Public Employee Post-Employment Benefits Commission
DRAFT DISCUSSION DOCUMENT FOR SACRAMENTO HEARING

Document Overview

Commission discussion at the Sacramento hearing will focus on policy issues and areas related to the following concept:

> ***In order to build awareness, support, and trust by taxpayers, including the employees of public agencies, the process through which benefits are adopted, modified and/or paid for needs to be open, transparent and defensible.***

In preparation for the hearing, this document provides background information on the following discussion topics:

- Timeliness of Reporting Data
- Increasing Public Transparency
- Actuarial Review Panel
- Actuarial Assumptions
- Funding Benefit Changes / Actuarial Review of Proposed Benefits
- Actions that Hurt Retirement System Credibility – Spiking and Disability Fraud
- Operational/Administrative Governance and Board Composition

Note

This document summarizes key issues for each discussion item and is not intended to be an exhaustive review of a particular topic. Subject matter experts will be available at the hearing to provide additional detail and answer questions.

TIMELINESS OF REPORTING DATA

1. Definition

N/A

2. Background

Public agencies are open institutions which have a responsibility to keep the public informed of their activities. Part of the governing process is to create accurate and timely reports on the business of governing.

Most public retirement systems in California create an annual Comprehensive Annual Financial Report (CAFR) which presents specific information about the financial conditions of the plan.[1] These reports are published by the individual pension systems and placed on their websites.

In addition, all public retirement systems are required to report their financial, actuarial and benefit status to the State Controller's Office within six months of the close of their business year. The Controller's Office collects very precise data from all public retirement systems. This information is submitted electronically by the retirement systems on special forms created by the staff of that state office.

- Retirement systems using a fiscal year submit their reports by December 31st of the year; those following a calendar year submit their reports by June 30th of the following year.
- Retirement systems that are late in reporting their data are subject to a $5000 fine.

In addition, defined benefit retirement systems are required to submit an actuarial valuation to the Controller every three years, at a minimum.

Government Code section 7504(d) requires that "The State Controller shall compile and publish a report annually on the financial condition of all state and local public retirement systems, containing, but not limited to, the data required in section 7502". (The reference to section 7502 applies to the financial, actuarial and benefit information discussed above.)

(The full text of Government Code sections 7501-7504 can be found at the end of this section.)

In contrast to current reporting standards for pensions described above, there does not exist a standardized process or set of guidelines for collecting OPEB information from public agencies.

3. Pension Issues

- Although retirement systems are required to submit reports within six months of the year-end close, and can be fined $5000 for failing to do so, the Controller's Office has often delayed publication of this information for years at a time. The last report published in July 2007 covered the fiscal year-end 2005. Previous reports have been delayed by as much as

[1] The Government Financial Officers Association (GFOA) created the standards for the CAFR.

three years. For example, the report for fiscal year-end 2001 was not released until June 2004.

- The State Controller's report serves as a reference source for individuals and organizations concerned with the status and adequacy of funding for public retirement systems in California. Delays in the time between the collection and reporting of data serve to degrade the usefulness of this report.

4. OPEB Issues

- Currently, the State does not have a process to gather and publish OPEB data from public agencies. Commission staff's experience conducting the PEBC OPEB survey has demonstrated that information regarding which agencies provide OPEB, the amount of an agency's unfunded OPEB liability and annual OPEB costs are not readily available.

- As public agencies and policy makers continue to address OPEB issues, it would be quite helpful to have a common site to accept and report OPEB-related data from throughout the state. The California State Association of Counties (CSAC), the League of California Cities and several other associations have requested that the Commission review the idea of establishing a centralized OPEB reporting mechanism.

- Many public agencies in California provide some form of access and/or employer contributions to support retiree health care and must comply with GASB 45. As a part of GASB reporting requirements, these agencies will already be gathering information regarding their OPEB obligations and should have this data available to submit for a state-level report. Depending on their size, agencies will have to report their OPEB information either every 2 or 3 years.

<u>Reference</u>

The full text of Government Code Sections 7501-7504 follows:

7501. It is the intent and purpose of the Legislature, in enacting this chapter, to safeguard the solvency of all public retirement systems and funds. The Legislature finds and declares that public agencies maintaining retirement systems can benefit from periodic and independent analysis of their financial condition. It is the purpose of Sections 7502, 7503, and 7504 to enable the State Controller to gather information to compare and evaluate the financial condition of such systems and to make such comparisons and evaluations.

7502. The State Controller shall review the annual financial report of each state and local public retirement system submitted pursuant to Section 7504 giving particular consideration to the adequacy of funding of each system. The State Controller shall also review the triennial valuation of each public retirement system submitted pursuant to Section 7504 and shall give particular consideration to the assumption concerning the inflation element in salary and wage increases, mortality, service retirement rates, withdrawal rates, disability retirement rates, and rate of return on total assets.

The State Controller shall establish an advisory committee which shall include enrolled actuaries, as defined in Section 7504, and state and local public retirement system administrators, to assist in carrying out the duties imposed by this section.

7503. All state and local public retirement systems shall prepare an annual report in accordance with generally accepted accounting principles.

7504. (a) All state and local public retirement systems shall, not less than triennially, secure the services of an enrolled actuary. An enrolled actuary, for the purposes of this section, means an actuary enrolled under subtitle C of Title III of the federal Employee Retirement Income Security Act of 1974 (Public Law 93-406) and who has demonstrated experience in public retirement systems. The actuary shall perform a valuation of the system utilizing actuarial assumptions and techniques established by the agency that are, in the aggregate, reasonably related to the experience and the actuary's best estimate of anticipated experience under the system. Any differences between the actuarial assumptions and techniques used by the actuary that differ significantly from those established by the agency shall be disclosed in the actuary's report and the effect of the differences on the actuary's statement of costs and obligations shall be shown.

