CITIZENS' GROUP ON PENSION REFORM

Report to the City of San Rafael City Council Subcommittee on Pension/OPEB Benefits

For a number of years, the City has been concerned that the costs of pensions and other post employment benefits (OPEB) have been taking resources which might otherwise be used to provide services to the public and repair and improve the City's infrastructure and capital assets. In that past several years the City has taken action to reduce those costs to some extent, and formed a City Council Subcommittee on Pension/OPEB Benefits to look into the issues. Looking for an unbiased opinion on the steps already taken and what actions the City might still take to contain those costs, The subcommittee called for formation of a citizen group to study the issues and report its thoughts.

Dirck Brinckerhoff was asked to choose and chair the group. The other members are Laura Bertolli, David Hellman, David Holsberry and Michael Lotito.

The members studied materials produced by others conversant with the issues, including, among other things,

Analyses of the current state of pension and health benefit funds of various entities, including San Rafael, by the Marin County Civil Grand Jury, the Marin County Council fo Mayors and Councilmembers, the Committee for Sustainable Pension Plans, the actuarial consultant for the Marin County Employees' Retirement Association, City of San Rafael staff and others;

Summaries and analyses of portions of pension law by the League of California Cities and by SEIU;

Legal analyses of the vested rights theories;

The Reed Initiative;

Staff reports to the San Rafael City Council on the progress made in negotiations with employee groups within the city.

The members also met with City staff and with Jeff Wickman, administrator of the Marin County Employees' Retirement Association.

The report below summarizes what the group learned, the actions so far taken by the City, the members' analysis of what may still be possible within the current legal structure, and a listing of additional approaches, not as suggestions, but as thinking points.

BACKGROUND INFORMATION:

There are Two Basic Types of Pension Plans:

1. Defined Contribution plans, under which the employer and employee contribute specified percentages of the employee's pay during the course of employment, and the retiree is entitled to collect, in one manner or another, the payments and the amounts they have earned by virtue of investment by the pension administrator.

In a defined contribution plan, the obligation of the employer to make payments into the plan lasts only as long as the employee is employed. The employer must simply deposit the correct amount monthly during employment. The pension administrator is then obligated to pay out, according to schedules, the total of the contributions and whatever gains the administrator has been able to garner by investment.

2. Defined Benefit plans, which are the type common for public employees, provide the retiree with monthly payments for life in an amount calculated on formulas based on years of service, type of service, retirement age, and the amount of earnings at retirement.

In this case, if the contributions plus the investment earnings are not enough to make those payments, the employer (in this case the City) must make up the difference.

Recently, governmental entities have come to realize that the obligations to which they have been bound by law and by agreement with employees, whether directly, through union agreements, or by virtue of the rules of their pension administrators, are taking and will take in the future, so much of their income that they will not be able to continue to provide the services expected and deserved by the citizens.

In reaction, the California legislature has passed laws which allow for, and in some cases mandate, changes in the entitlement formulas and funding processes for pensions for newly hired employees in particular and for all employees in some cases.

We will first look at how the defined benefits for retirees are expressed and calculated (Benefit Formulas), and then how they are paid for (Funding the Benefits).

Benefit Formulas:

Tiers --

Pension benefits are defined by formulas which provide for payments of a certain percentage of the employee's salary for each year served, depending on the age at retirement. These formulas (called "tiers") have changed over the years and have been different depending on the category of employee (Safety Fire, Safety Police, Miscellaneous).

