

WHOA! THE STATE OF PUBLIC PENSIONS IN LOS ANGELES COUNTY



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ASSESSMENT OF THE STATE OF PENSION PLANS IN LOS ANGELES COUNTY

INTRODUCTION

The 2010-2011 Los Angeles County Civil Grand Jury (CGJ) conducted an investigation of pensions in Los Angeles County (LAC) entitled: Assessment of the State of Pension Plans in Los Angeles County. This investigation was conducted in accordance with the authorities defined in the California Penal Codes (CPC) §914 through §939. Pursuant to CPC §926 et al, the CGJ engaged the services of an auditing firm to assist it with the pension investigation. This assessment was designed to accomplish the following objectives:

1. Complete an inventory of public pension plans in LAC, including those for both California Public Employees Retirement System (CalPERS) member and non-member agencies¹.
2. Prepare a financial profile of these plans, including information on member count; actuarial value of assets and accrued liabilities; funded status; annual benefit cost; employer and member contribution rates; interest rate earnings or discounting assumptions; current and normal contribution rates; retiree to active member ratios and other attributes.
3. Identify and assess other employer liabilities that may not be fully reported in plan documents. This includes outstanding bond indebtedness that may have been incurred by jurisdictions to prefund a portion of their pension liabilities; i.e., pension obligation bonds (POBs) and unfunded retiree health insurance benefits, also known as Other Post Employment Benefits (OPEB) that may be guaranteed to plan members.
4. Review key events influencing financial and investment management decisions and how the historical funding status of the plan may have influenced collective bargaining decisions and growth in employee benefit obligations over time.
5. Prepare in-depth profiles of up to 5 jurisdictions based on the attributes of the plans within the County, focusing on plan governance and management structure, the selection and use of actuaries and investment advisors, the process used to evaluate and select actuarial assumptions and the actuarial methodologies that are employed.
6. Test the bases and methodologies used by the selected jurisdictions for determining benefit amounts for retirees by sampling a limited number of retiree records to confirm adherence to the methodological approach employed by the plan and to identify possible instances of pension spiking or other possible abuses of plan provisions.
7. Provide the public with the tools to understand and engage in informed dialog with their elected officials regarding pension attributes and obligations in their community, and the

¹ The broad categories of plans include: (a) CalPERS City Individual Plans, (b) CalPERS City Risk Pool Plans, (c) CalPERS Special District Individual Plans, (d) CalPERS Special District Risk Pool Plans, (e) Independent Plans, (f) Public Agency Retirement System (PARS) Plans and Other Supplemental Plans, (g) Other Post Employment Benefit (OPEB) Plans for Cities, and (h) Other Post Employment Benefit Plans (OPEB) for Special Districts. A separate matrices showing Pension Obligation Bond (POB) debt by jurisdiction is also provided.

ramification that pension obligations may impose on other services if nothing is changed. These tools include the pension primer in Appendix B, the data compiled in the matrices of Appendix C and the profile examples provided in Sections 1, 2, 3, 4, and 5. If the public can embrace the ramifications of their pension obligations, they can support the political will to make the difficult choices needed to ensure their community has sustainable pension plans for its government employees.

In accordance with these objectives, this Report analyzes the key attributes of the 277 public pension plans in the County, based on available information contained in financial statements and actuary reports for each plan. The data was used to populate matrices, which were then used to profile the public pension plans in the County and provide the CGJ with information needed to select five plans for more in-depth review.

JURISDICTIONS

Jurisdictions in LAC have established 277 public pension plans that are administered either by the CalPERS or by separate, individual non-CalPERS pension trusts. CalPERS plans can be grouped into 2 general categories:

1. Individual plans – which are larger plans with 100 or more active members that receive separate actuarial evaluations to determine assets, liabilities and funded status
2. Risk Pool Plans – which are comprised of a group of smaller pension plans for which plan assets are invested in “risk pools.” Smaller pension plans are defined as those with less than 100 members in any year since 2003. Total assets, liabilities and funded status are reported at the risk pool level, and individual member agency information is adjusted by “side fund” balances that reflect the difference between the funded status of that plan and the risk pool at the time that plan entered into the risk pool.

At the time of this Report, there were 152 CalPERS plans for cities and 62 CalPERS plans for special districts for a total of 214 CalPERS plans in LAC. Of these, 81 were individual plans, and the remaining 133 were Risk Pool plans.

Individual non-CalPERS plans include 13 city and large special district plans reporting total actuarially accrued liabilities exceeding \$50,000,000 in the most recently reported actuarial valuation. There are 50 other smaller plans for special districts, including Public Agency Retirement System (PARS) plans² that have been established within the County. A full count of all CalPERS and non-CalPERS plans is included in Phase I with an accompanying inventory that shows plan attributes included in Appendix C.

ASSESSMENT OVERVIEW

This Assessment was conducted in accordance with Government Auditing Standards prepared by the United States Comptroller General and promulgated by the United States Government Accountability Office (USGAO). Also known as generally accepted government auditing standards (GAGAS), these standards provide a framework for performing high-quality audit work with competence, integrity, objectivity, and independence.

² PARS plans are typically established for part-time or seasonal workers, or to provide supplemental benefits to employees. The majority of PARS plans reporting information for this assessment are defined contribution plans.

This Assessment was performed in 2 Phases:

Phase I

Phase I involved the collection of pension plan information for each of the public sector jurisdictions within LAC. Typically, this involved obtaining 2 key documents: the Comprehensive Annual Financial Report (CAFR) for the jurisdiction and the financial statements, actuarial valuation or annual report for each of the plans.

This information was then used to populate a matrix that displays key attributes of each of the pension plans, as well as information on post retirement health insurance benefits, deferred compensation plans and any amounts that may have been borrowed by the jurisdiction to pre-fund its unfunded actuarial accrued liability (UAAL). This data was then sorted and analyzed, and recommendations were made to the CGJ on jurisdictions that may be appropriate for a more in-depth review of the plans.

Phase I was particularly challenging. A few smaller cities and special districts never responded to our requests for information despite repeated attempts to contact officials. In addition, CalPERS created unreasonable delays providing actuarial data for the 214 pension plans within the County for which it provides pension services. Although the information being requested is public, CalPERS does not post it on its website. Further, in order to obtain the needed information, we were required to file a Public Information Request (PIR) through the CalPERS Public Information Office; and the request was referred to the organization's Legal Office to coordinate compilation of the information from CalPERS actuaries. CalPERS offered to supply the information in 5 installments. Although the original request was made on December 29, 2010 and the PIR was filed with CalPERS on January 4, 2011, we did not receive all information until the evening of March 10. These delays were unreasonable, given that these are standard reports that are produced annually for all member agencies, should be publically available to the taxpayers, and should be easily retrievable by CalPERS staff for dissemination to the general public.

The effect was that the CGJ was hampered in its ability to select plans for in-depth analysis, and the auditor's ability to populate the matrix and conduct analysis of the data within the timeframe required by the CGJ's term became more difficult.

Phase II

Phase II involved the more in depth analysis of the 5 pension plans chosen by the CGJ. As mentioned previously, these systems were chosen after analysis of the information available for all plans within the County. The CGJ identified 1 well run plan and 4 other plans exhibiting characteristics that suggested weakness of financial difficulties for the sponsoring jurisdictions. Principally, the assessment of the jurisdictions appropriate for the in-depth review was based on the following indicators:

- **Actuarially Accrued Liabilities (AAL)**, which is the total plan liability based on an actuarial evaluation of plan membership, pensionable salaries, inflation, benefit formulae and other key variables
- **Unfunded Actuarially Accrued Liability (UAAL)**, which is the unfunded portion of the AAL based on an actuary's assessment of the value of plan assets available to fund plan liabilities

- **Funded status**, which is the percentage of total liabilities funded with plan assets that are valued on an actuarial basis
- **Effective Contribution Rate**, which is a calculated rate to be charged against pensionable salaries that includes the plan sponsor, or employer rate and any portion of the employee rate that may be paid; i.e., “picked up” by the employer
- **OPEB, or Retiree Health Benefit Funded Status**, which is the percentage of total OPEB liabilities funded with assets that are valued on an actuarial basis
- **Outstanding Pension Obligation Bonds**, which represent amounts jurisdictions may have borrowed to fund a portion of its UAAL

After analyzing these indicators, the CGJ selected the 5 jurisdictions for in-depth review. The project team met with each of these jurisdictions to discuss plan attributes, plan governance, collective bargaining challenges, the jurisdiction’s budget status and other matters. For the 3 non-CalPERS plans chosen for the review, a limited sampling to confirm benefit calculation methodologies and obtain a better understanding of how methodological approaches impacted benefit amounts was performed. While there were no exceptions to the methodologies or calculated benefit amounts found in these 3 independent plans, this exercise allowed identification of areas of concern that led to recommendations contained in the report. However, it was not possible to conduct similar analysis for the jurisdictions with CalPERS plans due to the general difficulty and delays encountered in accessing the CalPERS pension records and personnel.

PENSION PLANS SELECTED FOR REVIEW

The 5 agencies selected for in-depth review are described below:

1. Los Angeles County Employees Retirement Association (LACERA)

LACERA is the largest of the non-CalPERS plans in the State of California, managing pension and retiree health insurance benefits for employees of the LAC, the Little Lake Cemetery District, the Local Agency Formation Commission, the Los Angeles Office of Education and the South Coast Air Quality Management District. As of June 30, 2010, LACERA had nearly \$46.7 billion in AAL backed by slightly over \$38.8 billion in actuarial assets. With approximately 83.3% of its AAL backed by assets, the plan had UAAL of approximately \$7.8 billion.³ The LACERA AAL represented approximately 43.3% of the total public pension liability reported in the County for that year.

