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Reducing Pension and OPEB Costs

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4:15 p.m. – 5:30 p.m

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Employee Benefits

PENSION LIABILITIES

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Defining Pension Liabilities

- What does CalPERS consider when it calculates pension liabilities?
  - Demographic assumptions (e.g., life expectancy, length of service, retirement age, disability)
  - Economic assumptions (e.g., future salary increases and investment returns)
- What goes into the annual contributions to CalPERS?
  - **Normal cost** is the cost associated with the current year of service credit expressed as a % of covered payroll.
  - **Unfunded accrued liability** is the current value of the benefit for all accrued service credit amortized over a specified period that is unfunded

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What Affects Pension Liabilities?

- Investment returns
- Experience gains/losses
- PEPRA – minimal effect until new members replace classic members
- Changes in CalPERS' policies (improve funded status, less volatility in contribution rates)
  - New demographic assumptions effective as of the June 30, 2014 valuation (longer life expectancy)
  - Amortization and rate smoothing method changes effective as of June 30, 2013 valuation
    - Market value rather than actuarial value of assets for rate setting
    - Converted rolling amortization periods to fixed periods
    - Gains and losses are tracked and amortized over a fixed 30-year period, 5 year ramp up, 5 year ramp down
    - Changes in actuarial assumptions or methodology amortized separately over 20 year period
- Future change in assumed rate return possible

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Outside Pressures on Pension Liabilities

- Shift from GASB 27 reporting to GASB 68 reporting as of fiscal years beginning after June 15, 2014
- Tension between funding public services and paying for increasing pension liabilities
- Public perception
- Legislative initiatives

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GASB 68

- Establishes new accounting and financial reporting requirements for governments that provide their employees with pensions
- Replaces GASB 27
- Goals
  - Improve decision-usefulness of reported pension information
  - Increase transparency, consistency, and comparability of pension information across governments
- It addresses how pension costs and obligations are *measured and reported* in audited financial reports rather than how to fund such costs and obligations

GASB 68

- Effects
  - Required to report unfunded pension liability as a liability in the accrual-based financial statements
  - Reporting the net pension liability on the face of the financial statements will more clearly portray financial status putting pension obligations on equal footing with other long-term obligations
  - GASB 68 does not alter contribution rates
- Effective for fiscal years beginning after June 15, 2014

Substantial Shift From GASB 27 Reporting

- GASB 27
  - Pension costs are recognized as accrued benefits are funded (or how they should be funded, based on the actuarially required contribution (ARC))
  - There is no liability reported if the government fully funds the ARC or pays its contractually required contribution

Managing Pension Liabilities

- Less costly benefits for future hires complicated by CalPERS and PEPRA
  - CalPERS
    - Once in, always in unless you can afford to terminate CalPERS contract
    - Withdrawal liability is an insurmountable obstacle in many cases
  - PEPRA
    - New "classic member" hires are enrolled in plan in place on 12/31/12, new "new member" hires are enrolled in pre-designated plans based on classification
    - Prior option to create tiers is no longer viable except in limited cases for safety classification

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Managing Pension Liabilities

- Shifting costs to employees
  - New Members
    - Normal costs
      - Required contribution equal to 50% of normal costs
      - Can increase normal cost contribution pursuant to collective bargaining principles
    - Employer normal costs and unfunded liabilities
      - Cost-sharing of employer contribution rate pursuant to Section 20516

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Managing Pension Liabilities

- Shifting costs to employees
  - Classic Members
    - Section 20516.5 permits a unilateral shift of normal costs to classic members – permissive, not mandatory
      - Completion of good faith bargaining process.
      - Subject to applicable caps (8% miscellaneous, 12% safety)
      - Not applicable until January 1, 2018
    - However, Section 20691 already provides authority to eliminate EPMC
    - Eliminating EPMC may be impractical if Section 20636(c)(4) benefit has been added
    - Nonetheless, employers want to achieve AB 340 standard for classic members

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Managing Pension Liabilities

- Pension obligation bonds (POBs)
  - Bonds issued by state or local government to pay its obligations to the pension fund
  - Benefits
    - Savings generated by paying for pension costs with lower cost debt
    - Discounts from paying contributions up front rather than periodically
    - Potential for bond proceeds to perform better if investment performance exceeds assumed interest rate
    - Budget relief
  - Disadvantages
    - Pension fund investments underperform bond rate
    - Subjects bond proceeds to volatility of CalPERS investment return (e.g., equity correction could create more debt)

