Rescuing the Puerto Rico Retirement Systems

Implementing Permanent Solutions

February 27, 2013

The Employee Retirement System and the Teachers Retirement System (the "Retirement Systems") have the lowest[1] funded ratio compared to the 50 states

The annual benefits payable by the Retirement Systems are unsustainable

- The difference between pension obligations payable and available assets exceeds **$35.26 billion**[2] as of June 30, 2011

- The Employee Retirement System's ("ERS's") net assets will be depleted in **FY2013-2014** and its total assets in **FY2018-2019**. The Teachers Retirement System's (TRS's) assets will be depleted in **FY2021-2022**

- The average funded ratio in the 50 states is 63 cents[1]. Meanwhile in Puerto Rico:

  - We only have **6** cents for every dollar payable in ERS' benefits

  - We only have **20** cents for every dollar payable in TRS' benefits

- Beginning in FY2018-2019 and FY2021-2022, the ERS's average annual cash flow deficit will be approximately **$905 million** and that of the TRS will be approximately **$579 million**[3]

[1] Source: The Pew Center on the States, *"The Widening Gap Update,"* June 2012. In the case of the ERS, the net assets are the assets after reducing the POB's debt. These bonds are guaranteed by government employer contributions.
[2] $25.491 billion in the Commonwealth System and $9.768 billion in the Teachers System.
[3] The cash flow deficit is the difference between the money the system receives (contributions) and the benefit payments (disbursements) per year.

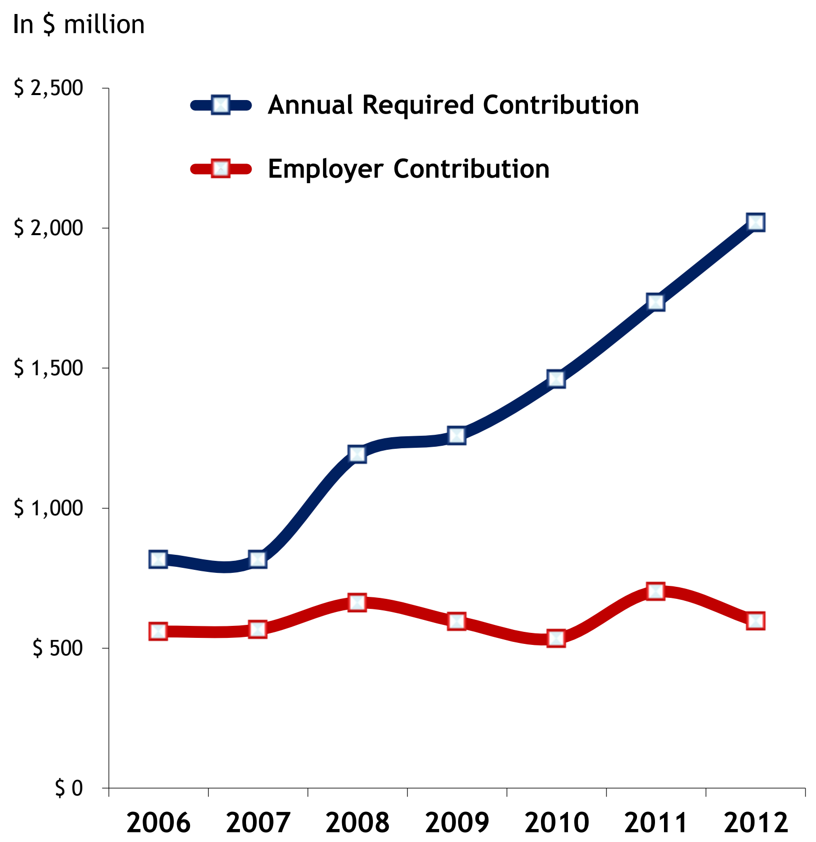
Past decisions have been the primary cause of the current crisis

A big part of the problem the Systems are facing goes back to the benefit increases made in the past, without identifying the resources needed to fund the costs of those increases