LACERA is governed by the California Constitution, the County Employees Retirement Law of 1937 (CERL), and the bylaws, procedures, and policies adopted by LACERA’s Boards of Retirement and Investments. The Los Angeles County Board of Supervisors may also adopt resolutions, as permitted by the CERL, which may affect benefits of LACERA members.⁴ The CGJ selected the County and LACERA for in-depth analysis because of the plan’s size and characteristics of the benefits provided to Miscellaneous and Safety (fire and police) employees, and because it was generally considered to be a well-run plan based on the indicators and performance criteria described above.

³ The technical terms used to describe fund assets and liabilities are explained in this report and defined in the Glossary of Terms included as Appendix A.

⁴ *Los Angeles County Employees Retirement Association 2010 Annual Report*

2. Los Angeles City Department of Water and Power Employee Retirement Plan (WPERP)

WPERP is one of several retirement plans established by charter for the employees of the City of Los Angeles. The Plan only provides pension benefits for employees of the Department of Water and Power (DWP). Other benefits, including retiree health insurance benefits, as well as a City-wide deferred compensation program, are managed separately by the Department or by other City agencies. As of June 30, 2009, WPERP had nearly \$8.9 billion in AAL backed by slightly over \$7.2 billion in actuarial assets. With approximately 81.5% of its AAL backed by assets, the plan had UAAL of approximately \$1.6 billion. Unlike most of the other public pension plans in the County, the DWP pension obligations are funded primarily by charges to ratepayers for water and power services.

The Retirement Plan was established in 1938 and is subject to the provisions of the City Charter and plan provisions adopted by the Retirement Board of Administration. It operates as a single-employer defined benefit plan to provide pension benefits, including death and disability benefits, to eligible Department employees. The Retirement Board is the administrator of the Pension Plan, as well as the Disability and Death Benefit Insurance Plan.

The Retirement Plan is comprised of 3 separate funds – retirement fund, disability fund, and death benefit fund. Also, the Retirement Board has investment oversight of the Retiree Health Benefits Fund (RHBF). Each fund under the Retirement Plan is considered an independent trust fund of the Department of Water and Power, which is a proprietary department of the City of Los Angeles.⁵ WPERP was chosen by the CGJ because it is a major City of Los Angeles plan funded principally with water and power ratepayer revenues.

3. Pasadena Fire and Police Retirement System (PFPRS)

The Pasadena Fire and Police Retirement System is a closed plan that provides pension benefits to fire and police retirees of the City of Pasadena. The plan covers all fire and police personnel who were employed by the City prior to July 1, 1977 except for those who elected to transfer to CalPERS as part of a special arrangement in June 2004. As of June 30, 2010, PFPRS had nearly \$166.1 million in AAL backed by slightly over \$109.7 million in actuarial assets. With approximately 66.1% of its AAL backed by assets, the plan had UAAL of approximately \$56.4 million.

PFPRS is a single-employer defined benefit plan governed by a Retirement Board (Board) under provisions of the City Charter.⁶ Since the Plan closed, the City has accumulated additional UAAL of \$193.7 million for its CalPERS Miscellaneous and Safety Plans and has outstanding Pension Obligation Bond (POB) debt of over \$111.5 million. In total as of June 30, 2010 the City was carrying over \$361.4 million in unfunded pension liabilities, not including interest on the POBs or obligations related to retiree health benefits. The CGJ chose PFPRS because it is a closed plan with a pattern of being underfunded by the City.

⁵ City of Los Angeles Water and Power Employees Retirement, Disability and Death Benefit Insurance Plan Financial Statements and Supplementary Information for the Years Ended June 30, 2010 and 2009 combined with the City of Los Angeles Water and Power Employees Retiree Health Benefits Fund Financial Statements and Supplementary Information for the Years Ended June 30, 2010 and 2009

⁶ City of Pasadena California, Comprehensive Annual Financial Report Year Ended June 30, 2010

4. Monterey Park CalPERS Miscellaneous and Safety Plans

The City of Monterey Park contracts with CalPERS to provide pension benefits for its Miscellaneous and Safety employees. As of June 30, 2009, the City's CalPERS plans had nearly \$213.7 million in AAL backed by slightly over \$184.7 million in actuarial assets. With approximately 86.4% of its AAL backed by assets, the plan had UAAL of approximately \$29.0 million.

CalPERS acts as a common investment and administrative agent for participating public entities within the State of California. Benefit provisions and all other requirements are established by State statute and City ordinance. In addition to the unfunded liabilities of its 2 CalPERS plans, the City had approximately \$49.2 million in unfunded OPEB obligations and \$16.9 million (\$32 million including interest) in outstanding pension obligation bonds as of the its last valuation date, for total unfunded pension obligation of \$95.1 million, not including interest on the POBs. Monterey Park was chosen by the CGJ because it is an individual CalPERS plan that is well funded at 92.7% as of June 30, 2009, but which has \$49 million in unfunded OPEB liability and owes \$32 million in Pension Obligation Bonds.

5. Hermosa Beach Safety Police Plan

The City of Hermosa Beach also contracts with CalPERS to provide pension benefits for its Miscellaneous and Safety employees. Because it has fewer than 100 employees in each of its plans, Hermosa Beach participates in CalPERS pooled fund plans, whereby the assets and liabilities of the City are pooled with those of other similarly sized jurisdictions that have elected the same plans for their employees. As of June 30, 2009, Hermosa Beach was participating in 3 such pooled plans: the Miscellaneous 2% at 55 Plan for non-sworn employees, the Safety 3% at 55 Plan for sworn Fire Department employees, and the Safety 3% at 50 Plan for sworn Police Department employees. The funded status for these 3 pooled plans as of that date was:

- a. Miscellaneous: 2% at 55 Plan 64.9%
- b. Safety - Fire: 3% at 55 Plan 61.5%
- c. Safety - Police: 3% at 50 Plan 60.2%

In addition to having low funded status in each of these 3 pooled plans as of June 30, 2009, the City had an additional negative "side fund balance" of \$13.9 million, representing the balance remaining on UAAL for the plans at the time they joined the various pooled funds. The amortization of this negative side fund balance significantly increases the City's annual contribution requirements, which is particularly apparent with the Police Safety Plan.

CalPERS acts as a common investment and administrative agent for participating public entities within the State of California. Benefit provisions and all other requirements are established by State statute and City ordinance. In addition to the unfunded liabilities of its 3 CalPERS pooled plans, Hermosa Beach had nearly \$2.5 million of UAAL in retiree health, or OPEB liability. While the City had not borrowed using POBs as of June 30, 2009, the CGJ was advised during interviews that management was poised to borrow using POBs during the current fiscal year to prefund its UAAL and negative side fund balance. Hermosa Beach was chosen by the CGJ because it is a CalPERS risk pool plan that has annual contribution rates that are among the highest in the County.

REPORT STRUCTURE

This Report is structured to allow a general member of the public to understand the state of public pension plans in the County. Appendix B provides a “short course” in pension terminology and concepts that could be found useful.

Phase I

Describes current trends and perspectives related to public pensions and analyzes the profile of Public Pension Plans in LAC. This Phase focuses on benefit design and the relationship to the collective bargaining processes; the types of pension plans that exist in the County; additional OPEB benefit obligations; and bond indebtedness factors that impact total retirement costs for the jurisdictions. Analysis stemming from the collection of data on each of the 277 Public Pension Plans in the County is also provided for understanding key characteristics and differences in pension benefit design and the financial status of the plans.

Phase II Sections 1, 2, 3, 4, and 5

Presents findings related to each of the jurisdictions and pension plans chosen by the CGJ for in-depth review. These sections describe the key attributes of each plan but focus on those areas where the jurisdictions may have opportunities to achieve short and long-term savings or improve plan administration.

Appendix C

Explores the attributes and obligations for Public Pension Plans offered to employees of the County or of a particular city or special district within the County. This Appendix contains 9 matrices: C.1 through C.9. These matrices are presented by broad plan category⁷ and then sorted alphabetically by jurisdiction name. A separate schedule of POB debt is also provided.

To understand all of the possible pension benefit obligations that may be borne by a particular jurisdiction, each of these plans and POB matrices need to be examined individually. Individual jurisdictions may have entries on multiple matrices since reported attributes are different for each broad category of the plan. Had the data been merged by jurisdiction, the presentation would have been cumbersome and confusing. To ensure clarity and minimize such confusion, a decision was made to segregate the information.

Using selected jurisdictions Phase II, Sections 1 through 5 of this Report presents key pension plan attributes such as:

- Funded Status
- Actuarial Value of Assets
- AAL

⁷ The broad categories of plans include: (a) CalPERS City Individual Plans, (b) CalPERS City Risk Pool Plans, (c) CalPERS Special District Individual Plans, (d) CalPERS Special District Risk Pool Plans, (e) Independent Plans, (f) Public Agency Retirement System (PARS) Plans and Other Supplemental Plans, (g) Other Post Employment Benefit (OPEB) Plans for Cities, and (h) Other Post Employment Benefit Plans (OPEB) for Special Districts. A separate matrices showing Pension Obligation Bond (POB) debt by jurisdiction is also provided.

