benefit plan.
- *Eligibility for Membership* – Employees of the Government of Puerto Rico (except teachers); employees of public corporations (except employees of (i) the Puerto Rico Electric Power Authority and (ii) the University of Puerto Rico); municipal employees (including mayors); employees of the Puerto Rico Police Department; employees of the Puerto Rico Fire Department; and irregular personnel fulfilling the requirements of a regular employees, who were hired on or after April 1, 1990 and before January 1, 2000.
- *Retirement Age* – Age 65 with 10 years of accredited service.
- *Standard Benefit* – 1.5% of the average compensation for the 5 highest years of compensation multiplied by the years of accredited service.
- *Employee Contribution* – Plan members make contributions equal to 8.275% of their salary.
- *Employer Contribution* – Employer contributions are statutorily set at 9.275% of the employee's salary.

3. System 2000

- *Type of Plan* – Hybrid, defined contribution plan.
- *Eligibility for Membership* – Employees of the Government of Puerto Rico (except teachers); employees of public corporations (except employees of (i) the Puerto Rico Electric Power Authority and (ii) the University of Puerto Rico); municipal employees (including mayors); employees of the Puerto Rico Police Department; employees of the Puerto Rico Fire Department; and irregular personnel fulfilling the requirements of a regular employees, who were hired on or after January 1, 2000.
- *Retirement Age* – Age 60.

- *Standard Benefit* – Upon attainment of retirement age the balance in the employee's account will be used to purchase an annuity contract.
- *Employee Contribution* – Plan member contributions range from 8.275% to 10% of the employee's salary, at the employee's option.
- *Employer Contribution* – Employer contributions are statutorily set at 9.275% of the employee's salary, but are applied to partially fund the accrued actuarial liability of the defined benefit plan that was closed in 2000.

As of June 30, 2009, the ERS had 75,697 retired members and 160,053 active members. Of those active, some 38,249 participate in the Act 447 benefit system; 56,991 participate in the Act 1 benefit system; and 64,813 participate in the System 2000 plan.[2]

Table 1

Summary Information – Employees Retirement System
As of June 30, 2009

Benefit Structure	Active Members	Average Age	Average Salary	Retired Members	AAL
Act 447	38,249	52.6	$32,219	73,836	$15,964,084,000
Act 1	56,991	46.0	$27,531	1,861	$2,260,582,000
System 2000	64,813	39.6	$23,008	-	$718,920,000
Total	**160,053**	**45.0**	**$26,820**	**75,697**	**$18,943,586,000**
MV Plan Assets					$1,851,223,000
Funding Ratio					**9.77%**
UAAL					$17,092,363,000
Annual Salary					$4,292,552,000
UAAL as % of Salary					**398.19%**
Average % of ARC made last 5 Years					**59.74%**

Source: Milliman, Inc.

Despite all these commendable prior efforts, the system's unfunded actuarial obligation continues to increase, primarily due to (i) the continuous increase in the pensioner population, (ii) the increased longevity of beneficiaries, and (iii) the fact that incoming pensioners have higher salaries and, thus, they are entitled to even higher annuities.

[2] The ERS *does not* cover government employees that participate in the Commonwealth's four other retirement systems, namely: (1) the Judiciary Retirement System; (2) the Puerto Rico Electric Power Authority Retirement System; (3) the Teachers Retirement System; and (4) the University of Puerto Rico Retirement System. This paper focuses only on the state of the ERS.

