MENDOCINO COUNTY POLICY #40	UNFUNDED ACTUARIAL LIABILITY
ADOPTED: October 8, 2002 ADOPTED BY: Minute Order MODIFIED: April 22, 2008 MODIFIED BY: Minute Order MODIFIED: November 3, 2009 MODIFIED BY: Minute Order	

Purpose and Intent

Coincident with the issuance of the Mendocino County Pension Obligation Bonds, Series 2002 (the "Bond"), the County of Mendocino will effectively "pay off" the entire Unfunded Actuarial Liability ("UAL") owned to the Mendocino County Employees' Retirement Association (the "Association"), replacing the County's Obligation to the Association with a new obligation to the holders of the Bonds.

The County shall always strive to achieve goals of (i) maintaining the highest possible credit rating and reputation for prudent financial management in the market place; and (ii) providing assurance to the County's taxpayers that the County is well managed and financially sound, the County will endeavor to avoid the creation of additional UAL in the future.

<u>Careful Consideration of Future Actions</u>. The County will endeavor to carefully consider all proposed actions, including future retirement plan enhancements that might impact the determination of the UAL and/or result in funding requirements that pose a financial burden to the County.

To this end, the County shall quantify, by actuarial study, both the near-term and long-term financial impact of all such proposed actions. Should such actuarial findings indicate an increase to the county's UAL, the County shall carefully evaluate the financial impact as measured by the additional funding requirements, if any, to be implemented.

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1937 Act County Retirement Systems

- Alameda
- Contra Costa
- Fresno
- Imperial
- Kern
- Los Angeles
- Marin
- Mendocino
- Merced
- Orange
- Sacramento
- San Bernardino
- San Diego
- San Joaquin
- San Mateo
- Santa Barbara
- Sonoma
- Stanislaus
- Tulare
- Ventura

1937 Act Key Events

- Pension Law G.C. 51000
- 1933: Social Security
- 1933 CalPERS: Generally G.C. 21000
- 1935: Local Agencies added to CalPERS
- 1937 Act: Generally G.C. 31000
- 1969: Meyers Milias Brown Act
- First benefit break-through
  - 1968: "CHP" 2% at 50
  - 1990: 2% at 55 Local Miscellaneous
- Industrial Disability Visibility
- 1981: Removal of Constitutional Investment Limitations
- 1992: Prop 162
- 1996: Ventura Decision
- 2000: AB 1937 (Correa): 3% 50 and 55 Local Option
- 2000: AB 448 (Floyd): 2% 55 Local Option
- 2001: AB 616 (Calderon): 3% at 60 and 2.7% at 55 Local Option
- 2003: AB 1587 (Committee): Eliminate option to exclude portions of workforce and require second tier to result from collective bargaining
- 2004: Defined Contribution Constitutional Proposition
- 2004: CAOAC/CSAC Pension Reform Principles
- 2009: SB 752 (Second Tier Orange County Hybrid DC/DB)
- 2010: Retirement Reform Initiatives

CSAC Guiding Principles for 2005-06 Pension Reform

In response to legislative, administrative, and initiative proposals early this year, CSAC staff has worked with a technical advisory group to develop proposed principles to guide our participation in discussions about reform of public pension systems. Our efforts have been guided by a firm belief that a legislative solution to pension reform is the best course to ensuring reform with clear cost-benefit outcomes for local government retirement systems and for taxpayers.

This document has been prepared with the understanding that it remains a work in progress and should be flexible in order to accommodate CSAC's coalition-building efforts. Staff will continue to modify and refine this document as necessary, under the guidance of our technical advisors and the Government Finance and Operations Policy Committee.

Preamble

Public pension reform has garnered widespread interest and has generated significant debate among policy leaders about the appropriate remedy for actual and perceived abuse, rising costs, and accountability to taxpayers. CSAC welcomes this discussion and approaches the concept of reform with the overarching goal of ensuring public trust in public pension systems, and empowering local elected officials to exercise sound fiduciary management of pensions systems, as well as maintaining a retirement benefit sufficient to assure recruitment and retention of a competent local government workforce. Proposed reforms should meet these broad goals, as well as CSAC's guiding principles.

The guiding principles and reform proposals are listed below and are intended to apply to new public employees hired after June 30, 2007 in both PERS and 1937 Act retirement systems.

Guiding Principles

- PROTECT LOCAL CONTROL AND FLEXIBILITY
  Local elected officials should be able to develop pension systems that meet the needs of their workforce, maintain principles of sound fiduciary management, and preserve their ability to recruit and retain quality employees for key positions that frequently pay less than comparable positions in the private sector. A statewide mandated retirement system is neither appropriate nor practical, given the diversity of California's communities. Further, a mandated defined contribution retirement system could force a reconsideration of the decision of local governments not to participate in Social Security.

- ELIMINATE ABUSE
  Public pension systems provide an important public benefit by assisting public agencies to recruit and retain quality employees. Any fraud or abuse must be eliminated to ensure the public trust and to preserve the overall public value of these systems.

- REDUCE AND CONTAIN COSTS
  Public pension reform should provide for cost relief for government, public employees, and taxpayers.

- INCREASE PREDICTABILITY OF COSTS AND BENEFITS FOR EMPLOYEE AND EMPLOYER
  Responsible financial planning requires predictability. Employers must be able to predict their financial obligations in future years. Employees should have the security of an appropriate and predictable level of income for their retirement after a career in public service.

