Taking Charge of Your Pension and OPEB Costs

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Roots of the Problem: Starting with OPEB*

- OPEB (retiree medical) was never funded
  - Lifetime retiree medical benefits are typical in California
  - Often eligible when vested in pension
    - Can be as early as age 55 with 5 years!
    - Cliff vesting @ 100% of benefit rather than annual accruals
  - Everybody waited until GASB 45 became effective
  - PAYGO rather than ARC funding during good years
  - Thus, no money available during lean years
  - Meanwhile, medical inflation outstrips CPI by 3x

*OPEB = Other Post-Employment Benefits
Roots of the Pension Problem

• 30 years of benefits increases
  – Often retroactive
    ◦ Created unfunded liabilities

• Aggressive investment assumptions
  – Vs. a decade of low returns
  – Plan designs were set in cement during Internet Bubble

• No increases in employee contributions
  – In fact, some employers went the wrong way!

• Unfunded liabilities doubled in 2008 bear market
Now the Emperor Has No Clothes

• CalPERS investment losses in 2008-09
  – Similar to, but worse than average public plan
  – Riskier portfolio strategies as they reached for yields
  – Doubling of unfunded liabilities

• Actuarial smoothing
  – They use 15 years, most normal plans use 5
  – Provided short-term budget relief
  – But increased UAAL
    ◈ Insufficient contributions failed to earn more on investments when markets were low
  – New smoothing period is longer than average employees’ career life span
Breaking News: Legislature’s Little Hoover Commission Report

• Conclusion: Benefits reductions for new employees will not be enough
• Major risk of pension and OPEB financial crisis
• Intergenerational “kicking the can”
• Will require new legal structure
  – To permit employers to freeze accrued benefits and reduce prospective benefits
  – Example: reduce pension multiplier for future service
  – Example: raise retirement ages for current employees
  – Example: Cap OPEB benefits and install reforms suggested here
• Would require either a ballot issue or a court test
  – Could become part of Governor’s tax-extension deal if GOP holds out for pension reforms
  – Watchdog groups are working on 2012 ballot proposals if nothing happens this year
    • Would establish “emergency” conditions to justify benefits freeze and rollbacks for incumbent employees
What you now need to ask your pension plan and your actuaries

• What will be our ARC under your system in 2015, 2016 and 2017?
• When will our ARC costs peak out as % of payroll? At what level?
• What would be the annual cost of our plan if we amortize our unfunded pension and OPEB liabilities over 15 years (or the average remaining service lives of our employees), instead of 25-30 years (as you do presently)?
• What would be our unfunded actuarial accrued liabilities (UAAL) if we used a lower discount rate for pensions? E.g.: 7% or 6%?
  – And that same rate for OPEB?
• How much would we have to pay next year to fully meet our actuarial obligations for OPEB? (compare with your current pay-as-you-go)
• Please provide a 20 year projection of our costs and our remaining unfunded liability if we continue “business-as-usual” vs paying full actuarial amortization (see Girard Miller GFR article, Feb 2011)
GASB Issue: Amortization

- Currently GASB allows 30-year amortization of unfunded liabilities, BUT…
- Retirees have expected lives of 18 years at age 65
- Some first responders leave public service in 20 years
- Average remaining career period for incumbents is probably 12-15 years (est)
- Intergenerational equity is a major objective in public pension accounting
  - Assign fair cost to service provided in the current operating year
The Coming Squeeze

• Stagnant revenues slowly increasing

• Prior claims on resources:
  – Call-backs from furloughs, thawing of pay freezes, deferred maintenance and equipment replacement, etc.

