

Item 6 of Final Report Outline
Commission Recommendations
A Plan to Address Pension and OPEB Obligations

Preface: Public Employees Post-Employment Benefits in California

Public agencies provide benefits in order to attract and retain top quality employees. The Governor’s Executive Order creating the Commission stated: “Promised pensions and health benefits are vitally important to state workers and their families, especially public safety officers who put their lives on the line everyday. And they are obligations that must—and will—be paid by government. We must seek ways to meet these obligations while not harming other government programs and taxpayers or handing invoices to future generations.”

Throughout the course of our hearings, the Commission received testimony from numerous active and retired public employees. They testified about the commitment they made to a career in public service and the importance of their pension and retiree health care benefits once they retired. The rising cost of health care has particularly impacted local government retirees, some of whom have had changes made to their health care benefits after they have retired. These increased costs, however, have also impacted government budgets. The Commission’s recommendations have been developed to balance these two concerns.

It is within the context of the Governor’s promise and the concerns we heard from the public that we present the following recommendations.

Group 1
Identify and Prefund Financial Obligations

Recommendation 1

Public agencies providing OPEB benefits should adopt prefunding as their policy. As a policy, prefunding OPEB benefits is just as important as prefunding pensions. The ultimate goal of a prefunding policy should be to achieve full funding.

Recommendation 2

Each public employer shall identify its OPEB liability, adopt a prefunding plan, and make it public. If a public employer does not establish a prefunding plan, it shall clearly identify an alternative approach for addressing its OPEB liabilities and make public its reason for not prefunding.

Recommendation 3

The State of California shall establish prefunding as both a policy and budget priority, develop and make public a prefunding plan, and begin prefunding its OPEB liabilities.

Rationale

- The majority of public agencies in California do not currently prefund their OPEB liabilities. Instead, most rely on the pay-as-you-go approach to cover current year costs without consideration of accumulated liabilities or future costs.

While financing through prefunding will initially cost the employer more than continuing pay-as-you-go, the employer's long-term total cost will be less than pay-as-you-go because prefunding enables the employer to fund benefits as they are earned and the resulting investment returns will help fund the benefits. For most agencies, the cross-over point comes 10 to 20 years after beginning to prefund. Each year of prefunding immediately reduces the long-term unfunded liability.

While GASB 45 does not require public agencies which provide OPEB benefits to begin prefunding, it does require that such agencies both determine their liability and disclose it. The Commission recognizes that its recommendations on prefunding cover a wide range of sponsoring agencies. **Some of these agencies may determine that it is not financially practical in the short term to fully prefund OPEB liabilities.** However, the Commission recommends that public agencies develop a long-term plan to prefund their liabilities and begin prefunding as soon as practical, even if the contribution is less than the normal cost. **It is not the intent of the Commission that its recommendations on prefunding be construed to require public agencies to begin prefunding in FY 2008/09.**

Recommendation 4

Any employer considering the use of OPEB bonds should fully understand, and make public, the potential risks they bring. Such risks include: shifting costs to future generations, converting a future estimated OPEB liability into fixed indebtedness, and the uncertainty concerning continued federal cost sharing for debt service on such a bond.

Rationale

OPEB bonds are essentially an arbitrage strategy for use when the employer believes that the return on invested funds will be greater than the cost of the debt. If this turns out not to be the case, then the employer has locked in higher costs for the life of the bond. In addition, while GASB 45 does not obligate an agency to prefund OPEB benefits, the use of an OPEB bond eliminates budgetary flexibility by obligating an agency to making regular debt service payments. Finally, an OPEB bond, like a pension obligation bond, shifts the accounting for an unfunded liability from the OPEB or pension fund to the general fund budget. Thus, it runs the risk of giving the appearance that an OPEB or pension fund liability has been funded when in fact only the method of accounting for it has been changed.

Group 2

Limit Contribution Volatility and Use Smoothing Methods Judiciously

Recommendation 5

Public retirement systems which consider contribution rate volatility to be a problem should consider the use of longer asset smoothing periods to lessen that volatility.

