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CalPERS and PEPRA: Impact on Pension and OPEB Liabilities

Independent Cities Association
Winter Seminar 2016
Santa Barbara, January 30, 2016
11:15 am – 12:30 pm

PRESENTED BY

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PENSION LIABILITIES

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Defining Pension Liabilities

- What does CalPERS consider when it calculates pension liabilities?
  - Demographic assumptions (e.g., life expectancy, length of service, retirement age, disability)
  - Economic assumptions (e.g., future salary increases and investment returns)
- What goes into the annual contributions to CalPERS?
  - **Normal cost** is the cost associated with the current year of service credit expressed as a % of covered payroll.
  - **Unfunded accrued liability** is the current value of the benefit for all accrued service credit amortized over a specified period that is unfunded
    - Expressed as a % of covered payroll for plans w/ 100+ members
    - Expressed as a lump sum for plans in risk pools

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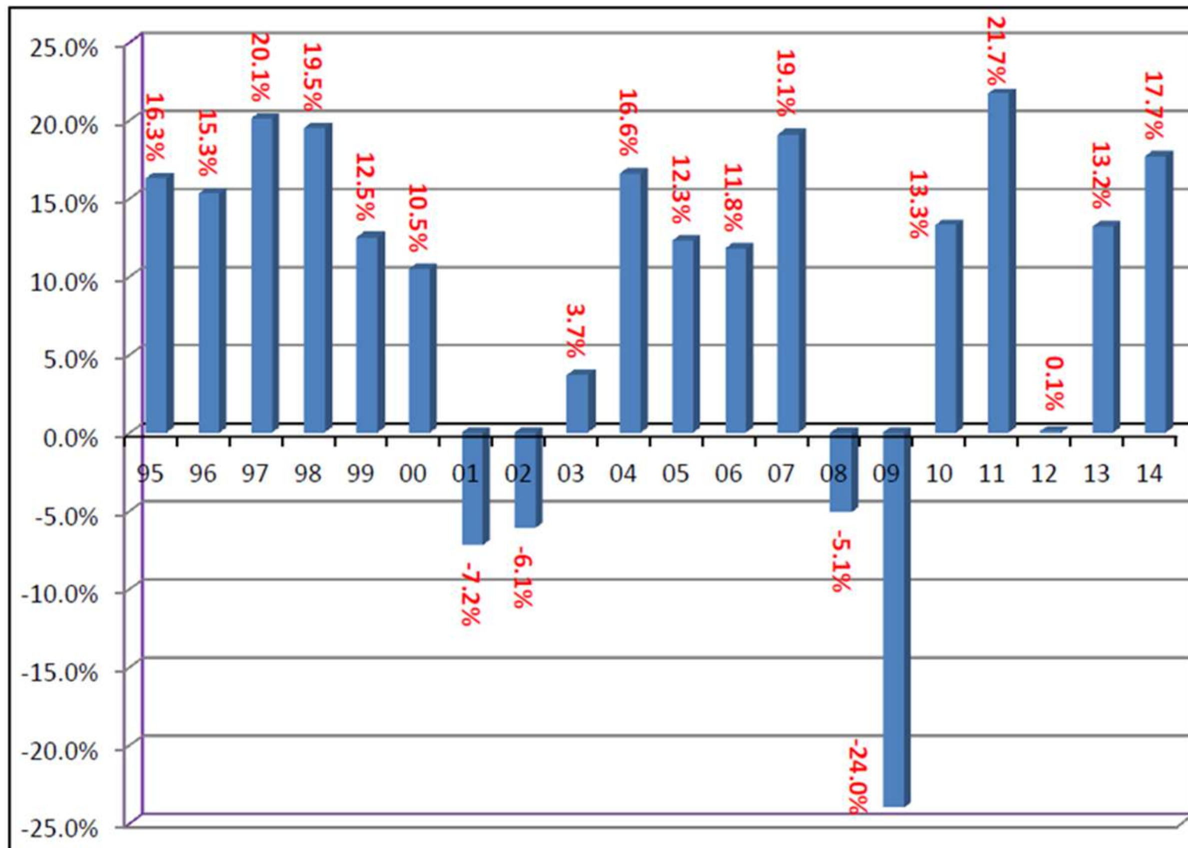
CalPERS History of Investment Returns



- **FY 2014/2015 return was 2.4%. This will have an impact on rates for the 2017-2018 fiscal year.**

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What Affects Pension Liabilities?

- Investment returns
- Experience gains/losses
- PEPRA – minimum effect until new members replace classic members
- Changes in CalPERS' policies (improve funded status, less volatility in contribution rates)
  - New demographic assumptions effective as of the June 30, 2014 valuation (longer life expectancy)

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What Affects Pension Liabilities?