• Meanwhile, OPEB “paygo”

• Costs march higher annually and are typically 1/3 of ARC
  – Often need another $2500-$6000 per active employee annually

• And pension contributions will rise 25-40% for many employers in the next two years
### Achievable reforms within CalPERS today

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<th>General – Miscellaneous Employees</th>
<th>Normal Cost*</th>
<th>Public Safety</th>
<th>Normal Cost*</th>
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<td>6.5%</td>
<td>2% @ 55</td>
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* Data Source: John Bartel, Actuary at CSMFO Channel Counties Chapter Meeting, 10/8/09

Note: 1.5% multiplier is available but only if Social Security is provided to at least some employees
Sustainable Reform Strategies

• Some of these changes will require municipal lobbying to get CalPERS to reform and provide more options
  – This is the single most important “networking” assignment you should take home today!

  ◆ You need to lobby CalPERS for sustainable benefits options, not what the union bosses want to offer you.

• Some of these options are easiest to make for your OPEB plan first, as it is locally controlled

• Establish new, lower benefits tiers for new hires and unvested incumbents
Sustainable Strategies

• Employee contributions
  – Usually much easier to make for incumbent employees than benefits roll-backs
    ◦ Legal issues – in CA there is no real alternative w/o law change
    ◦ Unions see value in benefits

• Goal: 50-50 cost sharing
  – Of Normal Cost (prospective)
    – UAAL remains employer responsibility

• Can apply to OPEB also

• Can phase in with 1% of salary initially and step-up 1% each year
Sustainable Reforms, cont’d

• OPEB plans: a benefits consultant’s view*
  – Institute CPI caps on the benefit
  – Eliminate spousal and survivor benefits
  – Pro-rate benefit based on years of service
    ♦ E.g., employee earns $10 or $15 per month of retiree medical stipend for each year worked, against the “target benefit”
      » Provides incentive to keep working
  – Increase retiree co-payments annually

*Legal issues remain outstanding for changes affecting vested incumbents
Sustainable OPEB reform: Narrow Networks

- Strategy begins with active employees
- Works for employers who have promised retirees same benefits as actives
- Narrow network HMOs are cutting costs as much as 25%
- By making this benefit the standard for actives, retiree costs can be cut
- Leverages the budget reduction
  - Lower actuarial AAL
  - Lower ARC
Sustainable Strategies, cont’d

• Dedicate 30-35% of budget surpluses and future revenue increases to retirement funding until you achieve full ARC.

• Install supplemental savings plans (e.g., retiree medical savings) to enable employees to fund their remaining share of medical costs at retirement.

• Hybrid DC-DB retirement plan (e.g., 50-50)?
  – Better than a pure 401(a) solution
  – Formulas depend on Social Security status.
What Moves the Dial the Most and the Fastest?

- Employee contributions
  - Eliminate “EPMC”
  - Require employees to contribute to OPEB
- Install narrow network HMO for retirees “entitled” to parity benefits
- Freeze OPEB as a stipend with a CPI cap
- Employee-only benefit for OPEB
  - E.g., $10-15 per month per year of service + CPI increases
- Limit OPEB to Medicare supplement (after age 65)
  - Unless employees want to pay half of full actuarial costs
- Raise retirement ages for new hires
- For new hires install a new multiplier if too high now
An Innovative OPEB solution: City of Beverly Hills strategy

• City bought out employees’ vested OPEB rights for 58% of workforce

• Issued taxable lease notes on parking structure for 11 years to finance this

• Established new OPEB defined contribution plan

• Scott Miller, CFO for more info
Establishing an OPEB trust fund

- Necessary, to receive employee contributions
- Will reduce GASB ARC (investment returns higher for trusts)
- Employer-controlled, especially when it’s all taxpayer money
- Governmental purpose IRS Section 115 trust
- Does not require a “pension board”
- Governance can be a streamlined or complex as you prefer
- Most smaller employers seek a simple “outsourced” solution
  - CalPERS (?)
  - Private sector options
    - Multi-employer trust (somewhat like a JPA)
    - Single-employer trust
Case Study: Proposed Asset Allocation

Vested Participant Liabilities

$14.6 million
56%

Unvested Participant Liabilities

$11.8 million
44%

Observation: The CalPERS asset allocation does **not** fit this fact set
Questions?