

SDCTA Review of Current Statewide Pension Systems and Recommended Reforms

Current State of Public Pension Plans in California

As of June 30, 2012 the California Public Employees' Retirement System's (CalPERS) state employee plan had an unfunded pension liability of approximately \$34 billion. The total unfunded pension liability for cities enrolled in CalPERS within San Diego County as of June 30, 2011 totaled approximately \$800 million. For the same period, the California State Teachers' Retirement System (CalSTRS) reported an unfunded liability of \$71 billion. It is projected that the CalSTRS system will run out of money in 31 years.

In San Diego County, many cities and counties have implemented pension reforms to the maximum extent allowed by state law. Jurisdictions are now beginning to implement new reforms allowed for under Assembly Bill (AB) 340, otherwise known as the California Public Employees' Pension Reform Act of 2013.

There have been discussions about trying to place a measure on the statewide ballot calling for additional statewide pension reform. This document provides background regarding the reforms outlined in AB 340 and further statewide reforms recommended by the San Diego County Taxpayers Association (SDCTA).

Governor Brown's Pension Reform Package

In October 2011, Governor Brown released his *Twelve Point Pension Reform Plan* that would, "apply to all California state, local, school and other public employers, new public employees, and current employees as legally permissible." The plan included:

- Requiring employees to pay 50 percent of the normal cost of the benefits;
- Hybrid pension plan with both a defined benefit and defined contribution element;
- Increasing retirement ages for new employees; and
- Eliminating pension spiking

In addition, the Governor's proposal included reforms to the CalPERS Board of Directors. The Governor intended to reform the composition of the Board to encourage independence and "financial sophistication." These elements were not included in the final pension reform bill (AB 340).

Elements of AB 340

Reforms within AB 340 fall into various categories that also incorporate various reforms initially proposed by Governor Brown. The reform elements within the legislation are highlighted below. A majority of the elements within the legislation are specifically for new employees hired after January 1, 2013. As well, the reforms within the legislation apply to not only employees enrolled within CalPERS, but

employees under a county retirement plan (otherwise known as a '37 Act county) or a State Teachers' Retirement System plan (STRS) are also affected.

Pensionable Compensation

Under AB 340, the pensionable compensation calculation to be used by both CalPERS and CalSTRS only includes the base pay of each employee. Pensionable compensation DOES NOT include:

- Any one-time or ad hoc payments
- Any employer provided allowances, reimbursement, or payment, e.g. housing, vehicle, uniforms
- Any bonus paid in addition to normal base pay
- Compensation for overtime

AB 340 also impacted the county pension systems governed by the 1937 Retirement Act (also known as the County Employee Retirement Law, or CERL).

These agencies are not enrolled within CalPERS, and often have their own retirement system governed by an independent board. Reforms to "pensionable compensation" include those listed for CalPERS members, but also exclude any compensation the retirement board determines was given to enhance a member's retirement. The definition also includes:

- "In-kind" compensation converted to cash;
- Any one-time or ad hoc payment;
- Severance payments while the employee is still employed;
- Payments for unused vacation, annual leave, personal leave, sick leave;
- Employer-provided payments/allowances for housing, vehicles, or uniforms;
- Any bonus; and
- Overtime pay

RECOMMENDATION

While the intent of AB 340 was to limit pensionable compensation to base pay alone, CalPERS issued an opinion stating various different specialty pays will be defined as a part of base pay. SDCTA recommends an amendment to the law stating that CalPERS or any other retirement board is prohibited from determining whether additional pays should be deemed pensionable, thus limiting pensionable compensation to only the true base pay offered by employers.

Required Normal Cost Sharing for New Employees

For new CalPERS enrolled employees hired after January 1, 2013, employees must pay at least 50 percent of normal cost. Normal cost is defined as the annual actuarially determined cost for the defined benefit plan expressed as a percentage of payroll. Employers will also be prohibited from paying a

portion of the employee share of pension costs, otherwise known as Employer Paid Member Contribution (EPMC).

Between January 1, 2013 and December 31, 2017, the employers may collectively bargain for both current and future employees to share the employer's contribution costs over and above the normal contribution required by employees. Any change to the contribution rate in excess of 50 percent of normal cost is subject to good faith meet and confer process and cannot be imposed upon the employees.