- **Strengthen Local Control to Develop Plans With Equitable Sharing of Costs and Risks Between Employee and Employer**
  Equitable sharing of pension costs and risks promotes shared responsibility for the financial health of pension systems and reduces the incentive for either employees or employers to advocate changes that result in disproportionate costs to the other party, while diminishing the exclusive impact on employers for costs resulting from increases in unfunded liability.

- **Increase Pension System Accountability**
  Public pension systems boards have a constitutional duty to (a) protect administration of the system to ensure benefits are available to members and (b) minimize employer costs. The constitutional provisions and state statutes governing such boards should promote responsible financial management and discourage conflicts of interest.

Reform Proposals

The following proposals represent specific reforms that serve to promote the principles outlined above. Proposals that directly affect employee benefits are intended to apply only to employees hired after June 30, 2007.

- Restrict public safety retirement eligibility to only those groups of employees who must endanger their own physical safety to protect the public as a major component of their employment.
- Establish a formula cap for public safety at 2% at 50 and a formula cap of 2% at 60 for miscellaneous employees. The cost of any defined benefit or defined contribution retirement enhancements beyond the base pension formula must be paid in full by employee contributions unless the employer agrees to share not more than 50% of the cost.
- Require that "final compensation" be calculated using highest consecutive three-year average, as opposed to a single highest year.
- Provide local agencies the option to implement defined contribution retirement plans within both PERS and 1937 Act systems, as stand-alone benefits or hybrid systems. Remove barriers to providing defined contribution plans to individual employee units within retirement membership categories.
- Amend the County Employees Retirement Act to eliminate the cost of the *Ventura* court decision by removing factors outside direct salary in determining "final compensation." Note: awaiting definition of "direct salary."
- Limit application of pension formula increases to prospective service in order to avoid unfunded liability resulting from extension of benefits retroactively. All costs for the extension of retroactive benefits are the sole responsibility of the employee.
- Limit pension benefits to career employees by excluding from eligibility temporary employees and contract employees. Within the PERS system, seek a definition of "employee" that restricts the effect of the *Cargill v. Metropolitan Water District* case.
- Require that surplus excess earnings be used according to the following priorities: pay down unfounded liability, offset employer cost for Pension Obligation Bond (POB) debt service, and pay for benefits in effect as of January 1, 2006. Surplus excess earnings may not be used to pay for enhanced pension benefits.
- Utilization of rate stabilization "best practices" including: 5-year direct rate smoothing; establish a rate funding corridor of 85%-115% of assets after system is 100% funded; if funding level is outside of the corridor, provide a 5-15 year time frame for adjustment of rates to get

back into the funding corridor; rate funding corridor should not be utilized to pay for new benefits; rate stabilization surcharge may be utilized.

- Pension Obligation Bond debt service should be disclosed in both employer and pension system actuarial reports.
- Upon agreement, permit employers and employees to share responsibility for all retirement system costs, including unfunded liabilities.
- Retirement boards and arbiters should not have the authority to grant pension formula increases nor should they act as advocates for pension formula increases. Note the PERS mission statement: "Our mission is to advance the financial and health security for all who participate in the System."
- Clarify the two-fold responsibility of retirement boards to (a) protect retirement system assets for the benefit of participants and (b) minimize employer contributions.
- Reform Industrial Disability Retirement (IDR) .

Pension Reform Proposals

Revisiting Pension Reform

The County Administrative Officers Association of California (CAOAC) has engaged in an ongoing study of public pension systems in an effort to determine appropriate benefit levels to attract and retain career county employees, while avoiding unnecessary or gratuitous costs for benefits.

In 2004, the CAOAC appointed a working group to develop recommendations for pension system reform. The product of this effort eventually was presented by California State Association of Counties (CSAC) staff to its Government Finance and Operations Policy Committee in January 2005 and later adopted by the Board of Directors of CSAC.

Beginning in October 2009, members of the CAOAC have revisited the CSAC Pension Reform principles and reform proposals. The result is a reaffirmation of the Guiding Principles of pension reform and revisions to the specific reform proposals.

Guiding Principles (Reaffirmed)

1. Eliminate Abuse: Public pension systems provide an important public benefit by assisting public agencies to recruit and retain quality employees. Perceived fraud and abuse must be eliminated to restore the public trust and preserve the overall public value of these systems.
2. Reduce and Contain Costs: Public pension reform should provide for immediate and long-term cost relief.
3. Increase Predictability of Costs for Employee and Employer: Responsible financial planning requires predictability. Employers must be able to predict their financial obligations in future years. Employees should have the security of an appropriate and predictable level of income for their retirement after a career in public service.
4. Provide for Equitable Sharing of Costs and Risks Between Employee and Employer: Equitable sharing of pension costs and risks promotes shared responsibility for the financial health of pension systems and reduces the incentive for either employees or employers to advocate changes that result in disproportionate costs to the other party, while diminishing the exclusive impact on employers for costs resulting from increases in unfunded liability.
5. Increase Pension System Accountability: Public pension systems boards have a constitutional duty to (a) protect administration of the system to ensure benefits are available to members and (b) minimize employer costs. The constitutional provisions and state statutes governing such boards should promote responsible financial management and discourage conflicts of interest.

Reform Proposals (Revised):

The specific reform proposals below are divided into two groups.

