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CALIFORNIA PUBLIC EMPLOYEES' PENSION REFORM ACT OF 2013

DEEPLY FLAWED LEGISLATION

ONE PAGE ABSTRACT

10/12/12

The California Public Employees' Pension Reform Act was passed 8/31/12 and signed into law the following month. All but one significant provision affects only new employees. It will take 15 years to produce noticeable improvement. It does next to nothing to prevent significant deterioration of local and state finances until then.

PEPRA's fatal flaw is most government Pension Funds are underfunded (many severely so) and it does nothing about it. They can't make investment profits on money they don't have. The more they are underfunded the more likely returns will fall short and unfunded pension debt will grow. Only governments must pay extra to eliminate unfunded pension debt – employees and retirees have no obligation. The more unfunded debt grows the more money governments pay to eliminate it, which forces them to provide fewer public services, invest less in public infrastructure, and deplete reserves.

Governments have two ways to eliminate unfunded pension debt. First – sell Pension Obligation Bonds which many have done. Pension Funds get the money but governments are still in debt. Bonds allowed governments to avoid solving the causes of this debt, therefore most governments developed more unfunded pension debt they must pay. Many will not be able to sell more Pension Bonds and will be forced to use the next option. Second – pay additional higher-interest amortization payments to the Pension Fund above their "Normal" yearly contributions. Many - probably most are using the "Level Percent of Payroll" method to eliminate this debt over 30 years. That causes payments for the first 12 years or so to be less than annual interest expense and so the debt grows (if all other Pension Fund projections come true).

The State is betting on huge sustained stock market profits and increased taxes to bail state and local government out.

Only 4 of 480 cities entered bankruptcy in the past few years; more will do so. The real danger will come with the next recession. Based on market cycles since WWII that's anywhere from 1 to 6 years from now – an average of 2.

"SB400" (one of the biggest blunders in State history) became law in 1999 and led to huge retroactive pension increases. CalPERS said investment profits would pay for them. But the stock market immediately tanked and is only now back to where it was when SB400 passed. It would have to be 3 times higher today to fulfill CalPERS' projection. CalPERS projected what would happen if returns were as low as they were in '66 through '75 but didn't make the results public or tell the legislature. CalPERS' "official" projection was the state would pay $680 million in 2011. Their unreleased "worst case" scenario indicated it would be $3.9 billion. It turned out to be $3.95 billion. The Legislature didn't ask for a "worst case" scenario. There was no plan if it happened. It did. Today's huge debt is the result. PEPRA is the same – no way to deal with market returns lower than projections which will happen in the next recession.

PEPRA has no impact on current retirees or on pensions earned by current employees in the past – therefore it had no impact on existing unfunded pension debt. That's its "fatal flaw". Some "easy" reforms are imposed on current employees from now on – no "airtime" purchases, some restrictions on "double dipping", no more retroactive increases. PEPRA states the "standard" is current employees should pay half the total yearly "normal" contribution to Pension Funds but there are upper limits that greatly reduce the savings to governments. Most "real" changes are imposed on new employees – higher retirement ages, lower pensions per year worked, tighter definition of and a cap on "pensionable" compensation, and they <u>will</u> pay half the "normal" yearly contribution. But employees still have no obligation to contribute to reduce unfunded pension debt which increasingly is the main problem.

Rhode Island passed reform a year earlier. They cut unfunded pension debt 41%; California 0%. Rhode Island cut state payments to the Pension Fund 40% next year; California 2% from what they would have been but they will still grow.

PEPRA is a profound failure in several important ways. Financially it didn't reduce and restructure existing unfunded pension debt or greatly reduce government pension guarantees, and is far from a comprehensive financial solution. There were also severe organizational-legal-accountability failures. We need serious reform of Pension Fund governance and of the state's retirement laws. We need deep reform of state and local government financial management. There has been little or no effective state oversight of Pension Funds especially at the local level.

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California Public Employees' Pension Reform Act of 2013
Deeply Flawed Legislation

10/12/12

John G Dickerson

Foreword

At the very last moment of its two-year session the California Legislature passed the California Public Employee's Reform Act (PEPRA) of 2013 – their long-awaited "Pension Reform". Governor Brown signed it Wednesday, September 12, 2012. This law doesn't come close to preventing continued serious deterioration of public services and infrastructure over most of the next 15 years because of rapidly growing payments of unfunded pension debt. That's its fatal flaw.

It was prepared behind closed doors with little public input and debate. The legislature had no competent analysis of what caused the debt, no financial targets for how much the debt and government payments needed to be reduced, or even projections of how much PEPRA reduced unfunded pension debt or payments to pension funds in the short term.

Senate President Darrell Steinberg said after the vote:

> *"I hope this puts this issue – which has so dominated the public discourse for a long time – if not away, at least off to the side so we can focus on some positive agendas."*

Steinberg is a Democrat – I'm a Democrat. Steinberg doesn't "get it" – this statement demonstrates how little he and by implication most of his fellow legislators understand the financial threat we face.

There are some "good" things in PEPRA. But compared to the scale of the problem PEPRA is trivial. It will fail to staunch the rapid deterioration of finances in much of California. The best that can possibly be said about it is it's a "start". By itself it's mostly a dud. Barring a miracle in the stock market this issue will soon be back worse than today.

The most effective pension reform in the US occurred a year ago in Rhode Island. It was that state's fifth effort to "fix" its pension debt crisis since 2005. I believe that's most likely to happen in California - dominant politicians will wait as long as possible before being forced by collapsing government finances, bankruptcies, and an increasingly angry electorate to do something – which step by step will tend to be as little as possible. They will slowly be forced to do what needs to be done. But the additional costs imposed on the people by their delay will be in the tens of billions. The inevitable reduction in retirement benefits for existing employees and some retirees will be far more severe than it had to be.

Just as happened in Rhode Island I believe about 5 years from now (give or take a couple) or in the next recession if it happens before then California will finally be forced to confront the full range of this threat.

PEPRA is 44 pages long and is not only complex in content, but also in language and form. I've read a good amount of it – but much of it is very hard to decipher. I admit much of what I know about PEPRA was gained from reading dozens of articles written by others about what it means. I particularly thank Jack Dean of Pension Tsunami for providing a daily listing of key articles in the press and in blogs about a wide range of pension issues. Visit his website at https://www.pensiontsunami.com/.

I've produced dozens of email newsletters, reports, and videos. You can access them and learn more about my understanding of all these issues at my website: https://yourpublicmoney.com/

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I've made what I believe is a "good faith best effort" attempt to avoid errors, but in a report of this scope and complexity my guess is one or two may have snuck through. If you see an error please let me know. I'll correct it and if warranted apologize.

But there are differences among facts, analysis, and conclusions. Errors of statements of fact are often just that – errors – or the result of confusing language. Errors in analysis may be simple errors, or may be a difference of opinion about what analytical methods are appropriate and how to apply them. Errors in conclusions are often just differences of opinion. I believe I reached these conclusions "in good faith", but there's no doubt some will disagree with them.

California Public Employees' Pension Reform Act of 2013
Deeply Flawed Legislation
10/12/12

Eight Page Summary

California's Legislature passed the Public Employee's Pension Reform Act of 2013 ("PEPRA") on August 31, 2012. The Governor signed it into law in September. PEPRA completely ignored existing unfunded pension debt. All but one major provision is imposed only on new government employees. It will take 15 years before noticeable improvement. PEPRA does next to nothing to prevent continued deterioration of local and state government finances until then.

I. THE FIRESTORM THAT WILL CONSUME CALIFORNIA'S "PENSION REFORM" - EXISTING UNFUNDED PENSION DEBT

Unfunded state and local retirement debt has been allowed to grow so huge it's driving its own growth.

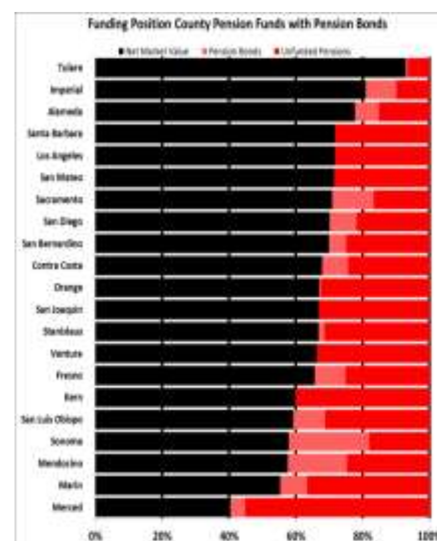
Pension Funds can't make investment profits on money they don't have. The more they are under-funded the more likely investment returns will fall short and unfunded pension debt will grow by the target rate of return. Only governments pay extra to eliminate unfunded pensions – employees and retirees have no obligation. The more unfunded debt grows the more governments pay to eliminate it, which forces them to provide fewer services, invest less in public infrastructure, and deplete reserves.

PEPRA totally avoided any reduction of existing unfunded debt. Barring a miracle in the stock market there are only two ways governments can reduce that debt –borrow money or make additional payments to the pension fund.

A. Pension Obligation Bonds and the Avoidance of the Fundamental Problems

Pension Funds will never be exactly 100% funded but should average 100%. They should never be more than 20% underfunded and then only at the bottom of "bear" stock markets. 2010 was right after such a low point in the market. Twenty one counties have their own separate County Pension Funds. In 2010 all 21 county Pension Funds were underfunded. Only 5 were in the 20% "safety zone".

You need to analyze government pension finances separately from their Pension Funds. Many counties sold "Pension Obligation Bonds" before 2010 with lower interest rates to eliminate earlier unfunded pensions. Pension Funds got the money but the counties still had the debt.



This is the counties' pension funding position shown as percentages of total pension obligations. The Pension Fund's deficit is the red area on the right - the County owes that to the Pension Fund. The light pink area is Pension Bond debt - the money is in the Pension Fund but the County still owes that to bond holders. The black area on the left is the portion of pension obligations that have been properly funded. The County doesn't owe that to anyone.

Just as Pension Funds shouldn't be more than 20% unfunded - and then only at the bottom of stock market cycles - counties shouldn't owe more than 20% of total pension obligations. The more debt beyond that the more a debt firestorm threatens. Two were in the safe range, one was close, 12 were "smoldering", 5 were twice as indebted as is "safe" they were blazing. One was 60% indebted - a profound firestorm.

All too often Pension Bonds just paper over the problems allowing governments to avoid solving them. Many won't be able to sell more Pension Bonds as debt spirals out of control. They'll be forced to use the second option.

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B. "UAAL" Amortization Payments and "Negative Amortization"

Many if not most governments plan to pay unfunded pension debt over 30 years. Payments to Pension Funds to eliminate this debt are called "Unfunded Actuarially Accrued Liability" (UAAL) Amortization payments. The full report has an explanation of the widely used "Level Percent of Payroll" method. For the first 12 years payments are less than annual interest expenses. The debt goes up – not down (negative amortization). Then payments are larger than interest but it takes 8 years to get back down to the original debt. That debt won't be paid until 20 to 30 years in the future.

How many California governments are increasing unfunded pension debt by use of the Level Percent of Payroll amortization method? It's beyond the scope of this paper to answer. The full report presents analysis of the 21 counties with their own Pension Funds. On average amortization payments were 25% less than interest. Only 3 paid more than the interest. These counties all together planned on increasing cumulative debt by over $1 billion a year (assuming all other actuarial projections come true) almost certainly because of Level Percent of Payroll amortization.

The full report presents information that CalPERS – the huge statewide system – not only uses Level Percent of Payroll but recently adopted a new method in which even if the Pension Fund achieves target rates of return governments would never pay off the unfunded debt!

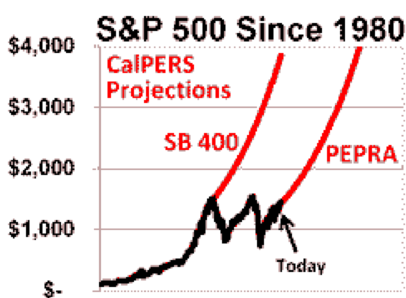
C. California Legislature's Real Bet – Huge Stock Market Profits and Increased Tax Revenue

In the absence of reducing the current value of unfunded pension debt the only hope to avoid continued serious deterioration of the finances of dozens if not hundreds of local governments and those of the State itself is some combination of a sustained miraculous bull stock market, very significant economic growth, a federal bailout, and very serious inflation along with probable attempts to significantly increase taxes.

D. Recessions, the Stock Market, Unfunded Pension Debt – The Warning of "SB 400"

Four California cities entered federal bankruptcy in the past few years - less than 1% of total cities. Several more are on the edge. But it's the next recession that's really dangerous - many more governments are likely to go bankrupt.

