

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

Document Overview

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

A competitive, affordable benefits package serves the public good by enabling public employers to recruit and retain qualified public employees.

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

- Actuarial Equivalency (Proportionate Benefit Design)
- Three-Legged Stool (Public Employee Participation in Social Security)
- Understanding of “Vesting” (Health Care)
- Part-Time Employee Access to Health Care Risk Pools
- Retiree Access to Health Care Risk Pools
- Medicare Eligibility and Coordination

Note

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

ACTUARIAL EQUIVALENCY (PROPORTIONATE BENEFIT DESIGN)

1. Definition

The proportionate benefit approach rewards employees for the length of their service by providing the highest pension or OPEB benefits to those who have the longest careers. Conversely, employees who retire earlier are provided with a benefit that is reduced in a manner proportional to the length of the employee's career.

2. Background

Current defined benefit pension formulas serve as a model of proportionate benefit design. In most defined benefit plans, an individual's age and years of service determine the percentage of final compensation that will be earned as a retirement allowance. Those who retire at an older age with more years of service receive a greater benefit.

From a personnel perspective, defined benefit formulas can be tailored to meet employer needs by providing incentives to encourage employees to postpone retirement until reaching a particular age or years of service.

For retiree health benefits, an increasing number of employers are moving to a proportionate benefit design by establishing schedules that link years of retirement service credit with the amount of employer contributions to health care in retirement. This schedule typically includes a threshold amount of service for a minimal level of employer support.

For example, employees of the State of California and University of California who were hired after 1990 and who retire with 10 years of service receive 50% of the maximum employer contribution toward health premiums. This amount increases by 5% for each year of service such that employees who retire with 20 or more years of service receive 100% of the employer contribution.

3. Pension Issues

- From a human relations perspective, defined benefit pension formulas serve as a model of proportionate benefit design that provide a rational basis for awarding benefits.
- Pension formulas offer incentives to encourage employees to retire at the time that employers would prefer, rather than earlier or later.

4. OPEB Issues

- Many agencies have arrangements that allow, in general, an employee to be eligible for lifetime health care after five years of service. This practice does not comply with the concept of providing benefits in a manner proportional to time worked and puts a significant cost burden on the employer.
 - For example, State health care "vesting" requirements – 10 years for 50% of the maximum employer contribution, 20 years for 100% of the employer contribution – do not apply to the California State University (CSU) or the employees of the Legislature. CSU and legislative retirees are eligible for the maximum employer contribution to retiree health benefit premiums after having worked for only five years.

- The practice of providing lifetime health benefits to employees with only a limited number of years of service can leave public agencies which participate in PEMCHA in a particularly vulnerable position.
 - As an example, an employee could work for five years at an agency that requires 20 years of service for retiree health care eligibility and then move to another PEMCHA employer that requires only five years for eligibility. The second agency would have to absorb the entire cost of providing the lifetime benefit, even if the employee retires after working there for less than a year.

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THREE-LEGGED STOOL (PUBLIC EMPLOYEE PARTICIPATION IN SOCIAL SECURITY)

1. Definition

The three-legged stool is commonly defined as a theory that the combination of an individual's personal savings, Social Security and a government-sponsored pension will provide a secure retirement income.

2. Background

Social Security

Prior to 1954, state and local governmental agencies were unable to provide Social Security coverage for their employees. Although local government agencies could choose to provide Social Security coverage after that date, it was not until 1961 that the State of California elected to provide coverage for its employees.

Other than fire and police, employees who are members of a government agency's pension plan become covered by Social Security once the agency contracts for coverage. Agencies can also extend Social Security coverage separately to fire and police groups.

A number of public agencies in California do not provide Social Security to their employees. It is generally agreed that about half of all public employees do not participate in Social Security.

- The single largest group of public employees who are not subject to Social Security coverage are public school teachers and administrators who are members of the California State Teachers' Retirement System.
- Most public safety employees do not participate in Social Security.
- Most public employees who do not participate in Social Security have defined benefit retirement plans on which to rely. However, there are a great number of part-time employees who are not in Social Security and also not eligible for their employer's defined benefit plans.
- Since 1991, the federal government has required that those public employees who are not members of a qualified pension plan must contribute to Social Security or to an alternate plan. Any such alternate plan must have a total contribution of at least 7.5% of payroll. Many agencies contract with outside vendors to offer a DC type plan with a 7.5% total contribution rate as a means of addressing the mandatory Social Security requirement.

Up until recently, public agencies which contracted for coverage could withdraw from Social Security. As many public agencies were withdrawing from Social Security, the US Congress passed legislation to close the window on withdrawing from Social Security participation. The law continues to allow public agencies to join Social Security but none can withdraw.

Two additional provisions impact Social Security benefits provided to public employees.

- *Windfall Elimination Provision (1983)* – This provision reduces the Social Security entitlement of governmental employees who receive a separate governmental pension, were not subject to Social Security taxes in their governmental employment, and who did not pay Social Security taxes on other substantial employment for at least thirty years.