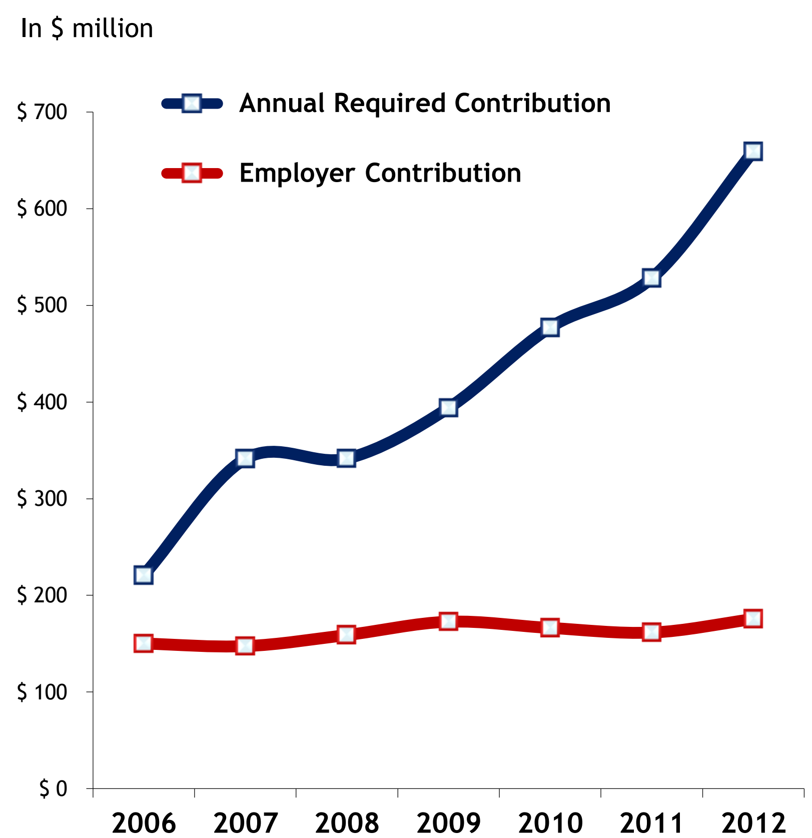
1. **The Government has not made the contributions recommended by the actuaries in order to cover the benefits provided to participants.**
2. **We have granted additional benefits (special laws and merit pensions) throughout the years without contributing the necessary resources to pay for them.**
3. **We have implemented early retirement programs without taking into account the actuarial impact on the Systems.**
4. **The increase in life expectancy of the Systems' retirees has led the Systems to pay more benefits than originally anticipated.**
5. **In addition to making the existing pension payments, the ERS has the obligation to pay the pension obligation bonds totaling $9 billion (including principal and interest).**

Government contributions have not been enough

Public Employees Retirement System

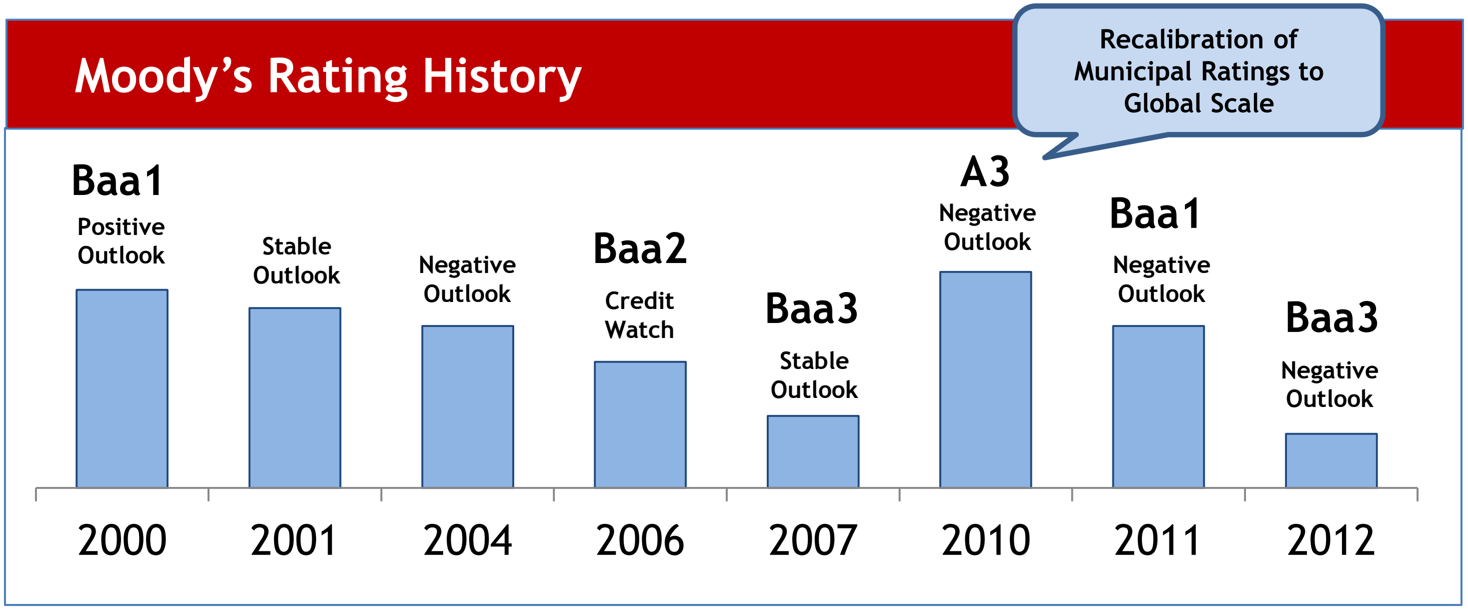


Teachers Retirement System



* Source: Based on the last actuarial report as of FY2011.