Based on the most recent actuarial valuation, done as of June 30, 2009, the system's funding ratio is 9.77%; the actuarial accrued liability ("AAL") is $18.944 billion; the actuarial value of plan assets is $1.851 billion; and the unfunded actuarial accrued liability ("UAAL") is $17.092 billion.[3] To put this last figure in perspective, the amount of the system's UAAL is equal to 27.23% of Puerto Rico's GNP of $62.758 billion as of June 30, 2009. This figure *does not* include an additional unfunded actuarial accrued liability of $1.633 billion related to the cost of providing health insurance to retirees.[4]

According to the actuarial valuation report, the UAAL is "expected to grow indefinitely into the future instead of being amortized." This means, in essence, that current member and employer contributions are not sufficient to fund the system's obligations; instead "the ERS is being disfunded." As a result, the future scheduled contributions "will not be adequate to accumulate sufficient assets to make future benefit payments when due."[5]

Given this dire financial situation, the ERS's current management believes

> That the capital markets by themselves cannot solve the System's funding problem. Somehow capital contributions must be increased and/or liabilities must be reduced. Management has come up with recommendations to improve the System. Among those stand out the increase in employee's and employer's contribution rates.[6]

The government, however, keeps granting benefit increases. Most recently, these benefit increases have consisted of:

- An increase in the minimum monthly pension benefit from $300 to $400, effective on July 1, 2007.
- Increases of 3% in all pensions effective on July 1, 2007, but compounded retroactively to January 1, 2007.
- Increases from $500 to $550 and to $600 in the retiree's Christmas bonus, effective in December 2006 and 2007, respectively.
- Increases of 3% in all pensions lower than $1,250 effective on July 1, 2008.

According to the ERS's financial statements, "these benefits are financed through legislative appropriations from the Commonwealth with respect to central government retirees and by the municipalities and public corporations with respect to their employees."

Grading the Puerto Rico Employees Retirement System

Recently the Pew Center for the States presented a comprehensive analysis of the funding performance of 231 state-administered pension plans and 159 state-administered health care plans, including some plans covering teachers and local employees.[7] The principal

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[3] Milliman, Inc., *Puerto Rico Government Employees Retirement System Actuarial Valuation Report as of June 30, 2009*, p. 2.

[4] This benefit is being financed on a pay-as-you-go basis with funds from the General Fund of the Commonwealth of Puerto Rico. See Milliman Report at page 7.

[5] Milliman Report at page 6.

[6] ERS Audited Financial Statements as of June 30, 2009, p. 9.

[7] The Pew Center on the States, *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform*, February 2010.

finding of this study is that at the end of fiscal year 2008 there was a $1 trillion gap between the $2.35 trillion states and participating localities had set aside to pay for employees' retirement benefits and the $3.35 trillion cost of those promises.

As part of its analysis, Pew assessed and graded the pension plans of all 50 states according to three criteria on a scale from zero to four points:

- Two points were awarded for having a funding ratio of at least 80%;
- One point was awarded for having an unfunded liability below covered payroll; and
- One point was awarded for paying on average at least 90% of the actuarially required contribution during the past five years.[8]

States earning four points were categorized as "solid performers". Those earning two or three points were deemed "in need of improvement." Those earning zero or one point were labeled as raising "serious concerns." Overall, 16 states were solid performers; 15 states were in need of improvement; and 19 states were considered to be cause for "serious concerns".

How does the Puerto Rico Employees Retirement System fare according to the criteria set forth by the Pew Center on the States?

Funding Ratio – According to the Pew analysis the percentage funded is the best indicator of whether a pension plan is in good shape. The 80% benchmark has been identified by the GAO as the threshold for adequate pension funding. The ERS had a funding ratio as June 30, 2009 of 9.77%. Accordingly, it gets zero points under this criterion. If Puerto Rico were a state, this funding ratio would put the ERS on 51st place out of 51 states. Illinois, the worst state in terms of funding, has funded 54% of its pension liabilities. In other words, Illinois's funding ratio is 5.5 times better than Puerto Rico's.

Unfunded Liability as a Percentage of Covered Payroll – Pension analysts believe that the payroll of all employees in a state's pension plan is a good proxy for spending capacity and an unfunded liability that is high relative to the employer's capacity to pay is an indicator of a plan in fiscal trouble. The ERS's unfunded liability as of June 30, 2009 equaled 398.19% of covered payroll. Therefore, it gets zero points under this criterion. Relative to the fifty states, only Connecticut had a higher unfunded liability as a percentage of covered payroll (449%).