- UAAL
- Covered payroll
- Sponsor annual required contribution rate (ARC) as a percentage of payroll
- Whether the sponsor “picks up” the employees’ contribution
- Sponsors contribution rate spread (columns U,V,W,X,Y,Z in C.1, columns M,N,O,P in C.2, etc.)
- Built-in cost of living adjustments (COLA) rates
- Other post-retirement benefits (OPEB)
- Post-retirement survivor allowance
- Benefit formula (how young can a employee start collecting retirement; how rich is the retirement)
- Whether pension obligation bonds (POBs) are in place

In order to review pension attributes for a single jurisdiction, multiple matrices may need to be consulted. For example, the City of Pasadena has a CalPERS Individual Plan for both Miscellaneous and Safety employees; has an Independent Plan for certain retired Fire and Police employees that has been closed since 1977; operates a Public Agency Retirement System (PARS) plan for part-time and seasonal employees; provides retiree health benefits through an OPEB plan; and has POB debt that had been used to fund benefits for members of the closed plan. Accordingly, Pasadena plans appear on 5 different matrices in Appendix C (C.1, C.5, C.6, C.7, and C.8). Appendix E lists all jurisdictions contained in this Report alphabetically and the matrices on which their respective pension(s) attributes are listed.

Each jurisdiction may use the data in this Report to:

1. Build and review a profile of its respective pension plans
2. Enable it to make informed decisions regarding how to move forward in a sustainable way to provide future pension obligations.

APPENDICES

There are 5 key appendices to this Report to encourage understanding of the public pension environment in Los Angeles County:

Appendix A “Public Pension Principles” summarizes key principles of public pension systems and the primary laws and regulations governing Public Pension Plans; including theories behind benefit design and actuarial estimates of assets and liabilities

Appendix B “Listing of Number of Plans by Jurisdiction and Where to Find in Appendix C (C.1, C.2, C.3, C.4, C.5, C.6, C.7, C.8, C.9)” is an alphabetical list of all

jurisdictions identifying the "C. matrix" in which their respective pension(s) attributes are cataloged

Appendix C Matrices showing the results of research as to the attributes of Public Pension Plans in LAC, sorted by jurisdiction name. Appendix C contains 9 separate matrices, C.1 through C.9, covering 8 broad plan categories and a ninth separate matrix showing POB debt by jurisdiction. The list below provides a guide to Appendix C:

C.1 CalPERS City Individual Plans

C.2 CalPERS City Risk Pool Plans

C.3 CalPERS Special District Individual Plans

C.4 CalPERS Special District Risk Pool Plans

C.5 Independent Plans

C.6 Public Agency Retirement System (PARS) Plans and Other Supplemental Plans

C.7 Other Post Employment Benefit (OPEB) Plans for Cities

C.8 Other Post Employment Benefit Plans (OPEB) for Special Districts

C.9 Pension Obligation Bond (POB) debt by jurisdiction is also provided

Appendix D "Public Pension Plans in Los Angeles County List of Acronyms" used in this Report

Appendix E "Glossary of Public Pension Terms" (Adapted from the CalPERS Glossary)

PHASE I

OVERVIEW AND MATRIX OF PUBLIC PENSION PLANS IN LOS ANGELES COUNTY

SUMMARY

In 2009, losses in the investment markets had a profound effect on pension systems. This event caused a rapid deterioration of retirement fund asset bases throughout the United States. Pension systems that had previously been shown to be well funded began to report investment losses of historic proportions. These losses caused the amount of the annual required contribution due to pension plans by public sector employers to increase. In Los Angeles County (LAC), many jurisdictions emerged from this market downturn with effective pension system contribution rates exceeding 30% of salaries and, in some cases, over 50% of salaries. This created severe challenges for jurisdictions that were already facing significant budget shortfalls as a result of the recession's impact on tax receipts.

In response to this emerging situation, some public officials and the popular press began to warn of public pension system collapse, with calls for radical reform. Public employee pension benefits began to be examined closely, actuarial assumptions related to long-term investment returns began to be challenged and the ability of local government to continue funding the higher contributions was questioned. Some public officials warned that cities and counties would face bankruptcy if not provided with relief from the burden of costly public employee benefits.

While many of these concerns have some merit, the economic recovery has already begun to greatly improve the financial outlook for pension systems in LAC. In addition, many employee unions have agreed to collective bargaining concessions that will lower public sector costs over the long run. As a result, some of the largest pension plans in the County have seen stabilization and improvement in the market value of assets that will help to bring them above the 80% threshold cited by experts as a benchmark for well funded plans. Should the recovery continue to improve, as expected over the long run by most economists, it is likely that jurisdictions will begin to feel relief from the high annual contribution requirements they are presently experiencing.

Nonetheless, local government jurisdictions and employee unions should take this opportunity to consider pension system alternatives that would lower costs in the immediate future and over the long term; modify actuarial policies to moderate fluctuations in annual required contributions; and build prudent reserves to safeguard future retiree health benefits for retirees. Well reasoned approaches to resolving concerns highlighted by the impact of the Great Recession would likely lower public pension system costs for the taxpayer, ensure pension system solvency and provide reasonable benefit continuation for public employees.

PURPOSE

The Civil Grand Jury (CGJ) conducted a comprehensive review of available information for all public pension plans in LAC in order to develop an inventory of plans that would contain basic

plan attributes and allow for high level analysis, identification of themes and patterns, and development of general findings and recommendations. The basic plan attribute data was cataloged into 9 matrices to facilitate the public's review, understanding and assessment of the financial state and liabilities of the plan(s) in their jurisdiction. Five (5) plans were selected by the CGJ for review and commentary.

BACKGROUND

The crash of the investment markets in late 2008 and 2009 had a profound effect on pension system investment returns and asset bases. As a result of double digit investment losses during that period, retirement fund assets declined rapidly and concerns about the ability of public pensions to fund employee benefit obligations began to surface. Pension funds were forced to increase the Annual Required Contributions (ARCs) charged to public sector employers to fully fund pension plan benefits for employees and retirees. To compound the financial dilemma for public agencies, these increases in annual pension contributions came at a time when local jurisdictions were already faced with severe tax revenue shortfalls that were forcing severe reductions in services to the public.

As this phenomena was replayed across the country, public officials and the press began to warn of public pension system collapse with calls for radical reform. Public employee pension benefits began to be examined closely and actuarial assumptions related to long-term investment returns were challenged. The ability of local government to continue funding higher contributions was questioned. Some public officials warned that cities and counties would face bankruptcy if not provided with relief from the burden of costly public employee benefits.

SIGNIFICANT REPORTS ON CALIFORNIA PUBLIC PENSION REFORM

In general timeframe, several reports on California pension reform emerged and a public dialogue began seeking ways to recover from the impacts of the recession. The following summaries describe some of the most significant reports and comments made by California public officials and others during this period.

1. Little Hoover Commission (February 2011)

In its report, "Public Pensions for Retirement Security" (the Little Hoover report), the Little Hoover Commission pointed to several areas where benefit design has resulted in an increased pension cost, including provisions to grant extra service credit, allowing employees to retire with full benefits at younger ages; modifying methodologies used to compute the single highest year of compensation; and lowering the minimum age of retirement. The Commission stated that these types of changes, provided to employees through the collective bargaining process, have contributed to the inability of public agencies to effectively lower public employee pension costs in the near term.

The Commission produced a series of recommendations that would:

- a. Establish "lower defined-benefit formulas"
- b. Establish hybrid pension models that would combine defined benefit plans with "employer-matched defined-contribution" plans

- c. Establish caps on the maximum salary that can be used to calculate pension payments, or on the maximum pension that a retiree may earn
- d. Require that employers make minimum contributions, even when investment earnings exceed expectations
- e. Require that employees make contributions
- f. Advocate for the Federal government to extend Social Security to uncovered workers

CalPERS responded to the Little Hoover Commission report criticizing the Commission's characterization that "pension costs will crush government." CalPERS identified what it perceived as weaknesses in the Commission's analysis such as the non-reporting of 2010 investment gains by CalPERS and the recent prevalence of benefit concessions being agreed to by employee groups and other factors as key observations to be considered. CalPERS did not forcefully disagree with any of the Little Hoover Commission recommendations.

However, it is worth noting that many of the suggestions made by the Commission have already been implemented in some LAC jurisdictions. For example, the City of Los Angeles Fire and Police Retirement System already imposes benefit caps at less than 100% of final salary for retiring employees. Further, many plans have already established deferred compensation alternatives for their employees and some employee unions have agreed to concessions lowering the amount of employee contribution that the employer agency subsidizes. Each jurisdiction needs to be viewed in the context of the labor agreements it has with its employee labor groups and other local considerations.

2. Stanford Institute for Public Policy Research (April 2010)

The Stanford Institute for Public Policy Research issued a report in April 2010 entitled, "Going for Broke: Reforming California's Public Employee Pension Systems" (the Stanford Report). In this Report, the authors examined the "funding shortfalls for CalPERS, CalSTRS and UCRS"⁸ to identify policies that would "prevent similar shortfalls in the future."

The report challenged the assumed interest rate of return, or discount rate, being used by these plans to forecast future plan assets. The centerpiece of the analysis concluded that if the assumed interest rate of return was adjusted to a "risk free" level of 4.14%, instead of the 7.75% presently assumed by the CalPERS Board's Investment Committee, the funded ratio would decline from 86.1% to 49.9%, increasing the UAAL by over \$200 billion. Significant recommendations made in the report are paraphrased below:

- a. Adopt probability based funding targets with a goal of being 80% certain that the asset base will cover 80% of liabilities

⁸ The California Public Employees Retirement System, the California State Teachers Retirement System and the University of California Retirement System.