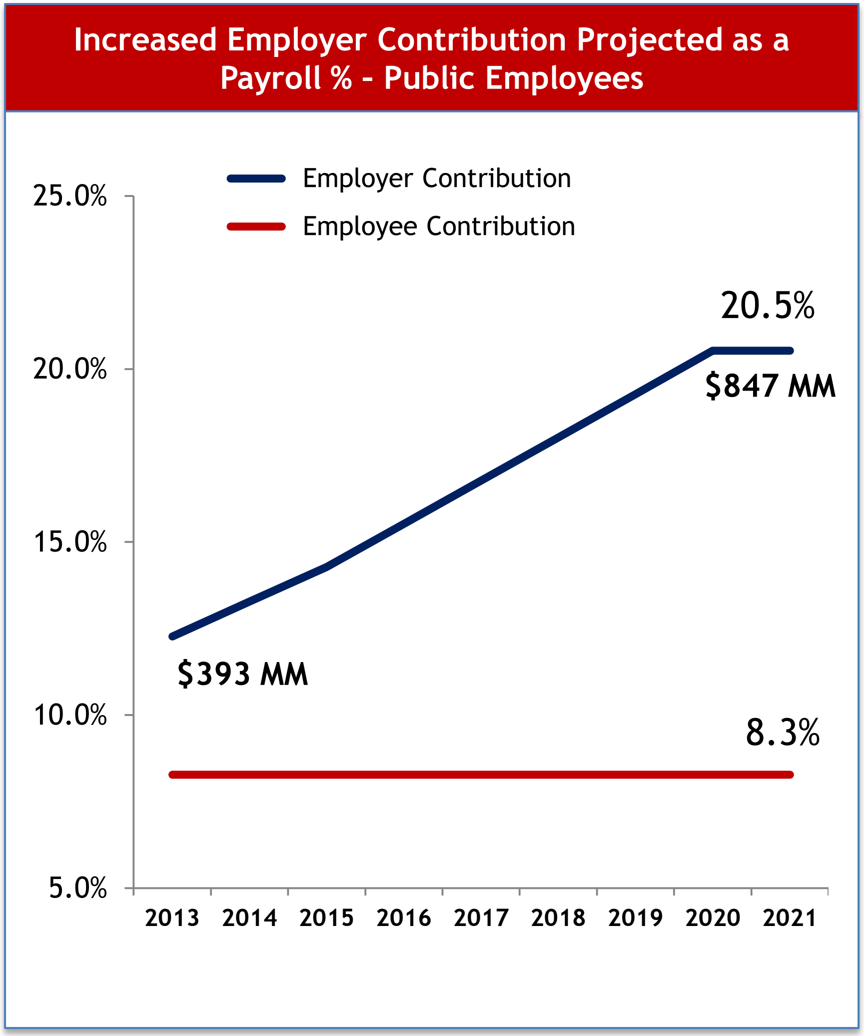
On December 13, 2012, Moody's downgraded Puerto Rico's credit