- *Government Pension Offset (1977)* – This provision reduces the spousal Social Security entitlement of individuals who are entitled to a governmental pension from employment not subject to Social Security taxes.

(See additional handouts from the Social Security Administration for a fuller explanation of the Windfall Elimination Provision and Government Pension Offset Provision.)

Medicare

Medicare was created in 1965. Coverage was automatically extended to governmental employees who were subject to Social Security coverage. In 1986, federal legislation was passed extending Medicare coverage to all governmental employees hired on or after April 20, 1986 who are not covered by Social Security.

State legislation was enacted in 1989 which allows local school districts to hold an election by their employees to determine if they want to extend Medicare coverage to employees hired prior to April 20, 1986. Currently, 881 school districts have elected to extend Medicare coverage to their senior teachers and administrators.

Personal Savings

There is a great concern that Americans in general are not saving sufficiently to meet their financial needs for retirement.

- The increase in personal debt that has occurred over the years has resulted in less discretionary income that can be put into savings.
- As presented in testimony before the Commission, the overall savings rate in America has declined from 10% in 1980 to less than 2% in 2003. In 2005, the savings rate actually went negative.
- With the real possibility of Social Security being altered, there is a growing concern that people need to begin to save more for retirement and the added expense for health insurance.

3. Pension Issues

- It has been suggested that the public pension element of the three-legged stool may have more importance for public employees, in light of arguments that access to Social Security and personal savings levels vary between some groups of workers.
- Both the costs and concern about the future of Social Security may deter public employers who currently do not participate in Social Security from joining that federal system.

4. OPEB Issues

- All public employees hired since April 1986 are in the Medicare program. Those hired prior to April 1986 may not be covered by Medicare if they were not subject to Social Security. Therefore, they will not be eligible for Medicare health benefits when they reach age 65, unless they qualify based upon other employment.
- Concerns have also been raised regarding both the amount of employer-sponsored health benefits provided to a retiree before age 65 and the employer-sponsored supplemental health plans available when retirees reach Medicare eligibility.

UNDERSTANDING OF “VESTING” (HEALTH CARE)

1. Definition

Vesting means that employees are entitled to their benefits within a certain period of time, even if they no longer work for their employer. Vesting refers to an absolute right, as opposed to an expectation.

2. Background

Retirement benefits, as prescribed by law or pension plan documents, are generally conceded to be a vested right and are normally prefunded. Prefunding provides the mechanism to ensure that a retirement benefit will be provided, even if an employee no longer works for the affected employer, an employer ceases to exist, or an employer terminates a retirement plan.

In comparison, vesting for OPEB is not as clear. OPEB vesting requirements are frequently found in collective bargaining agreements, personnel policies, resolutions or ordinances adopted by the governing body. These sources may specify two different but related issues:

- What constitutes vesting for access to an employer's group health coverage pool.
- How much the employer will contribute toward the premium cost of a health plan for retirees.

In disputes over the vesting of retiree health benefits, the courts have generally decided that the burden is on the employer to show that plan documents, collective bargaining agreements, and other communications have made it unambiguous that the benefits are not vested.

Many agencies contract with CalPERS for coverage under the Public Employees' Medical and Hospital Care Act (PEMHCA). This act specifies that employees have continued health coverage into retirement if that retirement takes place within 120 days of separation from employment covered by PEMHCA.

PEMHCA also specifies the extent of the employer payment toward the health premium under three different conditions:

- a. The employer can set an employer payment for retirees which is equal to or less than that provided to active employees. If the amount is less for retirees, it must annually increase by 5% until the employer contribution for actives and retirees is the same.
- b. Another provision which can be chosen by the employer is that employees, in general, will receive the full employer contribution towards health care in retirement if they work five years in employment covered by CalPERS.
- c. An alternate provision allows the adoption of a vesting schedule which requires a retiree to have a minimum of ten years of service with that employer in order to receive 50% of the employer contribution for retirees. The amount increases for each additional year of service so that the employer pays 100% of the employer contribution at 20 years of service.

It is important to note that the PEMHCA contract with CalPERS can be terminated and that upon such termination the health coverage of active employees and retirees is terminated. There is no continuing assurance of coverage upon termination of the health contract, unlike the termination of a contract for pension benefits.

3. Pension Issues

- There is no known pension issue regarding vesting.

4. OPEB Issues

- From the public presentations to the Commission, it is clear that many individuals do not understand the difference in obligations between retirement vesting and any legal requirement to provide retiree health care.
- Based on public testimony, it appears that vesting rules under PEMHCA are better understood. For other systems, the certainty found in pension vesting does not necessarily exist for retiree health care; and employer obligations for OPEB benefits are often unclear.

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PART-TIME EMPLOYEE ACCESS TO HEALTH CARE RISK POOLS

1. Definition

Health care risk pools refer to the size, demographics, and overall health of the population covered under any given health plan.