The US suffered 8 recessions in 35 years from 1947 through 1982 –1 every 4 years. After that recessions "spread out". The 1990 through 2000 bull market lasted a decade. The stock market quadrupled. These good times played a major role in one of the major policy blunders in California history. In 1999 the California Legislature passed "SB 400". Pensions were raised all across the state retroactively. At the time CalPERS published a brochure that stated *"a substantial portion of the cost of this package can be financed through the excess returns of the CalPERS fund without jeopardizing its future ability to meet pension obligations*" and asserted "*no increase over current employer contributions needed …*".



But an internal CalPERS memo at the time <u>that was not made public or provided to the Legislature</u> projected that if earnings were the same as the decade from 1966 through 1975 then State payments to CalPERS would be $3.95 billion in 2011. CalPERS' projection for the Legislature was State payments that year would be about $680 million. State payments turned out to be $3.9 billion – almost exactly the amount CalPERS didn't disclose was its "worst case" scenario. The Legislature didn't ask for such a scenario.

The market tanked. We've had 2 bear markets. It's just now back to where it was when SB 400 passed. The market today is about 1/3 of what CalPERS needed for their projections used to sell SB 400 to the Legislature to come true.

The current bull market is a little over 3½ years. The previous expansion lasted 4½ years. The bull market before that lasted nearly 10 years. Are we one year away from the next bear market – or 6?

The Legislature had no "worst case" scenario when it passed PEPRA. Its bet is the same as it was for SB 400 - a huge increase in stock market values and/or tax receipts. Once again they have no contingency plan if this doesn't happen. There will probably be two to four recessions before PEPRA begins to reduce unfunded pension debt because of changes in pensions for new hires. The sooner the first couple happen and the more ground that is lost the more California local government bankruptcies we will see. The Legislature did nothing to prevent this.

II. California Public Employees' Pension Reform Act of 2013 ("PEPRA")

A. How to "Sort Of" Simplify Understanding Pension Benefit "Reform"

The full report presents a way to somewhat simplify understanding changes in public pensions. First, they can affect three groups – current retirees, current employees, and employees to be hired in the future. Regarding current employees changes can affect the value of pensions earned in the past or just those yet to be earned before retirement. Second, you need to understand for each of these groups what the pension benefit is and how it is really paid.

B. The "California Rule" – Are/Should Current Employees Be Legally "Protected"?

Most officials in California and in 12 other states believe state law and constitutions prohibit them from changing the value of pensions for retirees and current employees, even for work current employees will do in the future. This "California Rule" explains why the Legislature "aimed" at future government employees not yet hired. There are numerous examples in history that if a debt is too big to be paid, it won't get paid. Federal Bankruptcy Courts change and even abrogate contracts all the time. Why can governments lay off employees and change every other aspect of their benefits but pension benefits can't be touched? One way or another the California Rule will be destroyed. The longer we wait the worse it will be for employees and perhaps for retirees.

C. What PEPRA Does

Of the dozens of analyses I've read one of the best is by San Luis Obispo City Councilman Andrew Carter who says "*Does this legislation represent 'real' pension reform? For new employees, it does. For existing employees, it doesn't*". The changes defined below are directly quoted from Carter's article.

1. Changes Imposed Only on New Employees

• New pension formulas with higher retirement ages and lower pension benefits. The pension multiplier for most public safety employees moves from 3 percent at 50 to 2.7 percent at 57 and for "all other" employees from as high as 2.7 percent at 55 and 3 percent at 60 to 2.5 percent at 67.

• A cap on the employee compensation which can be used to calculate pensions. The cap for employees who receive Social Security will be $110,100. The cap for those who don't will be $132,120. The actual pension received will be some percentage of that cap based on longevity.

• Pensions will now be calculated against an employee's highest average annual pay over three years instead of against the highest 12-month pay actually received. This limits pension spiking.

• Tighter definitions on the compensation that is pensionable. In general, just regular recurring pay — no severances, bonuses or leave payouts; no overtime unless required by 12-hour or 24-hour public safety shifts; no vehicle or uniform allowances. (Most of these items were already excluded by CalPERS.)

• A requirement that new employees pay half the "normal" cost of their pensions. The normal cost is part of the pension cost that public employers pay. When the pension fund has an unfunded liability like now, employers must kick in additional funds to pay down that liability.

2. Changes Imposed on Current and Future Employees

• After Jan. 1, employees will no longer be able to purchase "airtime" (fictional years of service) to increase their pension benefit.

• Employers will no longer be able to increase pension benefits retroactively. … most public employers, starting in 1999, awarded retroactive increases to employees without funding those increases.

• Employers will not be able to defer making pension payments unless CalPERS has a fund balance of greater than 120 percent. In the early years of the last decade, CalPERS allowed public employers to take a pension payment "holiday." (JD note – I don't know if this applies to local Pension Funds as well.)

• Public employees convicted of a felony related to their employment will forfeit pension benefits earned after the date of the felony.

• There will be new restrictions that limit a retiree's ability to return to government service. This is designed to reduce "double-dipping," but the legislation does nothing to close the primary loophole which allows it to take place. That's when a retiree from one pension system gets hired by a public employer covered by another system.

3. Change Imposed on Current Employees

After Jan. 1, 2018, employers will be able to require existing public safety employees to pay 12 percent of their pay for pensions and all other existing employees to pay 8 percent. Until that date, such payments may be negotiated freely, but cannot be imposed.

This last item requires more examination – in the next section.

4. Equal Sharing of Normal Cost for Current Employees – How Significant Is It?

PEPRA sets a "general standard" that employees should pay half the normal cost.

a) What is "Normal Cost", How Does It Relate to Unfunded Pension Debt, How is It Paid?

Actuaries analyze and report pension finances in "Actuarial Valuations". They specify two payments to Pension Funds:

- Normal Costs – split between the employer government and employees
- Unfunded Pension Amortization Payments – paid only by the employer government

NORMAL COST CONTRIBUTIONS: The Actuary estimates how much must be put into the Pension Fund next year so that if all their assumptions and projections come true there will be enough money in the Pension Fund to **pay the part of future pension payments that will be earned next year**. Even though the Actuary theoretically splits Normal Cost between governments and employees (usually not 50-50) many, perhaps most governments today pay part of or all of their employees' share of the Normal Cost.

UNFUNDED PENSION AMORTIZATION PAYMENTS: Unfunded pension debt is caused either because Normal Cost estimates were too low (by far the major reason) or it wasn't paid in full. Normal Cost Contributions have nothing to do with eliminating unfunded pension debt. Only governments pay extra to eliminate this debt.

b) PEPRA's Provisions Regarding Normal Cost

PEPRA defines three groups of employees (the percentages below are of total "pensionable" employee compensation):

- New Employees – All employees hired after 1/1/13 will pay half the normal cost and employer governments can't pay part of employee normal cost.
- Existing Employees –
  - State Employees – The Legislature asserts "Equal sharing of normal costs is currently the standard for most state employees". Presumably for other employees PEPRA sets percentages employee contributions will increase over the next two years. I can't tell if this will achieve the 50-50 standard.
  - Local Government Employees – PEPRA provides local governments the ability in 2018 to require current employees to pay Normal Cost contributions up to but no more than 12% of pay for police, county peace officers, and firefighters, 11% for other safety employees, and 8% for all other employees. Therefore employees would only be paying half the normal cost if 1) the normal cost is no more than 24% for police/county peace officers/firefighters, 22% for other safety employees, and 16% for all other employees, and 2) governments actually impose these requirements.

c) Today's "Normal Cost" Reality in Bay Area & North Coast County Pension Funds

Does the "cap" or maximum amount a local government can require its employees to contribute to the Normal Cost affect the real value of these provisions in PEPRA? The full report has analysis of four counties with independent Pension Funds that shows in 2011 total average Normal Cost was about 22%. Of that the counties' Normal Cost averaged about 11.5% and employee Normal Cost averaged about 10.5%. Much of the employee share is paid today by the counties.

d) Problems that Reduce the Value of this Supposed "50-50" Split to Local Governments

To the extent local governments pay part or all of their employees' Normal Cost, or the employee's share is less than 50%, there could be a significant transfer of payment obligation to employees thereby reducing government payments. But average employee contribution rates for employees in these counties already range from 9.8% to 12.2% averaging 10.5%. It may well be PEPRA's upper limits on employee contribution rates are already met or even exceeded today. If exceeded my reading of the law is those shares of Normal Cost will have to be reduced.

Many expect governments will give "extra raises" to in effect pay increased employee pension contributions. But governments under increasing financial pressure may not do so. Will local governments actually impose increased employee contributions (subject to these upper limits) if employee contribution rates today are lower?

But perhaps most importantly PEPRA does nothing to change the government's sole responsibility to eliminate unfunded pensions. The four counties paid average UAAL payments of 13.75% of total "pensionable" employee compensation. Several are using "Level Percent of Payroll" UAAL amortization so we can expect these payments to go up. As governments pay more towards unfunded pension debt (unavoidable for many if not most local governments and the state) the relative benefit of having employees pay more of their own Normal Cost declines.

This change will force employees to pay more of their normal cost. But the impact will be less than its "hyped up" to be.

5. The Pension Benefit Grid – What the Legislature Did

These are the major changes imposed by PEPRA presented in the grid explained in the full report.

	What the Pension Benefit Is	How They Are Really Paid For
Current Retirees		
Current Employees		
Earned in Past		
Earned in Future	• No More "Airtime" Purchase • No Retroactive Pension Increases • Some Restrictions on "Double Dipping"	• No More "Pension Holidays" for Employers • Certain groups of State Employees will Pay More of the "Normal Cost" • After Jan 1, 2018 Most Local Government Safety Employees may have to Pay up to 12% of Their Compensation for Normal Cost, Other Safety Employees up to 11%, All Others up to 8%
Future Employees	All of Above AND …	
	• Higher Retirement Age • Lower Pensions Per Year Worked • Cap on Pensionable Compensation • Pension Based on Highest 3 Years – Not Just Highest Year (to limit "Spiking") • Tighter Definition of Pensionable Compensation	• Employee Must Pay ½ "Normal" Cost

6. Other Things the Legislature Did

Government employees who are convicted of felonies won't receive pensions for the time they worked after they committed their crimes.

III. Pension Reform Done Right - Rhode Island

Rhode Island recently passed comprehensive pension reform legislation. The comparison to California is instructive.

California is big in geography, population and economy. Rhode Island isn't. California retirement benefits are set in collective bargaining agreements, in Rhode Island by the legislature. Rhode Island doesn't subscribe to the "California Rule". The Democratic Party dominates both states. Both have strong public employee unions and have had severe unfunded pension debt crises. Rhode Island's was more severe first. Rhode Island changed pensions systems and benefits four times between 2005 and 2009 each time saying they solved the problem. By 2010 it was severe.

A. Gina Raimondo Elected Treasurer – Lowers Return Assumption – Central Falls Defaults

Gina Raimondo (D) ran for State Treasurer to resolve the unfunded pension debt crisis, was elected in 11/10, and took office in January. In April she convinced the retirement system to lower the target rate of return from 8.25% to 7.5% which immediately significantly increased UAAL Amortization payments. Next month the City of Central Falls went into receivership and cut pension payments to retirees in half. Suddenly the people knew they had a very real crisis.

B. Truth in Numbers

In June Raimondo published a 14 page report to the people titled *Truth in Numbers*. Raimondo's primary objectives for Truth in Numbers were "to lay out the main reasons for the state's pension challenges, explain the implications for all Rhode Islanders, and offer a framework for devising solutions".

> *Past pension reform efforts ... have not been comprehensive enough to address the root causes of the problem. The result of this piecemeal approach is that state employees and teachers have endured several rounds of changes to their benefits, which have produced anxiety and insecurity, while the system remains woefully underfunded. The task ahead is to move swiftly to outline solutions, and to avoid the temptation to rush reforms that may be ill-designed or incomplete.*

Raimondo told the people their small state of 1 million people owed from $7 to $9 billion in unfunded pension debt. She identified the key causes of the debt. She told the people what would happen if the crisis wasn't resolved. She laid out a framework for solutions. She laid out five guiding reform principles. She finished by saying it's unfair to ask taxpayers to pay rapidly growing unfunded pension debt created by failures to properly manage pensions in the past, and it's dishonest to let state employees, teachers and retirees believe that full benefits will be there for their retirement given the deep problems in the current system. The time to act is NOW.

C. One-Hundred Community – Union Meetings in Ten Months

During her first 10 months in office Raimondo attended 100 community meetings where she delivered this message to angry crowds of employees and retirees. She told them it wasn't their fault – they did what they were asked to do but were failed by past politicians and union leaders. She said they were talking about Cost of Living Adjustments today, but if real reform wasn't passed they'd be talking tomorrow about whether retirees would even get pensions.

D. Pension Reform Commission

After *Truth in Numbers* was published Raimondo put a 12 person commission together to develop specific pension reform proposals that included 4 public union members. A proposed reform package was produce in 2 months.