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Managing Pension Liabilities

- Borrow from general fund to increase payments to CalPERS
  - Anticipated repayment through savings is uncertain
  - Funds are subject to CalPERS investment volatility
  - Loss of control over timing and allocation of payment
- Establish internal reserve fund
  - Subject to investment limitations of general fund investments
  - Would not offset pension liabilities
- Request a shorter amortization period
  - Increases short-term costs, affecting ability to provide services

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Managing Pension Liabilities

- Prefund pension liabilities through irrevocable trust
  - Pension volatility risk mitigation
  - Investment flexibility
  - City retains oversight and local control of fund management selection and monitoring of performance
  - Increased flexibility on use of trust assets
  - Offset pension liabilities for GASB 68 purposes

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Change on the Horizon?

- *Marin Association of Public Employees v. MCERA* (*Marin County*)
  - Employees argued that they had a vested right to the continued inclusion of payments formerly included under Section 31461 of the County Employees' Retirement Law in the calculation of pension benefits
  - Exclusion resulted from AB 340 and AB 197

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Change on the Horizon?

California courts have held that vested pension benefits can be changed before an employee retires if the following criteria are met:

- the change is made for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and to maintain the integrity of the system
- the change must be reasonable
- the change must bear a reasonable relation to the theory of a pension system
- changes which result in a disadvantage to employees ***should*** be accompanied by comparable new advantages

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Change on the Horizon?

- Court found that a modification in pension benefits was not required to be replaced by a comparable benefit, and that the fourth criterion is permissive rather than mandatory
  - The Court found that, while public employees have a vested right to a pension, a right that is secured at the time of employment, such a right is not to a fixed or definite pension but to a reasonable pension
  - Court focused on whether the modification constituted a substantial impairment of a vested right

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Change on the Horizon

- So a legislative body may make modifications to a pension system up until an employee's retirement in consideration of changing conditions that impact the viability and integrity of the system, such as unfunded liabilities
- If this ruling is upheld, it will signify a monumental shift in the way that pension reform measures are crafted, implemented, and evaluated

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OPEB LIABILITIES

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Looking at the Numbers

- $157.7 Billion
  - Combined OPEB liability of State of California and local governments as estimated by *California Common Sense*
  - $23 Billion liability attributed to cities ($18 Billion unfunded)
- $ 7.3 Billion
  - The amount that has been set aside to offset OPEB liabilities (source: *Surveying California's Unfunded Retiree Healthcare Obligations*, 2014)
- 82%
  - Percentage of public entities that offer retiree healthcare benefits out of 1,200 entities surveyed in 2008 by Public Employee Post-Employment Benefits Commission
- 73%
  - Percentage of surveyed public entities that set aside no assets to cover future retirement healthcare cost (source: *California Common Sense)*

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Looking at the Numbers

City	Unfunded OPEB Liability FY11
Los Angeles	$4,206,483,000
San Francisco	$4,364,273,000
San Jose	$1,844,628,000
San Diego	$1,204,090,000
Oakland	$520,882,000
Sacramento	$376,417,000
Anaheim	$206,994,000

Source: *Reform before Revenue: How to Fix California's Retiree Health-Care Problem*, Stephen D. Eide, October 2012 (assumed 6% rate of return)

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Primary Causes in Rising Costs

- Rising health care costs
- Retiree population is increasing (baby boomers)
- Workers are retiring younger
- Workers are living longer

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A Vested Right?

- Unlike pensions, the existence of a vested right is fact intensive and will vary from employer to employer
- Significant litigation
  - County of Orange
  - Sonoma County
  - San Jose
  - San Diego
  - Sappington

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What We Have Learned

- Recent case law has demonstrated that local governments have more flexibility to adjust retiree health benefits than they have for pension benefits
- However, the California Supreme Court established that retiree health benefits can be vested benefits
- Thus, in evaluating what a public entity can do with respect to its retiree health benefit program, resolutions, ordinances, MOUs and employment policies become critical to this analysis

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Strategies Used to Constrain Costs

- Capping employer's contribution for retiree health benefits
- Changing eligibility requirements (e.g., raising minimum age and service requirements, limiting benefits until Medicare eligibility)
- Eliminating higher cost plans
- Eliminating coverage for future retirees and, in some cases, for current employees (PEMHCA considerations)
- Shift from defined benefit to defined contribution
- Modification to benefits of current employees and retirees