For the purpose of this discussion, a part-time employee is defined as an individual who works less than full-time in an established position and whose hours worked are insufficient to qualify for participation in an employer's OPEB plan.

2. Background

Generally speaking, a larger risk pool is better able to achieve lower costs through purchasing power and through the spreading of underwriting risk. The use of larger pools results in smaller, more stable, and less volatile premium changes. A larger pool spreads the incidence of disease burden over a larger population, thus reducing the cost impact of poor health outcomes.

In addition, changing a risk pool profile (making it younger, reducing the disease burden) can generally reduce an employer's health care costs.

Eligibility for participation in PEMHCA health coverage is dependent upon an individual meeting the definition in PEMHCA law of "employee" (Government Code 22772). This definition excludes individuals employed in intermittent, irregular or less than half-time positions.

- Legislation added in 2000 allows contracting agencies (including school employers) the option of extending health coverage to part-time employees who work less than half-time (Government Code 22807). It is not known how many public agencies have used this option.
- Under PEMHCA, retiree health coverage is generally conditioned on whether an individual receives a retirement allowance. Consequently, part-time employees who are not members of the defined benefit plan may not be eligible to access group coverage for retirees even though their employer may have extended health coverage to active part-time employees.
- Part-time employees who become eligible for health coverage may not continue coverage upon leaving employment (other than COBRA) unless they retire within 120 days of separation.

3. Pension Issues

- N/A

4. OPEB Issues

- Among certain employers (e.g. school districts, community college districts, etc.) there is a widespread practice of prolonged part-time employment that prevent some employees from gaining access to benefits such as health care.
- In total employment years, part-time employees may have worked more hours over their work career than those who worked full time and qualified for all offered benefits.
- Part-time employees without health care may rely on publicly supported programs for health care. Costs for this group are then shifted from the individual employer to the broader society.

RETIREE ACCESS TO HEALTH CARE RISK POOLS

1. Definition

Health care risk pools refer to the size, demographics, and overall health of the population covered under any given health plan.

2. Background

Generally speaking, a larger risk pool is better able to achieve lower costs through purchasing power and through the spreading of underwriting risk. The use of larger pools results in smaller, more stable, and less volatile premium changes. A larger pool also spreads the disease burden over a larger population, thus reducing the cost impact of poor health outcomes.

3. Pension Issues

- N/A

4. OPEB Issues

- From the employer's perspective, depooling, or the removal of the retiree population from the health plan risk pool, will typically reduce the employer's costs. Retirees are older, carry a higher disease burden, and generally consume more health care dollars.
- When depooling occurs, retirees are placed into a separate, higher cost risk pool or are forced to purchase health care in the individual market. In both cases, higher premiums or reduced benefits are the result.
- Depooling may also result in a cost shift to publicly supported programs, such as Medi-Cal, if retirees cannot afford coverage through the individual market.
- An employer who chooses to leave retirees in a single risk pool with active employees will generally have higher total costs because the higher retiree costs will raise the lower cost of active employees.
- In a single risk pool arrangement, the retiree pays an artificially lower premium while the active employee pays an artificially higher premium. Under GASB reporting requirements, employers with a single risk pool are required to identify and report this "implicit rate subsidy" which is added to the employer's total liability.

MEDICARE ELIGIBILITY AND COORDINATION

1. Definition

Medicare coordination requires that when individuals are eligible for Medicare, they must be moved out of the employer's basic plan and enrolled in Medicare and possibly a Medicare supplement plan.

2. Background

Medicare was created in 1965. Coverage was automatically extended to governmental employees who were subject to Social Security coverage. In 1986, federal legislation was passed extending Medicare coverage to all governmental employees hired on or after April 20, 1986 who are not covered by Social Security. Eligibility can occur at an earlier age if the individual is determined to be "disabled" under Social Security guidelines.

Once an employee or retiree is eligible for Medicare, through coordination of benefits with Medicare, an employer's health plan can become a secondary payor with Medicare as the primary payor. This generally will reduce health care costs for the employer.

3. Pension Issues

- N/A

4. OPEB Issues

- Currently, some employers allow retirees eligible for Medicare to remain in the "basic" health plan or the plan designed for active employees. Also, some active employees develop medical conditions that establish Medicare eligibility prior to the normal age-based eligibility but employers do not shift these employees to Medicare and possibly a Medicare supplement plan.
- Allowing Medicare eligible employees or retirees to remain in "basic" health plans with active employees generally increases employer and employee health care costs. Because they are older or require more intensive health care if disabled, these individuals have higher health care costs.
- Until recently, very few public employers had a systematic approach for identifying retirees who are Medicare-eligible and for coordinating with Medicare.
- In recent years PERS has received a "credit" on their premiums from the health plans depending on how well it managed the transition of Medicare eligible members from the basic to Medicare supplement plans.
- Public employers should expect their health plan or plan administrator to proactively assist them in identifying such individuals and managing the transition to Medicare when appropriate.