(b) All state and local public retirement systems shall secure the services of a qualified person to perform an attest audit of the system's financial statements. A qualified person means any of the following:

(1) A person who is licensed to practice as a certified public accountant in this state by the California Board of Accountancy.

(2) A person who is registered and entitled to practice as a public accountant in this state by the California Board of Accountancy.

(3) A county auditor in any county subject to the County Employees Retirement Law of 1937 (Chapter 3 (commencing with Section 31450) of Part 3 of Division 4 of Title 3).

(4) A county auditor in any county having a pension trust and retirement plan established pursuant to Section 53216.

(c) All state and local public retirement systems shall submit audited financial statements to the State Controller at the earliest practicable opportunity within six months of the close of each fiscal year. However, the State Controller may delay the filing date for reports due in the first year until the time as report forms have been developed that, in his or her judgment, will satisfy the requirements of this section. The financial statements shall be prepared in accordance with generally accepted accounting principles in the form and manner prescribed by the State Controller. The penalty prescribed in Section 53895 shall be invoked for failure to comply with this section. Upon a satisfactory showing of good cause, the State Controller may waive the penalty for late filing provided by this subdivision.

(d) The State Controller shall compile and publish a report annually on the financial condition of all state and local public retirement systems containing, but not limited to, the data required in Section 7502.

INCREASING PUBLIC TRANSPARENCY

1. Definition

N/A.

2. Background

Pension or OPEB benefits are typically determined via collective bargaining agreements negotiated between the employer and representatives of the employees. When a tentative agreement is reached, it is generally brought before the governing body for concurrence.

The nature of this process often does not lend itself to public disclosure while negotiations are taking place. Some of the reasons for this lack of disclosure include:

- Both economic and non-economic issues are discussed during negotiations, with the employer representative periodically reporting during closed session on the progress of negotiations to the governing body.
- Negotiations are a give and take process wherein salary increase demands may be reduced or dropped in favor of other benefits or changes in the terms and conditions of employment.
- The bargaining position of both the labor organization and the governing body are kept in confidence so as not to reveal their respective strategies.

Generally, the public is only made aware of the nature of an agreement once it is presented to the governing body for approval. As negotiations are generally conducted in private meetings, the public is often unaware of the compromises on both sides which have occurred.

<u>Public Notification of Proposed Pension Benefit Changes</u>

For both State and local agencies, if an agreement provides for an increase in retirement benefits, existing law requires that the cost of a pension benefit enhancement be made public at least two weeks prior to the adoption of that benefit. (Please see the complete text of Government Code 7507 at the end of this section.)

- The required cost information must contain information on the “future annual cost” as defined to mean at least the annual dollar increases or the total dollar increases for the retirement benefit.
- The cost information must be prepared by an enrolled actuary.
- The valuation provided by actuaries must meet the Actuarial Standards of Practice which basically require that the information contained in the valuation is sufficient for another actuary to validate the results.
- There is no requirement that the cost information be presented in an easy to understand format. In the past, this has at times been an issue.

In the case of the State, implementation of negotiated changes in retirement or health benefits generally requires the introduction of legislation. Until recently, many of these legislative changes were not introduced until the closing moments of the legislative year and did not have public visibility until after the legislation was passed.

PENSION BENEFITS

The following section provides additional details regarding several retirement systems' requirements for approving/adopting pension benefit changes, as well as mechanisms for informing the public of these changes.

CalPERS

- If an agency (other than schools) seeks to change a benefit with CalPERS, it must adopt a resolution by majority vote of the governing body stating its intent to amend its contract with CalPERS.
- Retirement benefits for classified employees of schools are not subject to collective bargaining. State legislation is necessary to change the classified retirement benefit and such legislation is applicable to all classified employees eligible for the benefit. The public is able to offer comments on the proposed change through the legislative process.
- Approval of a contract amendment cannot occur in less than 20 days following the adoption of the previously mentioned resolution.
- If the employer is a city or county, the contract approval is in the form of an ordinance, which typically requires a first and second reading no less than 30 days apart (Government Code 20471).
- This statute also provides that approval of the contract can occur by passage of an ordinance approved by a majority of the registered voters of the public agency.

'37 Act County Systems

- Approval of pension benefit enhancements by a '37 Act county occurs with the passage of a resolution by the county board of supervisors.
- Depending on the benefit being provided, adoption of a resolution requires a simple majority, a 2/3 or even a 4/5's majority vote.
- Government Code 31592.5 requires that a '37 Act county must provide any organization that is recognized as representing retired employees with reasonable advance notice of any proposed changes to retirement benefits. The organization must be provided with a reasonable opportunity to comment prior to any formal action by the board on the proposed changes.

CalSTRS

- Defined Benefit retirement benefits are not subject to collective bargaining.
- State legislation is necessary to change benefits and any change is applicable to **all** members of CalSTRS regardless of school district. The public is able to offer comments on the proposed change through the legislative process.

San Francisco Employees Retirement System (SFERS)

- The voters of the City and County of San Francisco have the responsibility of approving the provisions of the San Francisco Employees Retirement System plan. Changes in retiree eligibility for health, dental and vision benefits are also subject to public vote.

Independent Public Retirement Systems

- Other than the establishment of the pension plan, there are no statutory provisions (except for Government Code 7507) which govern the process of enhancing benefits to an existing system.

Pension Trusts

- A pension trust is generally defined as a fund consisting of money contributed by the employer and/or the employee plus earnings to provide pension benefits. The statutory authority for creating a pension trust does not include a process for making changes to the benefit design of the trust.
- A pension trust differs from other pension plans in that it is funded by individual life insurance contracts, individual annuities, group life insurance policies or annuities, or any combination of the above.