The first reform proposals are those that can be achieved by individual counties through existing law, via collective bargaining, for implementation on employees first hired after their implementation. These reform proposals are used as guide-posts for individual counties for implementation of future ceiling benefit levels:

1. Miscellaneous Employee Benefit formula: Two percent (2%) at age sixty (60).
2. Safety Employee Benefit Formula: Two percent (2%) at age fifty (50).
3. Highest Compensation Earnable: Based upon highest three year average compensation.
4. Safety retirement eligibility: Restrict safety retirement status to those categories of employees who must endanger their own physical safety to protect the public as a major component of their employment.
5. Benefits That Exceed the Reform Proposals: Paid in full by employees.
6. Retroactive Enhancement in Benefit formulas: When permissible in current law, enhancements in benefits should be prospective only to avoid unfunded liability resulting from extension of retroactive benefit increases.
7. Final Compensation Earnable Determination for 1937 Act County Retirement Systems: Cash conversions of any accrued benefits that are eligible to be included as compensation earnable but that were earned prior to the final compensation period shall not be recognized for final compensation determination. End of career or termination cash payouts shall not be paid prior to termination of employment and shall not be recognized for final compensation determination.

Reform Proposals that require State legislative change:

1. Final Compensation Earnable Determination for 1937 Act County Retirement Systems: Reverse the impacts of the Deputy Sheriffs' Association v. Ventura County and subsequent judicial decisions that greatly expanded the factors used to determine final compensation earnable. Restrict final compensation earnable determination base salary compensation irrespective of any pay differentials or other remuneration paid in cash.
2. Sunset Selection of Specified Benefit Options: For agencies that have not implemented the following, and for agencies that have abandoned the following in favor of other benefit options, close the following as future benefit options for public agencies when selection of such benefits would result in a benefit enhancement:
    a. Miscellaneous employee benefit formulas that exceed two percent (2%) at age sixty (60).

   b. Safety employee benefit formulas that exceed two percent (2%) at age fifty (50).
   c. Computation of highest compensation earnable based upon a single year.
   d. Optional safety membership.
3. Retroactive Enhancement in Benefit Formulas: Ban retroactive benefit enhancements.
4. Exclusion from Benefits: Provide maximum flexibility to public agencies to exclude from receipt of retirement benefits non-career employees including those n temporary, provisional and contract employment.
5. Retirement Benefit Cost Sharing: Normal costs of the retirement benefits shall require equal percentage contributions from employees and employer. Permit employers and employees to share responsibility for all retirement system costs, including unfunded liabilities as result to the collective bargaining process.
6. Cost of Living Adjustments (COLAs) for Retirement Benefits: Eliminate the option for public agencies to increase their annual COLA increases above two percent (2%).
7. Industrial Disability Retirement (IDR):
   Implement cost saving efficiencies including:
   a. Provide public agencies maximum flexibility to rehabilitate and/or accommodate disabled workers and return those workers to the same or similar employment in lieu of IDR.
   b. Provide public agencies maximum flexibility to provide alternative employment to disabled employees in lieu of IDR.
   c. Employees eligible for IDR should first be afforded applicable service retirement benefits and then provided IDR benefits up to the applicable "cap" on total retirement benefits.

Twelve Point Pension Reform Plan

October 27, 2011

The pension reform plan I am proposing will apply to all California state, local, school and other public employers, new public employees, and current employees as legally permissible. It also will begin to reduce the taxpayer burden for state retiree health care costs and will put California on a more sustainable path to providing fair public retirement benefits.

1. Equal Sharing of Pension Costs: All Employees and Employers

While many public employees make some contribution to their retirement – state employees contribute at least 8 percent of their salaries – some make none. Their employers pay the full amount of the annual cost of their pension benefits. The funding of annual normal pension costs should be shared equally by employees and employers.

My plan will require that all new and current employees transition to a contribution level of at least 50 percent of the annual cost of their pension benefits. Given the different levels of employee contributions, the move to a contribution level of at least 50 percent will be phased in at a pace that takes into account current contribution levels, current contracts and the collective bargaining process.

Regardless of pacing, this change delivers real near-term savings to public employers, who will see their share of annual employee pension costs decline.

2. "Hybrid" Risk-Sharing Pension Plan: New Employees

Most public employers provide employees with a defined benefit pension plan. The employer (and ultimately the taxpayer) guarantees annual pension benefits and bears all of the risk of investment losses under those plans. Most private sector employers, and some public employers, offer only 401(k)-type defined contribution plans that place the entire risk of loss on investments on employees and deliver no guaranteed benefit.

I believe that all public employees should have a pension plan that strikes a fair balance between a guaranteed benefit and a benefit subject to investment risk. The "hybrid" plan I am proposing will include a reduced defined benefit component and a defined contribution component that will be managed professionally to reduce the risk of employee investment loss. The hybrid plan will combine those two components with Social Security and envisions payment of an annual retirement benefit that replaces 75 percent of an employee's salary. That 75 percent target will be based on a full career of 30 years for safety employees, and 35 years for non-safety employees. The defined benefit component, the defined contribution component, and Social Security should make up roughly equal portions of the targeted retirement income level. For employees who don't participate in Social Security, the goal will be that the defined benefit component will make up two-thirds, and the defined contribution component will make up the remaining one-third, of the targeted retirement benefit.

The State Department of Finance will study and design hybrid plans for safety and non-safety employees, and will fashion a cap on the defined benefit portion of the plans to ensure that employers do not bear an unreasonable liability for high-income earners.

3. Increase Retirement Ages: New Employees

Over time, enriched retirement formulas have allowed employees to retire at ever-earlier ages. Many non-safety employees may now retire at age 55, and many safety employees may retire at age 50, with full retirement benefits. As a consequence, employers have been required to pay for benefits over longer and longer periods of time.