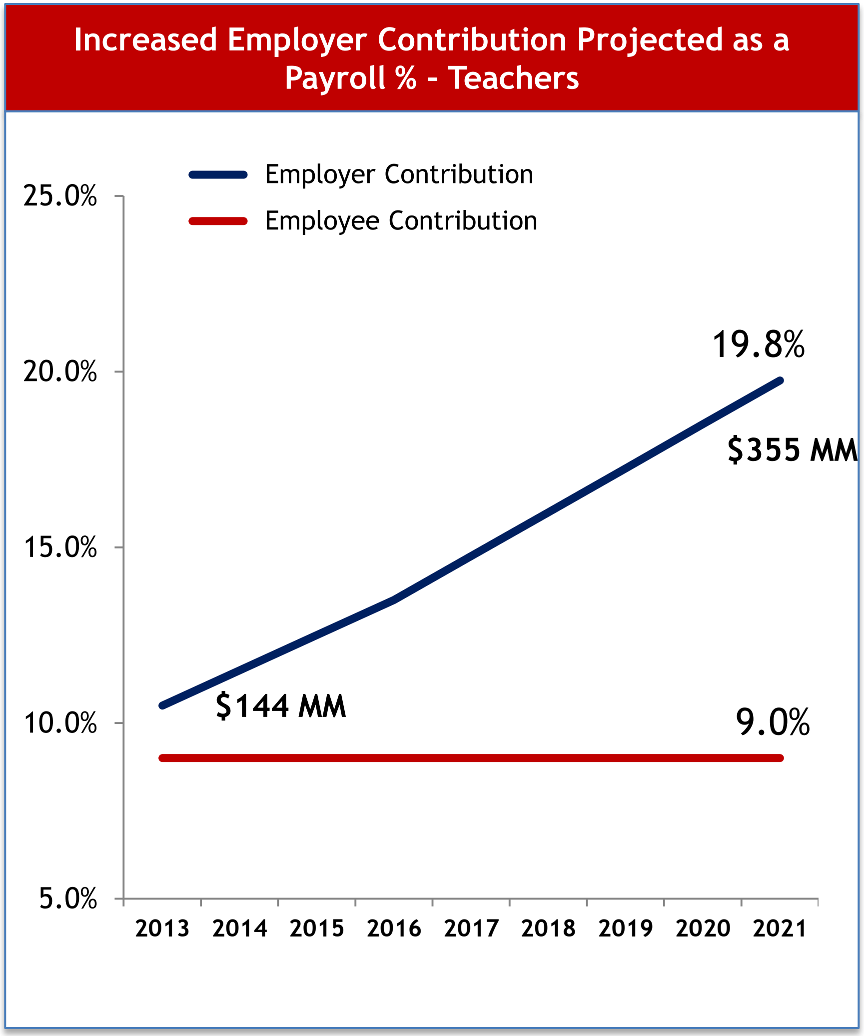


"Lack of a meaningful pension reform and no clear timetable to do so," cites Moody's in its report as one of the reasons for the downgrade.

"Reform of the Commonwealth's severely underfunded retirement systems is needed to avoid asset depletion and future budget pressure." Moody's added.

Increased employer contributions enacted in 2011[1] represent a considerable obligation to the Government



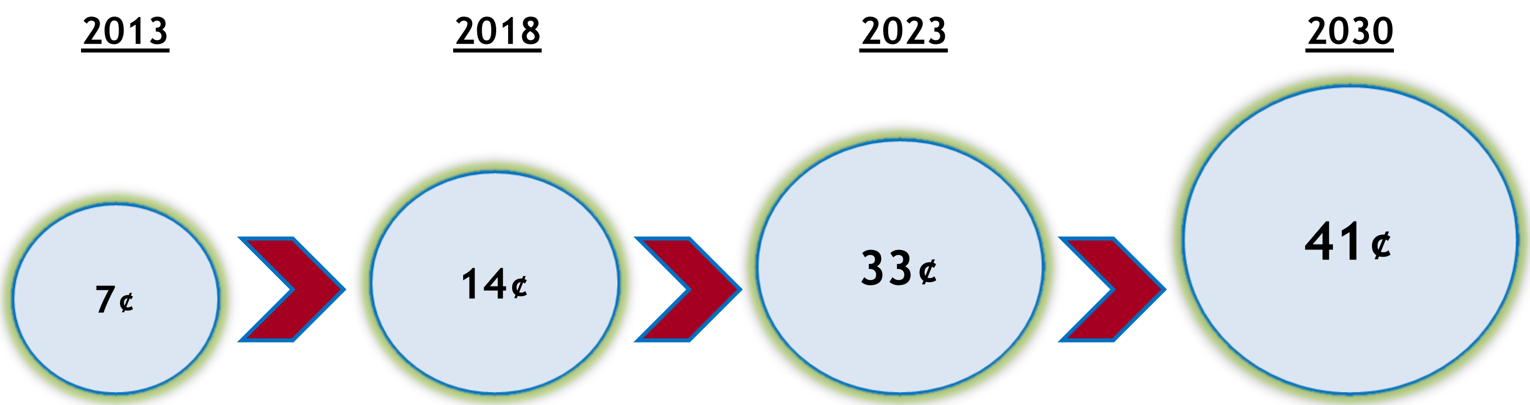


[1] Increase in employer contribution pursuant to Act 116 of 2011, for the ERS, and to Act 114 of 2011, for the TRS.

If we do not take meaningful measures now, the crisis of the Systems will keep getting worse

- At present, for every dollar in General Fund revenues, 7¢ are set aside to make pension payments.
- If drastic measures are not enacted to address the cash flow deficit of the Systems, the Government will have to divert resources normally used to provide essential services to citizens in order to make pension payments.
- Essential services would be affected: In only 10 years, for every dollar in General Fond receipts, 33¢ would have to be designated to make pension payments.