OPEB BENEFITS

Public Notification of Proposed OPEB Changes

In contrast to the public notification requirements for pensions under Government Code 7507, no comparable cost disclosure statute exists for OPEB.

Changes to PEMHCA Health Plan Benefits

- Under PEMHCA, all health plan benefit changes require approval by the CalPERS Board of Administration. All such changes occur at public meetings as formal agenda items.
- The Board usually discusses proposed changes at multiple meetings prior to final approval. This allows affected parties time to fully understand the issues before the Board actually accepts or rejects the changes.
- In addition, the proposed changes are provided in advance of the Board meetings at constituent meetings attended by interested parties.
- Once the Board accepts a benefit change, multiple mailings are provided to the affected members, explaining the change.

Contracting with PEMHCA

- Public agencies contract for health benefits under PEMHCA by adopting a public resolution.
- There is no requirement for the preparation of an actuarial valuation or to make public the cost of the benefit.
- Cost sharing arrangements between the employer and employees can be bargained concerning the premiums.

3. Pension Issues

- N/A

4. OPEB Issues

- In contrast to the public notification requirements for pensions under Government Code 7507, no comparable cost disclosure statute exists for OPEB.

<u>Reference</u>

The text of Government Code 7507 follows:

7507. The Legislature and local legislative bodies shall secure the services of an enrolled actuary to provide a statement of the actuarial impact upon future annual costs before authorizing increases in public retirement plan benefits. An "enrolled actuary" means an actuary enrolled under subtitle C of Title III of the federal Employee Retirement Income Security Act of 1974 and "future annual costs" shall include, but not be limited to, annual dollar increases or the total dollar increases involved when available. The future annual costs as determined by the actuary shall be made public at a public meeting at least two weeks prior to the adoption of any increases in public retirement plan benefits.

ACTUARIAL REVIEW PANEL

1. Definition

What is an actuary? An actuary is a professional who analyzes the financial consequence of risk. Actuaries use mathematics, statistics, and financial theory to study uncertain future events, particularly those of concern to insurance and pension programs. Pension actuaries, for example, analyze probabilities related to the demographics of pension plan members (e.g., the likelihood of retirement, disability, and death) and economic factors that may affect the value of benefits or the value of assets held in a pension plan's trust (e.g., investment return rate, inflation rate, and rate of salary increases). They determine the value of pension benefits and work with employers to devise strategies for funding the cost of the benefits.

2. Background

In 1992, retirement system boards were given Constitutional authority by Proposition 162 to set actuarial methods and assumptions as part of the "administration of the system". However, there is no such authority for OPEB system boards.

Retirement systems usually review actuarial methods and assumptions on a regular basis (typically every 2 to 3 years). Assumptions are almost always based on a system's experience and boards typically accept the actuary's recommended assumptions.

If this is the case, then what is the problem? Retirement system boards have at times used their authority to encourage plan sponsor behavior and, further, when plan actuaries have expressed concern over this, they have at times been overruled by their boards. Examples of such situations can be seen when:

- The CalPERS Board increased the actuarial asset value in the late 1990s of any agency which adopted enhanced benefits. This encouraged benefit improvements and also made the benefits seem less expensive than they actually were.

- Similarly, the San Diego City retirement system provided that city a reduction in contribution rates contingent on the city granting benefit improvements.

These and similar actions have created some mistrust between agencies and retirement system boards. This mistrust has led to suggestions that actuarial methods and assumptions should be legislated. Given the authority granted under Proposition 162, it is unlikely such legislation could usurp the authority California's retirement system boards currently have, but the fact that such suggestions have been made shows that a credibility problem exists within some parts of the public.

Generally, actuaries belong to the American Academy of Actuaries and must comply with the Academy's actuarial standards of practice.

- Actuarial standards of practice address problems of egregious behavior - they do not address situations where an actuary endorses something that is not a best practice.

- The general actuarial opinion is that actuaries associated with the above two examples certainly did not violate actuarial standards of practice. However, some would say that they did not encourage best practice. Explaining this distinction to non actuaries is very difficult.

3. Pension and OPEB Issues

Establishing a review panel that encourages **best** actuarial practices rather than acceptable actuarial practices would encourage actuaries to make stronger recommendations to retirement system boards. While it certainly would not mandate boards to adopt those recommendations, it would shine more light on the process.

Arguments for establishing an actuarial review panel include:

- Issues having actuarial implications should be identified and evaluated by those with technical background and expertise.
- There is no single clearinghouse for funding policies and practices - good or bad - from around the state and country which is available to evaluate the actuarial assumptions or proposed actions of a particular retirement system.
- There is no single advisory group that can reply to policy questions from retirement systems, policy makers and other interested parties.
- There is a need for an independent, technically strong group to provide comments and/or responses to complaints or inquiries regarding funding policies or other significant actuarial issues.

<u>Responsibilities</u>

The panel's responsibilities could include:

- Define range of actuarial model polices and best practices for both pensions and OPEB.
- Develop pricing and disclosure standards for California public sector benefit improvements.
- Develop quality control standards for California public sector actuaries.
- Gather model funding policies and practices from around the state and country.
- Reply to policy questions from retirement systems around the state.
- Comment on complaints or conflicts regarding funding policies.

<u>Composition</u>

The advisory panel members should have the appropriate financial, actuarial and/or technical background necessary to perform the duties assigned to the panel.