The retirement age for non-safety workers in 1932, when the state created its retirement system, was 65. The retirement age for a state highway patrol officer in 1935 was 60. The life expectancy of a twenty-year old who began working at that time was mid-to-late 60s, meaning that life expectancy beyond retirement was a relatively short period of time. Now with a growing life expectancy, pensions will pay out not just for a few years, but for several decades, requiring public employers to pay pension benefits over much longer periods of time. Under current conditions, many years can separate retirement age from the age when an employee actually stops working. No one anticipated that retirement benefits would be paid to those working second careers.

We have to align retirement ages with actual working years and life expectancy. Under my plan, all new public employees will work to a later age to qualify for full retirement benefits. For most new employees, retirement ages will be set at the Social Security retirement age, which is now 67. The retirement age for new safety employees will be less than 67, but commensurate with the ability of those employees to perform their jobs in a way that protects public safety.

Raising the retirement age will reduce the amount of time retirement benefits must be paid and will significantly reduce retiree health care premium costs. Employees will have fewer, if any, years between retirement and reaching the age of Medicare eligibility, when a substantial portion of retiree health care costs shift to the federal government under Medicare.

4. Require Three-Year Final Compensation to Stop Spiking: New Employees

Pension benefits for some public employees are still calculated based on a single year of "final compensation." That one-year rule encourages games and gimmicks in the last year of employment that artificially increase the compensation used to determine pension benefits. My plan will require that final compensation be defined, as it is now for new state employees, as the highest average annual compensation over a three-year period.

5. Calculate Benefits Based on Regular, Recurring Pay to Stop Spiking: New Employees

Where not controlled, pension benefits can be manipulated by supplementing salaries with special bonuses, unused vacation time, excessive overtime and other pay perks. My plan will require that compensation be defined as the normal rate of base pay, excluding special bonuses, unplanned overtime, payouts for unused vacation or sick leave, and other pay perks.

6. Limit Post-Retirement Employment: All Employees

Retirement with a pension should not translate into retiring on a Friday, returning to full-time work the following Monday, and collecting a pension and a salary. Retired employees often have experience that can deliver real value to public employers, though, so striking a reasonable balance in limiting post-retirement employment is appropriate. Most employees who retire from state service, and from other CalPERS member agencies, are currently limited to working 960 hours per year for a public employer, and do not earn any additional retirement benefits for that work. My plan will limit all employees who retire from public service to working 960 hours or 120 days per year for a public employer. It also will prohibit all retired employees who serve on public boards and commissions from earning any retirement benefits for that service.

7. Felons Forfeit Pension Benefits: All Employees

Although infrequent, recent examples of public officials committing crimes in the course of their public duties have exposed the difficulty of cutting off pension benefits those officials earned during the course of that criminal conduct. My plan will require that public officials and employees forfeit pension and related benefits if they are convicted of a felony in carrying out official duties, in seeking an elected office or appointment, or in connection with obtaining salary or pension benefits.

8. Prohibit Retroactive Pension Increases: All Employees

In the past, a number of public employers applied pension benefit enhancements like earlier retirement and increased benefit amounts to work already performed by current employees and retirees. Of course, neither employee nor employer pension contributions for those past years of work accounted for those increased benefits. As a result, billions of dollars in unfunded liabilities continue to plague the system. My plan will ban this irresponsible practice.

9. Prohibit Pension Holidays: All Employees and Employers

During the boom years on Wall Street, when unsustainable investment returns supported "fully-funded" pension plans, many public employers stopped making annual pension contributions and gave employees a similar pass. The failure to make annual contributions left pension plans in a significantly weakened position following the recent market collapse. My plan will prohibit all employers from suspending employer and/or employee contributions necessary to fund annual pension costs.

10. Prohibit Purchases of Service Credit: All Employees

Many pension systems allow employees to buy "airtime," additional retirement service credit for time not actually worked. When an employee buys airtime, the public employer assumes the full risk of delivering retirement income based on those years of purchased service credit. Pensions are intended to provide retirement stability for time actually worked. Employers, and ultimately taxpayers, should not bear the burden of guaranteeing the additional employee investment risk that comes with airtime purchases. My plan will prohibit them.

11. Increase Pension Board Independence and Expertise

In the past, the lack of independence and financial sophistication on public retirement boards has contributed to unaffordable pension benefit increases. Retirement boards need members with real independence and sophistication to ensure that retirement funds deliver promised retirement benefits over the long haul without exposing taxpayers to large unfunded liabilities.

As a starting point, my plan will add two independent, public members with financial expertise to the CalPERS Board. "Independence" means that neither the board member nor anyone in the board member's family, who is a CalPERS member, is eligible to receive a pension from the CalPERS system, is a member of an organization that represents employees eligible to or who receive a pension from the CalPERS system, or has any material financial interest in an entity that contracts with CalPERS. My plan also will replace the State Personnel Board representative on the CalPERS board with the Director of the California Department of Finance.

True independence and expertise may require more. And while my plan starts with changes to the CalPERS board, government entities that control other public retirement boards should make similar changes to those boards to achieve greater independence and greater sophistication.

12. Reduce Retiree Health Care Costs: State Employees

The state and the nation have seen the costs of health care skyrocket. The state's retiree health care premium costs have increased by more than 60 percent in the last five years and will almost double over ten years. This approach has to change.

My plan will reduce the taxpayer burden for health care premium costs by requiring more state service to become eligible for health care benefits at retirement. New state employees will be required to work for 15 years to become eligible for the state to pay a portion of their retiree health care premiums. They will be required to work for 25 years to become eligible for the maximum state contribution to those premiums. My plan also will change the anomaly of retirees paying less for health care premiums than current employees.