The tiers are usually described by the percentage of final average salary which would be payable per year of employment to an employee retiring at a particular age after having worked within the system for 10 years. Thus "2.7% at 57" is the shorthand reference to a whole chart showing benefit amounts payable to retirees depending on retirement age and years of service where an employee retiring at age 57 after 10 years of service is entitled to 27% of final average salary. Below is an example of a tier chart for a "2% at 55" tier, in which the intersection of the age column and the years of service row indicate that the benefit for a 55 year old employee retiring after 10 years of employment would be 20% of the employee's final average salary (2% X 10 years):

Years of Service	Age													
	50	51	52	53	54	55	56	57	58	59	60	61	62	63+
10	14.26	15.22	16.28	17.42	18.66	20.00	20.52	21.04	21.56	22.10	22.62	23.14	23.66	24.18
11	15.69	16.74	17.91	19.16	20.53	22.00	22.57	23.14	23.72	24.31	24.88	25.45	26.03	26.60
12	17.11	18.26	19.54	20.90	22.39	24.00	24.62	25.25	25.87	26.52	27.14	27.77	28.39	29.02
13	18.54	19.78	21.16	22.65	24.26	26.00	26.68	27.35	28.03	28.73	29.41	30.08	30.76	31.43
14	19.96	21.31	22.79	24.39	26.12	28.00	28.73	29.46	30.18	30.94	31.67	32.40	33.12	33.85
15	21.39	22.83	24.42	26.13	27.99	30.00	30.78	31.56	32.34	33.15	33.93	34.71	35.49	36.27
16	22.82	24.35	26.05	27.87	29.86	32.00	32.83	33.66	34.50	35.36	36.19	37.02	37.86	38.69
17	24.24	25.87	27.68	29.61	31.72	34.00	34.88	35.77	36.65	37.57	38.45	39.34	40.22	41.11
18	25.67	27.40	29.30	31.36	33.59	36.00	36.94	37.87	38.81	39.78	40.72	41.65	42.59	43.52
19	27.09	28.92	30.93	33.10	35.45	38.00	38.99	39.98	40.96	41.99	42.98	43.97	44.95	45.94
20	28.52	30.44	32.56	34.84	37.32	40.00	41.04	42.08	43.12	44.20	45.24	46.28	47.32	48.36
21	29.95	31.96	34.19	36.58	39.19	42.00	43.09	44.18	45.28	46.41	47.50	48.59	49.69	50.78
22	31.37	33.48	35.82	38.32	41.05	44.00	45.14	46.29	47.43	48.62	49.76	50.91	52.05	53.20
23	32.80	35.01	37.44	40.07	42.92	46.00	47.20	48.39	49.59	50.83	52.03	53.22	54.42	55.61
24	34.22	36.53	39.07	41.81	44.78	48.00	49.25	50.50	51.74	53.04	54.29	55.54	56.78	58.03
25	35.65	38.05	40.70	43.55	46.65	50.00	51.30	52.60	53.90	55.25	56.55	57.85	59.15	60.45
26	37.08	39.57	42.33	45.29	48.52	52.00	53.35	54.70	56.06	57.46	58.81	60.16	61.52	62.87
27	38.50	41.09	43.96	47.03	50.38	54.00	55.40	56.81	58.21	59.67	61.07	62.48	63.88	65.29
28	39.93	42.62	45.58	48.78	52.25	56.00	57.46	58.91	60.37	61.88	63.34	64.79	66.25	67.70
29	41.35	44.14	47.21	50.52	54.11	58.00	59.51	61.02	62.52	64.09	65.60	67.11	68.61	70.12
30	42.78	45.66	48.84	52.26	55.98	60.00	61.56	63.12	64.68	66.30	67.86	69.42	70.98	72.54
31	44.21	47.18	50.47	54.00	57.85	62.00	63.61	65.22	66.84	68.51	70.12	71.73	73.35	74.96
32	45.63	48.70	52.10	55.74	59.71	64.00	65.66	67.33	68.99	70.72	72.38	74.05	75.71	77.38
33	47.06	50.23	53.72	57.49	61.58	66.00	67.72	69.43	71.15	72.93	74.65	76.36	78.08	79.79
34	48.48	51.75	55.35	59.23	63.44	68.00	69.77	71.54	73.30	75.14	76.91	78.68	80.44	82.21
35	49.91	53.27	56.98	60.97	65.31	70.00	71.82	73.64	75.46	77.35	79.17	80.99	82.81	84.63
36	51.34	54.79	58.61	62.71	67.18	72.00	73.87	75.74	77.62	79.56	81.43	83.30	85.18	87.05
37	52.76	56.31	60.24	64.45	69.04	74.00	75.92	77.85	79.77	81.77	83.69	85.62	87.54	89.47
38	54.19	57.84	61.86	66.20	70.91	76.00	77.98	79.95	81.93	83.98	85.96	87.93	89.91	91.88
39	55.61	59.36	63.49	67.94	72.77	78.00	80.03	82.06	84.08	86.19	88.22	90.25	92.27	94.30
40	57.04	60.88	65.12	69.68	74.64	80.00	82.08	84.16	86.24	88.40	90.48	92.56	94.64	96.72
41	58.47	62.40	66.75	71.42	76.51	82.00	84.13	86.26	88.40	90.61	92.74	94.87	97.01	99.14