ACTUARIAL ASSUMPTIONS

1. Definition

Actuarial assumptions are the factors used by an actuary to estimate the cost of funding pensions and OPEB. Some examples of these assumptions include: interest and investment earnings, inflation, length of employment, benefits, mortality rates and retirement patterns.

2. Background

Actuarial methodology is not an exact science. The actual cost of a benefit is determined by reality, not by what actuaries anticipate that reality will be. Actuaries must do their best to estimate what that reality will be. Actuarial assumptions are the building blocks an actuary uses to determine those costs. Actuaries attempt to determine the long- term (fifty or more years) cost of a benefit by taking into consideration a variety of factors, including:

- Some retirees will live longer than others.
- Inflation will not be constant.
- The investment market will fluctuate.
- Health care costs change.
- Individuals will retire at different ages for different reasons (disability vs. service retirement).
- Some survivors receiving benefits will live longer than others.
- Salary changes will occur at different rates and amounts from individual to individual, etc.

The actuaries develop assumptions based on probability and averages as to what is likely to happen in the future regarding these conditions. The recommendations that result from actuarial assumptions serve as the foundation for determining funding levels to meet the promised benefits to members.

While there are many “moving” parts in developing actuarial studies, the methodology used to conduct these studies is well-established and set forth in accepted actuarial practices by the American Academy of Actuaries.

Accuracy is critical. Inaccurate data, wrong assumptions, or a missed calculation in a current study can result in different forecasts and have long-term financial impact. In addition, there is often an interrelationship between actuarial factors that can compound from one to the other and that significantly affect the outcome of forecasts. There is also a concern for the accuracy of the computer models used in forecasting.

Current Requirements for Public Retirement Systems

Under current law (Government Code Sections 7501 through 7504), each public retirement system is required to have an actuarial valuation performed at least once every three years.

- The actuarial valuation is used to evaluate the system's assumptions for reasonableness compared to the actuary's estimate of anticipated experience.

- The actuary is required to report any differences between the assumptions and techniques used by the agency and those of the actuary, and to disclose the costs resulting from those differences.

Additionally, the systems are required to have annual financial audits and submit audited annual financial reports to the State Controller.

Both CalPERS and CalSTRS employ full-time actuaries to perform statutorily required valuations and prepare reports to the Legislature and the Governor on a variety of topics. Additionally, CalPERS and CalSTRS contract with outside actuarial consulting firms, on a fixed period contract, to perform annual parallel valuations of the system to test assumptions and techniques and to report to the Boards on material differences. The results and findings are placed on Board meeting agendas.

In 1994 the Bureau of State Audits conducted an audit of both CalPERS and CalSTRS. The audit concluded that the assumptions, methods and estimates of unfunded liabilities were reasonable and in accordance with generally accepted actuarial practice.

Existing law (Government Code Section 20228) requires CalPERS to contract with an outside Certified Public Accountant to audit the annual financial statement. The contract is for five years and is not renewable to the same CPA. CalSTRS works under a similar requirement.

While GASB 45 does call for the public disclosure of liabilities, there are no similar statutory requirements concerning public notice regarding OPEB.

3. Pension Issues

- The consequence of error in an actuarial study can have severe financial consequences. Within the past dozen years, several California public pensions have experienced significant problems regarding the quality and or accuracy of their actuarial studies.

- Each year, California's public pensions are required to close their books and reconcile the financial records for the trust fund. From that closing, their Comprehensive Annual Financial Report (CAFR) is prepared for publication. These systems are then required to have their financial records audited by outside, independent, professional auditing firms to be sure they meet generally acceptable accounting rules and practices. The results are published for all interested individuals to review.

- Both the board of retirement and the plan's sponsor rely upon the information provided in these financial statements and the independent auditor's report. This double review significantly reduces the chances of serious errors going undetected.

4. OPEB Issues

- For the first time, with the recently created GASB 45 regulations, public employers which provide health care benefits to their retirees must have actuarial studies done to determine their unfunded liabilities for promised retiree health benefits.

- As with pensions, accuracy of data, assumptions and forecasting methodologies must be developed and tested. Due to the rapidly escalating costs of health care, it is difficult to have reliable studies at this early stage.

- GASB 45 requires that public agencies have periodic valuations performed. For those agencies with less than 200 active and retired employees, a valuation is called for at least once every three years, while the requirement for agencies with more than 300 actives and retirees is every two years.

FUNDING BENEFIT CHANGES/ACTUARIAL REVIEW OF PROPOSED BENEFITS

1. Definitions

The cost of benefit changes to a pension or OPEB plan ultimately depends on the increased or decreased amount of benefits which will be paid to members over time. However, plan funding policies determine the immediate impact on contributions as well as how any change in contributions will be spread over future years. Also, contractual provisions can affect how changes in costs are shared between the employer and the members, as well as how those new costs are related to other negotiated changes such as pay increases.

This discussion includes issues related to benefit increases such as:

- Funding policies for determining the cost of benefit increases
  - Prospective benefit increases
  - Retroactive benefit increases, including amortization periods
  - CalPERS and Prospective Only Benefit Increases
  - Linking benefit changes to changes in funding policy

Here are definitions of some terms used in this discussion:

- Prospective benefit improvements increase benefits only for service after some specified date. Also known as “future service” or “future service only” benefit increases.

- Retroactive benefit improvements increase benefits only for service prior to some specified date. Also known as “past service” benefit increases. While most retroactive benefit increases include all past service, a retroactive benefit increase could apply only to a portion of a member’s past service.

- Normal Cost is the portion of the total present value of benefits that is allocated to the current year of service for active members.

- Actuarial Accrued Liability (AAL) is the value today of the past Normal Costs for active members, plus the full present value of benefits for retired and inactive members, as of the date of the actuarial valuation. In effect, the accrued liability is what should be in the fund if the normal cost had always been contributed and all assumptions had always come true.