Contrary to current practice, rules requiring all retirees to look to Medicare to the fullest extent possible when they become eligible will be fully enforced.

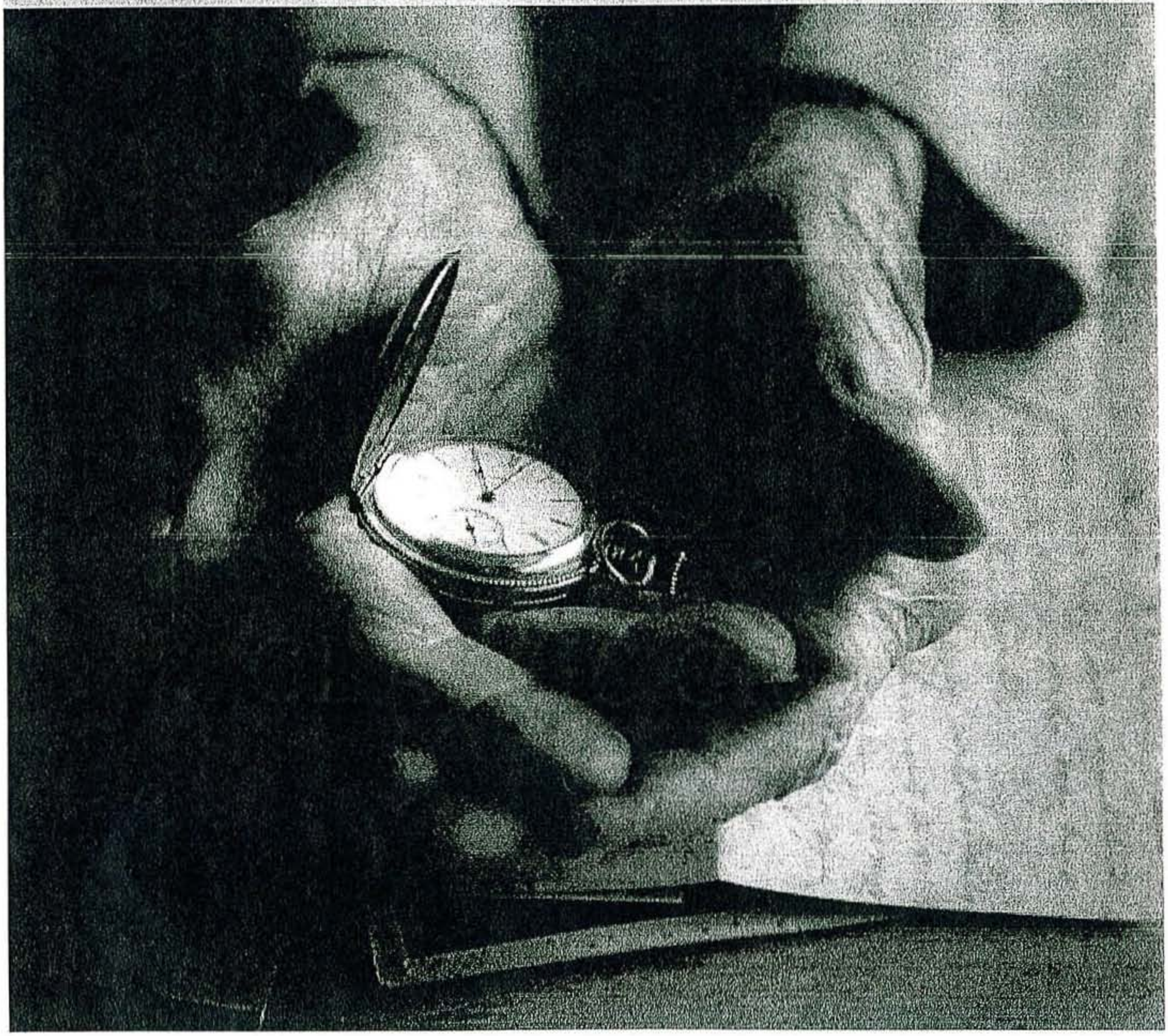
Local governments should make similar changes.

LAO

Public Pension and Retiree Health Benefits:

An Initial Response To the Governor's Proposal

MAC TAYLOR • LEGISLATIVE ANALYST • NOVEMBER 8, 2011



EXECUTIVE SUMMARY

The Governor presented a 12-point plan to change pension and retiree health benefits for California's state and local government workers on October 27, 2011. This report provides background on the state's retirement policy issues and our initial response to the Governor's proposals.

Our Office's Key Principles on Public Retirement Benefits. As we have noted in the past, we do not view the current system of defined benefit pensions for California's public employees as an intrinsically bad thing at all. Rather, we view pensions and retiree health benefits as just one part of overall public employee compensation—in many cases, as benefits offered in lieu of what otherwise might be higher salaries over the course of a public-service career. Moreover, we believe that encouraging public or private workers to defer a portion of their compensation to retirement represents sound public policy. Well-managed and properly funded retirement systems, therefore, are meritorious.

What Is the Problem With Public Retirement Benefits?

California's current structure of public employee pension and retiree health benefits has some substantial problems. There is a notable tendency in the current system for public employers and employees to defer retirement benefit costs—which should be paid for *entirely* during the careers of retirement system members—to future generations. This leads to unfunded liabilities that have spiraled higher in recent years and are producing cost pressures for the state and many local governments that will persist for years to come. Under the current system, governments have very little flexibility under case law to alter benefit and funding arrangements for current employees—even when public budgets are stretched, as they are today. Finally, there is a substantial disparity between retirement benefits that are offered to public workers and those offered to other workers in the economy.