E. Legislature Passes Pension Reform by Overwhelming Margin

Governor Lincoln Chaffee called the Legislature into Special Session to deal only with pension reform. Chafee and Raimondo presented the reform package in October. The Legislature dominated by pro-labor Democrats passed the most extensive pension reform legislation in US history by a very large margin 10 months after Raimondo took office.

F. Major Pension Changes and Financial Impact

Actuarial projections were provided before the Legislature voted on the bill that State unfunded pension debt and pension fund contributions would be cut 40% the next year. Some of the most significant changes were:

- Cost of Living Adjustments (COLA) for retirees were suspended until the Pension Fund was at least 80% funded and the Pension Fund's 5 year average return was at least within 2% of target - although there will be an automatic increase at least once every five years.
- Retirement ages were increased for future and current employees except those near retirement.
- A "Hybrid System" was imposed with a much smaller guaranteed pension and a defined contribution plan.

G. Motivations

> *"A government that doesn't work is in no one's interest ...Budgets that don't balance, public programs that aren't funded, pension funds that are running out of money, schools that aren't funded — How does that help anyone? I don't really care if you're a Republican or Democrat or you want to fight about the size of government. How about a government that just works? Put your tax dollar in and get a return."*
>
> *"I'm generally upset and saddened by all the antigovernment rhetoric that is in our country today," Ms. Raimondo says. "I respect public employees and school teachers. They deserve a secure retirement.*
>
> *From the pews of the church, Cindy Gould, a fourth-grade teacher, said that under the current system, she had 11 years to go until retirement. Under Ms. Raimondo's plan, she might have to work longer. But, Ms. Gould, 54, said she was willing to do so if that meant the elderly would get the medical care they need.*

H. Rhode Island Gets an A, California a D-

Unlike in Rhode Island, in California there was no honest identification of the causes of the unfunded pension debt. There were no capable projections of the impact of these debts on core public services. There was no identification of the financial change needed to restore government's ability to provide services. PEPRA is a set of disjointed actions focused on changing pensions for new employees that won't have a significant impact on the problem for 2 decades!

IV. Financial Impact – Rhode Island v. California

The full report gives examples of the analysis in Rhode Island v. California. Rhode Island cut unfunded pension debt and government payments by 40%. California didn't cut unfunded pension debt at all and reduced payments not even 2%.

V. What California's Legislature and Governor Didn't Do

Most people think "pension reform" means changing what pension benefits are. Yes – pension benefits must be changed, but many other types of changes are desperately needed. California failed to:

A. Financial Failures

1. Reduce and Restructure Existing Pension Debt

Gina Raimondo had this to say about ignoring unfunded pension debt.

> *"A lot of people say we've done pension reform when all they've done is tweaked something ... This problem will not go away, and I don't know what people are thinking. By the nature of the problem, it gets bigger and harder the longer you wait.*

That is precisely what California did. The debt is too big, it can't be paid. The longer we wait the worse it's going to get.

2. Greatly Reduce Local and State Government Guarantees to Eliminate Perverse Incentives

Governments guarantee pensions. That means poor investment returns, bad planning and terrible management has no impact on pensions. In the short term employees seem to get a "better deal" from the development of huge unfunded pension debts. Less money is taken from their paychecks as their "Normal Cost" contribution because actuaries underestimate how much really needs to be put into the Pension Fund. But they still get their guaranteed pensions. Politicians used to have more money to spend on things. They earned political credit from unions for promises about pensions – yet didn't have to pay a large part of their cost. Politicians and government employees run government Pension Funds. Is there any question why we have so much unfunded pension debt given these perverse incentives?

Rhode Island's move from guaranteed pensions to making retirement benefits more a function of economic growth and good Pension Fund management will have a powerful transformative effect on the attitudes of government employees and retirees. There's still a core promise of a basic income in retirement. But it aligns their interests with producing strong well managed Pension Funds and removes perverse incentives that rewarded actions that weaken Pension Funds.

3. Provide a Comprehensive Long-Term Financial Solution.

Gina Raimondo laid out what the unfunded pension debt really was and how it was likely to develop. She demonstrated the disaster that was unavoidable if major changes weren't made. She identified the main causes of that debt. She quantified how much both the debt and government payments needed to be reduced so pensions would be sustainable and necessary public services would be provided at a price that was fair for the people.

She and her team put together a comprehensive set of changes that would achieve those target reductions in debt and government payments, secure reasonable and secure retirements for public employees, and produce the public services the people deserve at a price that was fair to ask them to pay.

California's Public Employee's Pension Reform Act of 2013 doesn't come close.

B. Organizational – Legal – and Accountability Failures

We have several non-financial severe problems that PEPRA completely failed to confront.

1. Serious Reform of Retirement Boards and the Laws Governing Retirement Systems

No one is more responsible for creating this crisis than Retirement Boards. Not all failed their duty – too many did. They are dominated by government employees and retirees and politicians. All too often they are driven by the perverse incentives described above. Most are not anywhere near competent enough to oversee financial organizations.

California's Retirement Laws create many major problems. They are in serious need of major revisions.

2. Deep Reform of Local and State Government Financial Management

These excessive debts developed because of deeply flawed financial management systems and structure, and all too often internal cultures that favored obfuscation and the elevation of short-term expediency and political goals over the long-term welfare of the community – although there are also many examples of very praiseworthy performance. Significant reform of local and state government financial management is needed in California.

3. Strong, Effective Believable State Oversight of Local and State Pension Funds

There has been a hugely negligent default of responsibility by State and Federal agencies that should have been exercising reasonable oversight of California's pension funds – especially those at the local level. What's the point of laws and regulatory requirements if no agency with the responsibility to enforce the law will ever do so?

California Public Employees' Pension Reform Act of 2013
Deeply Flawed Legislation
10/10/12

California's Legislature passed the Public Employee's Pension Reform Act of 2013 ("PEPRA") on August 31, 2012. The Governor signed it into law in September. This analysis begins with what I see as PEPRA's Achilles' heel – it completely ignored unfunded pension debt that already exists. All but one of its significant provisions are imposed only on new government employees. It will take 15 years before we see noticeable improvement. PEPRA does nothing to prevent continued deterioration of local and state government finances until then.

I. THE FIRESTORM THAT WILL CONSUME CALIFORNIA'S "PENSION REFORM" - EXISTING UNFUNDED PENSION DEBT

Wildfires sometimes get so big they create their own weather. Huge fires create winds ten times more powerful than those around them. "Forward Bursts" shoot flames hundreds of feet up to 100 mph. "Fire Whirls" are burning tornadoes hurling flaming material over vast areas.[1]

Would you send one fire truck to put out such a fire? It's impossible. That's what PEPRA is – one fire truck sent to fight an out-of-control firestorm.

Unfunded state and local retirement debt has been allowed to grow so huge it's driving its own expansion. PEPRA tries to prevent fires 2 decades in the future but completely ignores today's debt firestorm. Here's an explanation using the state's 21 counties that chose not to participate in CalPERS (statewide public employee retirement system) but opted instead to have their own county Pension Funds. They owe 17% of total state and local government pension obligations.

Governments guarantee pension fund investment profits. In 2010 these counties guaranteed profits from 7.75% to 8.16% - averaging 7.9%. If returns fall short counties must make it up. The guaranteed profit is not on what the pension fund invests – it's on what the fund is supposed to have – total pension liability. In fact – the "target rate of return" is **really an annual interest rate** on the average **total pension obligation** in a year[2].

County Pension Funds were supposed to have $130 billion in 2010. They needed to earn $10.3 billion (7.9% of $130 billion). But based on market value of assets they were 27% under-funded. They only had $95 billion to invest. If they achieved their target rates on what they had to invest they'd make $7.5 billion - $2.8 billion short. If all other actuarial projections came true those counties would incur an interest expense of $2.8 billion. Deficient earnings is a major cause of underfunded pension funds but there are several others including inaccurate projections, diversions of money to pay other benefits, inadequate yearly contributions, etc. But whatever the cause …

Pension Funds can't make investment profits on money they don't have. The more they are under-funded the more likely investment returns will fall short. And - the more likely government unfunded pension debt will grow. Only governments must pay additional money to eliminate unfunded pension debt – employees and retirees have no such obligation. The more unfunded pension debt grows the more money governments have to pay to eliminate it, which forces governments to provide fewer public services, invest less in public infrastructure, and deplete reserves.

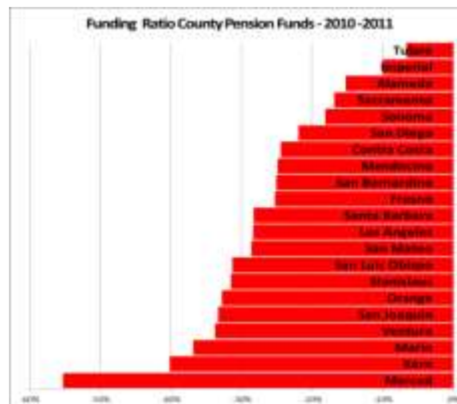
That's not a moral or a political statement. It's a financial math statement.

Unfunded state and local pension debt has gotten so big in California it's acting like these firestorms. It's creating its own "wind". It's growing itself. As we will see below the State of Rhode Island directly reduced the level of existing unfunded pension debt government had to pay – but California's PEPRA totally avoided any "write-down".

That leaves two ways governments can reduce unfunded pension debt –borrow money or make additional payments as if they borrowed money from the pension fund. But the way many if not most governments in the state implement these two choices is increasing the debt firestorm's intensity and making it more destructive as we will see below.

A. Pension Obligation Bonds and the Avoidance of the Fundamental Problems

Pension Funds will never have exactly the money they're supposed to have but on average they should be fully funded over the long-run. Many analysts say they should not vary more than 20% from being fully funded. At the low point of a business cycle they could be 20% under-funded, at the top they should be about 20% over-funded.

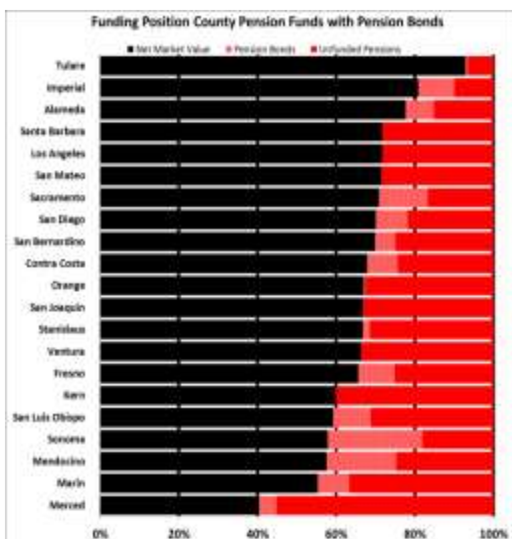


This shows the funding position of the 21 independent County Pension Funds based on investment market value according to their most recently available Actuarial Valuations (mostly 2011, some 2010).

They were all underfunded. Now - this is right after the market melt-down of 2008-09. If cycles in the future "act like" the past few decades this is a low point. But only 5 of these 21 are within the 20% "safety zone".

The average target rate of return and hence interest rate charged on unfunded pension debt for 15 years before 2011 was 8%. Many counties sold "Pension Obligation Bonds" with lower interest rates to eliminate earlier unfunded pensions trying to obtain lower interest rates. The form of the debt changed but the cause remains unfunded pension debt.

It's important to distinguish between the financial positions of Pension Funds v. that of their sponsoring governments. When governments borrow money by selling Pension Bonds the Pension Funds get the money, the government and its people keep the debt. It improves the finances of the Pension Fund – it doesn't change the government's debt.

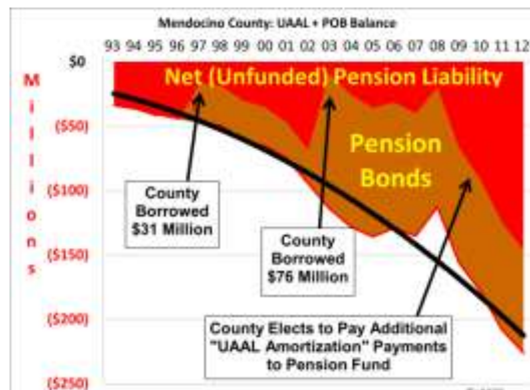


Here's the counties' pension funding position including Pension Bonds as of 2010. Unfunded pensions on the right are red. The light pink area is Pension Bond debt. These two are the total county unfunded pension debt. The black area is the portion of Pension Fund assets the county didn't borrow. It's a measure of how well these counties and their pension funds achieved their pension funding goals.

In the graph above, Alameda, Sacramento and Sonoma's pension funds appear to be less than 20% underfunded but only because the counties borrowed Pension Bonds. Alameda's close – but Sacramento and especially Sonoma are way below. When we consider Pension Bonds only two of 21 County Pension Funds are within the 20% safety range.

For governments with significant balances owed on Pension Bonds it is extremely deceptive not to include those in analyzing the impact of unfunded pensions on governments and their ability to provide the services and infrastructure the people expect.

