Public Employee Post-Employment Benefits Commission

Discussion Items for Sacramento Hearing

November 13, 2007

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.

Encouraging Awareness

- Timeliness of Reporting Data
- Increasing Public Transparency

Creating an Open, Defensible Process for Adoption and Payment of Benefits

- Actuarial Review Panel
- Actuarial Assumptions
- Funding Benefit Changes/ Actuarial Review of Proposed Benefits
- Actions that Hurt Retirement System Credibility – Spiking and Disability Fraud

Building Taxpayer Support and Trust

- Operational/Administrative Governance and Board Composition

Timeliness of Reporting Data - Background

Pensions

- All public retirement systems are required to annually report their financial, actuarial, and benefit status to the State Controller's Office or be fined $5000.
- Government Code section 7504(d) requires the State Controller to publish an annual report on the financial condition of all public retirement systems.
- State Controller's Office has often delayed publication of this information.

OPEB

- There is no standardized process for collecting and making public OPEB information from public agencies.

Timeliness of Reporting Data – Draft Recommendations

It is in the public's interest for public retirement systems and employers providing OPEB to report on the status and adequacy of funding for these benefits. Current reporting mechanisms do not provide for the timely and accurate disclosure of pension and OPEB liabilities.

1. Legislation should be introduced directing the State Controller's Office to develop a simple and inexpensive procedure to regularly collect and report OPEB data from California public agencies. The State Controller's Office should publish the report of OPEB data at least once every two years, within nine months of the close of the fiscal year.

2. The State Controller's Office should publish the annual report of public pensions which is required by current law within nine months of the close of the fiscal year.

Increasing Public Transparency - Background

Pensions

- For both State and local agencies, existing law requires that:

  If an agreement provides for an increase in retirement benefits, the cost of the benefit enhancement must be made public at least two weeks prior to the adoption.

- Required cost information must be prepared by an actuary and contain information on the “future annual cost” of the retirement benefit.

- No requirement for the cost information to be presented in an easy to understand format.

OPEB

- No comparable cost disclosure statute exists for OPEB.

Increasing Public Transparency – Draft Recommendations

Although existing law requires public disclosure of proposed pension benefit changes prior to adoption, some local agencies place the proposal on the consent calendar, where it is passed without discussion. Existing “sunshine” provisions for pensions do not apply to changes in retiree or active health care benefits.

3. Existing state law, Government Code 7507, which requires specific public notice concerning the cost of proposed pension benefits, should be amended to also apply to the granting or changing of OPEB benefits. This statutory change would require that the future costs of the proposed OPEB benefit change be determined by an actuary and be made public at least two weeks prior to adoption.

4. Pension or OPEB changes should be agendized, and presented by an actuary in accordance with the public notification requirements found in Government Code Section 7507. The presentation and report should be in language easily understood by the lay person. Such information shall not be placed on the consent calendar.

Actuarial Review Panel / Actuarial Assumptions – Background

Pensions

- Current law requires each public retirement system to:
  - Conduct an actuarial valuation at least once every three years.
  - Have annual financial audits and submit annual financial reports to the Controller.
- CalPERS and CalSTRS employ full-time actuaries and also contract with outside actuarial consulting firms to perform annual parallel valuations.

OPEB

- There are no similar statutory requirements for OPEB.

Actuarial Review Panel / Actuarial Assumptions – Background

- Actuaries are responsible for making method and assumption recommendations to retirement system boards. Ultimately, retirement system boards have the constitutional authority to select methods and assumptions.

- Some retirement system boards have at times used this selection process to encourage benefit improvements.
  - CalPERS Board and late 1990's benefit enhancements
  - City of San Diego

- General opinion is that above examples did not violate actuarial standards of practice. However, some say that they did not encourage best practice.

- In addition, several California public pensions have also experienced significant problems regarding the quality and/or accuracy of their actuarial studies.

Actuarial Review Panel / Actuarial Assumptions – Draft Recommendations

Actuarial standards of practice from the American Academy of Actuaries only address actuaries who practice outside the acceptable range of practice – and do not help actuaries and boards select **best practice** methods and assumptions.

5. In order to encourage greater transparency and understanding of actuarial methodology and assumptions, there should be a California actuarial advisory panel created at the state level. This panel should be within the Office of the State Auditor. Permanent staff should be assigned to support the activities of the advisory panel.

   The purpose of the advisory panel would be to provide the California Legislature, the Governor's office, public retirement systems, public agencies and other interested parties with impartial and independent information on pensions, OPEBs and best practices, so as to promote transparency and public confidence in actuarial functions.

Actuarial Review Panel / Actuarial Assumptions – Draft Recommendations

In-depth and independent review of actuarial assumptions and their forecasts are critical to all interested parties. A secondary review of financial and actuarial activities is in the best interests of the pension or OPEB fund, the plan sponsors, the taxpayers and the active and retired employees of the plan sponsor.

6. In addition to annual financial audits conducted by an outside independent financial auditor selected by plan trustees, the State Auditor should perform a complete financial audit of statewide retirement systems every three years. If a statewide retirement system administers an OPEB fund, that fund should also be included in the audit.

Funding Benefit Changes – Background and Recommendations

In the 37 Act Counties, employers have the choice of applying new retirement benefits on a prospective only basis or on a total service basis. Local bargaining can decide which application is chosen.