- b. Make contributions at the “Normal Rate” without exception
- c. Reduce the period used to amortize shortfall repayments to no more than half the duration of liabilities
- d. Invest in less volatile asset classes, focusing on fixed income instead of stocks;
- e. Offer employees both defined benefit and defined contribution pension alternatives

The report did not critique the other important assumptions used by actuaries to estimate future costs, including estimated inflation and payroll growth. These are significant factors to consider when projecting liabilities and reporting the funded status of retirement plans.

In its response to the Stanford report, CalPERS criticized the analytical modeling that was used by the authors and found exception with several of the recommendations. It was CalPERS' position that some of the recommendations were inconsistent with law and generally accepted accounting standards. In addition, CalPERS pointed to its history of achieving investment rates of return of an average of 7.9% in the previous 20 years and stated that the Board of Retirement's Investment Committee analyzes its assumed rate of return every 3 years and would set a new rate in February 2011. Consistent with this statement, the CalPERS Board evaluated rate recommendations by its actuary and chose to keep the assumed investment rate of return at 7.75% in March of this year.

Instead, pension plans should emulate the practices of both CalPERS and LACERA, which allow flexibility and require regular review over the pension plan horizon. When the investment forecasts require changes in rates, they should be implemented incrementally over the longer term investment horizon.

This is the approach taken by CalPERS and LACERA. These organizations:

- Conduct annual reviews of actuarial variables used to determine funded status, including the assumed investment rate of return
- Conduct more robust reviews of the assumed investment rate of return on a triennial basis, obtaining the advice of outside investment experts and actuaries as well as holding public meetings to discuss recommendations and perspectives

Both CalPERS and LACERA have managed pension trusts for local governments for over 70 years. During that period, these funds have met their pension obligations to members and been successful at accumulating significant asset reserves for future benefit obligations. Their current asset balances are sufficient to ensure that there is no threat of default on their obligations.

Further, a review of CalPERS investment return assumptions over the past 30 years since 1979-1980 indicates that the fund has often changed its assumed investment

return rate in response to market dynamics. In the late 1970s, CalPERS used an assumed rate of return of only 6.50%, increasing the assumption to as high as 8.75% in FY 1992-1993. Since that time, CalPERS has incrementally modified that rate downward to 7.75% by FY 2002-2003 where it has remained since that time. In calendar year 2010, CalPERS was again reporting investment gains of 12.5% after experiencing severe losses of -24% in 2009. CalPERS reports that at the end of 2010, the pension funds' investments had recovered "\$65 billion since the fund's low point in March 2009, at \$160 billion."

In June 1991 Governor Pete Wilson was urging the CalPERS Board to increase its assumed rate of return to 9.5% due to the particularly strong investment market at the time and the Governor's desire to reduce the amount of the annual contribution the State was being required to make for its employees. During that year, CalPERS was achieving actual investment yields of 12.5% and, in 8 of the 9 fiscal years between FY 1991-1992 and FY 1999-2000, CalPERS achieved double-digit returns that peaked in FY 1996-1997 at 20.1%.

By the end of FY 1998-1999, CalPERS was reporting a Funded Ratio of 128.4% and had a negative UAAL (a surplus) of nearly \$32.9 billion in its accounts. As a result, many CalPERS member agencies became "Superfunded"⁹ during this period. When the recession of 2000 began to take hold, local jurisdictions began to demand contribution refunds as a means of solving budget deficits they were experiencing due to losses in tax revenue.

This long-term, historical perspective is necessary to fully understand the dynamics of the investment market and the need to constantly reevaluate information that might drive projection variables in an unknowable future. The practices of both CalPERS and LACERA to regularly and periodically evaluate investment return and other actuarial assumptions, remaining flexible to respond to the dynamics of the investment market, are appropriate and should be continued. Plans with less rigorous actuary assumption evaluation processes should change their current procedures to emulate CalPERS and LACERA.

3. Public Employee Post-Employment Benefits Commission (January 2008)

- a. In December 2006, Governor Arnold Schwarzenegger signed Executive Order S-25-06, which established the Public Employees Post Employment Benefits Commission. The Commission was charged with reporting on the following topics for "all affected government bodies" in the State of California:
 - i. Identifying the amount and extent of unfunded liabilities for Other Post Employment Benefits (OPEB)
 - ii. Comparing and evaluating the advantages and disadvantages of various approaches for addressing unfunded post-employment benefits

⁹ Term used by CalPERS when the actuarial value of assets (AVA) is greater than the present value of benefits (PVB). When a member jurisdiction is Superfunded, no employer contribution is required.

- iii. Considering the advantages to the State from other post-employment benefits, such as providing health care
 - iv. Proposing a plan or plans for addressing unfunded post-employment benefits
- b. The Commission issued a report entitled “Funding Pensions & Retiree Health Care for Public Employees” in January 2008. This report included 34 recommendations that were grouped into the following broad categories:
- i. Identify and Prefund Financial Obligations
 - ii. Limit Contribution Volatility and Use Smoothing Methods Judiciously
 - iii. Increase Transparency and Accountability
 - iv. Improve Plan Design and Communication with Employees,
 - v. Provide Independent Analysis
 - vi. Strengthen Governance and Enhance Transparency
 - vii. Coordinate with Medicare
 - viii. Advocate Federal Tax Law Changes.

Significant recommendations came from this report, including several related to establishing strong prefunding policies, the use of OPEB bonds to pay down unfunded liability, requiring minimum employer contribution levels and establishing “tax-advantaged” supplemental savings plans in lieu of enhanced benefits.¹⁰

Review of OPEB benefits offered by LAC jurisdictions suggests that the application of the Commission’s recommendations will be mixed. Most jurisdictions have not been building asset reserves for OPEB liabilities, reporting funded status of 0.0%. This has not been universally the case. For example, the Los Angeles Department of Water and Power Employee Retirement Plan reported a Funded Status of 60.5% as of June 30, 2010 which has been achieved by contributing over 250% of the Annual Required Contribution in each of the past 3 fiscal years (2008 = 391.98%; 2009 = 261.43% and 2010 = 273.90%). As will be discussed later in this Report, DWP’s accelerated funding pattern may be due to its continuing strong financial position, based on electric and water utility collections, as well as a Citywide policy that has resulted in a similar pattern of funding for the City’s other large non-safety pension plan, the Los Angeles City Employee Retirement System (LACERS).

¹⁰ The report specifically referenced IRS Section 401(k), 403(b) and 457 plans, although all categories may not be available to public employees with established pension plans.

4. Professional Associations (February 2011)

A consortium of professional associations¹¹ issued fact sheets in 2010 and contributed to a series of articles included in the February issue of "Government Finance Review," a professional publication of the Government Finance Officers Association.¹² The themes of these publications are that public pension plans in the United States are not in trouble, suggesting that pension trusts have "substantial assets to weather the financial crisis." By their design public pensions have long-term time horizons that may allow the time needed to recover from market losses. They point out that market volatility is a two way street; and while it can lead to market losses, volatility can also result in long-term investment returns that continue to "exceed expectations."

In addition, the Government Finance Review articles:

- a. Question the soundness of recommendations made by the Stanford Report and others on adopting risk-free investment rates of return
- b. Examine steps being taken by State and local governments to reign in pension costs.
- c. Propose, in the Section on Other Post Employment Benefits (OPEB), or retiree health a number of practical steps for:
 - i. Prefunding liabilities
 - ii. Reforming benefits
 - iii. Cost sharing with employees
 - iv. Converting at least portions of the promised benefits to defined contribution instead of defined benefit plans

Other sections of the publication provide strategies for redesigning pension benefits through the collective bargaining and political processes.

The CGJ finds merit in many of the arguments made in all 4 of these studies. A well informed balanced approach to sustainable public pension systems is best achieved by objectively viewing all sides of the issues. Risk tolerance may vary from jurisdiction to jurisdiction.

¹¹ The National Governors Association (NGA), National Conference of State Legislators (NCSL), Council of State Governments (CSG), National Association of Counties (NACo), National League of Cities (NLC), U.S. Conference of Mayors (USCM), International City/County Managers Association (ICMA), National Association of State Budget Officers (NASBO), National Association of State Auditors, Comptrollers and Treasurers (NASACT), Government Finance Officers Association (GFOA) and National Association of State Retirement Administrators (NASRA).

¹² February 2011, *Government Finance Review*, "The Truth About Public Pensions" (Pg. 8), "Media Misperceptions" (Pg. 18), "OPEB Strategies" (Pg. 28), "Adjusting Benefits" (Pg. 36) and "Automatic Enrollment" (Pg. 42).

ATTRIBUTES OF LAC PUBLIC PENSION PLANS

Jurisdictions in LAC have established 277¹³ public pension plans that are administered either by CalPERS or by separate, individual non-CalPERS pension trusts. CalPERS plans can be grouped into 2 general categories:

3. Individual plans – which are larger plans with 100 or more active members that receive separate actuarial evaluations to determine assets, liabilities and funded status
4. Risk Pool Plans – which are comprised of a group of smaller pension plans for which plan assets are invested in “risk pools.” Smaller pension plans are defined as those with less than 100 members in any year since 2003. Total assets, liabilities and funded status are reported at the risk pool level, and individual member agency information is adjusted by “side fund” balances that reflect the difference between the funded status of that plan and the risk pool at the time that plan entered the risk pool.

At the time of this Report, there were 152 CalPERS plans for cities and 62 CalPERS plans for special districts for a total of 214 CalPERS plans in LAC. Of these, 81 were individual plans, and the remaining 133 were risk pool plans.