The graph to the right shows the all-too-typical pattern for governments that borrowed money by selling Pension Bonds. Mendocino County sold Pension Bonds in fiscal years 1997 and 2003. The Pension Fund had more money but the county's total unfunded pension-created debt just kept growing. The solid black line shows the trend over these 2 decades.



Mendocino County and dozens of other local governments never confronted the true causes of their increasing unfunded pension debt. They papered the problem over by borrowing more and more money – and the debt just kept growing. But they are running out of time – there is a limit to how much they can borrow.

This trend line cannot continue.[3] Local and state governments will increasingly not be able to sell Pension Bonds as their debt spirals out of control. They will be forced to use the other option to reduce unfunded pensions, described next.

B. "UAAL" Amortization Payments and "Negative Amortization"

As stated above when unfunded pensions get too big governments have to pay more money either to pay off Pension Bonds or to pay extra money to the Pension Fund. Both types of payments are defined in what's called "amortization[4] schedules" – tables showing how much is paid each period (say, each year), of that how much is paid in interest and how much in principal, and what the beginning and ending balance of the debt is each period. Most amortization schedules eliminate the debt in a specified timeframe.

When governments make payments directly to the Pension Fund to eliminate unfunded pension debt those are "officially" called "Unfunded Actuarially Accrued Liability" (UAAL) Amortization payments. (There are several complex issues regarding how to value unfunded pensions that are beyond the scope of this paper – one of which is "Actuarial" v. "Market" calculation methods. They aren't the same although over time their average values are close.)

Very few concerned citizens know that many if not most of today's government UAAL Amortization payment schedules actually increase the debt. The unfunded pension debt firestorm once again is made more intense as a direct result of choices made by government officials.

Many governments have adopted 30-year amortization periods. (Some governments chose considerably shorter periods.) As stated above the interest expense is the Pension Fund's target rate of return. The remaining question is how much the payments will be. And – here's the rub.

There are two main methods of figuring out what the payments will be. Let's **assume**:

Unfunded Pension Liability	$50 Million
Target Rate of Return (Interest Rate)	8%
Number of Years (Term)	30
Beginning Total Payroll	$75 Million
Annual Growth of Payroll	4%

For simplicity we'll assume one payment per year at the end of the year.

1. Level Dollar Amortization

This is like the best known amortization schedule - the "classic" 30-year fixed payment and interest rate home mortgage. The borrower pays the same amount each period (monthly for mortgages). In the early years most of the payment goes to interest and only a little pays down the debt. But each month the debt decreases so next month there's slightly less interest expense and a little more debt gets paid down. At some point the part of payments that goes to interest starts to rapidly decline and more and more goes to pay off the debt until finally the debt is paid in full.

Governments can chose to amortize unfunded pension debt for up to 40 years in some cases, but can choose to do so over a shorter number of years. Level Dollar Amortization means the plan is to pay the same amount of dollars each year. Payments are more than interest expense so the debt begins to be reduced starting with the first payment (assuming all other actuarial assumptions come true so the debt doesn't change because of other factors).

2. Level Percent of Payroll

Here's where the trouble lives!

Instead of making the same dollar payment every year (Level Dollar), this method makes the **payments the same percentage each year of projected payroll**. First total payroll is projected for the number of years chosen as the amortization period. The assumption is that total payroll will grow by the same percentage each year. Then a set percentage of each year's projected payroll is calculated that would eliminate the unfunded pensions over the number of years in the amortization period. That percentage of each year's payroll is what is projected to be each year's payment.

In our example the first year's payroll is assumed to be $75 million. We assume that will grow exactly 4% each year so next year's payroll will be $78 million and so on until payroll 30 years from now is assumed to be $233.9 million.

It turns out that if 3.93% of each of those yearly payrolls is paid to the Pension Fund then the beginning unfunded pension debt of $50 million will be eliminated after 30 years – assuming those payroll values "come true".

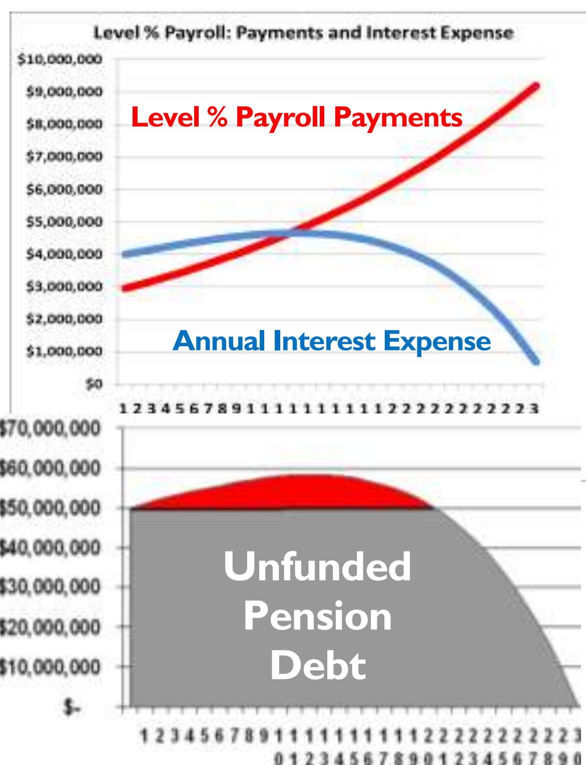
In this example the level dollar amortization payment would be $4.44 million a year for 30 years. Level percent of payroll starts at about $2.9 million then grows at 4% (assumed growth of payroll) and ends up at over $9 million in the last year.

Proponents of level percent of payroll payments make two arguments. First, since governments already pay a set percent of payroll as their "normal" pension contribution this is the easiest method to implement. Second, since payments grow presumably as the total budget grows this method takes the same economic bite out of government finances in each of those 30 years so the "pain" is spread out.

But there's another "advantage". As shown in the graph the Level Percent of Payroll method produces lower annual payments for many years – in our example for 12 years. Then at some point in the future payroll and therefore payments grow so that payments are larger than the Level Dollar method. The first year's payment – the one made by those who make the decision to use Level Percent of Payroll – is $1.5 million less. By the time the cross-over point happens in year 12 Level Percent payments will have been a total of $9 million less.

The Level Percent of Payroll method makes those payments easier on officials who decide which method to use!

But there's a huge problem – Negative Amortization which means that instead of reducing a debt, **the payments actually increase the debt.** Level Percent of Payroll produces negative amortization in the early years because **payments are less than the interest**. Unpaid interest expenses increase the debt.



This shows the annual payment in the Level Percent of Payroll method and annual interest expense. Total interest in the first 12 years is $52.6 million. Total payments are only $44.4 million. The government's unfunded pension debt will grow $8.2 million – assuming all other actuarial assumptions come true.

The bottom graph shows the balance of unfunded pension debt in this example. The government is actually PLANNING to increase unfunded pension debt by $8.2 million, or 16% of its beginning debt, over those 12 years! It's built into their own plans.

Then after year 12 finally payments are supposed to have grown enough to be more than interest expense and the debt starts to go down. But it takes another 8 years before the debt is back down to the level it was at the beginning. The plan is for the entire dollar amount of this debt to be paid in the decade between years 20 and 30 – an entire generation in the future!!!

This table shows the total dollar difference between the two amortization methods. Both pay off the original debt of $50 million. But the total interest expense paid in the Level Percent of Payroll method is $32 million more than that paid in the Level Dollar method.

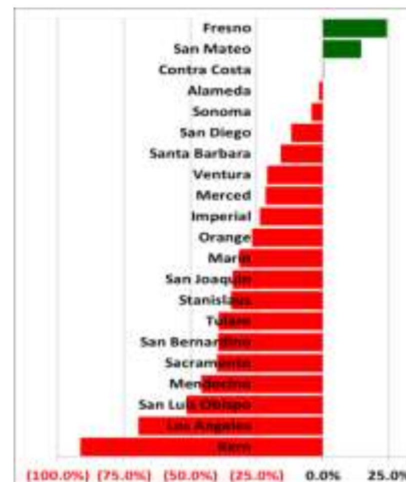
	Level Dollar	Percent of Payroll
Debt Paid	**$ 50,000,000**	**$ 50,000,000**
Interest Paid	**83,241,150**	**115,520,463**
Total Payments	**$133,241,150**	**$165,520,463**

Is this the decision people in office and citizens 20 years from now want today's officials to make? Probably not – but today many of those future citizens have no voice and very few are in office. Today's officials can choose to use the Level Percent of Payroll method to avoid the need to find more than $5 million (as in this example) of additional budget cuts over the next four years of their term – and shove the obligation to pay over $30 million more onto the next generation.

Now – how much of a real problem is this? How many California governments are paying unfunded pension amortization payments, how many are using Level Percent of Payroll, and where are they in the debt schedules – are they still in the first 12 years increasing debt, or are they finally paying down debt?

Those are the details of a larger question – how many California governments are actually increasing the ferocity and destructiveness of the government unfunded pension debt firestorm by their use of the Level Percent of Payroll amortization method?

It's beyond the scope of this paper to answer these questions completely. We'll examine them in terms of the 21 counties with their own Pension Funds.



This shows the percentage that county Pension Fund deficit payments were over or short of interest expense. (The base data is from the most recent Actuarial Valuations available when this analysis was done this past summer – a mixture of 2010 and 2011.) Together these counties paid about $1.7 billion. But as we saw on page 1the total interest based on target rates of return was $1.1 billion more. Over the 21 County Funds payments on average were 25% less than the interest. Only 3 counties paid more than the interest - Fresno, San Mateo and Contra Costa (just barely), Kern's payment of $12.3 million was $133 million short of the imputed interest expense and increased the pension deficit by 7.1% in one year! (This assumes the data obtained for this report is correct – see "foreward").

Through this mechanism alone these counties all together planned on increasing their cumulative debt by over $1 billion a year (assuming all other actuarial projections come true) almost certainly because of the use of the Level Percent of Payroll amortization method by almost all of these counties.

My focus has been the 21 counties that do not participate in CalPERS. I haven't invested anywhere near the effort researching or analyzing the big statewide systems or other types of independent local government systems. However negative amortization and other techniques that produce increased debt appear to be available for use in most if not all these other systems as well. This is from a Power Point presentation to the Stockton City Council in 2006 by Lehman Brothers regarding the City's proposed sale of Pension Obligation Bonds[5] to reduce their unfunded pension debt to CalPERS (oh what a quagmire in that sentence!):

Understanding the CalPERS Changes

Pension Funding & POB Overview

Due to CalPERS' new amortization methodologies, UAAL balance is likely to have grown

- CalPERS charges the City annual interest rate of 7.75% on its UAAL
  - Under prior methodology, payment grew by 3.25% annually to match expected growth in payroll
  - UAAL was fully amortized over a finite 30-Year term
- CalPERS changed the actuarial assumptions it uses to amortize its UAAL
  - Amortization is now calculated on a 30-year "rolling" basis
  - UAAL balance continues to grow because accumulated balance in Year 2 is re-amortized over a new 30-year term which has a negative amortization
  - Absent earnings greater than 7.75%, balance is expected to grow to $216.7 million in 2037

Previous 30 Year "Fresh Start" Amortization[1]

UAAL Amortization Balance

New CalPERS "30 Year Rolling" Amortization[1]

Balance grows to $216.7 million

UAAL Amortization Balance

1. Source: John Bartel & Associates

LEHMAN BROTHERS 2

This slide discusses a recent change in CalPERS' method to amortize the City of Stockton's (and other local government's) UAAL ("Unfunded Actuarially Accrued Pension Liability" – or unfunded pension debt). The top graph shows the UAAL balance under the previous CalPERS amortization system – which clearly is the same "negative amortization" UAAL balance curve shown on the previous page. But under the new CalPERS system shown in the lower graph even if returns were precisely the target rate of return of 7.75% then Stockton's beginning UAAL balance of $152 million would actually increase to $217 million over 30 years. It would never get paid off!

More evidence - this is from "Agenda Item 6" of the 2/19/03 CalPERS Benefits and Program Administration Committee meeting written by CalPER's chief actuary regarding "30 year Amortization extension Policy Guidelines:

> *With an amortization of the unfunded liability over thirty years as a level percent of payroll (which is expected to grow at 3.75% annually), the first 13 years of the amortization payment is less than the annual interest on the unfunded liability. This produces negative amortization and, without offsetting gains, the unfunded liability increases (by about 15%) during the first 13 years of the amortization period. Then, from the 14th through 30th year, the payment on the unfunded liability exceeds the interest and the unfunded liability is brought to zero in the 30th year. The actuaries will look at the projected unfunded liability to analyze whether the projected unfunded liability and the required payments remain manageable over the 30-year funding period.*

It's a safe assumption that many if not most governments in California are using unfunded pension debt amortization methods that are actually increasing the debt today because of negative amortization – whether Level Percent of Payroll Amortization or other schemes such as that for CalPERS described by Lehman Brothers to the City of Stockton. And since the bulk of unfunded pension debt was created as a result of the 2007-09 stock market debacle we can also safely assume governments using the Level Percent of Payroll method are still in the early years of their payments so that they are increasing their underlying debt – or at least making it more than it would be with a Level Dollar payment method.