Local CalPERS employers must apply new retirement benefits on a total service basis, meaning both prospectively and retroactively.

7. All public agencies which have the authority to determine their own pension benefits should have the flexibility to adopt pension benefit increases on a prospective basis only. How the benefit is adopted should be decided through the local bargaining process.

8. To avoid intergenerational cost shifting, the total cost of retroactive benefit increases should be funded over a period no longer than the average future working lifetime of the active members.

Funding Benefit Changes – Background

- The cost of pension or OPEB benefit changes ultimately depends on the level of benefits which will be paid to members over time.
- Plan funding policies determine the immediate impact on contributions and how any change in contributions will be spread over future years.
- On occasion, some retirement boards have conditioned changes to their funding policy on plan design actions by either Governor, Legislature or employer agencies.
  - Move to 1 year final compensation for state employees
  - CalPERS Board and late 1990's benefit enhancements
  - City of San Diego

Funding Benefit Changes – Draft Recommendations

There have been times when some public retirement systems have manipulated aspects of their funding policy to encourage employers to grant benefit increases.

9. Benefit improvements by the employer should not be contingent upon the actions of the retirement board.

Spiking – Background

- Spiking is generally seen as the intentional inflation of final compensation so as to increase the retirement benefit.
- 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.
- Responses from LACERA, CalSTRS, and CalSTRS to the “Thirty Ways to Spike Your Pension” document provide examples of systematic procedures adopted by the major retirement systems to control spiking.
- Spiking, while not eliminated completely, is a much less serious problem.

Spiking – Draft Recommendations

Since spiking most often takes place shortly before retirement, the inflated benefit which spiking produces is usually unfunded. Historically, it has been primarily a management abuse.

10. Retirement systems and public agencies should be open and transparent concerning what elements are included in final compensation for management.

During current bargaining between the State and its employees, almost all bargaining units which have settled, have approved a return to a 3 year final compensation from a 1 year final compensation period.

11. The 3 year final compensation period recently bargained at the State level seems to be a best practice for discouraging pension spiking. When local agencies with a 1 year final compensation period are engaged in the collective bargaining process, the Commission recommends that they bargain a return to a 3 year final compensation period.

Disability Retirement Reform – Background

- High profile media stories concerning disability abuse have served to lessen support for public retirement disability programs among the general public.
- During the last legislative session, CalPERS sponsored legislation which would enhance public retirement systems' ability to prevent disability fraud.
- These bills were held in order to see how they would fit with Commission proposals. They would:
  - Make it a crime to present false statements when applying for a benefit or to keep a payment, knowing that it is fraudulent and undeserved (AB 36)
  - Require a member who retired for disability after age 50 to submit to a medical re-evaluation for up to 36 months or face penalty or benefit cancellation for refusal (AB 219)
  - Require workers' compensation insurers and EDD to provide information needed to investigate for unlawful application or receipt of benefits (AB 545)

Disability Retirement Reform – Background

- Within the 37 Act, each county retirement board rules on disabilities within its own system. The CalSTRS Board decides on disability applications in that retirement system.

- Prior to 1975, CalPERS made disability determinations for all state, school and public agency members, as well as whether disabilities were the result of a job related injury or illness for state and local safety members.

- After 1975, responsibility for disability determinations for local safety members was statutorily changed to local public agencies.

- Consequently, there can be significant differences between employers as to what constitutes a “disability”.

Disability Retirement Reform – Draft Recommendations

12. The Commission endorses the reform policy language found in the current legislative session's AB 36, AB 219 and AB 545, and urges the Legislature to enact that language in 2008.

13. Legislation should be introduced to return the decision-making authority for CalPERS local safety member disability determination to the CalPERS Board.

Operational/Administrative Governance – Background

- Pension fund governance has received greater attention in recent years as pension funds have become larger and investment options more complex.
- Concerns have also been raised about retirement system mismanagement, misuse of funds, and conflicts of interest.
- Retirement systems have adopted reforms to address these governance issues.
  - Rules to eliminate “pay to play” for CalSTRS board.
  - AB 246 prohibits county retirement board members from selling or providing investment products to any 37 Act retirement system.
  - SACRS’ Uniform Trustee Appointment Policy recommends appointment procedures and qualifications for appointed retirement board members.

Operational/Administrative Governance – Draft Recommendations

According to best practice literature, effective fund management requires that the appointed members of retirement system boards should have expertise which balances representation of members and the public and minimizes political influence and economic conflicts of interest.

14. Trustees of public retirement systems should receive continuous training related to the understanding and fulfillment of their fiduciary responsibilities, as well as ongoing training for the investment of fund assets.

Operational/Administrative Governance – Draft Recommendations

Adoption of sound governance policies helps to ensure better organizational performance and fewer conflicts of interest and provide less opportunity for misuse of fund assets. Such policies also lend credibility to the governance requirements which trustees place on companies where plan assets are invested.

15. Boards which oversee pension and OPEB trust funds should meet or exceed the transparency governance requirements they place on companies or other investment vehicles where plan assets are invested.

16. Public retirement system boards of trustees should establish an independent audit committee made up of trustees to oversee and participate in the opening, processing and closing of the annual audit report to the full board. This recommendation is made to make trustees more active participants in the audit process.

17. Boards which govern pension and OPEB trusts should have very strong conflict of interest policies. All trustees should annually attest in writing that they understand and are in compliance with the conflict of interest policy.