Recommendation 6

A retirement system which has adopted an asset smoothing method should resist efforts to alter that method for short-term gain, including, but not limited to, contribution rate reductions and benefit increases.

Rationale

To stabilize employer rates, actuarial methods have been developed to help “smooth” short-term variability in the market value of assets. The shorter the smoothing period, the quicker that gains and losses will be recognized, resulting in a more rapid increase or decrease in the employer contribution rate. The longer the smoothing period, the slower gains and losses will be recognized, resulting in a slower increase or decrease in the employer contribution.

There is no “best” smoothing period for all retirement systems. CalPERS only system in country with 15 years. CalSTRS only major system in the country with only three years. A few have eight years. Five years is, by far, the most common.

Recommendation 7

Generally, employer contributions should not fall to zero. An employer should be permitted to have a full or partial contribution holiday only when its retirement plan is substantially overfunded. As used here, “substantially overfunded” means that the existing surplus is used to pay for all or part of the normal cost only after that surplus is amortized over a 30 year period, the longest amortization period allowed by GASB. In particular, employer contributions should fall to zero (“full contribution holiday”) only in the rare situation that the surplus is so great that it could be expected to fund a full 30 years of normal costs.

Recommendation 8

An employer whose pension account is overfunded and who has an OPEB liability should, as its first priority, use that surplus to address its OPEB liability. This should be done either by (1) transferring such surplus directly to OPEB funding in a manner which complies with federal and state law, or (2) using the budgetary savings from any contribution holiday (determined in accordance with Recommendation 7) to make additional contributions to OPEB funding. DNA TO LEA's.

Rationale

The Commission recommends that full employer contribution holidays should never be permitted except under the circumstances set out above in Recommendation 7.

Group 3 Increase Transparency and Accountability

Recommendation 9

Legislation should be enacted directing the State Controller's Office to develop a simple and inexpensive procedure to regularly collect and report OPEB data from California

public agencies. In order to minimize reporting requirements for public agencies, all the data collected for this report should be contained in the GASB 45 actuarial valuation report periodically required of each public agency and in the agency's GASB 45 footnote. Reporting should be mandatory for those agencies which provide OPEB benefits.

NOTE: May have some bargaining implications if comparison of gross numbers made without regard to numbers and terms.

Recommendation 10

The State Controller's Office should publish the annual report of public pensions, which is required by current law, within 12 months of the receipt of data but in no case longer than 18 months after the end of the fiscal year.

Rationale. As a part of GASB reporting requirements, these agencies will already be gathering information regarding their OPEB obligations and should have this data available to submit for a state-level report. Depending on their size, agencies will have to report their OPEB information every 2 or 3 years.

The best information, however, is only as useful as it is available, and it is the intent of the two above recommendations to make ongoing reporting of unfunded pension and OPEB liabilities available on a timely basis.

Recommendation 11

With the exception of school districts and county offices of education, legislation should be enacted to amend Government Code Section 7507 to provide for more clarity in its cost reporting requirements and for clear accountability within a public agency adopting new benefit levels. Specifically, where that section now calls for the determination of "future annual costs," it should be clarified to include "normal cost and any additional accrued liability." Concerning increased accountability, language should be added which requires that the person holding the position with the responsibilities of a chief executive officer within the affected agency acknowledge in writing the actuary's cost determination for the new benefit. **School districts and county offices of education shall comply with disclosure requirements pursuant to AB 1200 (Chapter 1213, Statutes of 1991) and AB 2756 (Chapter 52, Statutes of 2004).**

Recommendation 12

With the exception of school districts and county offices of education, legislation should be enacted to amend Government Code Section 7507 so that it also applies to the granting or changing of OPEB benefits. As with pension benefits, this statutory change would require that the future costs of the proposed benefit change be determined by an actuary and be made public at least two weeks prior to adoption. **School districts and county offices of education shall comply with disclosure requirements pursuant to AB 1200 (Chapter 1213, Statutes of 1991) and AB 2756 (Chapter 52, Statutes of 2004).**