- Actuarial Value of Assets (AVA) is value of assets that is used when determining the employer contribution requirements. It is generally based on the market value of assets but in a way that reduces or “smoothes” short-term market volatility.

- Unfunded Actuarial Accrued Liability (UAAL) is the excess, if any, of the plan’s Actuarial Accrued Liability over the plan’s Actuarial Value of Assets. A plan with a UAAL must receive contributions in excess of the normal cost in order to get back on its funding schedule.

- Surplus is the excess of the plan’s actuarial value of assets over the plan’s actuarial accrued liability. A plan with a Surplus may temporarily reduce contributions below the level of the Normal Cost.

- Amortization is the process of paying off any UAAL or taking credit for any Surplus over a period of years (the "amortization period").

Generally the employer contribution rate will be the sum of the Normal Cost plus any UAAL amortization payment, reduced by any member contributions.

2. Background

California's public sector pension benefit levels are generally set by some combination of statutory authorization and collective bargaining between the employer and employees. **Historically**, the cost of any improvements in the basic benefit formula was determined and allocated as follows:

- A prospective (future service) benefit increase would cause an increase in future Normal Costs. Any corresponding increase in member contributions (either through bargaining or as required by statute) was used to fund a portion of this increased Normal Cost.

- A retroactive (past service) benefit increase cause would cause an increase in the UAAL, with an associated increase in the UAAL amortization cost. This cost was typically paid entirely by the employer. The immediate cost impact depended on the amortization period, with longer amortization periods producing lower immediate cost but with payment spread out over a longer period of time.

- Amortization periods for increases in UAAL due to benefit increases generally ranged from 15 years to 30 years. The periods from 15 to 20 years represented the approximate working lifetime of the active members, while the 30-year period was the longest period allowed by the applicable GASB standards.

- Note that a benefit increase including all service was treated as a combination of a prospective and retroactive increase, with increases in both Normal Cost and UAAL amortization. Any member contribution increases were based on and applied to only the increase in Normal Cost.

Changes - Since the rise and fall of the investment markets at the turn of the 21st century, there has been considerable benefit improvement activity among California's pensions. This has included various changes in the historical approaches to funding benefit increases as set out above, including the use of surplus, funding policy changes, and the application of member contributions. Before reviewing those changes, a comment on retroactive vs. prospective increases in general and on CalPERS in particular.

CalPERS and Prospective Only Benefit Increases

While the majority of California public pension benefit improvements have been implemented both prospectively and retroactively, many retirement systems give agencies the ability to grant benefit improvements either prospectively only, or both prospectively and retroactively, if desired. However, this has not been the case with agencies which participate in CalPERS, where statutory language prevents agencies from implementing benefit formulas on a prospective only basis. CalPERS law has historically[2] also applied benefit improvements to all

[2] The notable exceptions to this were found in SB 400 and AB 616, which applied to the State and to local agencies, respectively. Both of those bills included language which expressly limited benefit increases to those participants employed when the formula became effective, although the new benefits were still applied to all service, past and future, of current employees.

non-retired participants, including those not working for an agency when the improvement became effective.

<u>Using Surplus to Fund Benefit Increases</u>

In the late 1990s, high levels of investment returns put many of California's public retirement systems into a surplus position. These surpluses were often used to allow the employer contribution level to fall below the Normal Cost or, at times, all the way to zero. Furthermore, under the funding policies then in place, these surpluses were being amortized over relatively short periods, with some systems (including the CalPERS agency valuations) using periods as short as five years. Under these policies it did not take too large a surplus to produce a credit that largely or entirely offset the Normal Cost, producing a "contribution holiday" for the employer.

These surpluses also had a significant impact on the immediate cost of benefit increases. This impact worked somewhat differently for the retroactive and prospective portions of a benefit increase, although the two were interrelated.

- **Retroactive benefit increases** usually increase the unfunded liability and the associated amortization cost. However because the plans were in surplus, any retroactive benefit increases instead reduced the surplus, and the associated amortization credit. In effect the surplus was used to fund the increase in the Accrued Liability caused by the retroactive benefit increase.

  The market downturn in the early 2000s caused the assets of most plans to fall below the level of plan liabilities. Although this eliminated the plan surpluses, any increases in Accrued Liability due to previous benefit increases remained as part of the plan's unfunded liability and associated amortization cost.

- **Prospective benefit increases** cause an increase in long-term Normal Cost, regardless of the plan's funded status. However for many plans, because of the short surplus amortization periods in use at the time those surpluses were large enough to offset some or all of the increase in the Normal Cost, at least while the surplus lasted.

  For example, for CalPERS agencies the following scenario was not uncommon. The regular valuation might show a Normal Cost of, say, 10% of pay, but because of a surplus there were no required contributions and none expected to be required for 11 years. A benefit improvement cost study done to determine the cost of a new benefit formula would then show that, after the benefit increase took place, the new Normal Cost was 15% of pay. There were still no immediate contributions required, but now contributions were projected to resume at the higher Normal Cost level in 6 years.

In this example, the surplus was used to fund all of the retroactive increase and the first 6 years of the cost of the prospective increase. This resulted both from the high levels of surplus and from the use of short surplus amortization periods. Note that in 2005 CalPERS changed their funding policy so that any future surplus will be amortized over 30 years.

Linking Benefit Changes to Changes in Funding Policy

On occasion, some retirement boards have conditioned changes to elements of their funding policy to plan design actions by either the Governor, the Legislature or by employer agencies. For example:

- Governor Deukmejian agreed to sign the bill giving 1 year final compensation to state employees in exchange for the PERS Board's agreement to allow the State to stretch out its contribution to PERS in a year with a budget shortfall.