Beginning on January 1, 2018, if current and new employees within a bargaining unit under CalPERS are not paying for at least 50 percent of their normal pension costs, then the employer may unilaterally require employees to pay 50 percent of the total annual normal cost up to an 8 percent contribution rate for miscellaneous employees and 12 percent contribution rate for local police officers, firefighters and county peace officers (11 percent for all other local safety members).

For CERL agencies, a board of supervisors may require the members pay all or part of the member's or employer's contributions or both. When dealing with represented employees, contributions must be negotiated and approved by the bargaining units; these contributions cannot be imposed. After January 1, 2018, a board of supervisors may require that employees pay 50 percent of the normal cost of benefits, but no more than 14 percent above the normal contribution rate for general members and no more than 33 percent for police, firefighters and peace officers (37 percent for all other safety members).

AB 340 had no impact to the contribution rate of current members. The contribution rate for current CalSTRS members is set via statute at 8 percent of pay. New members post-AB 340 are required to pay 50 percent of the normal cost of the 2 percent at 62.

RECOMMENDATION

SDCTA recommends that the caps put in place on the employee contribution toward normal cost be removed for those bargaining units not paying at least 50 percent of normal cost by January 1, 2018. For CalSTRS members, SDCTA recommends legislation that requires current members to pay at least 50 percent of normal cost.

New Lower Defined Benefit Pension Formulas/Higher Retirement Age/Final Compensation

Both new public safety, miscellaneous employees and CalSTRS members hired after January 1, 2013 will receive a new lower cost pension benefit that reduces the pension formula and increases retirement age.

For new miscellaneous employees enrolled in CalPERS and CERL, they will receive a 2 percent at 62 pension benefit

formula, increasing to 2.5 percent at 67. The minimum retirement age under this formula is 52.

For new CalPERS and CERL public safety employees, one of three pension benefits is available to be offered by employers:

Figure 1: New Retirement Formulas

	Normal Retirement Age	Maximum Benefit
Basic Formula	1.426% at 50	2% at 57
Option Plan 1	2% at 50	2.5% at 57
Option Plan 2	2% at 50	2.7% at 57

The formula that is offered after January 1, 2013 must be the one that is closest to the formula presently offered to the same classification and that provides a lower benefits at 55 years of age. Furthermore, the decision about this benefit must be negotiated with the represented employees and cannot be unilaterally imposed upon them.

AB 340 changed the retirement benefit formula that primarily affects CalSTRS members hired on or after January 1, 2013. New hires are enrolled into the new structure known as "2 percent @ 62" in which the "age factor" ranges from 1.16 percent at age 55 and 2.40 percent at age 65. For comparison to the structure for existing employees, new employees must work until they are two years older in order to achieve an "age factor" of 2 percent. AB 340 also eliminated the career factor (an age factor boost for those with 30+ years of service) that has been included in employee retirement formulas.

New employees enrolled within any of these benefit formulas will also have their final pensionable compensation based off the highest consecutive 36-month work period. This is instead of allowing pensionable compensation to be based off a high 12-month period which has previously been offered to employees within some jurisdictions.

In June 2012, City of San Diego voters approved Proposition B, which enrolled new non-police employees into a defined contribution plan. The plan caps the employer contribution and does not require the employee to contribute to the plan. The capping of the contribution allows the city to maintain a stable cost for the benefit and eliminate any future unfunded liability costs.

RECOMMENDATION

SDCTA recommends an amendment to state law to allow local jurisdictions to implement a defined contribution plan for non-public safety employees. The contribution rates between the employer and employee must be enough to satisfy IRS requirements if the agency is not enrolled in Social Security. The cost-sharing of the contribution rate should be subject to negotiations.

For public safety employees, SDCTA recommends limiting pension payouts to 80% at age 57 of the highest 36 consecutive month salary.

Opt-In to Lower Cost Retirement Plan

In January 2013, Congresswoman Loretta Sanchez (CA-46) introduced House Resolution (H.R.) 205 that would amend the Internal Revenue Code to clarify the treatment of certain retirement plan contributions picked up by governmental employers.