General Fund Portion Designated to Pay Pension Benefits per Revenue Dollar*

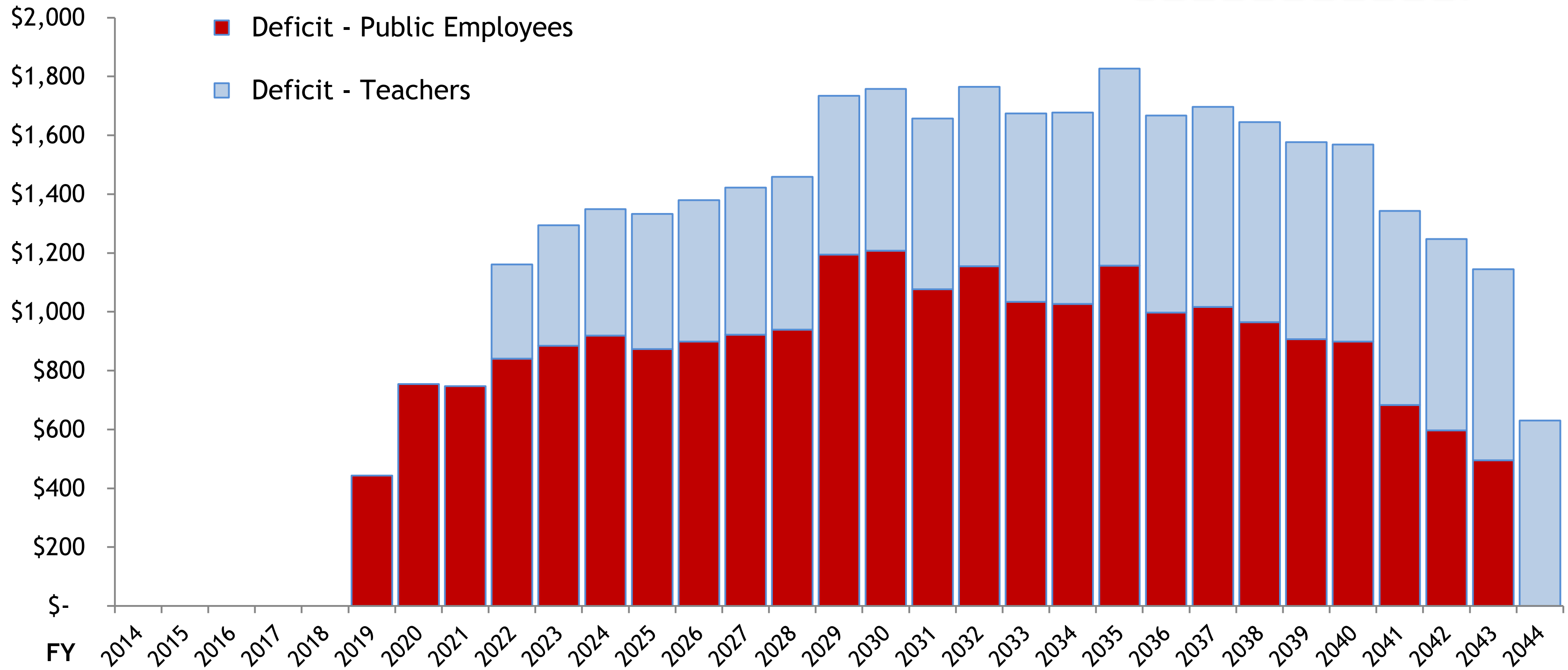


* This analysis assumes that the General Fund revenues of $8.75 billion (as of FY2012-2013 budget) will remain constant, as well as a payroll based on a present and future population of 134,566 employees. The General Fund item includes: employer contribution, Law 70 contribution, the Special Laws contribution, and the annual cash flow deficit (“pay-as-you-go”).

Our Systems face significant cash flow deficiencies

Annual Cash Flow Deficit of the Retirement Systems
(projected in $ millions)

AVERAGE ANNUAL DEFICIT: $1.38 billion



The amount of the average annual deficit underscores the urgency of implementing a comprehensive reform