Recommendation 13

With the exception of school districts and county offices of education, legislation should be enacted to amend Government Code Section 7507 to require that pension and/or OPEB benefit changes be subject to the public notice requirements found in that section and be presented with an actuary available to answer any questions or to provide additional information, as needed. The presentation and report should be in language easily understood by the layperson, and such information should not be placed on the consent calendar. **School districts and county offices of education shall comply with disclosure requirements pursuant to AB 1200 (Chapter 1213, Statutes of 1991) and AB 2756 (Chapter 52, Statutes of 2004).**

With the changes set out in Recommendations 11, 12, and 13, as shown in underline, Government Code Section 7507 could read as follows:

“7507. The Legislature and local legislative bodies, with the exception of school districts and county offices of education, shall secure the services of an enrolled actuary to provide a statement of the actuarial impact upon future annual costs, including normal cost and any additional accrued liability, before authorizing increases in public retirement plan benefits or in OPEB benefits. An “enrolled actuary” means an actuary enrolled under subtitle C of Title III of the federal Employee Retirement Income Security Act of 1974 and “future annual cost” shall include, but not be limited to, annual dollar increases or the total dollar increases involved when available as well as normal cost and any additional accrued liability. The future annual costs as determined by the actuary shall be made public at a public meeting at least two weeks prior to the adoption of any increases in public retirement plan or OPEB benefits. An actuary shall be present to provide information as needed at the public meeting where the adoption of the new benefit will be considered. The adoption of any benefit affected by this section shall not be placed on the consent calendar. Upon adoption of a new benefit, that person in the agency with the responsibilities of a chief executive officer shall acknowledge in writing that he or she understands the current and future cost of the benefit as determined by the actuary.”

Rationale

Pension or OPEB benefits are typically determined via collective bargaining agreements negotiated between the employer and representatives of the employees. When a tentative agreement is reached, it is generally brought before the governing body for ratification. The nature of this process often does not lend itself to public disclosure while negotiations are taking place.

Because the Education Code provides reporting requirements which are separate from, but comparable to, those found in Government Code Section 7507, the above three recommendations reference legislation in the Education Code as controlling for school districts rather than Section 7507.

Group 4

Improve Plan Design and Communication with Employees

Recommendation 14

An employer making a contribution to retiree health care should make that contribution proportionate to the number of years of employment and should reward longer careers. This recommendation should be implemented through collective bargaining and should be applied to newly hired employees. The use of proportionate credit to earn the employer contribution for retiree health care should apply only to service retirement.

Rationale

For purposes of this discussion, proportionate benefit design means that the longer an employee works, the more benefits she will earn.

NOTE: Potentially only affects our chapters with a very short “vesting” period.

BARGAINING IMPLICATIONS: 50% Plus earned per year. That is not common for us.

Recommendation 15

An employer providing retiree health care should make that benefit dependent upon the employee retiring within a set time after separation from the job.

Rationale

120 days or so.

Recommendation 16

Public sector employers should provide tax-advantaged supplemental savings plans (e.g. 457, 401(k), 403(b), etc.) to their employees on an “opt out” basis. Public employers and their employees should jointly determine the details of any plan offered, including: whether to use a “hard” or “soft” opt out, the minimum contribution amount, and any default investment selection for employee contributions. Employers should also develop an ongoing program to educate employees about their savings options.

Recommendation 17

Public employers should provide regular explanations to their employees concerning the advantages of their defined benefit (pension and OPEB) plans, the role of compounded interest in their personal savings programs, and the advantage of contributing to savings on a pre-tax basis. Employees who participate in Social Security should be educated that this is a supplemental program only and not a retirement plan. This information should be communicated at regular intervals throughout an employee’s career.