- In 1999 the actuarial value of assets (AVA) was at around 90% of the market value. The CalPERS Board adopted a policy where the AVA would be increased to 95% of market value only for those agencies which adopted improved benefits.

- In 2001, with the regular AVA close to 95%, the CalPERS Board adopted a policy giving employers who adopted new benefits the option of having their AVA increased to as high as 110% of market value. This action was taken by the Board in spite of the advice of both legal and actuarial staff that it was not a good idea.

The last two examples linked changes in funding policy to the adoption of increased benefits in a way which reduced the immediate cost of those new benefits.

- As the Commission heard in testimony, the retirement board for the City of San Diego changed city contribution requirements in exchange for benefit increases.

3. Pension and OPEB Issues

In practice, all the issues raised here relate primarily to pension plans. To the extent that OPEB benefits are increased, most of these issues could apply as well.

ACTIONS THAT HURT RETIREMENT SYSTEM CREDIBILITY – SPIKING AND DISABILITY FRAUD

SECTION I: PENSION SPIKING

1. Definition and Background

While no hard and fast definition of spiking exists, it is generally seen as the intentional inflation of final compensation so as to increase the retirement benefit. Since it most often takes place shortly before retirement, the inflated benefit which spiking produces is usually unfunded.

Inflating final salary is the most common and direct type of spiking, but many other more creative examples have been seen as well, such as one-time bonuses in the final compensation period, manipulating allowable pay differentials and special compensation, or saving and cashing in large amounts of sick leave or vacation in the final compensation period. In retirement systems where overtime is allowed to be added to final compensation, the more senior employees are often able to work many additional hours during the final compensation period.

It is easier and more effective to spike final compensation when the final compensation period used to calculate a pension is shorter rather than longer. The two periods most commonly used in California are the 1 highest year and an average of the three highest consecutive years. In the current round of bargaining between the State of California and its employees, every bargaining unit which has settled has moved back to a three year average from the use of the single highest year. The State reports that it sought that change to eliminate both the reality of, and the public perception of, spiking.

While pension spiking is almost always an abuse by management, since that group has control of reporting procedures, there have been some examples of spiking which included rank and file employees through an MOU.

2. Approaches Taken to Address Spiking

At the Commission's August 23, 2007 hearing in San Jose, Mr. Ted Costa, a spokesman for People's Advocate, spoke about the problem of pension spiking in California and gave the Commission a document which he called, "Thirty Ways to Spike Your Pension".

Staff gave the document to the Los Angeles County Employees' Retirement Association (LACERA), the Public Employees' Retirement System (CalPERS), and the State Teachers' Retirement System (STRS) with the request that they consider and respond to each of the 30 items. Since these three systems are governed by the three major retirement laws in California, their combined responses give a good overview of how pension spiking is being addressed in this state. A brief summary of each system's approach to addressing spiking is presented below. Please see the Appendix for each system's response to the "Thirty Ways" document.

LACERA

LACERA is the largest of the twenty county retirement systems which operate under the County Employees' Retirement Act of 1937 (37 Act). More than with CalPERS or CalSTRS, the 37 Act retirement systems have had spiking defined and regulated by the courts. So, through a combination of court rulings and legislation, the 37 Act counties have decided what compensation is reportable to the retirement system to be used as the basis for calculating a pension. Such compensation is generally referred to as "pensionable earnings". The 37 Act defines "pensionable earnings" broadly to mean cash paid to an employee.

In 1983, the California Court of Appeal ruled that pensionable earnings should be limited to only those items of compensation which were paid in cash to all members in an employment classification. This excluded compensation paid for such things as bilingual pay, educational incentive pay, and any other pay which was paid to only those employees with special qualifications.

In 1997, the California Supreme Court issued its final decision in Ventura County Deputy Sheriffs' Association v. Ventura County Employees' Retirement Board, in which it ruled that the 1983 Court of Appeal had been incorrect and that cash paid to employees for services rendered for other than regular pay for time worked was pensionable.

Following the Ventura decision, LACERA developed a list of items which were pensionable as well as items which were not. That list was placed in the 37 Act along with the collective bargaining process to be followed to change that list.

As an ongoing guard against spiking, LACERA's legal department reviews all MOUs between the county and its employees to determine if any new pay items are pensionable.

Another safeguard against spiking comes from the LACERA computer system's ongoing edit of all payroll information received from employers. When something is flagged by this edit, it is investigated by staff to decide if it is pensionable or not. Finally, there is a manual examination of the records of those employees nearing retirement or those who are newly retired, which can result in error corrections paid by either LACERA or the employee. LACERA reports that it can and does reduce pensions based on "spiked" data.

Appendix A from LACERA reviews the "Thirty Ways" and describes their applicability to the retirement system.

CalPERS

In the early 1990s, the **Sacramento Bee** ran a series of investigative articles on pension spiking which constituted the first systematic examination of how spiking was being conducted by some public agencies. Spurred on by these and other media reports, the Legislature introduced several pieces of legislation aimed at ending spiking.

Of these bills, the CalPERS-sponsored SB 53 (Chapter 1297, Statutes of 1993) was the most extensive and addressed itself only to CalPERS – the system where the most cases of spiking had been identified. The effect of SB 53 was to place guidelines in the law and to direct CalPERS to develop regulations setting out what would be – and would not be – included in final compensation.

CalPERS does have statutory authority to deny increases in compensation for pension purposes which do not fit its guidelines and reports that it does so on a regular basis.

Appendix B from CalPERS reviews the “Thirty Ways” list and describes how each is treated under that retirement system’s anti-spiking provisions.