H.R. 205 would add section (B), "TREATMENT OF ELECTIONS BETWEEN ALTERNATIVE BENEFIT FORMULAS." The section specifically reads,

"(i) IN GENERAL. – For purposes of subparagraph (A), a contribution shall not fail to be treated as picked up by an employing unit merely because the employee may make an irrevocable election between the application of two alternative benefit formulas involving the same or different levels of employee contributions.

(ii) APPLICATION TO EXITING EMPLOYEES. – Clause (i) shall be applied without regard to whether the employee is already covered by one of the benefit formulas referred to therein."

Congressmen John Campbell and Ed Royce, both representing portions of the County of Orange, have joined as co-sponsors to the bill.

H.R. 205 would amend the Internal Revenue Code to allow current government employees to elect to participate in a lower cost retirement plan without the penalty of previous contributions paid for by their employer to be determined as deferred compensation. Passage of the bill would allow not only employees of Orange County to move forward with this reform, but the cities of San Jose and San Diego as well.

Both Measure B in San Jose, and Proposition B in San Diego, included language that would allow current employees to enroll in lower cost pension plans instead of paying higher costs for their current defined benefit plans.

RECOMMENDATION

SDCTA recommends language be included within state law that will allow for current employees to opt-in to lower cost retirement plans should federal law be amended to allow for this change in benefits.

Composition of Retirement Boards

The CalPERS Board of Directors consists of 13 members, six of which are elected by members, three are appointed (two by the governor) and four are ex-officio. The CalSTRS Board consists of three elected positions representing current educators, a retired CalSTRS member appointed by the Governor and confirmed by the Senate and three public representatives appointed by the Governor and confirmed by the Senate. One member is a school board representative appointed by the Governor and confirmed by the Senate. There are also four ex-officio members.

In Governor Brown's initial 12-point pension reform plan, Governor Brown stated there has been a "lack of independence and financial sophistication on public retirement boards [that] contributed to unaffordable pension benefit increases." The plan to reform the CalPERS Board recommended adding two additional independent public members with financial expertise and replacing the State Personnel Board appointed representative with the Director of the California Department of Finance.

In November 2004, City of San Diego voters passed Proposition H which amended the composition of the San Diego City Employees' Retirement System (SDCERS) Board. The measure required seven of the 13 members be independent professionals with at least 15 years of financial experience and no vested interest in the system. Of the remaining six members, two are to be representatives from the Municipal Employees Association, one Police Officer's representative, one representing Firefighters and one City retiree representative.

RECOMMENDATION

SDCTA recommends reforming the composition of both the CalPERS and CalSTRS retirement boards to require two-thirds of the members be independent professionals with at least 15 years of financial experience and no vested interest in the system, regardless of the size of the board.

Pension System Assumed Rate of Return & Amortization Period

Over the past few years, a number of pension agencies have begun to reduce their assumed investment rate of return. When these systems do not meet their investment targets, taxpayers are responsible for funding the difference. Reform advocates often state that these targets, as high as 7.75 percent for a local agency, are much too high and should be lowered to recognize the new state of our economy and relieve the burden placed on taxpayers.

Reducing the assumed rate of return does impact the cost to both employees and taxpayers in the short-term. Lowering this target does increase the amount of funding needed to provide the benefit to retirees, so often the move to reduce the target comes in incremental steps.

Additionally, pension systems have adopted various amortization periods that guide how long each will take to pay off the debt that has accumulated. The local pension systems that govern the City of San Diego and County of San Diego pension plans have adopted relatively conservative amortization periods; paying off unfunded liabilities over a 15 or 20 year period, respectively. CalSTRS has adopted an amortization period that pays off pension debt over a 30 year period. CalPERS has adopted a more unconventional amortization period, known as a rolling 30 year amortization. Under this method, CalPERS calculates the first year payment of their unfunded liability as if they are scheduling to pay off the debt over 30 years, but in year 2, the total debt is reset and they pay the first year again. This re-calculation is made every year, never allowing the plans obligations to be fully funded.

Moody's Investor Service has recently adopted new rules that impact the unfunded pension liabilities of government agencies. The rating agency believes government financial reports understate the risk of unfunded pensions to buyers of government bonds and do not provide for adequate transparency and comparability. One of the adopted rules states accrued actuarial liabilities will be adjusted based on a high-grade long-term taxable bond rate index discount rate (5.5% for 2010 and 2011). In addition, all unfunded pension liabilities will be amortized over a 20 year period.