Negative Amortization of unfunded pensions is a powerful impetus to California's unfunded pension debt firestorm.

C. California Legislature's Real Bet – Huge Stock Market Profits and Increased Tax Revenue

In the absence of reducing the current value of unfunded pension debt I believe the only hope to avoid continued serious deterioration of the finances of dozens if not hundreds of local governments and those of the State itself is a combination of a sustained miraculous bull stock market and very significant economic growth in California that translates into greatly increased government revenues and/or significant increases in tax rates.

If these don't occur the existing unfunded pension debt is so huge that a very large number of California local and state government pension funds are so underfunded they simply don't have enough money to invest to earn enough to restore adequate funding. Their sponsoring governments will be obligated to pay more and more money to their pension funds – one way or another – to make it up.

Without miracles it will take two decades more or less before the people see a significant improvement in pension funding ratios from the combination of "savings" achieved by reductions in pensions for employees hired in the future and the passing away of current retirees and those soon to retire. And that's assuming near-target investment profits.

PEPRA has many more failings than this complete avoidance of the threat posed by existing unfunded pension debt (see page 20) – but this dynamic alone almost certainly condemns PEPRA to fail to prevent more and more government layoffs and the continued destruction of the public services and deterioration of public infrastructure the people expect and need over the next 2 decades.

D. Recessions, the Stock Market, Unfunded Pension Debt – The Warning of "SB 400"

When the healthy catch a cold the weak catch pneumonia. So it is with governments and debt – during bad economic times governments with low debt have budget "challenges" but those with too much debt have crises. Recessions throw people out of work increasing unemployment and social stress thereby increasing the demand for a range of government services. But they also reduce government revenues – lower property and income tax receipts. Pension Fund investments lose value during "bear" stock markets thereby increasing government unfunded pension debt which leads to increased payments from the government to eliminate that debt.

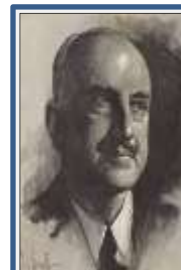
California has 58 counties, about 480 cities, and perhaps a couple thousand special districts that aren't component units of cities or counties. In recent years 4 cities filed for federal bankruptcy – less than 1%. Several others are rumored to be vulnerable. Although tough economic challenges remain in many jurisdictions the stock market has significantly improved since its low point in October, 2007 gaining back in total the value lost in the bear market that started in April, 2007.

While this number of cities filing bankruptcy is unusual historically, what will happen during and immediately after the next downturn in the economy and stock market? That's when excessive unfunded pension debt loads will really impose their damage.

The US suffered 8 recessions in the 35 years from 1947 through 1982 – an average of about 1 every 4 years. After that the recessions "spread out" considerably. This table shows the last 3 recessions and declining stock markets and the following "bull" markets – the current period of market growth since the "bottom" is now 3 years 8 months.

Recessions: Gross National Product			S&P 500 (Shaded rows are bear markets)		
Period	Duration	Change	Period	Duration	Change
7/90 – 3/91	8 months	-1.4%	6/90 – 10/90	5 months	-15%
			11/90 - 8/00	9 yrs 9 mths	+399%
3/01 – 11/01	8 months	-0.3%	9/00 – 2/03	2 yrs 6 mths	-45%
			3/03 – 10/07	4 yrs 7 mths	+84%
12/07 – 6/09	18 months	-5.1%	4/07 – 2/09	22 mths	-53%
			7/09 – 10/12	3 yrs 8 mths	+99%

Sources: Wikipedia http://en.wikipedia.org/wiki/List_of_recessions_in_the_United_States,
Yahoo! Finance website: https://finance.yahoo.com/q/hp?s=%5EGSPC



Those who cannot remember the past are condemned to repeat it.

***The Life of Reason*, Vol 1**, George Santayana, 1906

The bull market from November 1990 through August 2000 lasted almost a full decade. The S&P 500 stock market index quadrupled. These seemingly incredibly good times played a major role in what in retrospect was one of the major policy blunders in California history. In 1999, just one year before the "dot-com bubble" burst, the California Legislature passed "SB 400" unanimously in the state Senate and 70 to 7 in the Assembly. SB 400 very significantly raised pensions for public employees and allowed increased benefits to be applied retroactively. At the time CalPERS published a brochure[6] that touted the plan.

> *(page 5)*
>
> *HOW WILL IMPROVEMENTS BE FINANCED?*
>
> *CalPERS has enjoyed excess earnings in its fund, as a result of the booming stock market and investment strategies of the CalPERS Board. A substantial portion of the cost of this package can be financed through the excess returns of the CalPERS fund without jeopardizing its future ability to meet pension obligations.*

(page 7)

IMPACT ON THE STATE OF CALIFORNIA

Taxpayers – No increase over current employer contributions I needed for these benefit improvements.

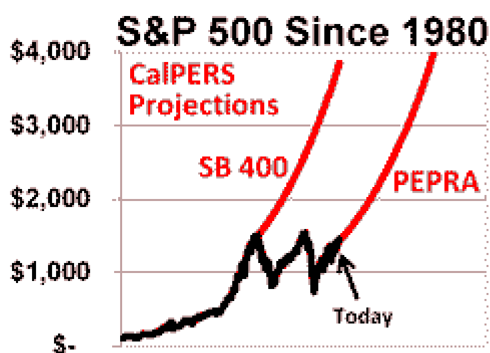
(page 13 - quoting from a resolution by the CalPERS Board)

WHEREAS, during the past ten years, CalPERS has earned an annual return of 13.5% on its investments;

The brochure stated CalPERS' returns for the four years ending in 1998 were 16.31%, 15.31%, 20.09%, and 19.50%.

CalPERS stated in the brochure that there would be no need for contributions to increase as a result of these greatly increased benefits – the good times would roll on forever, it seemed. SB400 kicked of a vigorous round of retroactive pension increases all across California at the state and local levels. And then the "dot com bubble" burst erasing half the gains of the previous decade.

SB400 passed almost at the end of a 10 year stock market run in which values increased 400%. Since then we've had 2 bear market in which each time the market lost half its value. The market is just now back to where it was when SB 400 was passed.



CalPERS "official" forecast when SB 400 was passed was it would earn 8% on average every year. Now – in fact that means its return on investments in the stock market needed to be significantly higher because a lot of CalPERS' portfolio is in "safe – low risk" investments such as bonds that yield lower returns. But if we apply the 8% growth rate to the S&P 500 index the market would have been about $3850 by now. It's at 1460. As I say the stock market would have had to have grown more than CalPERS' target average returns – say to about $4800. The market is somewhere between 30% to 40% of what CalPERS needed it to be in order for their projections they used to sell SB 400 to the Legislature to come true.

In that context there's another story that needs to be told about SB 400 so that "we can remember the past – and not be condemned to repeat it". From CalPensions.com – a report published 7/27/10:

> *As CalPERS publicly said a decade ago that a major pension increase … could be paid for with investment earnings rather than higher state costs, its actuaries made a startlingly accurate forecast of the impact if earnings fell short.*
>
> *The actuaries said the annual state payment to CalPERS, $159 million in 1999, could soar to $3.954 billion in fiscal 2010-11 — a long-range forecast that scored a near bull's-eye on the $3.888 billion state payment for the fiscal year that began this month.*
>
> *Legislators were told in a 17-page CalPERS brochure that the pension increase, SB 400 in 1999, would not increase state costs. And as* critics have pointed out, *the brochure did not mention the state would have to pay if investments faltered.*
>
> *But the agenda for a meeting of the CalPERS benefits committee meeting on June 15, 1999, shows that the board was informed of the risk. … The board was given "hypothetical scenarios" of what would happen under three different investment returns during a 10-year period that ended, as it happens, with the current fiscal year.*
>
> *If investments hit the earnings target assumed by CalPERS … the state payment this fiscal year (note – fiscal year 2010-11 when this report was written) would be $679 million.*
>
> *But if earnings during the decade averaged 4.4 percent, a repeat of the decade from 1966 to 1975, the state payment would be $3.954 billion.*

The State of California's yearly payments to the pension fund increased from $159 million to $3.9 billion since SB 400 was passed[7]. CalPERS didn't tell California legislators about its "low-investment return" scenario, but its projected state payment to CalPERS turned out to be spot-on.

But more to the point of this paper – **there were no provisions in SB400 that would accommodate what would happen if investment returns were considerably below CalPERS' projections**. If market returns were below expectation that would be big trouble – and that's what happened.

The current bull market is a little over 3½ years. The previous expansion lasted 4½ years. The bull market before that lasted nearly 10 years. **Are we one year away from the next bear market – or 6?**

Keep in mind **the pension increases granted in SB 400 are still in place for everyone hired through 2012** unless their government employer reduced benefits in the meantime for new hires – mostly not what happened. At the time SB 400 was passed **CalPERS projected the stock market today would be about 3 times higher than it is**. We are bearing the debt burden caused by the Legislature basing its decision on this deeply flawed CalPERS projection of the stock market with no provision for how to avoid today's huge debt if the stock market didn't achieve the projection.

It's nothing short of astonishing that the CalPERS Proposal, which promoted the largest non-voter approved debt issuance in California history, was not accompanied by disclosures of risks or conflicts of interest. Frankly I've never seen anything like the CalPERS sales document, which makes even Goldman Sachs's alleged non-disclosure look like child's play.

This episode illustrates the perverse nature of CalPERS's governance. The party with 100% of the risk and 0% of the upside – i.e., the citizenry – has no control over CalPERS. Indeed, what little influence the citizens have, which comes through the officials they elect and who sit on CalPERS's board, is diluted because those officials can receive contributions from CalPERS's beneficiaries and others, such as money managers who earn fees from CalPERS.

David Crane – Testimony to Legislative Committee May 2010

The Legislature's bet in PEPRA is the same as it was for SB 400 - a huge increase in stock market values and/or tax receipts. Once again they have no contingency plan if this doesn't happen.

There will probably be two to four recessions before PEPRA begins to noticeably reduce unfunded pension debt because of changes in pensions for new hires. The sooner the first couple happen and the more economic and stock market ground that is lost the more California local government bankruptcies we will see. The Legislature did nothing to prevent this.

II. California Public Employees' Pension Reform Act of 2013 ("PEPRA")

This section briefly describes some of the changes the Legislature made in what pension benefits are.

A. How to "Sort Of" Simplify Understanding Pension Benefit "Reform"

Pension benefits can be very complicated to understand. A helpful way to somewhat simplify them is to think about them in "two dimensions". The first dimension is the differences among three different groups of public employees – current retirees, current employees, and future employees. (Pension benefits for current employees who have already been hired must be thought of in two time frames as shown below.) The second dimension is what the benefits are and how they are really paid for. I emphasize the word "really" because all too often what the public is told about how pension benefits are paid for isn't "really" true.

Who is Affected?	What the Pension Benefit Is	How They Are Really Paid For
Current Retirees		
Current Employees		
Benefits Earned in the Past		
Benefits to be Earned in the Future		
Future Employees Not Yet Hired		

B. The "California Rule" – Are/Should Current Employees Be Legally "Protected"?

An excellent recent legal review[8] presents one of the most powerful issues facing California pension reform:

> *In many states … courts have held that the same statutes that established state retirement systems also created a contract between the state and its employees that cannot be impaired. In particular, courts in California and the twelve other states that have adopted California's precedent have held not only that state retirement statutes create contracts, but that they do so as of the first day of employment. The practical result of this rule is that pension benefits for current employees cannot be detrimentally changed, even if the changes are purely prospective. Thus, the only readily available option for changing employee pension benefits in these states is to limit such changes to new hires.*

An adequate discussion of this complex legal, financial and moral issue is beyond the scope of this review of PEPRA, but the "California Rule" explains why the California Legislature's actions are primarily "aimed" at future government employees who have not yet been hired.

The California Rule is an attempt to deny very unpleasant economic reality. There are numerous examples in history that if a debt is too big to be paid, it won't get paid. Federal Bankruptcy Courts change and even abrogate contracts all the time. And what exactly is the logic that allows governments to lay off employees and change every other aspect of their benefits but pension benefits can't be touched?

One way or another the California Rule will be destroyed.

C. What PEPRA Does

Of the dozens of analyses I've read one of the best is by San Luis Obispo City Councilman Andrew Carter[9] who says -

> *Does this legislation represent "real" pension reform? For new employees, it does. For existing employees, it doesn't.*

The changes defined below are directly quoted from Carter's article.