CalSTRS

While the STRS law does not specifically define “pension spiking”, the Education Code does provide guidelines for defining “creditable compensation”. As with the other systems above, these guidelines include requirements that:

- Compensation be treated consistently throughout an employee’s career;
- Compensation be consistent throughout an entire classification of employees; and
- Compensation be excluded which is paid for the principal purpose of increasing an employee’s final compensation in order to enhance the pension benefit.

CalSTRS reports that it uses these guidelines and others to decide what is spiking.

CalSTRS informs staff that an important tool it uses to prevent spiking is the school district audit, along with its statutory authority to disallow compensation which it finds is paid principally to increase the pension benefit. Further, CalSTRS staff reports that they are statutorily authorized to reduce spiked pensions and do so.

Appendix C provides additional details on CalSTRS’ response to this topic.

3. Summary

The reaction of all three pensions systems listed above to the “Thirty Ways to Spike Your Pension” document from The People’s Advocate is that the document is overly broad, outdated and at times includes as “pension spiking” some items which are legally pensionable but with which it simply disagrees.

There is no question that before the **Sacramento Bee** articles mentioned above, spiking was a very real problem in many of California’s public pension systems. There were very few guidelines and a great deal of creativity on the part of some public employers. Since that time, however, systematic procedures have been adopted by the major systems and spiking, while not eliminated completely, is a much less serious problem.

SECTION II: DISABILITY REFORM

Staff has put the issue of disability reform before the Commission because it is treating all benefits – pension and OPEB – as part of total compensation. In that light, any savings on one type of benefit can lead to savings for the employer and/or the employees, or can make more money available for other benefits. Thus, for our purposes here, money saved through disability retirement reform might be used by an employer to help fund retiree health care benefits.

In addition, there have been numerous high profile media stories concerning disability abuse which serve to lessen support for public retirement disability programs among the general public. One such recent story was concerning the practice known a “Chiefs’ Disease” in which high ranking safety members were found to apply for a disability retirement and then go to work in a job with very similar duties to the job they were just disabled from.

Within the 37 Act, each county retirement board rules on the disabilities within its own system. The situation is the same for CalSTRS, the State Teachers' Retirement System, where the Board decides on all disability applications made by members of that retirement system.

Prior to 1975, CalPERS also made disability determinations for all state, school and public agency members and also made determinations as to whether disabilities were the result of a job related injury or illness for state and local safety members. After 1975, the responsibility for making disability determinations for local safety members (and whether the disability was the result of a job related injury or illness) was statutorily changed to local public agencies, that is, to the employers of the safety members who were applying for disability. Consequently there can be and has been - significant differences in standards between employers as to what constitutes a "disability", with some local agencies at times using disability retirement as a substitute for the disciplinary process. CalPERS reports that the awareness among local agencies of this disparity causes ongoing concern for some agencies over the equity of pooling disability experience as part of the rate setting process.

During the last session of the Legislature, CalPERS sponsored legislation that would enhance their ability to prevent disability fraud. These proposals included the following concepts:

- Make it a crime to present false statements and representations when applying for a benefit under CalPERS law, CalSTRS law, and the County Employees' Retirement Law of 1937 (37 Act) or to keep a payment from the system, knowing that it is fraudulent and undeserved. (AB 36, Niello).

- Require a member who retired for disability after age 50 to submit to a medical re-evaluation for up to 36 months or face a penalty or benefit cancellation for refusal. Presented as a cure for "Chiefs' Disease". (AB 219, Jeffries).

- Require that workers' compensation insurers and the Director of EDD provide CalPERS and its investigators with information they deem necessary when investigating someone for the unlawful application or receipt of CalPERS benefits. (AB 545, Walters).

These bills were held because the Legislature wanted to wait to see how the legislation would fit with the Commission's proposals. Staff recommends that these CalPERS concepts be endorsed for action in the coming legislative session.

OPERATIONAL/ADMINISTRATIVE GOVERNANCE AND BOARD COMPOSITION

1. Definition

Retirement system boards are generally in charge of overseeing pension operations, guiding investment policy, hiring investment consultants, making determinations on individual pension issues and approving changes in actuarial assumptions.

Fund governance refers to the organizational governance policies and practices adopted and followed by institutional investment funds such as retirement system boards. Good fund governance helps to ensure better organizational performance, fewer conflicts of interest, and less opportunity for misuse of fund assets.

2. Background

Pension fund governance has received greater attention in recent years as pension funds have become larger, investment options more complex, examples of fund mismanagement and conflicts of interest have been highlighted in the press, and as pension boards themselves have placed governance requirements on the companies in which their funds are invested.

<u>Board Composition</u>

California statutes define the composition of the governing boards of CalPERS, CalSTRS, and county retirement systems that operate under the County Employees' Retirement Law of 1937 (1937 Act) as follows:

CalPERS	***CalSTRS***	***'37 Act County Systems***
• One member of the State Personnel Board • Director of the Department of Personnel Administration • The Controller • The State Treasurer • Two gubernatorial appointees (an official of a life insurer and an elected official of a contracting agency) • One legislative appointee • Six elected active and retired members of the system	• The Superintendent of Public Instruction • The Controller • The Treasurer • The Director of Finance • Five gubernatorial appointees • Three elected active members of the system	• The county treasurer. • Two general (non-safety) members elected by the general members of the system. • One safety member elected by the safety members of the system. • One retired member elected by the retired members of the system. • Four members who are registered voters not in any way connected with county government, except that one may be a county supervisor, appointed by the board of supervisors.