[8] The "actuarially required contribution" is the amount of money that needs to be paid to the plan each year for benefits to be fully funded in the long run, typically 30 years.

Table 2
Funding Status
As of June 30

Year	Actuarial Value of Assets	Accrued Liability	Unfunded Liability	Funded Ratio	Covered Payroll	Unfunded Liability as % of Payroll
2009	$1,851,223,000	$18,943,586,000	$17,092,363,000	9.77%	$4,292,552,000	398.19%
2007	$2,891,501,000	$16,769,512,000	$13,878,011,000	17.24%	$4,246,409,000	326.82%
2005	$2,327,871,000	$13,969,000,000	$11,641,129,000	16.66%	$4,125,866,000	282.15%
CAGR	**-5.57%**	**7.91%**	**10.08%**			

Source: Milliman, Inc.

Average Percentage of Actuarially Required Contribution Made During the Past Five Years – According to the Pew Center, making at least 90% of the actuarially required contribution is a good rule of thumb for determining which states are on the right track toward being adequately funded. The employers contributing to the ERS made an average contribution equal to only 59.74% of the actuarially required contribution during the period between 2005 and 2009. Therefore, the ERS gets zero points under this criterion. Among the fifty states, only Connecticut (58%), New Jersey (33%), and Washington (37%) had a lower five-year average contribution percentage.

The ERS, thus, gets a score of zero on the four-point scale devised by the Pew Center on the States for evaluating pension systems, joining Alaska, Colorado, Illinois, Kansas, Kentucky, Maryland, New Jersey, and Oklahoma. This score means that all these jurisdictions have failed to make significant progress toward adequately funding their pension obligation.

In addition to the problems setting aside funds to pay for its future obligations, the ERS faces a significant cash flow problem and its ability to pay benefits to current retirees is in jeopardy. According to the actuarial valuation report, current annual benefit payments and administrative expenses paid by the ERS are significantly larger than the member and employer contributions made to the system. Therefore, the ERS has to use some of its investment income to cover this negative cash flow. As a result, "system assets can be expected to decline as negative cash flow (contributions less benefit payments) exceeds expected investment income."[9] Even more worrisome, the actuaries warn that the expected negative cash flows would exhaust net system assets in 2014 (even assuming the annual investment return assumption of 7.5% is met).

How the States Have Responded

For many years state policymakers have disregarded the problems posed by their public pension systems. However, a convergence of factors has made this issue difficult to

[9] Milliman Report at page 9.

ignore any longer. States that have not properly funded their public pensions are realizing that further postponing payment only makes the problem worse because pension costs inexorably continue to increase over time. This leaves states and future taxpayers in worse shape because every additional dollar that goes to fund the growing pension liability is a dollar that cannot be used for education, health care, public safety, or other government priorities. In addition, significant investment losses during the past two years "signal that states cannot simply sit back and hope the stock market delivers returns large enough to cover the costs."[10]

At the same time, a large number of baby boomers in state and local governments are nearing retirement and it is expected that many of them will live longer, meaning that states need to get their pension problems under control now if they want to avoid facing debilitating costs in the future. On the other hand, the amount of the funding gap and the growing realization that taxpayers will eventually be asked to fund the bill for benefits that they often lack themselves has generated a strong backlash and produced a potent push to alter the status quo. Organizations and business groups that advocate smaller government seek to generate public outrage for what they perceive to be an excessive largesse granted to government workers. For example:

- The California Foundation for Fiscal Responsibility launched a campaign in 2009 to publicize the benefits of 5,115 public sector employees whose pension benefits exceed $100,000.
- In Illinois, the Civic Committee of the Commercial Club of Chicago has advocated for lowering pension benefits; requiring pension retiree health contributions from all employees; requiring retirees to pay a greater share of health care costs; and increasing the retirement age. According to the Pew Center study, this group consistently pointed out that private sector companies have turned away from defined benefit plans and that Illinois government workers in many cases enjoyed higher pension benefits than workers in the private sector.