Rationale

An estimated 50% of California's public sector employees do not currently participate in Social Security. Public school teachers and administrators who are members of CalSTRS are the single largest group of public employees without Social Security coverage. Most public safety employees also do not participate in Social Security.

Recommendation 18

Public employers should provide clear explanations to employees concerning current eligibility rules for retiree health care and the terms under which retiree health care is earned. Employers should also clearly explain to their employees the conditions under which health benefits for retirees are to be funded and paid. This information should be communicated at regular intervals throughout an employee's career and through plan documents and collective bargaining agreements.

Recommendation 19

Public employers should provide timely notification to both active and retired employees when proposing a change in retiree health care benefits. This notification should be provided in a time frame that reasonably allows affected employees and retirees to understand the impact of the benefit change, to review other options available to them, and to comment to the employer on the proposed changes.

Rationale

The Commission has heard extensive testimony concerning situations where the process for earning health care in retirement was not understood by active or retired employees. It was apparent in much of this testimony that there were misunderstandings among many of the retirees concerning the level of employer contribution they had earned while working as active employees. This resulted in some retirees finding themselves without the health care benefit they had planned upon.

The Commission also heard troubling testimony about the experiences of retirees from local agencies where changes in benefits were made after the employees had retired. The Commission believes that local agencies should adopt a similar policy to that articulated by the Governor when he announced the creation of the Commission. Specifically, he said,

“Promised pensions and health benefits are vitally important to state workers and their families, especially public safety officers who put their lives on the line every day. And they are obligations that must – and will – be paid by government.”

The Commission strongly encourages agencies to not make changes which will have a detrimental effect on their retirees.

Recommendation 20

CalPERS should periodically inform its contracting agencies about the option of allowing permanent part-time employees access to the PEMHCA health care system. The amount of the employer contribution, if any, should be collectively bargained.

Recommendation 21

Public employers should evaluate participation in alternate arrangements, including joint power authorities (JPA) and regional health care risk pools, as a means of providing retirees with access to health care coverage.

Rationale

As discussed above, the Commission heard testimony concerning situations where changes were made in benefits after the employees of local agencies had retired. In some instances, retirees were placed into a separate, higher cost risk pool or forced to purchase health care in the individual market. Concerns have been raised that some retirees may not be able to afford the higher premium costs resulting from these changes. In light of this testimony, the Commission encourages public employers to meet their existing commitments to retirees and also explore alternative options to providing retirees with access to health care.

Group 5 Provide Independent Analysis

Recommendation 22

Legislation should be enacted to create a California actuarial advisory panel at the state level. The purpose of the advisory panel would be to provide the California Legislature, the Governor's office, public retirement systems, public agencies, and other interested parties with impartial and independent information on pensions, OPEBs, and best practices.

Such a panel would encourage greater transparency and understanding of actuarial methodology and assumptions used by public retirement systems and would gather and provide information concerning best actuarial practices. Individuals appointed to the advisory panel should have the requisite technical and educational skills to carry out their duties.

Rationale

1. An actuary is a professional who explains the unexpected in a way that cannot be understood.

Recommendation 23

All public pension plans should have periodic performance audits performed by an independent auditor.

Group 6 Strengthen Governance and Enhance Transparency

Recommendation 24

A retirement board should not provide incentives for an employer to enhance benefits, and benefit improvements by the employer should not be contingent upon a quid pro quo by the retirement board.

Rationale

San Diego: "One shouldn't blame the pencil for the mathematical error."

Recommendation 25

Retirement systems and public agencies should be open and transparent concerning the elements included in final compensation. All public retirement systems in California should have in place safeguards against pension spiking.

Rationale

A practice commonly referred to as "pension spiking" is generally seen as the intentional inflation of final compensation with the primary purpose of increasing the retirement benefit. Since it most often takes place shortly before retirement, the inflated benefit which spiking produces is usually unfunded. Such actions have an adverse impact on both the funding and credibility of public retirement systems. Historically, spiking has been primarily a management abuse.