- Changes in CalPERS' policies (improve funded status, less volatility in contribution rates)
  - Amortization and rate smoothing method changes effective as of June 30, 2013 valuation
    - Market value rather than actuarial value of assets for rate setting
    - Converted rolling amortization periods to fixed periods
    - Gains and losses are tracked and amortized over a fixed 30-year period, 5 year ramp up, 5 year ramp down
    - Changes in actuarial assumptions or methodology amortized separately over 20 year period
- Future change in assumed rate return possible

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Impact of Change in Demographic Assumptions

			Prior Year Assumptions	New Assumptions
		June 30, 2013	June 30, 2014	June 30, 2014
1. Present Value of Projected Benefits				
a) Active Members	$	57,844,158	59,914,572	62,426,393
b) Transferred Members		10,405,670	11,512,658	11,855,913
c) Terminated Members		2,321,404	2,616,993	2,319,139
d) Members and Beneficiaries Receiving Payments		64,739,343	65,377,623	69,034,462
e) Total	$	135,310,575	139,421,846	145,635,907
2. Present Value of Future Employer Normal Costs	$	8,662,694	8,511,937	8,888,158
3. Present Value of Future Employee Contributions	$	7,868,565	8,033,850	7,986,006
4. Entry Age Normal Accrued Liability				
a) Active Members [(1a) - (2) - (3)]	$	41,312,899	43,368,785	45,552,229
b) Transferred Members (1b)		10,405,670	11,512,658	11,855,913
c) Terminated Members (1c)		2,321,404	2,616,993	2,319,139
d) Members and Beneficiaries Receiving Payments (1d)		64,739,343	65,377,623	69,034,462
e) Total	$	118,779,316	122,876,059	128,761,743
5. Market Value of Assets (MVA)	$	83,219,465	95,433,110	95,433,110
6. Unfunded Liability [(4e) - (5)]	$	35,559,851	27,442,949	33,328,633
7. Funded Ratio [(5) / (4e)]		70.1%	77.7%	74.1%

- Keep in mind that the value is based on investment return as of June 30, 2014 of 17.7%.

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Outside Pressures on Pension Liabilities

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

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"Before we get into the numbers, how's accounting set for red ink?"

GASB 68

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

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GASB 68

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

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Substantial Shift From GASB 27 Reporting

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

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City Dilemma

- Explaining the complex pension figures you did not prepare to…
  - Your Council, constituencies and stakeholders
    - Education
      - Take advantage of the resources available, including CalPERS and GASB
    - Develop a communication plan
  - Your external auditor – discuss implementation in advance

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Managing Pension Liabilities

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

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Managing Pension Liabilities

- Shifting costs to employees
  - New Members
    - Normal costs
      - Required contribution equal to 50% of normal costs
      - Can increase normal cost contribution pursuant to collective bargaining principles
      - While 7522.30(e)(1) provides that an employer cannot contribute a greater amount on behalf of unrepresented, managerial or supervisory employees, (e)(2) forecloses options to increase employee rate for unpresented employees as it mandates collectively bargained MOU

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Managing Pension Liabilities

- Shifting costs to employees
  - New Members
    - Employer normal costs and unfunded liabilities
      - Cost-sharing of employer contribution rate pursuant to Section 20516
      - PEPRA increased flexibility of cost-sharing provisions

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Managing Pension Liabilities

- Shifting costs to employees
  - Classic Members
    - Section 20516.5 permits a unilateral shift of normal costs to classic members – permissive, not mandatory
      - Completion of good faith bargaining process.
      - Subject to applicable caps (8% miscellaneous, 12% safety)
      - Not applicable until January 1, 2018
    - However, Section 20691 already provides authority to eliminate EPMC

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Managing Pension Liabilities

- Shifting costs to employees
  - Classic Members
    - Eliminating EPMC may be impractical if Section 20636(c)(4) benefit has been added
    - Nonetheless, employers want to achieve AB 340 standard for classic members
    - What is the alternative?
      - Section 20516 cost-sharing of employer rate
      - Tax implications

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Managing Pension Liabilities

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

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Managing Pension Liabilities

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

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Managing Pension Liabilities

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

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OPEB LIABILITIES

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Looking at the Numbers

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

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Looking at the Numbers

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

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

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GASB Statement No. 45

- In June 2004, new accounting standards were issued requiring public entities to begin reporting the expected future cost of retiree health care benefits on their financial statements.

- In complying with the requirements, many entities learned that the cost of retiree health benefits was growing faster than their budgets could accommodate

- Why does it matter? If enough money is not set aside to adequately fund these future costs, an entity may experience negative impacts to its bond rating resulting in higher interest and borrowing costs

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GASB Statement No. 45

- Entities took steps to control and better manage the liability for retiree health benefits to avoid:
  - Deterioration in services provided; or
  - Elimination of retiree health benefits altogether
- Options
  - Prefunding these costs through Section 115 trusts, VEBA Trust or Section 401(h) accounts; and/or
  - Finding other ways to reduce those costs

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Looking Ahead to GASB 75

- Alters the measurement and reporting standards previously in place under GASB 45
- Key changes
  - Moves accounting for OPEB to the balance sheet and income statement from the notes disclosure
  - Frequency of valuations for small employers (under 200 covered participants)
- Required for fiscal years beginning after June 15, 2017

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Primary Causes in Rising Costs

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

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Strategies Used to Constrain Costs

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

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PEMHCA

- Employers providing health benefits through CalPERS cannot eliminate retiree health benefits even for future employees
- Equal contribution rule under Government Code Section 22892
  - Section 22892(c)
  - Section 22893 vesting schedule

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PEMHCA

- PEMHCA workaround
  - Ability to reduce retiree health benefit contribution to no less than the minimum employer contribution
  - Create tiers based on hire date, retirement date or employee group
  - May impose service requirements but consider vesting restrictions under PEPRA
  - Use of funding vehicles to provide higher benefit to employees and certain retirees

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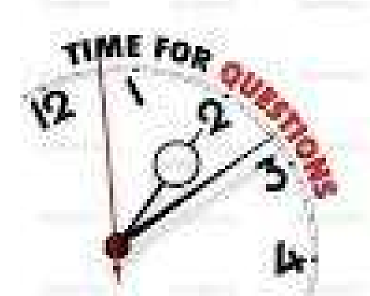

Questions

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Answers

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Thank You

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