1. Changes Imposed Only on New Employees

• New pension formulas with higher retirement ages and lower pension benefits. The pension multiplier for most public safety employees moves from 3 percent at 50 to 2.7 percent at 57 and for "all other" employees from as high as 2.7 percent at 55 and 3 percent at 60 to 2.5 percent at 67.

• A cap on the employee compensation which can be used to calculate pensions. The cap for employees who receive Social Security will be $110,100. The cap for those who don't will be $132,120. The actual pension received will be some percentage of that cap based on longevity.

• Pensions will now be calculated against an employee's highest average annual pay over three years instead of against the highest 12-month pay actually received. This limits pension spiking.

• Tighter definitions on the compensation that is pensionable. In general, just regular recurring pay — no severances, bonuses or leave payouts; no overtime unless required by 12-hour or 24-hour public safety shifts; no vehicle or uniform allowances. (Most of these items were already excluded by CalPERS.)

• A requirement that new employees pay half the "normal" cost of their pensions. The normal cost is part of the pension cost that public employers pay. When the pension fund has an unfunded liability like now, employers must kick in additional funds to pay down that liability.

2. Changes Imposed on Current and Future Employees

• After Jan. 1, employees will no longer be able to purchase "airtime" (fictional years of service) to increase their pension benefit.

• Employers will no longer be able to increase pension benefits retroactively. … most public employers, starting in 1999, awarded retroactive increases to employees without funding those increases.

• Employers will not be able to defer making pension payments unless CalPERS has a fund balance of greater than 120 percent. In the early years of the last decade, CalPERS allowed public employers to take a pension payment "holiday." (JD note – I don't know if this applies to local Pension Funds as well.)

• Public employees convicted of a felony related to their employment will forfeit pension benefits earned after the date of the felony.

• There will be new restrictions that limit a retiree's ability to return to government service. This is designed to reduce "double-dipping," but the legislation does nothing to close the primary loophole which allows it to take place. That's when a retiree from one pension system gets hired by a public employer covered by another system.

3. Change Imposed on Current Employees

After Jan. 1, 2018, employers will be able to require existing public safety employees to pay 12 percent of their pay for pensions and all other existing employees to pay 8 percent. Until that date, such payments may be negotiated freely, but cannot be imposed.

This is the only significant provision imposed on current employees (as I read the law). This requires more examination – in the next section.

4. Equal Sharing of Normal Cost for Current Employees – How Significant Is It?

The last item above stems from the Legislature setting a "general standard" in PEPRA that employees should pay half the normal cost. This is an important "rhetorical" change from current practice and at first glance might seem to have a significant impact on current employees. What is "normal" cost? Does it have anything to do with unfunded pension debt? What real financial impact will this provision have? We examine these questions in this section.

a) What is "Normal Cost", How Does It Relate to Unfunded Pension Debt, How is It Paid?

Actuaries analyze and plan important aspects of the finances of Pension Funds that are reported in documents referred to as "Actuarial Valuations". These are usually produced every year. This is a very brief description of certain values reported in these Valuations related to this aspect of PEPRA. Actuarial Valuations are rather complex – I've produced a report describing to "normal" folks how Valuations "work" – see Endnote [10].

Actuarial Valuations specify how much two types of payments to the Pension Fund must be during the coming year (sometimes for multi-year periods):

- Normal Costs – split between the employer government and its employees
- Unfunded Pension Amortization Payments – paid only by the employer government

NORMAL COST CONTRIBUTIONS: The Actuary estimates how much needs to be put into the Pension Fund so that if all their assumptions and projections come true there will be enough money in the Pension Fund to **pay the part of future pension payments that will be earned in the coming year**." There are two important points.

First - "pay the part of future pension payments that will be earned in the coming year" is key – this only has to do with the part of future pension payments being earned in one year.

Second – the value of Normal Costs is an estimate. Given the great complexity of how Pension Funds actually "work" we can be absolutely confident that these estimates are always "wrong" – they are never precisely correct. It will always turn out in hindsight decades later that the amount of Normal Cost payments for any particular year should have been more or less. If they could have been less that means the Pension Fund wound up "overfunded" relative to the part of future pension payments earned in a particular year. If they needed to be more that means the Fund is underfunded relative to the part of pensions earned that year. However, the way Pension Funds are "supposed to work" is that the estimated Normal cost will be more than it needed to be some years, less in others – but on average over many years these differences are supposed to "cancel each other out" and produce a fully funded Pension Fund.

Even though the Actuary theoretically splits Normal Cost between governments and employees (usually not 50-50) many, perhaps most governments today pay part or all of the employee share of the Normal Cost. Very few governments disclose that fact to the people. This is done for safety employees more than for other employees.

UNFUNDED PENSION AMORTIZATION PAYMENTS: If significant unfunded pension debt develops – as it has - the unavoidable conclusion is either that given how things really turned out the actuary's estimate of Normal Cost was too low – that in fact the "true Normal Cost" was higher than estimated - or the government and/or its employees didn't pay in what the actuary defined as Normal Cost. Some of today's unfunded pension debt was caused because governments and employees didn't pay all the Normal Cost, but most was caused by the undeniable fact that in hindsight we now know the Normal Cost should have been significantly higher than it was.

The Normal Cost Contributions defined in Actuarial Valuations have nothing to do with eliminating unfunded pension debt. Unlike Normal Costs which are "split" between governments and their employees only governments are obligated to eliminate unfunded pension debt – employees and retirees don't pay anything to help.

b) PEPRA's Provisions Regarding Normal Cost

In applying the rhetorical standard that the contributions for Normal Cost should in reality be split 50-50 between governments and employees and governments shouldn't pay part of employee contributions, PEPRA distinguishes between three groups of employees:

- New Employees – This appears to be what the general standard states - public employees hired after 1/1/13 will pay half the normal cost and employer governments can't pay part of those employees' normal cost.

- Existing Employees – PEPRA has one provision for State employees and a separate provision for local government employees:
  - State Employees – The Legislature asserts in PEPRA that "Equal sharing of normal costs is currently the standard for most state employees".[11] But immediately after that statement the Legislature identified a number of groups of State employees – mostly State Peace Officers and Firefighters – and specified their share of Normal Cost contributions would increase by 1.0% or 1.5% in the next one or more years depending on which group. Since I don't know the current contribution rates for the various groups defined in the law I don't know if these increases will achieve the 50-50 standard. I was not able to find language that would cause further increases in the future if the 50-50 standard isn't met.
  - Local Government Employees – PEPRA provides local governments the ability in 2018 to require current employees to pay Normal Cost contributions up to but no more than 12% of their pay for police, county peace officers, and firefighters, 11% for other safety employees, and all other employees up to 8%. Thus these employees would only be paying half the normal cost if 1) the normal cost is no more than 24% for police/county peace officers/firefighters, 22% for other safety employees, and 16% for all other employees, and 2) governments actually impose these requirements on employees.

My reading of PEPRA makes me think that in fact the provision in this part of the law that states that governments will not be allowed to pay any part of the employee's Normal Cost contribution applies to all employees – current and new – except current state and local government employees have a limit on how much they can be required to pay.

c) Today's "Normal Cost" Reality in Bay Area & North Coast County Pension Funds

Does the "cap" or maximum amount a local government can require its employees to contribute to Normal Cost affect the real value of these provisions in PEPRA? (This analysis looks only at local governments which is my focus..)

This table shows the overall contribution rates for four Bay Area and North Coast counties with independent Pension Funds as shown in their 2011 Actuarial Valuations. The percentage rates are the average portion of each payroll that are to be contributed to the Pension Fund.[12]

Contribution Rates – 2011 Actuarial Valuations

	Marin	Mendocino	San Mateo	Sonoma
Gross Normal Cost	21.03%	21.92%	21.57%	23.63%
Less Employee Contributions	-10.09%	-9.84%	-10.32%	-12.17%
Employer Normal Cost	10.94%	12.08%	11.25%	11.46%
UAAL Amortization	15.56%	11.22%	19.72%	8.47%
Total Employer Rate	26.50%	23.30%	30.97%	19.93%

The first line is the total Normal Cost for the year. The actuaries calculated that 21¢ to 23¢ needed to be put into these County Pension Funds for every $1 of "pensionable" employee compensation just to fund future pension payments being earned that year. Then the employee contribution rate is subtracted to show the counties' normal contribution rate. Remember that today much of the employee contribution is actually paid by the counties so the total rate paid by the counties is almost certainly significantly more than the Total Employer Rate shown above.

Now – although the normal cost is supposedly shared in some proportion between employees and governments, only the government is responsible to pay additional money to eliminate unfunded pension deficits that develop. Technically these are called "unfunded actuarially accrued (pension) liabilities" (UAAL). UAAL amortization payments are added to the counties' normal cost rate to obtain the total contribution rate for the counties.

Sonoma pays only 8.47% because it has the highest portion among all 21 non-CalPERS counties of total pension obligations financed with Pension Obligation Bonds. It has low UAAL Amortization payments and high Bond payments. San Mateo pays 19.7% because it is one of only 4 of the 21 counties that never sold Pension Bonds and therefore only has UAAL Amortization payments. The other two counties – Marin at 15.6% and Mendocino at 11.2% - sold Pension Bonds and have significant UAAL Amortization payments.

d) Problems that Reduce the Value of this Supposed "50-50" Split to Local Governments

There are several issues that impact the significance of the "50-50" sharing of normal cost aspect of PEPRA for local governments.

The average employee contribution rates shown in the table above range between 9.84% and 12.17%. These are averages for all employees – safety and others. PEPRA sets the upper limit at 8% for regular employees, 12% for most safety employees, and 11% for other safety employees. It appears these four counties are already at or close to the limits set by PEPRA and may even be exceeding them.

To the extent these counties are paying part or all of their employees' contributions there could be a significant transfer of the obligation to pay at least part of the Normal Cost from these counties to employees. But the new upper limit on employee contribution rates may already be met or even exceeded today. If they are exceeded my reading of the law is those rates will have to be reduced.

But, there's another wrinkle in how employee contributions are actually paid for. Many governments give raises to groups of employees that essentially pay for their share of Normal Cost. Again safety employees receive this assistance more than other employees. It's why the excellent website CalPensions.com said:

> *The nonpartisan Legislative Analyst's Office said much of the long-term savings from the employee contribution will be offset by pay raises at the end of the new labor contracts.*

However the more constrained government budgets are the less able governments are to simply increase employee salaries to "make up for" the imposition that employees actually pay a significant share of their pension costs.

And that begs the question - "Will local governments actually impose increased employee contributions subject to these upper limits if employee contribution rates today are lower?" The law leaves that decision to local governments. Many pension reformers believe public unions exert undue influence over elected government officials. We'll have to see whether local officials will be willing to risk incurring the wrath of these unions.

But PEPRA does nothing to change the government's sole responsibility to eliminate unfunded pensions. As can be seen in the table Marin and San Mateo pay significantly more unfunded pension payments than normal cost contributions. Mendocino's payments are nearly equal and the only reason Sonoma's unfunded pension debt payments appear so low relative to normal contributions is they sold hundreds of millions of new Pension Obligation Bonds a couple of years ago thereby moving their unfunded pension debt out of the pension fund and into the county's bonded debt.

As described in "Pension Obligation Bonds and the Avoidance of the Fundamental Problems" on page 2 Pension Obligation Bonds are part of the government's unfunded pension debt. Employee and retiree-dominated Pension Funds don't think of these bonds that way – they got the money. But the Counties – and dozens of other local California governments that sold these bonds – got the debt. They are simply unfunded pension deficits "refinanced" as bonds in the hope that the interest charged on the bonds will be less than the Pension Funds will earn on the proceeds of the bonds. Over the past 12 years that hasn't been a good bet – but billions of Pension Obligation Bonds were sold by governments all across the country.

PEPRA not only doesn't require employees and/or retirees to contribute to eliminate unfunded pension debt in the form of UAAL, but they also have no obligation to help pay the Pension Obligation Bonds borrowed to shore up their weak Pension Funds.

By definition unfunded pension-created debt means not enough money was contributed to the Pension Fund in the past – that is, either the "Normal Cost" wasn't paid or it was significantly underestimated.

Bluntly speaking – **far too many pension funds have been managed in such a way to make yearly Normal Costs appear lower than they really were. The result is that both employees and government officials had more money to spend in the past and the resulting much larger unfunded pension debt was shoved into the future for the government – which really means the people - to pay.**

<u>As governments pay more and more towards unfunded pension debt – which is unavoidable for many if not most local governments and the state – the relative benefit of having employees pay more of their own normal cost declines</u>.

This change to force employees to pay more of their normal cost is significant – it will have an impact. But the impact will be far less than it will by "hyped up" to be.