Recommendation 26

Legislation should be enacted which would do the following: 1. Make it a crime to make a fraudulent claim for a retirement or disability benefit or to keep a payment made on the basis of a fraudulent claim; 2. Require that workers' compensation insurers and the Director of EDD provide CalPERS investigators with information they deem necessary when investigating someone concerning the application for, or the receipt of, CalPERS benefits.

Rationale

Over the past two decades, few disability reform bills have been both meaningful and successful, since changes in this area are most often seen as zero-sum by the various interested parties. However, there is legislation (AB 36 and AB 545) currently before the Legislature which has previously enjoyed bipartisan support, which addresses disability fraud, and whose content the Commission endorses. That content is reflected in the text of Recommendation 26.

Recommendation 27

The granting of a disability retirement should be based solely on medical information and should not consider personnel, disciplinary, or other ancillary issues.

Rationale

NOTE: We would not longer be able to negotiate a disability retirement for someone in lieu of a disciplinary/evaluation dismissal.

Recommendation 28

Boards overseeing pension or OPEB trust funds should evaluate not only reported actuarial liabilities and assets but also the underlying assumptions including discount rates, investment returns, mortality, health care inflation, and whether plans are open or closed systems. Boards should understand the sensitivity to changes in these assumptions, as well as the difference between actuarial values and market values. The authorities responsible for appointing members to public retirement boards should seek out individuals with expertise in the areas of public finance, investments, and public administration. In addition, the trustees of public retirement systems, as well as the trustees of OPEB trusts, should receive continuous training related to the understanding and fulfillment of their fiduciary responsibilities, actuarial methodology and assumptions, and conflict of interest requirements.

Recommendation 29

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

It is very important for retirement system board members to make decisions based solely on their fiduciary responsibilities.

Recommendation 30

Boards overseeing pension and/or OPEB trust funds should meet or exceed the transparency governance requirements they place on companies or on investment managers of plan assets.

Recommendation 31

Public retirement boards of trustees should establish a separate audit committee, made up of trustees, to oversee and participate in the opening, processing, and closing of the annual audit report to the full board.

Rationale

Within a number of California's local public retirement systems, board members often do not actively participate in the audit process, leaving that role to senior staff. Best practice literature holds that the trustees should play an active part in the audit process.

Group 7

Coordinate with Medicare

Recommendation 32

Health plan sponsors should identify individuals who are Medicare-eligible and inform them of the need to enroll in Medicare in a timely manner. Employers should provide those individuals with information on penalties which result from delayed enrollment in Medicare.

Recommendation 33

Employers should provide incentives to individuals to enroll in Medicare and possibly a Medicare supplement plan once they become eligible for Medicare.

Rationale

All public employees hired since April 1986 are eligible for participation in the Medicare program. Medicare coordination refers to the practice of moving a Medicare-eligible individual from an employer's basic health care plan to a supplement to Medicare plan. Such coordination reduces employer costs by shifting first payor responsibility to the federal Medicare program. Many local governments outside of PEMHCA request that their health plan partners or third-party administrators aggressively transition individuals when appropriate.

Under existing law, CalPERS has a process to shift members to Medicare supplement plans when they become eligible for Medicare. PEMHCA stipulates that individuals who become eligible for Medicare Part A and Part B after January 1, 1985 may not be enrolled in a basic plan; if an individual chooses to enroll in Medicare, then he or she may enroll in a health plan coordinated with Medicare (Government Code Section 22844). However, information provided by CalPERS indicates that while such authority does exist, significant populations have been exempted from the requirement by Board policy. There are ongoing premium costs associated with Medicare-eligible individuals who remain in basic health plans. Individuals who delay enrollment in Medicare face life-long penalties which escalate, based on how long an individual has delayed enrollment.