Individual non-CalPERS plans include 13 city and large special district plans reporting total actuarially accrued liabilities exceeding \$50,000,000 in the most recently reported actuarial valuation. Approximately 50 other smaller plans for special districts, including Public Agency Retirement System (PARS) plans,¹⁴ have been established within the County. Exhibit 1 shows the inventory of public pension plans in LAC:

Exhibit 1. Inventory of Public Pension Plans in LAC¹⁵

Total Number of Pension Plans	277
CalPERS Plans	
Cities	152
<i>Individual</i>	71
<i>Risk Pool</i>	81
Special District	62
<i>Individual</i>	10
<i>Risk Pool</i>	52
Independent Plans	
County, Cities, & Large Special Districts	13
Supplemental Plans	50

Source: Jurisdictions’ annual reports, CalPERS actuarial reports and other listings of special districts.

As noted in the Introduction to this Report, the CGJ encountered difficulty in its attempts to acquire the annual financial reports and other pension plan documents for several jurisdictions. It was particularly difficult to obtain information for the special districts’ plans and independent supplemental plans, both of which are typically very small plans representing a very small

¹³ The scope of the inquiry did not include pension plans for school systems, community colleges, universities, or government associations.

¹⁴ PARS plans are typically established for part-time or seasonal workers, or to provide supplemental benefits to employees. The majority of PARS plans reporting information for this assessment are defined contribution plans.

¹⁵ Does not include pension plans for school systems, community colleges, universities, or government associations.

number of members. For special districts where no annual financial report was available, the CGJ relied on the limited information provided by the CalPERS actuarial reports. Very limited information was provided for most of the independent supplemental plans in the jurisdictions' annual financial reports.

FINANCIAL PROFILE AND OVERALL FUNDED STATUS

Collectively, these plans had actuarial accrued liabilities (AAL) of approximately \$108.2 billion as of the most recent actuarial valuation, of which \$17.8 billion was unfunded (unfunded actuarial accrued liabilities, or UAAL).¹⁶ In addition, the jurisdictions for which these funds provided pension benefit administration services had an additional \$33.9 billion in retiree health care, or OPEB liabilities, of which \$30.2 billion was unfunded. Other Pension Obligation Bond (POB) debt held by these jurisdictions equaled nearly \$1.2 billion, bringing total UAAL for pensions and OPEB and pension obligation bonded indebtedness to nearly \$49.2 billion. The financial profile of the plans within LAC is shown in Exhibit 2:

Exhibit 2. Profile of Pension Liabilities in LAC (in \$billions)

	Pension Benefits		Retiree Health Care Benefits (OPEB)		Total Liability	Pension Obligation Bonds (Principal + Interest)	Total Unfunded Liability and Pension Debt
	Liability	Unfunded Liability	Liability	Unfunded Liability			
County	\$ 46.7	\$ 7.8	\$ 24.0	\$ 24.0	\$ 70.7	\$ 0.6	\$ 32.4
Cities Subtotal	56.3	9.4	8.2	5.0	64.5	0.6	15.0
Special Districts Subtotal	5.2	0.8	1.6	1.2	6.8	-	2.0
Total	\$ 108.2	\$ 18.0	\$ 33.8	\$ 30.2	\$ 142.0	\$ 1.2	\$ 49.4

Source: Jurisdictions' annual financial reports and actuarial reports.

Using this data, the overall funded status for all retirement benefits can also be calculated. As shown, the total liability, considering all types of jurisdictions and all types of retirement liabilities (pension and retiree health care), is approximately \$142 billion as of the most recent valuations available. The overall Actuarial Value of Assets (AVA) is \$94 billion (total liability minus unfunded liability), which calculates to an overall funded status of approximately 66.2%. When combined with the pension obligation bonded indebtedness of \$1.2 billion, the funded status declines to 65.4%. This is well below the 80% level that most experts consider the benchmark for a well funded plan.

It is important to note that, although the pension funds within the County have significant unfunded liabilities, they are in no danger of short-term default. For example, at the beginning of

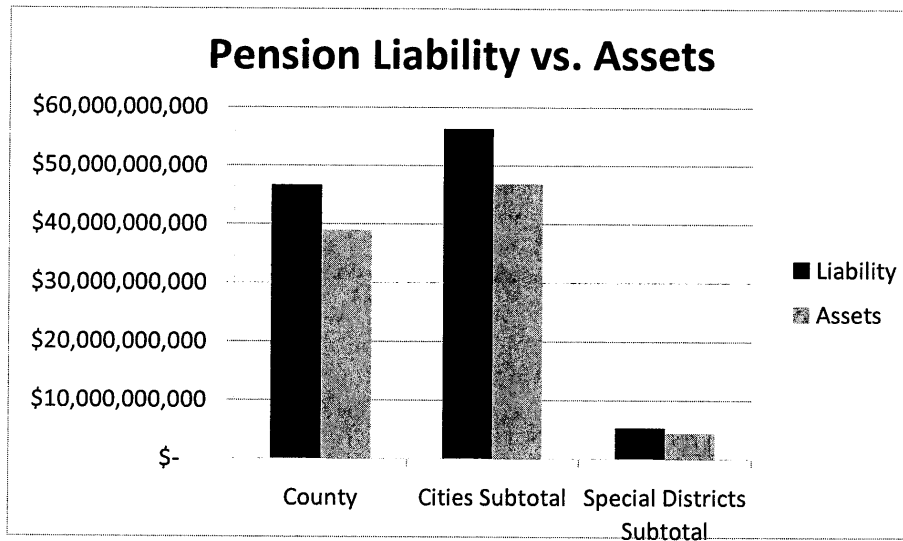
¹⁶ The most recent actuarial evaluation for the retirement plans may be for either 2009 or 2010, depending on the plan, so the numbers being reported from our survey are generally conservative. This occurs because the actuarial value of assets (AVA) has declined for these agencies since the 2009 valuation, despite the investment market recovery in 2010, due to the smoothing of market gains and losses over multiple years. Meanwhile, the AAL has continued to climb due to the actuarial impacts of inflation, salary growth and other factors driving future costs.

FY 2009-2010, LACERA reported total market valued assets of approximately \$30.5 billion. During the year, LACERA reported total expenses for benefits and administration of approximately \$2.2 billion. This reflected an asset to expense ratio of about 14, meaning that LACERA's beginning assets were 14 times greater than expenses incurred during the year. Further, contributions from the County and employees were nearly \$1.3 billion; and investment earnings were over \$3.8 billion in that year, for a total of approximately \$5.1 billion of additional assets that entered the system— nearly 2.3 times greater than current year expenses.

PENSION FUND ASSETS, LIABILITIES AND CONTRIBUTION RATES

Exhibit 3 shows the AAL and AVA for public pension systems Countywide, with the difference between the liability bar and the asset bar representing UAAL (unfunded liability):

Exhibit 3. Pension Liabilities Compared to Assets



Source: County, cities, and special district annual financial reports; CalPERS actuarial reports for individual and risk pool plans

As shown, the plans within the County continue to report significant assets, even when contrasted against projected liabilities.

1. Percent of Annual Required Contribution (ARC) Funded for Pension Benefits

All of the cities and special districts providing benefits through CalPERS contributed 100% of their Annual Required Contributions (ARC) for their pension plans as of the most recent information for each jurisdiction. LAC also contributed 100% of its ARC. Of the 11 independent plans with liabilities over \$50 million, only 2 plans did not contribute 100% of the ARC. Pasadena Fire and Police Retirement System (FPRS) contributed just 35.5% of its ARC, and the Antelope Valley Health Care District contributed 52.7% of its ARC in FY 2010. The Pasadena FPRS is the subject of one of the CGJ's case studies performed as part of this assessment (See Section 4).

2. Employer Effective Contribution Rate Components

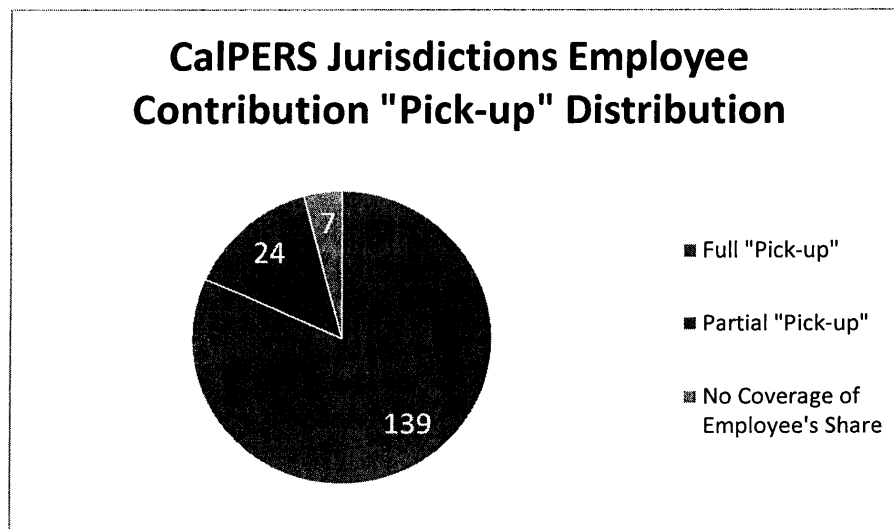
In most jurisdictions throughout LAC, it would be misleading to view the employer "normal cost" contribution rate without also incorporating an analysis of 2 other components of the employer's total contribution. In addition to the base "normal" rate, the full magnitude of the employer's contribution includes:

- a. An amortization of unfunded liability
- b. The "pick up" of the employee's contribution in cases where the jurisdiction pays the employees share as an employment benefit to workers

Information on the unfunded liability component was most readily available for the city plans. The average contribution rate for unfunded liability of the 71 non risk pool CalPERS city plans was 5.151%. Of these 71 plans, 5 had negative unfunded liability contribution rates, indicating a better funded status resulting in a credit effect on the total employer contribution rate. The low of the 71 plans was negative 1.885% (improved rate) for the Long Beach Safety Plan and the high was a positive 18.001% (worsened rate) for the Torrance Police Safety Plan.