The University of California Retirement System is governed by the Regents of the University, which under Article IX, Section 9 of the California Constitution has "full powers of organization and governance" subject only to very specific areas of legislative control. The board consists of 26 members including:

- 18 appointed by the governor for 12-year terms
- One student appointed by the Regents to a one-year term
- Seven ex officio members – the Governor, Lieutenant Governor, Speaker of the Assembly, Superintendent of Public Instruction, president and vice president of the Alumni Associations of UC and the UC president.
- No employee or retiree representatives (with the exception of two faculty members – the chair and vice chair of the Academic Council – who sit on the board as non-voting members).

Section 17 of Article XVI of the California Constitution gives the retirement boards of public retirement systems plenary authority and fiduciary responsibility for the investment of public pension funds and the administration of the retirement system.

- However, the only qualifications that members of retirement boards must posses under Section 17 and under relevant statutes is that members be able to discharge their duties with the care, skill, prudence, and diligence that a prudent person acting in like capacity and familiar with these matters would use.
- Aside from *ex officio* members, there are no specific occupational or educational requirements placed on retirement board members.

As the value of pension fund assets has increased over the years and the range of investment products used by funds has expanded, boards' tasks have grown more complex. For this reason, the Stanford Institutional Investors' Forum recommends more education, more training and more professionals on pension boards.[3] At least one study has found support for the notion that a higher degree of expertise on a retirement board is related to higher investment returns and plan funding status.[4]

The State Constitution [Article XVI, Section 17(f)] provides that the composition of retirement boards that have at least one elected member may "not be changed, amended or modified by the Legislature unless the change, amendments, or modification enacted by the Legislature is ratified by a majority vote of the electors of the jurisdiction in which the participants of the system are or were, prior to retirement, employed."

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[3] "Best Practice Principles," The Stanford Institutional Investors' Forum Committee on Fund Governance, May 31, 2007.
[4] Mitchell, Olivia S. and Ping Lung Hsin. 1994. "Public Pension Governance and Performance." National Bureau of Economic Research, January 1994.

Conflicts of Interest

In recent years in California and across the U.S., concerns have been raised about retirement system mismanagement, misuse of funds and conflicts of interest. Some of the specific issues include:

- The influence of board members who are beneficiaries themselves voting for provisions from which they stand to gain.
- Board members accepting gifts, honoraria and other perks from investment firms.
- Board members using influence to procure contracts for campaign donors.
- Manipulating actuarial assumptions and methods to lower contribution rates and/or pay for new benefits.
- Board members using their position to market investment products.

Reforms

Retirement systems have adopted a variety of reforms to address board member qualifications, conflicts of interest and other governance issues.

In 1998, CalPERS unsuccessfully attempted to restrict campaign contributions from investment firms to the two *ex officio* elected officials on the Board in the wake of a controversy related to that issue.

In September 2007, the CalSTRS board voted to approve rules which limit campaign contributions that the governor and other public officials with influence over the pension fund can receive from money managers. The regulations are aimed at investment managers and their firms that do at least $100,000 a year in business with CalSTRS and those negotiating to contract with the fund. The provisions of the rule include:

- An aggregate annual contribution limit of $5,000 from a firm and $1,000 maximum from an individual.
- Barring violators from doing new business with the fund for two years.
- Allowing firms 90 days to disclose an inadvertent violation.
- Requiring board members to recuse themselves from investment decisions involving campaign contributors.

Similar concerns about the relationship between the financial industry and county retirement boards led to AB 246 (Torrico, Chapter 315, Statutes of 2007), which prohibits a member of a county retirement board from selling or providing investment products to any 37 Act retirement system.

In 2004, California's State Association of County Retirement Systems (SACRS) drafted the Uniform Trustee Appointment Policy to recommend application and appointment procedures as well as qualifications for retirement board members appointed by county boards of supervisors. SACRS urged 1937 Act County Board of Supervisors to use these recommendations to enact a county policy on the appointment of members to the Board of Retirement when a term expires or a vacancy occurs. SACRS recommends that the appointment policy consist of three parts:

(1) a procedure for filing applications; (2) a set of recommended qualifications for appointment; and (3) a procedure for selecting the best qualified candidates. The recommended qualifications for appointment to the board of retirement are a demonstrated expertise:

- As an executive financial manager in a public agency or private enterprise.
- In developing, planning and implementing investment and money strategies.
- In the interpretation of executive level financial reports and correspondence.
- In the human resources and employee benefits arena.
- In commitment and willingness to spend the necessary time to work as a Board member.

Following allegations related to conflicts of interest and the adoption of questionable actuarial methods that brought the City of San Diego close to bankruptcy, that city removed some of the retirement board positions that were designated for active and retired employees in favor of individuals with financial expertise.

Outside of California, a variety of reforms aimed at increasing retirement board expertise and limiting conflicts of interest have been proposed or implemented including:

- Separating the investment function and placing oversight for long-term state investments under another entity governed by investment experts.
- Requiring retirement boards to hire external auditors, independent investment consultants, independent actuaries and independent legal counsel to monitor and review retirement system activities.
- Conducting comprehensive review of board duties and delegating more day-to-day operations to staff.
- Increasing the transparency of pension fund activities by making the following more readily accessible to the public: financial reports, board governance rules, and procedures used to award contracts and to appoint and elect board members.
- Changing the composition of retirement boards by decreasing the number of employee and retiree representatives and replacing them with members of the public or members with financial expertise.
- Adopting ongoing educational and certification requirements to ensure that board members obtain the qualifications necessary to fulfill their fiduciary responsibilities.

3. Pension Issues

- Currently, fund governance is primarily an issue for pensions.

4. OPEB Issues

- As more employers begin to use trust funds to prefund OPEB benefits, there will be similar concerns about conflicts of interest and the composition of the boards which govern those trusts.