The Commission recognizes that local governments can achieve considerable savings in their retiree health plans when eligible individuals enroll in Medicare. However, the Commission also recognizes that individuals may receive fewer benefits, or be required to pay more out-of-pocket for health care services if they are enrolled in Medicare rather than in their local government's retiree health plan. Recommendation #33 is designed to ensure that both local governments and their retirees benefit from the retiree's eligibility for the Medicare program. This objective is best achieved if local government's offer inducements to eligible retirees to join Medicare and if retiree's retain the choice of whether or not to join Medicare.

Group 8

Advocate Federal Tax Law Changes

Recommendation 34

At the request of numerous local agencies, the Commission agreed to consider several proposed tax changes. Because the Commission can play a unique role in communicating these issues to the IRS, the Commission will write a letter to the IRS recommending the following:

Investment of Assets Used to Fund Retiree Health Benefits: The IRS should modify Revenue Ruling 81-100 to allow the commingling for investment purposes of the funds held to pay public employee OPEB obligations with retirement system funds, subject to appropriate safeguards. Those safeguards should require that OPEB funds must be held in trust solely for the benefit of retirees and beneficiaries and that investments and income must be properly accounted for and allocated.

Rationale - Many California public agencies are now beginning to prefund their retiree benefit obligations. Under current tax laws, it is very difficult to commingle assets held for OPEB benefits with assets held for pension obligations. Because the amount of funds currently set aside for OPEB benefits is much smaller than are pension assets, economies of scale are not available for investing OPEB funds. Therefore, net investment costs will generally be higher, reducing the net amount available to pay OPEB benefits.

Collectively Bargained Retiree Health Benefits: The IRS should interpret the law in the same manner for retiree health benefits as it does for pensions, and not tax health benefits which are collectively bargained, even if they are not fully insured. The IRS also should not tax retiree health benefits that provide higher premium subsidies to retirees with longer service, whether or not those benefits are collectively bargained.

Rationale - Collectively bargained employer-provided health benefits generally are tax-free to active and retired employees. The IRS has interpreted the tax law to limit tax-free retiree health benefits that are collectively bargained, unless the benefits are “fully insured.” “Fully insured” means that the employer pays premiums to an insurer and the insurer assumes the risk to pay all health care risks. Many California public agencies, however, provide benefits that are not fully insured. Federal tax law provides that if health benefits are not fully insured, then they are taxable for the top 25% of wage earners if they “discriminate” in their favor. For this purpose, “discrimination” means the top group of employees, in terms of pay, receiving better benefits than do other employees. For the IRS, this includes giving longer term employees more retirement health care benefits, often through the use of a “vesting” schedule.

Saving For Retirement: Redeposits and Service Purchase: The IRS should not change its current rules concerning pick ups and should not change its rules allowing pre-tax redeposits and the pre-tax purchase of service credit, particularly since there has been no change in the governing law.

Rationale - Federal tax law allows employers to “pick up” the members’ contributions for tax purposes only, thereby making them pre-tax. The IRS has also established that pre-tax pick up rules apply to the redeposit of previously withdrawn member contributions and to the purchase

of service credit. This has allowed vested employees to redeposit previously withdrawn contributions or to purchase service credit with pre-tax dollars. The IRS is considering rule changes which would make members pay these contributions on an after-tax basis, thereby making them more expensive for employees.

Health Benefits: Retirees, Step Children, Domestic Partners, and All Others Covered by the Retiree Health Plan: The IRS should not tax the health care benefits provided to everyone covered by a health care plan simply because the plan provides coverage for retirees' step children and domestic partners who are not tax dependents of the retirees.

Rationale - The IRS has recently ruled that if any health benefits are paid for anyone other than a spouse, tax dependent, employee, or retiree - and if the value of retiree coverage is not taken into account at the time the employee worked and earned those benefits - then the benefits for **all** retirees covered by the plan are taxable. Under this ruling, if a health plan covers step children or domestic partners who are not legally tax dependents, then **all** retirees covered under the plan are taxed on their benefits, regardless of whether they personally have a step child or domestic partner. (California law requires that domestic partners receive the same benefits as those provided to spouses.)