Various studies reviewing the impact of these changes show unfunded liabilities doubling due to the lowering of the discount rate. Lowering the assumed rate of return will increase pension costs for both the employer and the employee.

RECOMMENDATION

SDCTA recommends both CalPERS and CalSTRS adopt a layered 15-year amortization period. Additionally, SDCTA recommends CalPERS and CalSTRS set the assumed rate of return to match the lesser of the past 15-year average, or 6 percent. Each system should phase in the implementation over a five-year period.

Pension Reform Element	California Public Employees' Pension Reform Act of 2013		SDCTA Recommended Reforms	
	Current Employees	New Employees	Current Employees	New Employees
Pensionable Compensation	Current Pension System definition.	Base pay only. Excludes other forms of reimbursements, bonuses, deferred compensation, etc. Pensionable compensation capped at \$110,100 (if in Social Security) or \$132,120 (if not in Social Security). Cap annually adjusted for inflation.	Current Pension System definition.	Base pay only. Prohibits pension boards from including additional specialty pays as pensionable compensation.
Pension Cost Sharing	Current Pension System definition.	New employees pay at least 50% of normal costs. Cannot impose employee payment of more than 50%, must be negotiated. Prohibits employer from paying employee contribution (EPMC).	Current Pension System definition.	Misc Employees: Employee/Employer contribution split subject to negotiations, but no less than 50% of normal costs. Safety Employees: Cost sharing of unfunded liability subject to negotiations.
CalPERS Retirement Formulas	Current Pension System definition.	Requires implementation of new retirement formula for new employees. Misc Employees: 2%@62; maximum benefit of 2.5%@67. Minimum retirement age of 52. Safety Employees: May use 1 or more of following 3 tiers: <ul style="list-style-type: none"> • Basic Safety Formula: 1.836%@55 or 2%@57 • Option 1 Formula: 2.357%@55 or 2.5\$@57 • Option 2 Formula: 2.5%@55 or 2.7%@57 Minimum retirement age of 50.	Current Pension System definition.	Misc Employees: Enrolled in a defined contribution plan. Contribution amounts set to an amount that allows for 75% income replacement ratio. Safety Employees: Enrolled in a defined benefit plan that caps retirement at 80% at age 57 of highest 36 consecutive month salary.
Opt-In Clause			If allowed under federal law, current employees should be given the option of enrolling into a lower cost retirement plan.	
Final Average Compensation	Current Pension System definition.	Final compensation based solely on 3-year highest average.	Current Pension System definition.	Final compensation based solely on 3-year consecutive highest average.
CalSTRS Retirement Formula	Current Pension System definition.	2%@62 formula. Final compensation based solely on 3-year highest average.		Local school districts allowed to enroll in a defined contribution plan with similar requirements of CalPERS cities.
CalSTRS/CalPERS Board Composition				Composition of both the CalPERS and CalSTRS retirement boards to require two-thirds of the members be independent professionals with at least 15 years of financial experience and no vested interest in the system, regardless of the size of the board.
1937 Act System Retirement Formulas	Current Pension System definition.	Requires implementation of new retirement formula for new employees. Misc Employees: 2%@62; maximum benefit of 2.5%@67. Minimum retirement age of 52. Safety Employees: 2.7%@57. Minimum retirement age of 50.	Current Pension System definition.	Misc Employees: Enrolled in a defined contribution plan. Contribution amounts set to an amount that allows for 75% income replacement ratio. Safety Employees: Enrolled in a defined benefit plan that caps retirement at 80% at age 57 of highest 36 consecutive month salary.
Investment Rate of Return & Amortization Period				SDCTA recommends both CalPERS and CalSTRS adopt a layered 15-year amortization period. Additionally, SDCTA recommends CalPERS and CalSTRS set the assumed rate of return to match the lesser of the past 15-year average, or 6 percent. Each system should phase in the implementation over a five-year period.
Increase in Pension Benefits				SDCTA recommends any increase in pension benefits for employees be subject to voter approval.