Sustaining a financially manageable system of public employee retirement benefits—one that is more closely aligned with the benefits offered private-sector workers—will require substantial, complex, and difficult changes by the Legislature, the Governor, local governments, and voters.

Governor's Proposal Is a Bold, Excellent Starting Point

Would Help Increase Public Confidence in California's Retirement Systems. We view the Governor's proposal as a bold starting point for legislative deliberations—a proposal that would implement substantial changes to retirement benefits, particularly for future public workers. His proposals would shift more of the financial risk for public pensions—now borne largely by public employers—to employees and retirees. In so doing, these proposals would substantially ameliorate this key area of long-term financial risk for California's governments. At the same time, the Governor's proposals aim for a future in which career public workers receive a package of retirement benefits that would be (1) sufficient to sustain employees' standards of living during their retirement years and (2) more closely aligned with benefit packages offered to private-sector workers. For all of these reasons, we believe that the Governor's proposals could increase public confidence in the state's retirement benefit systems.

Many Details Left Unaddressed in Governor's October 27 Presentation. Despite the strengths of the Governor's pension and retiree health proposal, it leaves many questions unanswered. In particular, we do not understand key details of how his hybrid benefit and retirement age proposals would work. Moreover, the Governor's plan leaves unaddressed many important pension and retiree health issues, including how to address the huge funding problems facing the state's teachers' retirement fund, the University of California's (UC's) significant pension funding problem, retiree health benefit liabilities, and other issues. In making significant changes to pension and retiree health *benefits*, we would urge the Legislature also to tackle these very difficult issues concerning the *funding* of benefits.

Raising Current Workers' Contributions Is a Legal and Collective Bargaining Minefield. The Governor proposes that many current public employees be required to contribute more to their pension benefits. Others have proposed reducing the rate at which current employees accrue pension benefits during their remaining working years. Our reading of California's pension case law is that it will be very difficult—perhaps impossible—for the Legislature, local governments, or voters to mandate such changes for many current public workers and retirees. Moreover, employer savings from these changes likely will be offset to some extent by higher salaries or other benefits for affected workers. Given all of these challenges, we advise the Legislature to focus primarily on changes to future workers' benefits. Such changes should produce net taxpayer savings only over the long run but are certain to be legally viable.

A Golden Opportunity to Make These Benefits More Sustainable

Clearly, there is significant public concern about public pension and retiree health benefits. In our view, the current structure of these benefits—wherein state and local governments provide compensation in forms that are very different from that offered in the private sector—impairs the public's ability to assess whether government is carefully managing its funds and can affect the public's trust in government itself. We believe that the Legislature, the Governor, and voters should change these benefits—as well as the way in which governments and workers fund the benefits—in order to address these problems. These changes will involve difficult, complex choices. In the end, however, we believe that such changes can result in the public becoming more comfortable with public retirement benefits. This, in turn, will help ensure that the state and local governments can continue offering such benefits in the future.

DESIGNING PUBLIC-SECTOR PENSIONS FOR THE 21ST CENTURY
A RISK-MANAGED APPROACH

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Executive Summary

Public Sector Defined Benefit Pensions Have a History of Success...

The history of public employee defined benefit pension systems in this country can and should be viewed as a tale of long-term success. Since their beginnings in the early part of the last century, these plans have served plan sponsors, participants, beneficiaries and taxpayers very well as an effective vehicle for delivering cost-efficient, adequate and secure retirement benefits for employees of state and local governments. [1]

Through their long history and with only a few exceptions, state and local government defined benefit pension plans have met the benefits and financial objectives for which they were originally established. The retirement income security provided for many covered employees could not have been achieved without the successful establishment and operation of the public employee defined benefit retirement systems that serve nine out of ten state and local government full-time employees.

...But Fiscal Constraints Pose Tough Choices for Public Policymakers

Most public employee defined benefit retirement systems remain well funded and financially sound. But an increasing number are not. Many of the state and local governments that sponsor plans, even those that are well funded, are watching their budgets become strained to the breaking point, partially because of the increasing cost of supporting growing numbers of workers in retirement.

Now, at a time of uncertain future economic growth, record federal deficits, and burgeoning costs of entitlement programs, some public sector executives and legislators are asking the question:

Are our public sector defined benefit plans sustainable going forward?

They are not alone. Many private sector companies, too, are making wrenching decisions to cut back on pension and retiree health promises just to survive.

The concerns and purposes of governments are not the same as the private sector. It would be a mistake for public policy makers to assume that the trend in the private sector to move swiftly to offload defined benefit pension risk to workers is the right decision for the public sector. However, it would also be a mistake for public sector policy makers not to reassess just how much pension funding risk they can realistically accept going forward. Taxpayers will hold their feet to the fire to at least consider plan designs that share that risk for the future.

The Discussion Is Not as Black and White as "DB vs. DC"

We seek in this paper to show how new risk-managed retirement designs can protect public sector workers at the same time as they help apportion risk more evenly between sponsors and participants to avoid the fiscal disconnects that, in some cases, threaten fiscal stability for a growing number of government bodies.

In some instances, public sector entities may wish to consider providing new defined contribution plans as replacements or alternatives. If that step is taken, care needs to be taken that the risk-sharing pendulum does not swing too far. A defined contribution plan that is intended to be the primary or core source of retirement benefits should be designed differently than the traditional private sector 401(k) plan or the standard 457(b) or 403(b) supplemental tax deferred compensation arrangements common in the public sector.