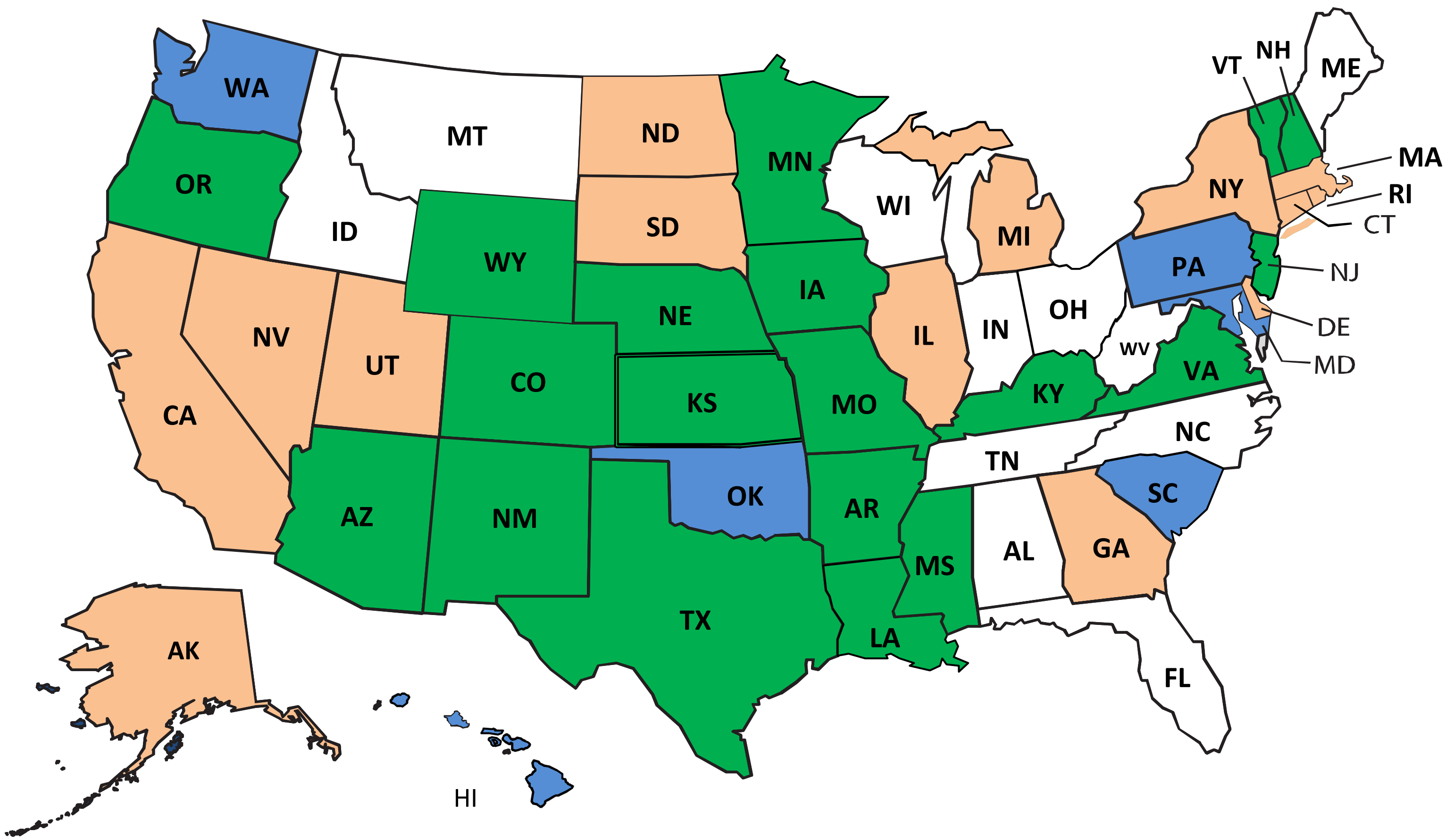
Puerto Rico is Not Alone

Many states have reformed their pension systems

	Most Recent Cases	Puerto Rico
Change in Plan for Future Employees	• Michigan (defined contribution) • Virginia (hybrid plan) • Utah (hybrid or defined contribution option)	• System 2000
Change in Plan for Present Employees	• Rhode Island (hybrid) • Michigan (hybrid, optional)	• N/A
Change in COLAs	• Rhode Island (suspended all COLAs until the system reaches 80% funded ratio; future COLAs based on return on investment) • Maryland (maximum is 1%, if the expected return on investment is not met) • Oklahoma (prohibits COLAs without parallel fund appropriation) • Kansas (completely eliminated, except for those retiring before 12/31/13)	• 3% triennial COLA has to be legislated; none have been approved since 2007
Reduction of Benefit Multiplier	• Rhode Island (1%; 2% for public safety employees) • Atlanta (new employees at 1%)	• 1.5% and 2.0% for Act 447 and 1.5% for Act 1
Computation of Average Salary	• Rhode Island (last 5 years) • South Carolina (last 5 years for new employees)	• 36 months of highest salary under Act 447 and 5 years of highest salary under Act 1
Eligibility Age	• Rhode Island (67 years, same as for Social Security; except for public safety employees) • South Carolina (65 years for non police officer employees)	• 55 under Act 447; 65 years under Act 1 and 60 years under Act 305
Employee Contribution	• Atlanta (from 8% to 13%) • California (from 6% to 12%)	• 8.275%