Of the 170 CalPERS jurisdictions for which the information was available, 139 (82%) "pick up", or pay the entire employee contribution on behalf of the employee. Another 24 jurisdictions (or 14%) contribute a portion of the employee's share. Only 7 (or 4%) of these 170 CalPERS jurisdictions do not pick up the employee's contribution. Exhibit 4 summarizes the "pick up" statistics:

Exhibit 4. Distribution of Employee Contribution "Pick up" by Jurisdictions



Source: Jurisdictions' CAFR documents.

By contrast, only one of the major independent cities and special districts (those with more than \$50 million in liabilities) contributes the employee's share on behalf of the employee. LACERA, all 3 City of Los Angeles plans, and all 5 plans of the LAC Metropolitan Transportation Authority each require their employees to contribute at the established employee contribution levels through payroll deductions. The contributions

generally vary based on benefit plan, age of entry and other actuarial determined factors.

For tax purposes, Internal Revenue Code Section 414(h)(c) provides that, "...for any plan established by a governmental unit, where the contributions of employing units are designated employee contributions, but the employer 'picks up' the contributions, the contributions are treated as employer contributions." CalPERS states that, "The effect of a pick up is to defer tax on employee contribution amounts until the member retires and receives retirement benefits, or separates from employment and takes a refund of contributions."

Therefore, because the pick up is considered to be a form of tax deferred compensation, the agreement to pick up the employees' contribution is not considered a vested pension benefit of employees or retirees. Instead, research, confirmed by public officials interviewed for this assessment, suggests that the pick up is merely a contractual obligation of the jurisdiction made under the terms of Memoranda of Understanding (MOU) with employee unions. As a result, the terms of the pick up or the amount to be paid by the jurisdiction can be modified through the collective bargaining process for all current employees and not just new employees.

This is an important consideration. If jurisdictions are considering more immediate reductions in their costs of pension and retiree health benefits, one approach may be to negotiate with labor unions to reduce the amount of the employee contribution pick up being paid by the employer. Such savings could be realized immediately and not be dependent on new employee hires and turnover.¹⁷ For CalPERS member agencies, removing the agreement to pick up the employees contribution would result in savings of 7% to 9% of salaries, depending on whether the employee group falls under the Miscellaneous or Safety groups of employees category.

BENEFIT AND ACTUARIAL CONSIDERATIONS

The foundation for the actuarial analysis and calculation of contribution amounts and rates is the market basket of benefits that are provided to employees. For non-CalPERS agencies, plan design can vary considerably. For example, the County and the City of Los Angeles have designed multiple tiers of plan benefits for their employees that differ depending on the category of employee, the date of initial employment and plan choice. For CalPERS jurisdictions, employers may select from an extensive menu of possible plan benefits to customize a pension system for their employees.

After the investment gains of the late 1990s, employee bargaining groups began to request enhancements to the basic benefit formulas that jurisdictions could then choose to adopt as part of their retirement plan. In response to these conditions, in 2001 the State Legislature approved changes in the law that enhanced these formulas by:

- Allowing public employees to retire with full benefits at younger ages
- Increasing the percentage of salary for each year of service for determining pension amounts

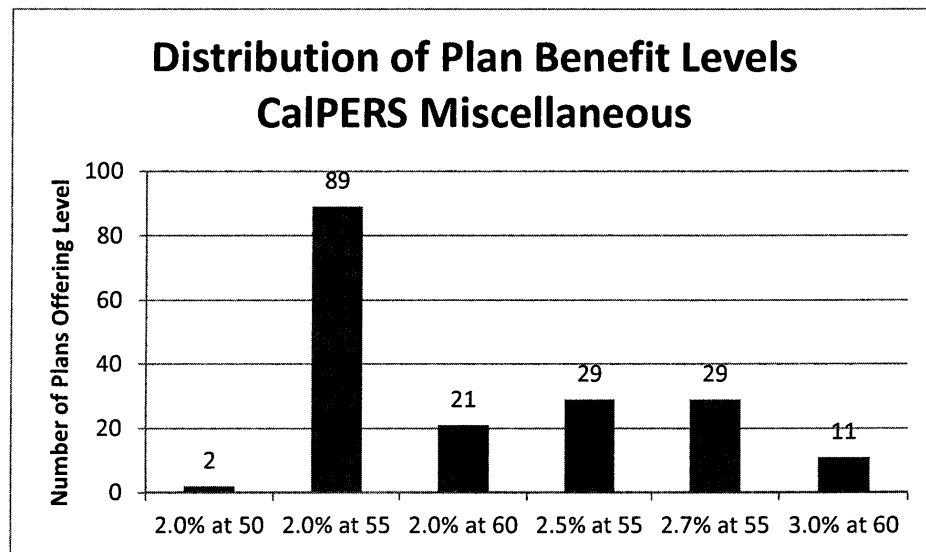
¹⁷ CalPERS projects employer contribution rates two years in advance. Therefore, actual budget savings would not be achieved until year three, unless CalPERS modifies its current policy.

In LAC, the County and City of Los Angeles resisted these enhancements. However, in June 2003, the CalPERS Board of Administration adopted these enhancements as available options for member agencies. Most significantly, police and firefighter employees would now be eligible for 3% at 50 plans if the option was successfully negotiated with the CalPERS member agency.

In LAC and around the State, there was a concerted effort by employee bargaining groups to secure the more generous benefit formulas. The following 2 Exhibits show the benefit options chosen by LAC CalPERS member agencies as of the FY 2009-2010 valuations. Exhibit 5 shows the distribution of plan benefit levels for the CalPERS Miscellaneous category, and Exhibit 6 shows the distribution of plan benefit levels for the CalPERS Safety category.

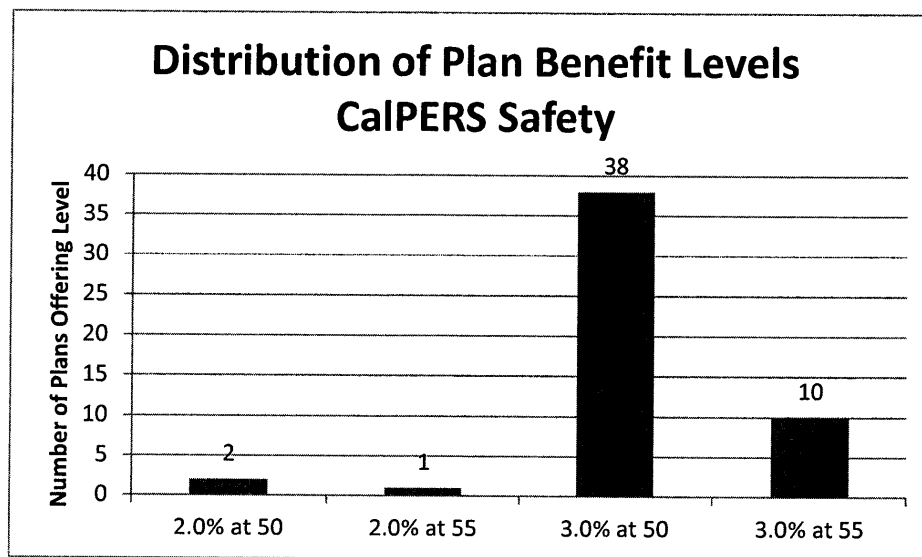
As shown in Exhibit 5 and Exhibit 6, these changes in the law allowed employee bargaining groups in many LAC jurisdictions to access the improved benefit formulas by FY 2009-2010. This migration to the improved benefit formulas is particularly apparent when viewing Exhibit 6, which shows that 38 of the 51 CalPERS Safety Plans in the County (74.5 %) have moved to the more generous 3% at 50 Plan:

Exhibit 5. Distribution of LA County Plan Benefit Levels – CalPERS Miscellaneous



Source: CalPERS actuarial reports for individual and risk pool city plans

Exhibit 6. Distribution of LA County Plan Benefit Levels – CalPERS Safety



Source: CalPERS actuarial reports for individual and risk pool city plans

Although minor variations in plan design are incorporated into this general profile, the current data shows that benefits for employees have migrated to the most generous levels. For example, a Safety Plan retiree with 30 years of service credit can retire at the age of 50 earning 90% of salary. If this individual can add service credit by obtaining military credit or purchasing sick time credit, “air time” or other service credit enhancements, the pension amount can easily reach a pension level of 100% of salary in pension from the age of retirement.

1. Service Credit Enhancements

CalPERS agencies and all of the individual plan jurisdictions have established policies that allow members to purchase service credits that effectively add years of service for time worked in other governments, sick leave and non-worked time that can be purchased by the employee at an actuarially determined cost; i.e., “air time.” Many of these are briefly described below:

- a. Sick Leave – Some agencies allow employees to convert sick leave balances into earnings for the computation of final average salary and/or use sick leave hours balances in the computation of service credit. The use of sick leave is subject to plan limitations and Internal Revenue Service Section 415 limitations on pensions. CalPERS agency members, for instance, can receive one year of service credit for every 250 days of unused sick leave.
- b. Non-Worked Time – Known popularly as “air time,” some agencies allow members to purchase service credit at an actuarially determined cost. Such credits are not based on actual worked time. Termed “Additional Retirement Credit” at LACERA, employees may enter into contracts for either lump sum payments or installment payments during employment. Payments can be made from after-tax payroll deductions or rollover amounts transferred from contributory accounts such as 401(k) or IRA accounts. Similar provisions exist for CalPERS agencies termed “Additional Retirement Service Credit.”