Unlike these other plans, which focus on wealth accumulation as a primary objective, a core defined contribution plan can and should focus on providing retirement income and security. The plan design must, therefore, include features that mitigate investment risks to employees and the risk of outliving their account balance after retirement. Traditional 401(k), 457(b) and 403(b) plans are rarely designed with these objectives in mind and subject participants to an unreasonable level of risk that their retirement income needs will not be met.

Public Finances Took a Big Hit in the Recent Recession and Bear Market

Currently many state and local governments, like many corporations in the auto and aviation industries, find themselves struggling to financially maintain their long-standing defined benefit pension arrangements.[2] The reasons for this financial stress are several and vary from state to state. A major factor lies with the 2000-2002 recession and bear market. During the recession almost every state and local government experienced dramatic decreases in tax revenues. This, coupled with budget expenditures that did not drop proportionately, caused many entities to dive deeply into the financial reserve cushions that many had previously established. Ultimately, these "rainy day" and other reserve funds were dramatically diminished by investment losses and as governments drew on them to prop up beleaguered budgets.

Public Sector Defined Benefit Plan Costs Are Increasing

The bear market investment losses experienced by public employee defined benefit pension plans have added to the financial burdens of state and local governments. The investment losses were severe enough in many cases to completely eliminate the surplus positions many public pension systems had enjoyed. It was not unusual for funding levels to drop from over 110% to 60-75% during this period and sometimes even lower. [3] Significantly higher pension contribution requirements have resulted at a time when public sector budgets are already highly stressed.

Other factors have also acted to increase the costs of defined benefit plans. In some cases, large benefit improvements were adopted shortly before the market downturn, adding liabilities just at the wrong time. In other cases, the plan had not been funded adequately, and investment losses compounded the situation by putting these plans even further into the red.

The magnitude of the increased pension contribution requirements was surprising to many. During the "easy" years of the 1990s, public defined benefit plans often enjoyed funding surpluses. Yet, (with the benefit of hindsight), we have learned that few fully understood that these favorable funding levels masked an important fact - that, over time and as the plans had matured, their financial underpinnings had become increasingly less stable than before.

As these plans have matured, certain destabilizing trends occurred. The numbers of retirees naturally increased over the years. Benefit payments from the plans increased as well. With higher benefit payments, the plans became more reliant on investment income to cover these outflows. Plan liabilities became larger as a percentage of covered compensation and as a percentage of entity tax bases and revenues.

Changing GASB Accounting Rules Could Threaten Government Credit Ratings

Government Accounting Standards Board (GASB) rules issued in 1994 imposed a higher level of reporting and disclosure of public sector pension plan funding status. This additional transparency was useful to plan sponsors in evaluating the financial health of their defined benefit plans. However, hindsight shows that few entities conducted the kinds of studies that would have shown that the maturation of these plans had increased the potential volatility of pension funding requirements, especially in the face of economic downturns.

Thus, the impact of the recession on pension costs was largely unanticipated and shocked the budgets of state and local governments across the country. State and local governments that had grown used to relatively low contribution levels during the 1990s (and spent the savings elsewhere in their budgets or made benefit improvements when investment returns were high) have most acutely felt the fiscal pain.

The Funding of Pension Costs is Less Predictable than Ever

In the years following the recession, most state and local governments have started on a slow path to recovery. [4] Improvements in revenue flows and financial positions have been following a generally improving economy. Despite this improving fiscal environment, state and local governments continue to experience a high level of financial stress and instability. Public coffers are improving, but continue to be tight as expenditures keep pace with rising revenues.

Increasing and pent-up demands for Medicaid, public education, law enforcement, transportation and infrastructure funding continue to draw heavily on limited financial resources. The higher investment return funding assumptions of public pension plans in the past are also in question for the future leaving the funding of pension costs less predictable than ever. [5]

Retiree Health Costs Are Adding to the Pain

New financial concerns are being added to the equation because of an emerging awareness of very large liabilities for retiree health benefits. Although full accurate data are not readily available nationally, partial and anecdotal evidence suggests that the liability for the promised health benefits to retirees by state and local governments is mostly unfunded. *The Wall Street Journal* has estimated that retiree health obligations for some states range from $500 million to as much as $40 billion. Some estimate the retiree health liabilities of state and local governments may exceed $1 trillion.

Under new GASB rules set to go into effect for most large entities for fiscal years beginning after 2006, state and local governments will need to begin reporting and disclosing (but not expensing) their level of retiree health liabilities and the cost each year to fund the liability. The new reporting and disclosure accounting requirements may negatively impact credit ratings of governmental entities that do not take remedial action.

Health care costs for active and retired employees are estimated to consume about 15 percent of state and local total compensation (with expectations that this will increase to 20 percent of wages by 2008). This, coupled with estimates that a 65 year old will need $210,000 and probably more in savings to pay for Medicare part B premiums, Medicare supplement insurance and out-of-pocket health expenses, adds additional emphasis on the importance for state and local governments to find alternatives for designing, funding, refinancing, and reducing current retiree health benefits.

Alternatives will include cutting the level of benefit promises for current employees and retirees where possible, reduced insurance benefit designs, and issuing so-called "retiree health obligation bonds". Related solutions will also include changing the nature of the retiree health benefit promise from one that is a *promise* of continued insurance coverage to one that only provides *access* to insurance coverage with a fixed DB or DC based health care cost subsidy.