Many states have reduced benefits to existing and new employees

Reforms During the Past Decade



Reduced benefits

Increased employee contributions

Increased employee contributions and reduced benefits

Source: The Pew Center on the States, "*A Decade of Pension Reforms*", April 2011

Rhode Island is a recent example of a comprehensive and meaningful pension reform

Rhode Island – Status Prior to the Reform:

- Rhode Island had an actuarial deficit of $6.833 billion and a funded ratio of 48.4% at the end of FY2010.
- The annual required contribution was expected to go up from $303 million in FY2010 to over $600 million in FY2013 and up to $1 billion in 2022

The Pension Reform Enacted in 2011:

- Reduced the State's $6.833 billion actuarial deficit by more than $3 billion
- Rhode Island transferred ALL of its employees from a defined benefit system to a defined contribution one in 2012
- Reduced projected employer contributions by 42% for FY2013
- Preserved the benefits obtained up to June 30, 2012 – hybrid plan for the future
- Suspended COLA benefits until the funding ratio exceeds 80%
- Increased the minimum retirement age to 67 for new employees

Corrective Measures

The current benefit structure will have to be modified

Public Employees System		
Defined Benefit Plan		**Defined Contribution Plan**
Act 447 of 1951	**Act 1 of 1990**	**Act 305 of 1999**
• Merit pension of 75% (30 years in service and 55 years of age) or 65% (30 years in service and less than 55 years of age)	• Reduced the benefit structure	• Closed the Defined Benefit Plan for new employees
• Benefit: 1.5% of average salary during the first 20 years in service and 2.0% of average salary during subsequent years	• Benefit: 1.5% of average salary during years in service	• Benefit: There is no defined benefit. Pension depends on the employee's contribution plus return on investment
• Average salary computation based on highest salaries during any 36 month period in service	• Average salary computation based on the last 5 years in service	• Upon retirement, the total value accrued is disbursed to the member's account
• Minimum benefit: $400/month	• Minimum benefit: $400/month	• Minimum benefit: N/A
• Retirement age[a]: 58 years	• Retirement age: 65 years	• Retirement age: 60 years
• Active members: 22,866	• Active members: 46,452	• Active members: 62,043
• Retired employees[b]: 109,097	• Retired employees[b]: 7,540	• Retired employees[b]: 21

(a) Except for merit pensions and reduced pensions upon retirement before the age of 55.
(b) According to data as of December 31, 2012. Including beneficiaries and disabled workers.