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Future Employees

- Future employees have no vested rights before they are hired, unless those rights are set forth clearly in an MOU or other controlling documents
- However, PEMHCA requires minimal funding by employers providing health benefits through the CalPERS health benefit program

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Current Employees

- Recent case law suggests that in certain cases retiree health benefits are a condition of employment subject to negotiation
- Most of these cases have focused on changes to retiree health benefits that have resulted from the collective bargaining process
  - If there is a pattern of changes to retiree health benefits from one MOU to another and an absence of language amounting to a guarantee of a vested benefit, changes are likely permissible
- But what about unrepresented employees?
  - Apply the *California League* criteria, as modified by REAOC III, to determine whether the employer intended to provide a vested benefit

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Retirees

- Modifications are presumptively suspect, except in circumstances, where the question of *what* has been promised is ambiguous
- Examples of changes deemed permissible
  - Increase in retiree contribution toward coverage through cap on the employer contribution
  - Requiring the retiree to pay for any increases in premium
  - Changes in carriers and/or types of coverage
  - Where benefits have been tied to employee benefits, reducing retiree benefits consistent with reductions in employee benefits

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Case Studies

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Reducing Pension Liabilities

- City A faces CalPERS employer contribution rates increasing by 8-10% over the next 5 years
- Does not have the funds to cover the entire cost
- How should the City plan to reduce its pension obligations?

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Reducing Pension Liabilities

- Options:
  - Cost-sharing
    - Taxability of EPEC
  - Prefunding arrangement (115 trust)
    - Addresses funding existing liabilities, not cutting them
  - Cut benefits for future employees
    - No legislation yet permitting benefit cuts for current employees
    - But consider potential impact of *Marin* case

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Reducing Pension Liabilities

- Adopted solution:
  - City A decided to adopt a 115 trust to prefund pension liabilities
    - Will make funds available to offset fluctuations in CalPERS contribution rates
    - Can be offset against pension liabilities on financial statements
    - Lower long-term pension costs
    - Diversification and City control of investments

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Reducing OPEB Liabilities: Case Study 1

- City B wanted to reduce its OPEB liabilities
- Relevant facts:
  - Materials describing health benefits did not present post-employment health benefits as an inducement for employees to either accept or remain in their positions
    - Nothing guaranteed a specific benefit
  - City did not participate in PEMHCA

Reducing OPEB Liabilities: Case Study 1

- Adopted solution:
  - Current employees – decreased contribution towards retiree health benefits to the same amount that the City agrees to contribute towards health benefits during employment
    - Subject to meet and confer requirements for represented employees
  - Future employees – no retiree health benefits
    - Note if participate in PEMHCA, would have to pay minimum contribution
  - Current retirees – froze benefit levels
  - Adopted cafeteria plan for current employees and HRA for retirees
  - Achieved substantial savings

Reducing OPEB Liabilities: Case Study 2

- City C wants to reduce its OPEB liabilities
- Relevant facts
  - City participates in PEMHCA
  - City has represented and unrepresented employees
  - Current benefit structure: City pays percentage of health insurance premium directly to CalPERS, employee pays remaining percentage

Reducing OPEB Liabilities: Case Study 2

- City's proposed solution
  - Current employees:
    - Receive a City contribution for a percentage of CalPERS health premiums
    - PEMHCA minimum contribution will be paid directly to CalPERS
    - Balance of the City contribution will be paid through a Section 125 plan (salary reduction for employee's share of premiums)
    - Employees hired before a certain date have the option to irrevocably waive City contribution under 125 plan during retirement and instead receive a 401(a) contribution equal to up to 3% of the compensation deferred to a 457(b) plan
  - Future employees:
    - Receive City contribution to the 125 plan during employment but not upon retirement
    - Instead, they will receive a contribution to a 401(a) plan equal to up to 3% of the compensation deferred to a 457(b) plan
    - City contributes PEMHCA minimum to CalPERS

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Reducing OPEB Liabilities: Case Study 2

- Potential Issues
  - 401(a) structure does not provide intended tax-free treatment for retirees
  - Retiree participation in 125 plan

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Reducing OPEB Liabilities: Case Study 2

- Proposed Alternative Solution
  - Adopt retiree-only HRA to fund reimbursements for retirees
    - Can pre-fund using 115 trust
  - Cafeteria plan for current employees only

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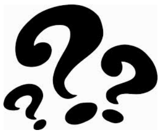

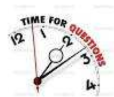

Questions
&
Answers

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Thank you for attending.

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