Economic and Global Uncertainty Adds to Fiscal Risks

The prospect for higher costs to fund federal Social Security and Medicare entitlements also loom on the budget horizons of state and local governments. The ballooning federal deficit will limit the ability of state and local governments to find new sources of revenues to deal with these financial demands.

The world's political situation, including the global war on terrorism, creates additional uncertainty for the economic stability that is necessary for predictable funding of retirement benefits.

Budget-Constrained Policy Makers Are Taking a New Look at Pension Design

All of these factors have created an environment in which state and local governments (like their private sector corporate counterparts) have begun to take a new look at the design, funding, administration and governance of public sector retirement benefit plans. This process will not be an easy one. The tone of the discussion so far has rarely been collegial. The relative merits of defined benefit versus defined contribution plan designs have been debated using strong rhetoric with predictions of disaster or calamity if one side or the other side should prevail.

In this heated environment, the opportunity for effective and sound policymaking can easily be lost. Yet it is essential that public policymakers pause and engage in a thoughtful and considered reexamination of the basic tenets of these plans. This reexamination should focus on the benefits and risk management objectives surrounding public retirement benefit design and funding: 1) workforce attraction and retention, 2) benefit adequacy and security, and 3) funding affordability and volatility.

An Alternative Approach: Risk-Managed Pension Policy And Hybrid Plans

Recent experience has shown clearly that there is no such thing as a riskless pension plan. The standard approach to public pension design and funding has, however, failed to identify and measure the risks that do exist. Historically, the approach and has principally been to: 1) establish benefits objectives, 2) determine the cost and 3) budget as much toward achieving the objective as could be afforded.

Largely missing from this process is an assessment of the risks associated with any particular plan design. Key questions about 1) what risks exist, 2) the magnitude of each risk, 3) who bears any particular risk and 4) how that risk can be mitigated have often been inadequately addressed. The failure to assess these risks can be serious for both public sector plan sponsors and their employees in terms of failed pension financing schemes and/or inadequate and insecure retirement benefits.

One of the likely advantages of identifying and managing retirement plan risk areas is that there will be a greater tendency to adopt plan designs that are more appropriately balanced or which share the financial risks between employers and employees. Going forward, using this approach will mean the increasing use of "hybrid" and "combination" approaches that include elements of both traditional DB and DC plans.

This paper proposes that public sector policy makers add financial risk management processes when reconsidering the future of public retirement design and funding. The principal risk areas to be assessed include the following:

- **Defined benefit plan risks**
  - Long-term funding risk - the risk that investment and other actuarial experience may be worse than expected, forcing contribution rates to increase above acceptable levels over the long-term
  - Short-term funding volatility risk - the risk that investment return volatility will cause contribution rates to increase above acceptable levels over the short-term
  - Inflation risks - the risk that the value of accrued benefits will be eroded by inflation

- **Defined contribution plan risks**
  - Longevity risk – the risk of participants outliving their retirement assets
  - Inflation risk – the risk that the value of accrued benefits will be eroded by inflation
  - Investment risk – the risk that by the end of the investment period not enough has been accumulated to fund an adequate and secure retirement benefit

In many cases the level of risk for both DB and DC plans can be managed to a significant extent through more appropriate plan design and funding policies. This will increase the chance of meeting the benefits and financial objectives of both the plan sponsor and the participant, regardless of whether the plan is defined benefit or defined contribution in design.

The Goal Is to Reach the Best Achievable Solution with the Available Resources

The current challenge to public sector policymakers is finding a process that clearly identifies the issues and the basis for deciding the best achievable solution under the circumstances.

One way to meet this challenge is to approach retirement plan design as follows:

- ***First, develop a basic retirement benefits policy.*** Define the goals and objectives the sponsor wants the retirement benefit program to achieve.
- ***Second, apply a financial risk management filter.*** Identify the plan design elements that are most and least likely to achieve the benefit goals and objectives in light of available financial resources and potential market fluctuations.

The advantage of using this approach is that it does not prejudge what plan design is better. It does not assume that either defined benefit or defined contribution plans are inherently superior to the other. Instead, it identifies the most appropriate design as the one that is most likely to meet both the financial and benefits objectives of the plan sponsor.

Using a financial risk management filter will also help reduce the political aspects of the discussion that often impede the ability to move toward sound solutions. It allows policymakers the opportunity to prudently strike the right balance between meeting 100% of all the benefits goals and objectives and dealing with the long and short term financial realities faced by governments.

Public Pension Stakeholders Will Need to Forge a New Consensus

A consensus on workable solutions will not be easy to come by. Emerging demands on budgets to address and fund health benefits for retirees, baby boomer demographic trends, investment market volatility, and increasing longevity, among many other factors, will complicate the process. Legal constraints on changing benefits for existing employees will be a major barrier to short-term fixes. Public sector policy makers will also often need to balance the needs of existing employees and taxpayers against future employees and taxpayers. The equity of shifting current pension liability burdens to future generations of taxpayers and employees should be a central part of the discussion.

The stakeholders involved in forging a new public sector retirement benefit policy are myriad, but must be taken into account. They include governors and other executive level officials, legislative bodies, public employees and their representatives and unions, public pension trustees and staff, taxpayer advocacy groups, investment managers, actuaries, lawyers and the media. The process is inherently political in nature because that is the nature of government. In this context, creative approaches to moving forward on the reassessment of public pension policy will need to be developed. If a new basis for the design and funding of public pension plans is not established, it will not matter which side of the DB vs. DC debate wins – because the number of winners will be far outnumbered by the losers.