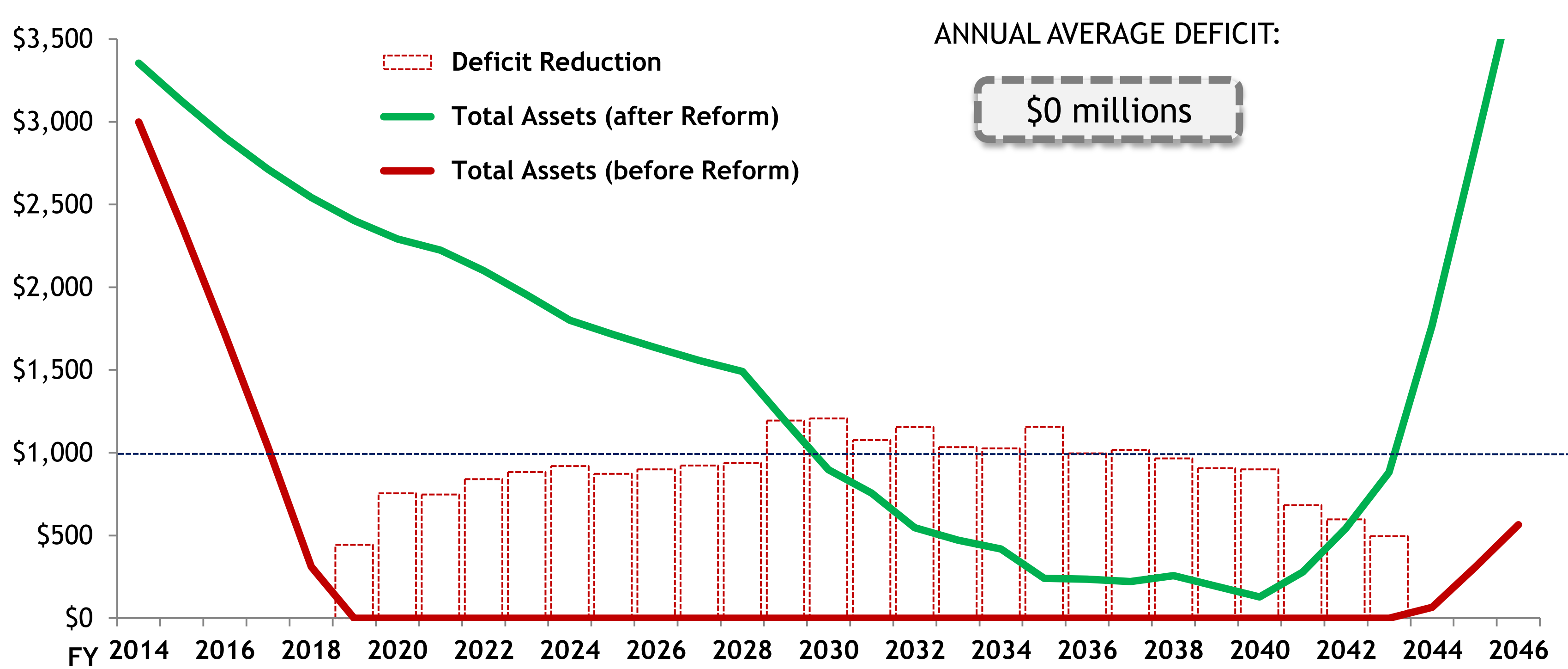
Summary of corrective measures

Measures	Public Employees Retirement System	
1) Change Benefits to Future Retirees	✓	All participants under Act 447 and Act 1 will be prospectively moved to a defined contribution plan
2) Eliminate Merit Pension	✓	Only those participants eligible to retire with a merit pension on or before June 30, 2013, may retire with a merit pension
3) Increase Retirement Age	✓	Staggered increase in eligibility age: • Act 447: from 58 to 65 years of age • Act 1: from 65 to 67 years of age • System 2000: from 60 to 67 years of age • Police Officers and Firefighters: from 50 years (Act 447 and System 2000) or any age plus 30 years in service (Act 1) to 58 years of age
4) Increase Employee Contribution	✓	Increase in employee contribution to the System from 8.275% to a minimum of 10%
5) Change Special Laws Benefits	✓	• Reduction of Christmas bonus and contribution to the medical plan, elimination of summer bonus, increase of medication bonus (“Special Laws Benefits”) for retirees • Elimination of Special Laws Benefits for future retirees
6) Convert the System 2000 benefits to an annuity	✓	Upon retirement, System 2000 participants will receive their benefits in the form of a lifetime annuity computed on the basis of their accrued contributions, plus any return on investment, instead of a lump sum
7) Increase Minimum Pension	✓	Increase in minimum pension from $400 to $500 monthly

Even with the implementation of all these measures, the Public Employees System will need a multimillion annual contribution to meet its pension obligations

- Amendments consists of moving Act 447 and Act 1 participants to a New Hybrid Plan, increasing the retirement age to 65 and 67 years of age (for regular employees) and to 58 years of age (for police officers and firefighters), converting System 2000 benefits to an annuity, increasing the contribution for all employees to 10%, modifying Special Laws Benefits, and injecting a multimillion amount (of over $100 million) for the next decades.

Result of Proposed Reform (in $ millions)



Note: The amounts presented are estimates and are subject to change. This graphic takes into account a rate of return on investment of 6% but excludes the increase in minimum pension to $500. The annual average deficit amount includes only the ERS.

Consequences of failing to enact these measures

1. The retirement of over 240,000 Commonwealth employees, firefighters and police officers would be at risk
   - When the Systems' assets run out, there will be no money to make pension payments; the General Fund would have to assume the pension payments, and the General Fund's situation is fragile

2. We would be putting at stake essential services in our Island. If we were to appropriate more funds from the General Fund, there would be less funds to:
   - Educate our children
   - Protect our homes
   - Take care of our health
   - Improve our infrastructure

3. Puerto Rico's credit could be downgraded to junk status, resulting in devastating consequences for the Island

The proposed Reform is reasonable, fair and sensible

1) Benefits accrued by retirees and active public employees subject to defined benefit plans are grandfathered by the Reform.
2) It distributes the economic impact of the proposed changes equally among all stakeholders:
   a. Employer (taxpayers in general): increase in employer contributions established under Act 116 of 2011 and the additional injection into the Public Employees Retirement System of over $100 million per year for the next decades
   b. Retirees: reduction of benefits provided under the Special Laws.
   c. Active public employees: modification in the benefit structure, staggered increase in retirement age, and increase in employee contribution.
3) It is sensible towards the most disadvantaged individuals:
   a. Minimum pension is raised from $400 to $500.
   b. Funds generated by eliminating and reducing the Special Laws benefits to individuals receiving the highest pensions, are redistributed to those receiving the lowest pensions.
4) System 2000 participants are guaranteed the opportunity to receive a lifetime annuity at the end of their careers to secure their retirements.