5. The Pension Benefit Grid – What the Legislature Did

These are the major changes imposed by PEPRA as described above presented in the grid shown on page 10:

	What the Pension Benefit Is	How They Are Really Paid For
Current Retirees		
Current Employees		
Benefits Earned in the Past		
Benefits to be Earned in the Future	• No More "Airtime" Purchase • No Retroactive Pension Increases • Some Restrictions on "Double Dipping"	• No More "Pension Holidays" for Employers • Certain groups of State Employees will Pay More of the "Normal Cost" • After Jan 1, 2018 Most Local Government Safety Employees may have to Pay up to 12% of Their Compensation for Normal Cost, Other Safety Employees up to 11%, All Others up to 8%
Future Employees Not Yet Hired	All of Above AND …	
	• Higher Retirement Age • Lower Pensions Per Year Worked • Cap on Pensionable Compensation • Pension Based on Highest 3 Years Compensation – Not Just Highest Year (to limit "Spiking") • Tighter Definition of Pensionable Compensation	• Employee Must Pay ½ "Normal" Cost

The Legislature made no changes to what pensions are or how they are paid for related to current retirees. It made very minor changes to pensions related to current employees – with one possible exception in terms of increased portions of yearly "normal costs" paid by employees in the future. However a careful examination of how these provisions will "work" given the realities of Pension Fund finances today calls into question how much the "real" value of these provisions will be in terms of reducing the financial burden on governments.

It did make a number (not enough) of major changes to both sides of the equation for future employees.

6. Other Things the Legislature Did

Government employees who are convicted of felonies won't receive pensions for the time they worked after they committed their crimes.

III. Pension Reform Done Right - Rhode Island

We have an outstanding model of successful pension reform we can use to compare to what happened in California – Rhode Island. I've published a separate report titled *Gina Raimondo's Shining Example – Pension Reform in Rhode Island*. There is much to be learned by comparing the two. This is a short summary of what happened in RI.

There are substantial differences between the two states. Many are obvious – California's geography, population and economy are very large and diverse. Rhode Island is small and not very diverse. Other differences related to government pension benefits are not obvious. Retirement benefits in California are established in collective bargaining agreements whereas they are established by legislative action in Rhode Island. California is one of 13 state's whose leaders appear to be convinced they can never reduce pension benefits to employees or retirees. Rhode Island leaders do not believe that – they believe they have the authority to make changes if needed to protect the financial integrity of their state and local governments.

There are similarities. The Democratic Party dominates both states and both have very strong public employee unions. And both have been faced with very severe government pension debt crisis – but Rhode Island's was more severe first.

Since 2005 Rhode Island's Legislature – the General Assembly – has changed its pension system and benefits four times – each time saying they hoped the solved the problem, but each time the debt kept growing. Finally by 2010 the crisis had become apparent as public services were being slashed across the state.

A. Gina Raimondo Elected Treasurer – Lowers Return Assumption – Central Falls Defaults

Gina Raimondo ran for State Treasurer as a life-long Democrat to confront and resolve the state's unfunded pension debt crisis. She was elected in November 2010 with 62% of the vote. Public unions tried to get her to promise not to cut pension benefits but instead she promised she'd try with all her might to resolve the crisis, tell the truth, and talk with the unions all the way along.

She took office in January. In April she led the charge to lower the state Pension Fund's target rate of return from 8.25% to 7.5%. This immediately produced a funding crisis because the Fund's calculated "Unfunded Actuarially Accrued Pension Liability" (UAAL) increased very significantly. The Fund's return over the past decade had been 2.28% and the Actuary reported the Fund had only a 30% chance of earning 8.25% over the next 2 decades.

The following month the City of Central Falls went into receivership and cut its pension payments to retirees in half. Rhode Islanders had been increasingly worried as they saw public services being cut all over the state. Suddenly with the news that real pensions had been cut in half the people realized they had a very real crisis on their hands.

Gina Raimondo was running a Rhode Island venture-capital firm when the mother of two read that a growing fiscal crisis might force cutbacks in libraries and buses. The threat drove her to seek public office for the first time. "I literally put the paper down and said, "I have to do this, I have to run."

Raimondo grew up in an Italian-American family riding public buses to public schools attending summer recreation programs in public parks. Her immigrant grandfather learned English at evening classes at the public library. Her father went to college on the GI Bill. She values public services and appreciates those who provide them.

"We're in the fight of our lives for the future of this state," Ms. Raimondo said. And if the fight is lost? "Either the pension fund runs out of money or cities go bankrupt."

On 9/8/11 Raimondo attended one of dozens of public meetings with union members. "You're going after the retirees! In this economic time, how could you possibly take a pension away?" yelled a union official. Another said her efforts were immoral.

Rhode Island, she said, had a choice: it could pay for schoolbooks, roadwork, care for the elderly and so on, or it could keep every promise to its retirees.

"I would ask you, is it morally right to do nothing, and not provide services to the state's most vulnerable citizens?" she asked the crowd. "Yes, sir, I think this (pension reform) is moral."

Pension reforms that only affect not-yet-hired employees don't save much money. Californians should think about what Raimondo says about that when thinking about AB340.

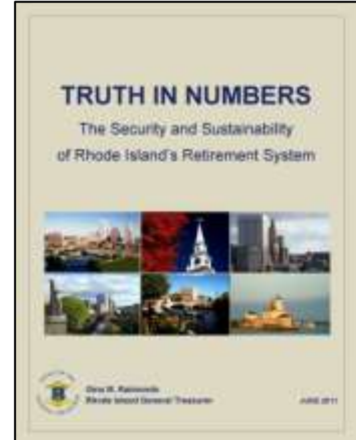
A lot of "people say we've done pension reform when all they've done is tweaked something," Ms. Raimondo points out. "This problem will not go away, and I don't know what people are thinking. By the nature of the problem, it gets bigger and harder the longer you wait."

Sources: New York Times, Yale Law School, Bloomberg.

B. Truth in Numbers

In June Raimondo published a 14 page report to the people of Rhode Island titled *Truth in Numbers*.

We have never seen a *Truth in Numbers* report in California. We won't see real reform until we do.



Raimondo's primary objectives for Truth in Numbers were "to lay out the main reasons for the state's pension challenges, explain the implications for all Rhode Islanders, and offer a framework for devising solutions". [13]

> *Past pension reform efforts … have not been comprehensive enough to address the root causes of the problem. The result of this piecemeal approach is that state employees and teachers have endured several rounds of changes to their benefits, which have produced anxiety and insecurity, while the system remains woefully underfunded. The task ahead is to move swiftly to outline solutions, and to avoid the temptation to rush reforms that may be ill-designed or incomplete.*

Raimondo told the people their small state of 1 million people owed somewhere between $7 to $9 billion in unfunded pension debt depending on whether government or private sector accounting rules were used.

She identified the key drivers of the debt as a) past failure to use sound actuarial funding, b) generous pension improvements without adequate funding, c) many failures designed into the system itself, d) retirees living significantly longer than assumed requiring more pension payments than planned, and e) lower than assumed investment returns.

She told the people that if the crisis wasn't resolved a) the increasing costs of the system would be unsustainable for taxpayers, b) increasing burdens would be placed on future state employees, c) deep cuts would be made in vital public services, d) pension funds could run out of money, and e) the state's borrowing costs for critical infrastructure improvements would go through the roof.

She laid out a framework for solutions. The first step was to agree on a financial definition of the part of retirement security the state and local governments should provide. She made it clear the state's problem could not be solved by changing pensions only for new employees. She said the goals of retiree security and taxpayer affordability and services both had to be considered. And then she laid out five guiding principles for reform:

- Accurate and Transparent Assumptions
- Equitable and Reasonable Pension Changes
- Intergenerational Fairness – Don't Impose the Costs Only on the Kids
- Comprehensive Self-Correcting Processes Within the Pension System
- Unfunded Pension Liability owed to Retirees and Current Employees is the Main Problem that Must Be Solved

She finished by saying it's unfair to ask taxpayers to pay rapidly growing unfunded pension debt created by failures to properly manage pensions in the past, and it's dishonest to let state employees, teachers and retirees believe that full benefits will be there for their retirement given the deep problems in the current system. The time to act is NOW.

C. One-Hundred Community – Union Meetings in Ten Months

During her first 10 months in office Raimondo attended over 100 community meetings where she delivered this message over and over – often to very hostile angry crowds of employees and retirees. She repeatedly said it wasn't the employees' or retirees' fault – they took a job with benefits, did what they were asked to do, but were failed by past politicians and union leaders who didn't do what they should have done.

She told them they were talking about whether retirees would get Cost of Living Adjustments, but that if comprehensive pension reform weren't passed they would soon be talking about whether retirees would get pensions.

D. Pension Reform Commission

After *Truth in Numbers* was published Raimondo put a 12 person commission together to develop specific pension reform proposals. Four public union members joined other government officials, accountants and financial consultants. The produced a proposed reform package by the end of September.

E. Legislature Passes Pension Reform by Overwhelming Margin

The Governor – Lincoln Chaffee – called the General Assembly into Special Session to deal only with pension reform. Chafee and Raimondo – likely opponents for Governor in 2014 – joined together to present the proposed pension reform package to the General Assembly in October. The Assembly – dominated by pro-labor Democrats – passed the most extensive pension reform legislation in US history on 11/17/11 – one year after Raimondo was elected, and 10 months after she took office. The vote was 57 to 15 in the House, 25 to 2 in the Senate.

F. Major Pension Changes and Financial Impact

Overnight the state's unfunded pension debt and pension fund contributions were cut 40%. Some of the most significant changes were:

- Cost of Living Adjustments for retirees were suspended until the Pension Fund was at least 80% funding and the Pension Fund's 5 year average return was at least 5.5% - although there will be an automatic increase at least once every five years – limited to no more than 4% per year.
- Retirement ages in general were increased significantly for current and future employees except those near retirement under the old rules.
- A "Hybrid System" combining a much smaller guaranteed pension benefit and a defined contribution (like a 401k) was imposed.

Actuarial projections were provided before the Legislature voted on the bill that showed that on passage of reform **the state's existing unfunded pension liability and payments to the Pension Funds would decline 40%!**

G. Motivations

"A government that doesn't work is in no one's interest ...Budgets that don't balance, public programs that aren't funded, pension funds that are running out of money, schools that aren't funded — How does that help anyone? I don't really care if you're a Republican or Democrat or you want to fight about the size of government. How about a government that just works? Put your tax dollar in and get a return."

"I went toe-to-toe with the public unions looking out for the kids of Rhode Island because if we didn't fix those pensions, there would be no good public schools. ... That is what motivated me, every single day."

"I'm generally upset and saddened by all the antigovernment rhetoric that is in our country today," Ms. Raimondo says. "I respect public employees and school teachers. They deserve a secure retirement."[14]

Cutting benefits for public employees "isn't what you think about when you think about a progressive Democrat" ... But you have to do it because if you don't, then you can't invest in the future."[15]

"That was my mantra the whole time: Progressives care about public services," Raimondo told me. "A coalition of supporters developed, and it wasn't just the chamber of commerce. It was younger teachers, police, heads of social service agencies . . . Advocates for the disabled really came out."[16]

In some ways, the central question is not only what the government owes to pensioners but what citizens owe to one another. From the pews of the church, Cindy Gould, a fourth-grade teacher, said that under the current system, she had 11 years to go until retirement. Under Ms. Raimondo's plan, she might have to work longer. But, Ms. Gould, 54, said she was willing to do so if that meant the elderly would get the medical care they need.[17]

H. Rhode Island Gets an A, California a D-

Contrast how Gina Raimondo did Pension Reform to what happened in California.

	Rhode Island	California
Before Specific Proposals Are Made Officials Tell the People :		
Accurate Description of the Size of the Debt	✔	✘
Honest Analysis of What Caused the Debt	✔	✘
Projections of Payments and Impact on Services	✔	✘
Requirements to Achieve Comprehensive Solution	✔	✘
Pension Reform Proposals		
Comprehensive Solution	✔	✘
Accompanied by Financial Projections Showing Results	✔	✘
Process of Developing Reform		
Strong Broad Public Input and Dialogue	✔	✘

In California there was no honest examination or comprehensive identification of the major causes of the unfunded pension debt crippling the state and dozens of local governments. There were no capable projections of the range of probable financial futures of these obligations and their impact on the ability of governments to provide their core public services. There was no identification of the necessary financial objectives to restore governmental financial stability to provide the services the public needs. And the final product was a set of disjointed actions focused primarily on changing pensions for new employees that won't have a significant impact on the problem for 15 years!

IV. FINANCIAL IMPACT – RHODE ISLAND V. CALIFORNIA

The Legislature passed PEPRA without having clear financial objectives about how much existing unfunded pension debt needed to be reduced, how much government payments to pension funds needed to be reduced, the required impact on pension expenses – nor did it have competent projections of the financial impacts of PEPRA. It had no targets – it had no credible projections.

I've searched for several days for projections of the impact of PEPRA on current unfunded pension debt and near-term government payments to pension funds. I've asked a dozen well-connected people if they know of such projections – no one does. I've concluded they don't exist – even today more than a month after PEPRA was passed.