In sum, escalating costs, significant investment losses, demographic pressures, and taxpayer backlash have forced the hand of policymakers with respect to this issue. At least a third of the states have appointed study commissions, task forces, or other similar groups to analyze the options for public pension reform.

The Pew Center on the States, based on its analysis of state policy changes and practices over time, has identified five key reforms that have proven feasible and offer the opportunity to improve the performance of public sector retirement systems.

- *Keeping Up with Funding Requirements* – According to the Pew Center Study, the "make or break factor" for keeping a pension system well funded is to make the actuarially required contribution consistently. Some states, such as Arizona and Tennessee, have constitutional or statutory requirements to pay the full actuarially required contribution every year. However, if a state is faced with a significant budget deficit, then this legal requirement may not amount to much. A statutory requirement giving priority to pension contributions over other state obligations could help states in this position. During the period between 2005 and

[10] The Trillion Dollar Gap at page 7.

2009, the government of Puerto Rico made only 59% of the actuarially required contribution.

Table 3
Schedule of Employer Contributions
As of June 30

Year	**Actual Contribution**	**ARC**	**% Contributed**
2010	$590,742,000	$1,459,774,000	40.47%
2009	$594,509,000	$1,258,695,000	47.23%
2008	$581,285,000	$1,191,275,000	48.80%
2007	$566,524,000	$816,472,000	69.39%
2006	$559,198,000	$816,472,000	68.49%
2005	$374,823,000	$578,387,000	64.80%
2004	$330,336,000	$578,387,000	57.11%
Total	**$ 3,597,417,000**	**$ 6,699,462,000**	**53.70%**

Source: Milliman, Inc.

- *Investment Return Assumptions* – States need to make sure that the assumptions used to calculate the actuarially required contribution are accurate, for example, estimating the lifespan of retirees or the expected investment returns. Many states assume an 8% annual return on their pension fund investments but many financial experts consider this to be an unrealistic expectation given the current market environment. Currently 11 states assume investment rates of return in excess of 8%; some 22 assume return rates equal to 8%; and 17 states assume annual investment returns of less than 8%. Some states have recently reduced their investment return assumptions. For example, Utah lowered its return expectation from 8% to 7.75%, while Pennsylvania reduced its expected return from 8.5% to 8%. However, as of December 2008 the top 100 *private* pension plans had an average assumed return of 6.36%.[11] Lowering the expected investment return assumption *increases* the actuarially required contribution because states expect investment returns to cover less of the cost, but a more conservative assumption protects states from sudden increases in contributions when investment returns fall short of expectations. The Puerto Rico ERS currently assumes a 7.5% annual rate of return on its investments, which is among the most conservative in the United States.

[11] The Trillion Dollar Gap at page 9.

Table 4 Historical Rates of Return As of June 30	
Year	**Rate of Return**
2009	-13.23%
2008	-2.26%
2007	18.23%
2006	13.88%
2005	12.35%
5 Year CAR	5.11%

Source: Milliman, Inc.

- *Lowering Benefits and Increasing the Retirement Age* – States such as Kentucky, Nevada, New Jersey, New York, Rhode Island, and Texas have reduced benefits offered to *new employees* or raised the retirement age. Reducing benefits to *current retirees* appears to be both legally and politically difficult. However, the state of Colorado recently enacted a pension bill that reduced the annual cost of living increases made every year to current retirees. According to the *New York Times*, "apparently this is the first time state legislators have forced current retirees to share the pain".[12] On the other hand, the legality of lowering benefits and/or increasing the retirement age for *current employees* appears to be a "significant gray area" where there is little case law that can be of guidance.[13] The Puerto Rico ERS both lowered benefits and increased the retirement age for new employees hired on or after April 1, 1990.
- *Sharing Risk with Employees* – Many states have moved away from defined benefit plans to either (1) a hybrid system that guarantees a lower minimum benefit combined with a defined contribution element that does not guarantee any returns; or (2) a pure defined contribution system. The Puerto Rico ERS has already made the transition to a defined contribution structure for all employees hired on or after January 1, 2000.
- *Increasing Employee/Employer Contributions* – In many states the employee contribution is fixed at a lower rate than the employer contribution. Recently, some states such as Iowa, Minnesota, Nebraska, and New Mexico, have increased contributions either from employees or employers, or both. In Puerto Rico, employee contributions to the defined benefit plan of the ERS are fixed at 8.275% of covered payroll and employer contributions are fixed at 9.275% of covered