"Compensation" for purposes of Tiers:

The compensation to which the tier percentages are applied is the "Final Average Compensation" for a specific period. That had commonly been the last 12 months of employment.

The compensation included in that average (called "Pensionable Compensation") has been comprised of regular salary, payments for additional services outside normal working hours, certain types of unused leave, and certain other payments. By saving up these add-ons and taking them in their last year of employment, employees were able to increase dramatically the Final Average Compensation used to calculate their pensions. This practice is known as pension spiking.

Vested Rights:

Currently, the unions and most courts take the position that the benefit tier (and definition of Final Average Compensation) applicable to any employee at retirement is the most beneficial one applicable to members of his or her category during the period of his or her employment. The theory, supported by the Constitutions of the United States and of California, is that, as a part of the employee's whole compensation package, the employee accepted (or continued) employment based on the promise of that tier's benefits. As a result, it is said that the employee's rights to the benefits in that tier become "vested" and irrevocable once he or she has worked under it, even though new employees may be entitled only to less beneficial tiers, and regardless whether the employee and employer had, during the period of employment, contributed enough to the pension administrator to fund those payments.

State Legislative Moves:

While it was somewhat like shutting the barn door after the cow has left, when people realized that the promised benefits were unsustainable without either increasing taxes or reducing services, the California legislature passed The Public Employee Pension Reform Act of 2013 ("PEPRA"), which made a number of changes in public pensions in California. Because of the vested rights theory, these changes affect mostly "new employees", who are those hired on or after 1/1/2013.

Among other things, PEPRA established:

1. New tiers, which provide for pensions calculated at a lower percentages of salary and at higher retirement ages,
2. A 36 month Final Average Compensation period rather than the12 month period which had been the previous standard.
3. A cap on "Pensionable Compensation" at 120% of the maximum salary used to calculate Social Security contribution for the rest of the population
4. Exclusions of certain types of payments (mentioned earlier) from the calculation of "Pensionable Compensation" to prevent pension spiking.
5. A cap on cost of living increases (COLA) which pension administrators are allowed to pay.

San Rafael's Progress:

The chart below shows the changes in benefit tiers, final average compensation and maximum cost of living increases applicable to San Rafael's employees depending on the date of their employment. As can be seen, the City and the employees had agreed to significant reductions in benefits before the passage of PEPRA.

Dates	Min Age to Retire	Formula	Max COLA	FAC* Period
Before 7/1/11				
Safety	50	3% at 55	3%	1 yr.
Miscellaneous	50	2.7% at 55	3%	1 yr.
7/1/11 to 12/31/12 (Negotiated before PEPRA)				
Safety	50	3% at 55	2%	3 yrs.
Miscellaneous	55	2% at 55	2%	3 yrs.
1/1/13 to Present (PEPRA)				
Safety	50	2.7% at 57[1]	2%	3 yrs.
Miscellaneous	52	2% at 62	2%	3 yrs.