It's incredible we still don't have comprehensive analysis about what the impact of PEPRA is on today's debt and tomorrow's government payments.

A. Example of Analysis We Should Have – Rhode Island

Gabriel Roeder Smith & Company produced an Actuarial Analysis of the Rhode Island Retirement Security Act of 2011[18]. They calculated that the Unfunded Actuarially Accrued Pension Liability as of 6/30/10 was $7.3 billion. The State's pension reform reduced that by $3 billion down to $4.3 billion – a reduction of over 40%. They calculated Rhode Island and local governments that participated in the State's Pension Funds would have paid $690 million to the Pension Fund in fiscal year 2013. As a result of pension reform payments were reduced by $275 million from $690 million to $415 million – a reduction of 40%. These are astonishing reductions in one year!

There's a mountain of complexity in these projections. One of the most important is they assume everything works out as planned – which never happens exactly. One of the most important impacts of Rhode Island's changes is that if things turn out worse than planned the State's unfunded pension liability will be much lower than it would have been.

But these are clear statements of the projected impact of Rhode Island's pension reform Act in terms of the reduction of unfunded pension debt and government payments to pension funds in the next year.

B. What We Got in California

The "best" projection I found of the impact of California's "pension reform" Act was produced by CalPERS immediately after PEPRA was passed. This table shows their "quick and dirty" projection of the financial impact of PEPRA on CalPERS (it does not include impacts on all other public retirement systems in California):

Table 1 CalPERS Estimated Total Savings

	Estimated Total Dollar Savings Over 30 Years	Estimated Present Value of the Dollar Savings
Low	$43.3 Billion	$12.0 Billion
High	$55.8 Billion	$15.0 Billion

These are projected savings over 30 years. But savings compared to what? What would total government payments to the pension fund have been and by what percentage are they reduced? And what is the impact next year and the year after that? Further – there is no estimate of the reduction in unfunded pension debt – did California's Act reduce debt now and if so by how much?

In its Executive Summary CalPERS stated:

> *This cost analysis was prepared by CalPERS as part of its preliminary assessment of the PEPRA for the purpose of estimating the cost impact of the proposed benefit changes. It provides estimates only, based on the limited information available to CalPERS at the time it was prepared and the short timeframe which CalPERS had with the draft legislation, and for these reasons the cost analysis is subject to change.*[19]

This analysis was published on the day PEPRA was passed by the Legislature – clearly PEPRA was not informed by these projections – they are almost an afterthought.

The Total Pension Liability (Actuarial Accrued Liability) of all state and local government pension funds in California in 2010 was about $725 billion. CalPERS along accounted for about 40%.

According to CalPERS' 2010 Comprehensive Annual Financial Report (CAFR) total government contributions to the various CalPERS pension funds was about $7.1 billion in both 2010 and 2009.

According to CalPERS' analysis of the impact of PEPRA the total reduction of government payments to CalPERS' pension funds in the fiscal year ending June 30, 2014 will be in the range of $135 million to $145 million.

That means CalPERS appears to project that the savings next year to governments in terms of reduced CalPERS pension fund payments represents not quite 2% of what those payments were in 2010. Government payments to CalPERS pension funds have gone up since 2010 and we can be pretty confident the percentage reduction in what government payments to CalPERS' pension funds next year would be less than the 2% reduction CalPERS predicts – perhaps around 1.7% or so.

Rhode Island's Legislature reduced unfunded pension debt in state retirement systems by 40% and next year's government payments to state-operated pension funds by 40%.

California's Legislature didn't reduce unfunded pension debt one dime and lowered next year's government payments to pension funds by about 1.7%.

Contrast that with the 40% reduction obtained by Rhode Island's reform! The difference is so huge that we can safely assume the savings to all levels of California local and state government agencies of the Pension Reform Act are miniscule compared to those achieved in Rhode Island.

Rhode Island's reduction in government pension fund payments in the year after they passed their reforms was about 40% which was the same percentage reduction in their unfunded pension liability. However, Rhode Island made significant cuts in projected payments to current retirees by suspending Cost of Living Adjustment payments until their Pension Funds were above 80% funding levels and the Funds were consistently earning at least 75% of its target returns. In contrast California didn't lower any payments to current retirees – they only lowered what will be paid to new employees. That means there was no immediate impact on unfunded government pension debt.

V. WHAT CALIFORNIA'S LEGISLATURE AND GOVERNOR DIDN'T DO

Most people think "pension reform" means changing what pension benefits are. Yes – pension benefits must be changed, but many other types of changes are desperately needed. California failed to:

A. Financial Failures

1. Reduce and Restructure Existing Pension Debt

Unfortunately – barring a miracle in the stock market and a booming economy – PEPRA is pretty much doomed to fail to stop the hemorrhaging of red ink in the California's local and state governments. As discussed on page 1, the level of state and local government unfunded pension debt has grown so large that the inherent interest on the debt is "out of control" in many jurisdictions. But the legislature completely ignored today's unfunded pension debt.

Gina Raimondo had this to say about ignoring the unfunded pension debt that exists.

> *"A lot of people say we've done pension reform when all they've done is tweaked something ... This problem will not go away, and I don't know what people are thinking. By the nature of the problem, it gets bigger and harder the longer you wait."*[20]

That is precisely what California has done – tweaked something while ignoring the huge debt which by its nature will continue to get bigger and harder. Simply put – the debt is too big, it can't be paid. The longer we wait to confront that truth the worse it's going to be for everyone.

2. Greatly Reduce Local and State Government Guarantees

Governments guarantee pensions. That means they make up for poor investment returns. They fill in the gaps caused by bad planning and terrible pension fund management. The bizarre truth is that because of these guarantees employees get a "better deal" from the development of huge unfunded pension debts because less money is taken from their paychecks as pension contributions while they were working but they still get their guaranteed pensions.

At the same time politicians (at least use to) have more money to spend on things other than pensions – in the short-run – because they weren't paying the true cost of the promises they were making about retirement to employees. They earned political credit from unions for the promise – and didn't have to pay for a large part of it.

These perverse incentives for government work forces and politicians are a major reason thousands of local and state governments across the country are so deeply mired in unfunded pension debt today.

Rhode Island's move from guaranteed pensions to making retirement benefits more a function of economic growth and good Pension Fund management will have a very powerful and even transformative effect on the attitudes of government employees and retirees. It aligns their interests with what it takes to produce strong and properly managed Pension Funds and removes perverse incentives that reward actions that weaken Pension Funds in the long run.

3. Provide a Comprehensive Long-Term Financial Solution.

Gina Raimondo first laid out what the current debt really was and the likely projections of government payments to pension funds. Next she showed the people including government employees and retirees the disaster that was almost certainly unavoidable if major changes weren't made. She then identified the main causes of that debt that had to be confronted. She then quantified how much the debt and government payments needed to be reduced so that the pension system could be sustainable and a legitimate level of public services would be provided at a price that was fair for the people of Rhode Island to pay.

And then she and her team put together a complete set of changes that would achieve those targeted reductions in debt and government payments, would secure reasonable and secure retirements for public employees, and would produce the public services the people deserve at a price that was fair to ask them to pay.

California's Public Employee's Reform Act of 2013 doesn't come close to such a comprehensive analysis or long-term solution.

B. Organizational – Legal – and Accountability Failures

But we have many more types of severe problems with state and local Pension Funds that must be confronted – and that PEPRA completely failed to confront.

1. Serious Reform of Retirement Boards and the Laws Governing Retirement Systems

Government employees and retirees and their unions often say the money in government Pension Funds is "their money". No it isn't. It isn't their money until they get their monthly pension payments. To the extent the public guarantees those pensions that money is what is supposed to stand between the public and the bottomless pit that far too many government Pension Funds have turned into. No set of people are more responsible for creating our current crisis than the Retirement Boards that terribly mismanaged these funds. Those Boards are dominated by government employees and retirees and politicians who are both driven by the perverse incentives described in "Greatly Reduce Local and State Government Guarantees" on page 22 and who also are not anywhere near competent enough to oversee such complex financial organizations.

California's County Employee Retirement Law (CERL) is 370 pages long and has to be one of the worst written most convoluted opaque laws ever. It is practically impossible to understand. A year ago the Mendocino County's Board of Supervisors asked its County Counsel to figure out which parts of CERL the County had adopted – what parts of the law the County and its Retirement Association is supposed to follow. One year later they still don't know.

Many aspects of CERL specifically violate several requirements of standard fiduciary responsibility, violate other laws, and violate common sense. Take for example – "Pension Fund Excess Earnings".

Section 31592.2 of the California Government Code is a part of CERL. It defines what it calls "Excess Interest" in confusing legalese which has become known as "Pension Fund Excess Earnings". This can be simply described as Pension Fund investment earnings in any one year that are above the Fund's target investment returns given the amount it has to invest and a couple of smaller requirements that don't have much impact. "Excess Earnings" may be used to pay retiree healthcare and similar benefits or to increase monthly pensions above what was contractually bargained for.

Now – the most important assumption in Pension Fund finance is the target rate of investment return which for more until recently averaged 8% in California County Pension Funds. Of course Funds never earn exactly 8%. They'd be over some years – under in others. But the idea was that over the long run they would average 8%.

So – how can a Pension Fund average, say, 8% returns on investment if in any single year the amounts above 8% are stripped out of the Pension Fund to spend on other things regardless of the funding position of the Fund? It doesn't matter if the Fund is underfunded. All that matters is what the return was in any one year. The Pension Fund must absorb the shortfalls in bad years but can't keep the surplus in good years.

The answer – of course – is the Pension Fund is doomed to be underfunded.

And that's the law in California.

This provision is stupid! I consider it also to be legal fraud against the people. But – it's also such a significant violation of the Internal Revenue Code that public Pension Funds could lose their tax advantaged status. The IRS forced the City of San Diego to permanently cease this practice that had created tens of millions of unfunded pension debt for that city.[21]

The laws governing public pension funds in California are in serious need of major revisions.

2. Deep Reform of Local and State Government Financial Management

These excessive debts didn't "just happen". They didn't "fall out of the sky". They aren't "Acts of God". And although serious debate can and needs to be focused on the structure of the nation's financial industries and what I believe to be the lax imposition of reasonable and necessary legal requirements on those industries, much of our governments' financial problems were created by deeply flawed financial management systems, structure and culture within those governments themselves.

There are two studies about aspects of government pension debt that in my judgment are the best on their subjects – they are truly outstanding. One is Gina Raimondo's *Truth in Numbers* I describe in page 17. The other is the "Kroll

Report" about the pension scandals in the City of San Diego (see endnote 22). That City was the harbinger of the pension crises and scandals that have gripped our nation. Theirs was the first major public pension scandal in recent times. A blue-ribbon audit committee was created with significant resources to investigate the scandal and make recommendations. Their Executive Summary is an amazing document. Except for a few aspects that were unique to San Diego – their analysis and conclusions apply exactly to dozens of other local and state governments.

> *Evidence made available in this investigation demonstrates numerous failures of San Diego City government - on the part of government officials and outside professional "gatekeepers" alike - to conform to the law, to adhere to principles of sound governance and financial reporting, and to protect the financial integrity of the City's pension system and thereby the welfare of the City itself.... The evidence demonstrates not mere negligence, but deliberate disregard for the law, disregard for fiduciary responsibility, and disregard for the financial welfare of the City's residents over an extended period of time[22].*
>
> *While this conduct was plainly unlawful, the evidence does not demonstrate that City officials set out with the objective of defying legal mandates. Rather, the evidence suggests that at root San Diego City officials fell prey to the same type of corruption of financial management and reporting that afflicted municipalities such as Orange County and such private sector companies as Enron, HealthSouth, and any number of other public corporations. That is, San Diego officials cultivated and accepted a culture of financial management and reporting premised upon non-transparency, obfuscation, and denial of fiscal reality.[23]*

Of course there are many jurisdictions that have not strayed this far – whose officials have adhered to high standards of public duty. But I believe there are far more instances of the type of behavior described above than should be the case.

But the problem isn't just with these types of severe egregious misdeeds. Far too many governments in California have no comprehensive financial planning systems beyond their annual budgets. In my home county of Mendocino the offices of Treasurer-Tax Collector and Auditor-Controller have been "hand me down jobs" for decades where the previous officeholder hand picks his or her successor and there is practically no effective public accountability.

These excessive debts developed because of deeply flawed financial systems and management structure in California local and state governments. We can't escape the black hole of this debt without significant reform of local and state government financial management.

3. <u>Strong, Effective Believable State Oversight of Local and State Pension Funds</u>

There has been a hugely negligent default of responsibility by State and Federal agencies that should have been exercising reasonable oversight of California's pension funds – especially those at the local level. What's the point of laws – even terribly defective laws such as the County Employees Retirement Law – if no agency with the responsibility to enforce the law will ever do so?