- c. Others – Common to most retirement plans in the County, members may receive service credit for military time, employment with other government agencies, temporary employment with the sponsoring agency, Federal service organizations; e.g., Peace Corps, periods involving leaves of absence and others.

2. Final Average Salary (FAS) Computation and Opportunities for Pension Spiking¹⁸

The final average salary (FAS) that is used in conjunction with years of service, age, and other factors to calculate retirement benefits may vary depending on the time period over which the FAS is based and the types of compensation that are classified as “pensionable.”

Jurisdictions typically calculate the FAS for employees using one of two time periods: 12 months or 36 months. As shown in Exhibit 7, 85% of CalPERS plans in LAC use a method which calculates the average salary over the most recent 12-month employment period with the highest proportion being for regular plans at 94%. While risk pool plans are more likely to utilize an average of the most recent 36-month period, the rate is still low at 20%.

In jurisdictions where the 36-month period is used for FAS, employees must work for multiple years to elevate the average salary used in determining their pension benefit. Although the CGJ did not find evidence of such spiking in the limited case study sampling, to the extent that instances of “pension spiking” might occur, it would be more prevalent in jurisdictions where the shorter FAS period is used. The pervasive use of the 12-month period to compute FAS throughout LAC may indicate an increased risk for abuse:

¹⁸ Pension spiking (From Wikipedia): Pension spiking is the process whereby public sector employees grant themselves large raises or otherwise artificially inflate their compensation in the years immediately preceding retirement in order to receive larger pensions than they otherwise would be entitled to receive. This inflates the pension payments to the retirees and, upon retirement of the “spikee”, transfers the burden of making payments from the employee’s employer to a public pension fund. This practice is considered a significant contributor to the high cost of public sector pensions. Several states including Illinois have passed laws making it more difficult for employees to spike their pensions.

Pension spiking is largely seen in public sector and is an example of the principal-agent problem. In the classic principal-agent problem, a principal hires an agent to work on his behalf. The agent then seeks to maximize his own well being within the confines of the engagement laid out by the principal. The agent, or bureaucrat in this instance, has superior information and is able to maximize his benefit at the cost of the principal. In other words, there is asymmetric information.

In the case of pension spiking the general public (the principal) elects officials to hire the bureaucrat who then hires the public servants, who are the ultimate agents of the general public. Thus, the principal is three steps removed from the bureaucrat. In the case of pension spiking, the public has allowed a pension system to be created which is based on the compensation in the last year of service and delegated the setting of this cost to the bureaucrat.[] The bureaucrat, who will often himself or herself benefit from a spiked pension or the same laws permitting pension spiking, fails to stop the practice, a clear conflict of interest.

Exhibit 7. CalPERS Final Average Salary Methodological Distribution

Period Used to Determine Final Average Salary By Plan Type for CalPERS Agencies

	12 Months	36 Months
Risk Pool Plans	80%	20%
Regular Plans	94%	6%
Total	85%	15%

Source: CalPERS actuarial reports for each jurisdiction.

3. Benefit Enhancements

The other major factor driving the determination of FAS and the level of pension benefit is the set of earnings that are counted as “pensionable.” Categories of compensation such as sick leave credit, vacation buy-back, vehicle allowance, uniform allowance and special bonuses may count toward pensionable earnings in many jurisdictions throughout the County. The categories of pensionable earnings are not readily available in the jurisdictions’ financial reports. However, the CalPERS plan actuarial statements include an indication of whether the jurisdiction opts to allow its members to apply sick leave credit.

These provisions can increase the amount of the calculated pension or the amount of the actual pension during retirement. For example, the LAC established a “Longevity Pay” provision for certain employee groups as an alternative, to attempts by certain employee groups to obtain 3% at 50 or other more generous base pension formulas. As shown in Phase II (Section 1) of this Report, these provisions effectively increase the amount of the FAS for employees. They were reportedly seen by the County as being less costly alternatives to the formula changes that were being requested at the time.

4. Cost of Living Adjustments (COLA)

The primary driver of pension increases after retirement are the Cost of Living Adjustments (COLA) that are agreed to by the jurisdiction. For example, the LAC has set pension COLAs at actual inflation based on the Consumer Price Index (CPI) to a maximum of 2% for all plans, except Plan A which is set at 3% . However, while the basic CalPERS plan offers a 2% COLA, member agencies may purchase a COLA up to 5% at an additional cost. Of the 152 CalPERS member agencies identified as part of this assessment, only 20 (13.2%) had purchased increased COLAs at the time of the last valuation. Half of these purchased the 5% COLA, including the City of Bell for its Miscellaneous employees.

5. Investment Smoothing

Retirement plans typically “smooth” investment rates of return¹⁹ in order to reduce the volatility in the amount of annual contributions that need to be made by employers and employees. CalPERS retirement plans smooth investment rates of return over 15-year periods. Other plans in LAC, including LACERA and the Los Angeles City plans, smooth investment rates of return over more typical 5-year periods, which can result in greater rate volatility when there are dramatic swings in the market value of investments.

Recognizing that the return on investments can be volatile from year to year, actuaries typically compute a rolling average of investment returns rather than relying on actual annual returns to prepare their estimates of current and future fund assets. This mechanism is designed to “smooth” the natural volatility of market fluctuations and make annual contribution requirements more predictable. CalPERS policy is to smooth investment returns over 15-year periods.

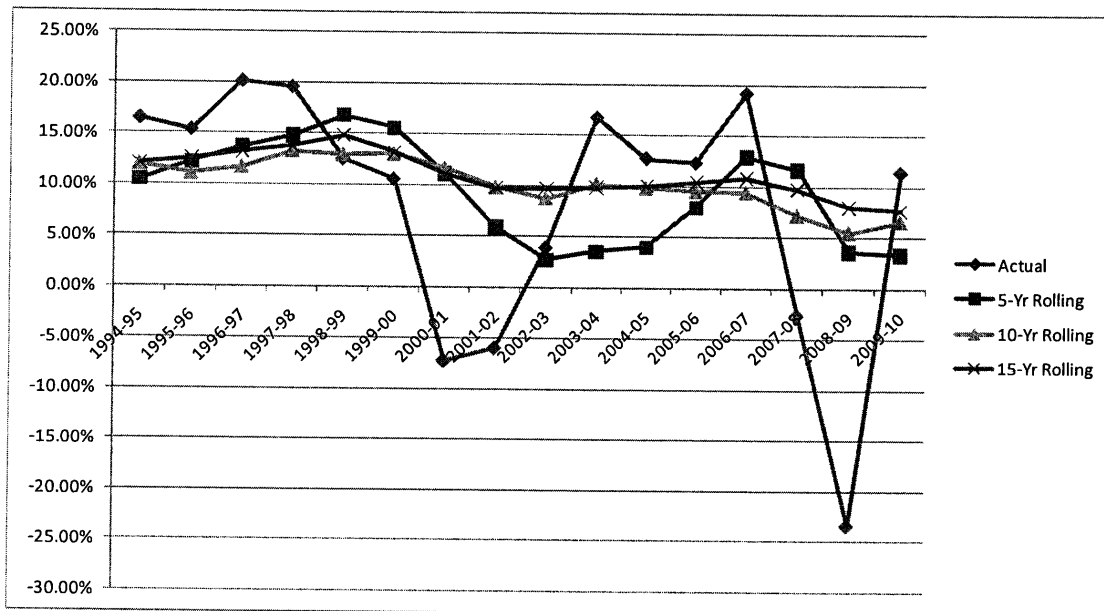
The Little Hoover and the Stanford reports suggest that jurisdictions contribute their normal contribution as a minimum amount each year to ensure adequate funding of pension benefits. While this would moderate underfunding during periods of low investment returns, it would inflate the actuarial value of assets during periods of extraordinary investment gains. The resulting actuarially determined overfunding of plans could expose jurisdictions to public criticism and to demands from employee groups for additional benefits.

An alternative to the suggestion of making the normal contribution, the minimum allowed ARC would be to modify the smoothing methodologies used by actuaries so that the calculated ARC would move within a narrower band closer to the normal contribution rate. Extraordinary gains and losses would then be recognized over a longer period of time so that the appearance of over or under funding would not be as dramatic. By establishing “smoothing corridors,” as done by CalPERS, the risk of recognizing and responding to severe economic conditions would be tempered. Exhibit 8 shows the effect of a 5-year, 10-year and 15-year smoothing on investment rate assumptions using CalPERS investment return data available for this assessment.

As shown by this simple model, the actuarial assumed rate of return using both the 10-year and a 15-year smoothing methodologies cause the actuarial investment performance to moderate swings in actual investment gains and losses, and thus the actuarial value of assets. This would ensure that jurisdictions contribute an amount each year that is closer to the normal contribution rate.

¹⁹ Rate smoothing is accomplished by calculating the rolling average rate of return over a period of time greater than one year. This method of calculating rates of return has the effect of moderating annual changes in investment performance over a longer term investment horizon.