[12] Ron Lieber, "Battle Looms Over Huge Costs of Public Pensions", *New York Times*, August 6, 2010.
[13] The Trillion Dollar Gap at page 31.

payroll. Neither contribution rate has been increased since 1990. The system's actuaries strongly recommend that the employer's contributions be significantly increased above the current rate of 9.275%.

Conclusion

The Puerto Rico ERS is in a dire situation due to years of inadequate planning; the lack of discipline on the part of the policy makers in charge; the failure to make actuarially required contributions on a consistent basis; the enactment of new benefits and cost of living increases without properly analyzing or understanding the long term consequences; and the failure to provide adequate funding for health care benefits for retirees. The bottom line is a $17 billion problem that keeps on growing.

Addressing that problem raises issues of extraordinary financial, political, legal, and moral complexity. The financial dimensions of the problem are simply staggering. The UAAL of the Puerto Rico ERS is equivalent to 27% of Puerto Rico's GNP as of 2009. An obligation of this size cannot be fulfilled with accounting gimmicks or financial engineering tricks. The money has to come from somewhere; otherwise benefits have to be reduced.

On the political side, pensioners have always been an influential and well organized bloc and politicians love to pander to them. However, the potential blowback from taxpayers should not be ignored and we should expect a growing number of people in Puerto Rico questioning why are they stuck with the bill for pension benefits that they often lack themselves. This conflict appears almost inevitable given the extent of the unfunded liability. Puerto Rico, collectively as a society, owes approximately 30% of its income to 5% of its population. Wealth transfers of this magnitude do not occur without serious political consequences. In addition, dedicating financial resources to adequately fund pension plans entails reducing resources for other important government activities such as health, education, and public safety that address other compelling social needs.

The legal issues related to pension reform can also be quite complex. While it is generally assumed that retiree benefits cannot be reduced due to constitutional and/or statutory protections, the state of Colorado has recently enacted legislation doing just that. In addition, the legality of changing the terms and conditions of plan benefits applicable to *current employees* appears to be an open issue and there is little case law that can be of guidance. Is it permissible under the Puerto Rico and U.S. constitutions to modify or cut future pension benefits that have already been promised to current employees?

On the moral plane, vexing issues of political morality emerge. On the one hand, promises have been made to thousands of government workers and they have relied and planned their lives based on those promises. On the other hand, members of younger generations are right to claim it is unfair for them to pay the costs associated with the mistakes of the past. Why should we pay for the failure of past policymakers to plan adequately and for their craven reluctance to adequately fund the promises they made? At the heart of this issue lies the knotty moral problem of how do moral and political obligations arise. Are we as individuals only subject to moral obligations we voluntarily choose to undertake or are we be bound by at least some moral ties we have not consented to, or voluntarily chosen, and that we have inherited, such as the $17 billion liability of the Puerto Rico ERS?

Addressing Puerto Rico's pension problem along these four vectors will require tolerance, capacity for frank dialogue, commitment to good faith bargaining, and the willingness to make and honor concessions among retirees, current employees, and taxpayers in general. It appears to us that any fair solution to this $17 billion problem will require each one of those groups to make painful tradeoffs. Perhaps retirees could be asked to accept cutbacks on recently enacted benefits; current employees could be asked to increase their contributions; and taxpayers in general could be asked to pay a special tax to be applied towards reducing the ERS's unfunded liability. In this context, Richard Lamm, former Democratic governor of Colorado, has stated that "we have to do what unions call givebacks, that is the only way to sanity. Any other alternative, therein lie dragons." We agree.