*Final Average Compensation

[1]Safety Option Plan Two (required by PEPRA based on prior formula)
Lower tier could be applied to new hires if agreed in collectively bargained MOU without impasse.

Funding the Benefits:

The retirement plans are funded by a combination of contributions by the employer and employee paid to a pension administrator. For many government entities the administrator is the California Public Employee's Retirement System. For San Rafael and numerous other Marin entities, the Marin Employees' Retirement Association ("MCERA") which invests the contributed money with the goal of having enough funds available when employees retire to make the promised payments to them and to any eligible beneficiaries for the rest of their life.

Normal Cost

Using assumptions as to the rate of return on the invested funds, the rate of inflation, and the expected retirement age of employees, the pension administrator calculates the amount of contributions needed each year to invest so that there will be enough in the fund to make the pension payments. The contribution needed if we were starting with a clean slate is called the "Normal Cost".

Normal Cost is the amount needed to be contributed in each year to have enough available to pay the defined benefits when the employees retire. (Assuming past contributions had been sufficient.)

In making its projections of the amount needed, the actuaries for MCERA currently calculate the needs based on the following assumptions:

Investment Return/Discount Rate	7.50%	
Inflation:	3.25%	
Real Rate Of Return	4.25%	(Investment minus Inflation)
Salary Growth	3.25%	
Membership Growth (# employees)	0.00%	i.e., total number of employees remains stable

It is common with most governments that the employer and employees each pay a portion of the Normal Cost.

As a result of negotiations with the employee unions, most of the San Rafael employees are paying very close to half of the Total Normal Cost.

Cost Sharing: The PEPRA requirement is that new employees pay at least half of Total Normal Cost. For pre-1/1/2013 employees, that is a "goal".

Unfunded Liability:

In the case of most every government entity's pension fund, a history of benefit increases, optimistic actuarial assumptions, and investment losses has created a situation in which the past contributions have not built the fund's assets to sufficient size to make the benefit payments required by the formulas. The difference between the amounts now in the funds and the amounts needed to cover the expected pension obligations to retirees is referred to as the "Unfunded Liability".

The shortfall arose for many reasons, among them:

1. In the past, to attract and keep good employees, cities have agreed to increase benefits beyond what they originally planned for (the result is like saving for a trip to Disneyland and then paying for an excursion to Europe instead),

2. people have lived longer than projected, thus collecting payments longer than expected,

3. the value of investments has not grown at the projected rate (and in recent years, dramatically decreased)

4. employees have negotiated or found ways to increase their income just before retirement ("pension spiking") so that the contributions during their regular employment income turn out not to be enough to cover the retirement payments under the defined benefit formulas (which use only the final year(s)' compensation to determine benefits).

To assure payment of the promised pension benefits, it is necessary to make payments in addition to the Normal Cost to make up the Unfunded Liability.

To make up the Unfunded Liability, MCERA is requiring contributions in addition to Normal Cost to bring the plan to 100% funded within 17 years. (I.e., based on a 17 year amortization.)

Because the 2008 loss in asset value was so great, and making it up would put such a strain on the City's finances, to soften the load, MCERA is requiring contribution for half of the 2008 losses based on a 30 year amortization.

Last year, in addition to its portion of the Normal Cost and the two portions of the Unfunded Liability, San Rafael made an additional contribution of $1,000,000.

FINDINGS:

1. Before the passage of PEPRA, the City had, through negotiation and agreement with its employees, taken many of the measures required or allowed by PEPRA.

2. Possible Additional Measures for the City:

<u>For New Members:</u>

Under PEPRA, the City can agree with New Members in a MOU to pay some or all of the employer's share of Normal Cost. (Negotiation and agreement is required; unilateral imposition is not allowed.)

New employees can also agree to pay some or all of the payments toward the Unfunded Liability

This agreement may be reached with individual bargaining units; agreement with the whole classification is not required.