Exhibit 8. Effect of Variable Smoothing Assumptions on Assumed Rate of Return



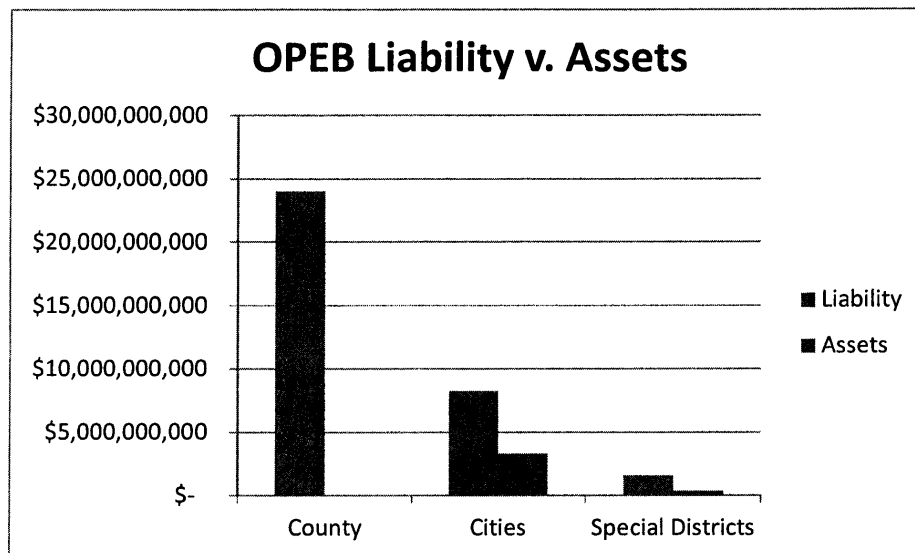
Source: CalPERS reports on fiscal year annual rates of return

RETIREE HEALTH CARE ASSETS AND LIABILITIES

A different quandary emerges when considering the funding profile for retiree health care benefits, also known as Other Post Employment Retirement Benefits (OPEB). As shown in Exhibit 9, the total liability for all OPEB plans in the County, cities, and special districts, based on the most recent information available from those jurisdictions, was approximately \$33.9 billion. However, with only \$3.7 billion in combined assets, the overall funded status of OPEB plans county wide is 10.8%. A large portion of the OPEB liability is held by LAC, amounting to \$24.0 billion or 71% of the total liability held by all jurisdictions.

Without viewing the detail of each city's OPEB funded status, Exhibit 9 may suggest that the cities are in a much better funded position than the County. However, the aggregate cities' figure is heavily skewed by the OPEB plans of the City of Los Angeles. In fact, a large majority of other city OPEB plans are completely unfunded, but the City of Los Angeles' higher funded status and large share of total liability distorts the aggregate city level summary. The funding levels of OPEB plans in the City of Los Angeles are shown in Exhibit 10 with the LACERS plan, the Department of Water and Power plan (WPERP), and the Fire and Police plan (FPRS) funded at 63.8%, 60.5% and 32.3%, respectively.

Exhibit 9. OPEB Liabilities Compared to Assets



Source: Jurisdictions' CAFR documents.

Exhibit 10. Funded Status of OPEB Plans in the City of Los Angeles

City Plan	Liabilities	Assets	Funded Status
LACERS	\$2,233,874,000	\$1,425,726,000	63.8%
WPERP	\$1,631,916,204	\$ 987,475,976	60.5%
FPRS	\$2,537,825,000	\$ 817,276,000	32.2%
LA City Combined	\$6,403,615,204	\$3,230,477,976	52.2%

Sources: CAFRs and actuarial reports for each of the three entities.

As shown in Exhibit 11, at least 56 of the 88 cities have no assets reserved for OPEB and are thus 0.0% funded. An additional 14 cities report some partial funding of OPEB, ranging from a low of 0.5% in Santa Fe Springs to a high of 83.5% in Manhattan Beach. At least 5 cities do not offer or did not report OPEB liabilities, and it is unknown whether there are OPEB plans in 13 other cities which did not report at all.

Exhibit 11. Distribution of Funded and Unfunded OPEB Plans in LAC Cities

0% Funded	56
Partially Funded	14
Without OPEB	5
Unknown OPEB	13

Source: Jurisdictions' CAFR documents.

Prior to 2008, public agencies were not required to report OPEB liabilities. On December 15, 2008, Governmental Accounting Standards Board (GASB) Statement 45 went into effect requiring the reporting of estimated liabilities for retiree health plans. Most jurisdictions reported

that they had not set aside any funds and that significant liabilities were developing due to growth in the plans and the rapidly increasing cost of health care. Recognizing the funding dilemma being faced by these jurisdictions, GASB Statement 45 embodied the following key provisions:

- Like pension benefits, OPEB assets and liabilities would need to be estimated over the benefit horizon on an actuarial basis.
- Any unfunded liability could be amortized or spread over a period of up to 30 years, “approximately equal to a typical public employees’ term of employment.”²⁰
- The Annual Required Contribution (ARC) consists of the normal cost and the portion of the UAAL to be amortized in the current period.

Although GASB does not recommend funding strategies, various other notable organizations have made comments and recommendations in this regard. The United States Government Accounting Office stated in a 2008 report that:

Pay-as-you-go financing has been the norm up to the present day. The initial estimates of the unfunded liabilities will be daunting. But that is a natural consequence of pay-as-you-go financing. Just as the unfunded liabilities did not accumulate overnight, it may be unrealistic to expect them to be paid for overnight. Rather State and local governments need to find strategies for dealing with unfunded liabilities, and such strategies will take time, will require difficult choices, and could be affected by changes in national health policy.²¹

Other professional organizations are more explicit. The Government Finance Officers Association of the US & Canada (GFOA) states in its Best Practice literature:

Recommends that the financing of post-employment benefits as they are earned (i.e., prefunding v. pay-as-you-go funding) offers significant advantages from the vantage point of equity and sustainability. Just as important, the earnings on the resources thus accumulated will lower the amount that ultimately must be budgeted by the employer. GFOA strongly recommends that OPEB involving explicit benefit payments be prefunded on an actuarial basis, as discussed in GFOA's Best Practice, *Ensuring the Sustainability of Other Postemployment Benefits*.²²

The CGJ concurs with the observations and recommendations of the GAO and GFOA. Although there may be circumstances when funding the full ARC for OPEB may not be necessary or desirable, in most circumstances jurisdictions should make every effort to prefund the benefit. As suggested by the GFOA, this permits the jurisdictions to accumulate reserves from which investment earnings may be used to offset a portion of the jurisdictions’ required contributions. Without the accumulation of reserves and resulting investment returns, the cost of accrued and future benefits will need to be paid exclusively from taxpayer revenues.

²⁰ March 2011 internet version, Government Accounting Standards Board, *Other Post Employment Benefits: A Plain-Language Summary of GASB Statements No. 43 and No. 45*

²¹ January 2008, Report to the Committee on Finance, U.S. Senate, GAO-08-223, *State and Local Government Retiree Benefits, Current Funded Status of Pension and Health Benefits*

²² GFOA of the UC & Canada, *Best Practice: Considerations for Prefunding OPEB Obligations (2008)*

6. Ability to Modify OPEB Benefits

California and Federal case law is reportedly mixed on a jurisdiction's ability to modify OPEB benefits for existing employees and retirees. Depending on how the benefits are structured and the contractual obligations agreed to by the employer and employee during the period of employment, there may be some opportunity to modify benefits for both future and current employees. However, contract law is unclear; and mere past practice or agreement in a Memorandum of Understanding with represented employees may create an implied or actual contractual agreement between the jurisdiction and the employees.

Therefore, a legal assessment would need to be conducted in each LAC jurisdiction to determine the extent which current modifications to retiree health benefits would be allowed. If legal tests were met, jurisdictions would potentially be able to cap benefit amounts, require copayments from retirees or implement other changes that could reduce costs. In the City of Vallejo which declared bankruptcy in 2008, modifications to retiree health benefits have successfully been negotiated with retiree groups and labor organizations that will reduce the City's costs.²³ This is an extreme situation, and the same flexibility may not be available in LAC jurisdictions that provide this benefit.

Jurisdictions that provide OPEB benefits should explore the degree of flexibility they have to modify OPEB benefits for existing retirees and employees. Even if this is not legally permitted, jurisdictions should proceed with efforts to modify benefits in a manner that would reduce costs of benefits for future employees. For example, one jurisdiction reviewed for this study is exploring the impact and potential savings that might be achieved by more effectively coupling retiree health benefits with Medicare.

PENSION OBLIGATION BOND (POB) FINANCING

Pension Obligation Bond (POB) financing is used by some jurisdictions to pay down a portion of the pension system's UAAL. The POB debt is a general obligation of the jurisdiction, which means that it is secured by the general taxing authority of the jurisdiction. Unlike other general obligation borrowing, POBs do not need to be authorized by the voters.

In LAC, 17 jurisdictions have current POB debt. For these jurisdictions, the total POB debt including interest, as of the most recently reported data, was approximately \$1.17 billion²⁴, of which approximately 51% was held by the County. According to County financial documents and County and LACERA management, LAC's outstanding POB debt including interest will be completely paid by June 30, 2011. The remaining 49% of the total POB debt was held by 16 cities, with final maturity dates ranging from 2015 to 2036. Appendix C.7 shows the detailed amounts of the POB debt for the County and each of the 16 cities.

As shown in Phase II (Sections 3 and 5) of this Report, some cities within the County are contemplating borrowing funds using POBs, including some that currently have no POBs (Hermosa Beach) and others with significant POB debt (Pasadena). The wisdom of borrowing using POBs is highly dependent on the jurisdiction's needs, current market conditions and other factors that may impact cost effectiveness and political acceptance (See Appendix B).

²³ Updated 4/16/2009, U.S. Bankruptcy Court, Eastern District of California, Sacramento Division Case No. 08-26813, *Official Unsecured Creditors Committee of Retirees, Retiree Committee Information*

²⁴ Figure does not include interest payments for four jurisdictions: Baldwin Park, Burbank, La Verne and Long Beach.