Payment of part of the unfunded liability may seem fair if it is for that portion of the unfunded liability which relates to the costs for that employee's future benefits (i.e., not that part which covers benefits for employees already retired.

New tiers for new employees could be devised, but they would have to be certified as having no greater risk or cost than the PEPRA tiers and must be approved by the Legislature. Presumably they would also have to be negotiated with employees, and with the requirement of legislative approval, it would be foolhardy to try to obtain that without first having agreed with employees.

For Members hired before 1/1/2013:

It appears that, after Jan 1, 2018, similar negotiating is allowed with existing members with respect to payment of some or all of the employer's share of Normal Cost and some or all of the payments toward the Unfunded Liability.

Also, after January 1, 2018, the City can, after exhausting impasse, impose a requirement that employees pay 50% of Normal Cost, provided the employee contribution doesn't exceed 8% of salary for misc., 12% for safety and 11% for other employees. – San Rafael is near or at those maximums already.

General:

Since the structure of government pensions and the allowable changes to them are so tightly prescribed by state law, the most effective way to accomplish dramatic changes will be to pressure our legislators to pass laws which go beyond PEPRA and somehow allow changes to benefits for those who have worked or are working under more advantageous tiers and rules.

Reduce rights in emergency

Retiree Health Benefit Costs:

For all past employees, San Rafael is committed to paying anywhere from $386 per month to the full premium for retirees' health insurance. In 2009 and 2010, the City negotiated to cap those benefits so that they would not increase over time. Starting with employees hired in 2009, the City will be paying the legal minimum (currently $115 per month) for retirees to use toward purchasing their own coverage, regardless of employment category, age of retirement, or health status.

The City has a trust fund, currently administered by CalPERS, to fund the liability for these benefits. This liability is currently approximately 35% funded.

Additional Thoughts:

The following ideas, outside the pension laws as they now stand, have been suggested by some, but are not agreed by all. They are not presented as recommendations of the group, and may not be desirable or feasible, but are mentioned as options for consideration.

1. Salary freezes or reductions from what might be agreed to so those funds are used to pay into the pension fund;

2. Since the health care benefits are not 'vested' in accordance with law, consider reducing that benefit in some fashion and use those funds towards the pension issue (consider, however, whether "promissory estoppel" may prevent this – see Retired Employees Assn of Orange County v. County of Orange and IBEW Local 1245 v. City of Redding,);

3. Consider outsourcing certain functions to transfer the liability to a third party or cap the liability to those who have accrued 'benefits' and have the private sector employer assume the risk instead of the taxpayer (however, see unpublished appellate decision in Costa Mesa City Employees’ Assn. v. City of Costa Mesa, which questions a city’s ability to contract out essential services);

4. Consider combining services with other towns to reduce costs and place the savings into the pension fund (though, depending on the benefits available in each of the combined agencies, consider whether Govt. Code Sec. 31,485.9 may require increasing all benefits to the highest of the combining agencies);

5. Increase taxes;

6. Any combination of the above;

7. Consider retaining an 'independent' third party specialist to negotiate the agreements to avoid the emotional pain that comes from the current system;

8. Ensure that the management representatives who negotiate the deals do not receive parity to improvements agreed to with the unit employees;

9. Engage in a massive educational effort for all voters to have them understand how the quality of services are being and will continue to be impacted by the debt which exists;

10. Support the Reed initative, or other like modifications to state law, whether by initiative or legislative action.

11. Use the GASB68 standards requiring the City to report pension unfunded liabilities on the Statement of Net Assets as an opportunity to educate the public and the public employees so that all may be more receptive to taking actions necessary to resolve the issues we now face.

12. Since people are living longer, raise the age at which people can retire (this would likely require creation of new tiers – see above on the practicality);

13. Move towards defined contribution when/if this ever becomes possible, and bring agreements for new hires be more in line with private industry, where benefits are being cut.

14. Extend the wage average used to calculate the pension amount, over a longer period, say 5 or 7 years?