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

10/12/12

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Eight Page Summary

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 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.

This is an 8 page summary of the 24 page full report. They have the same basic outline although in some places the full report has deeper "layers" in the outline. You can read the summary and if you want more detail you can go to the same section in the full report. All references to source material are noted and shown as endnotes in the full report.

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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.

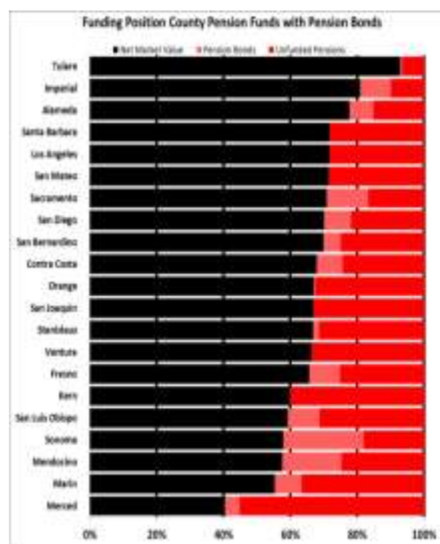
Pension Funds can't make investment profits on money they don't have. The more they are under-funded the more likely investment returns will fall short and unfunded pension debt will grow by the target rate of return. Only governments pay extra to eliminate unfunded pensions – employees and retirees 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.

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!

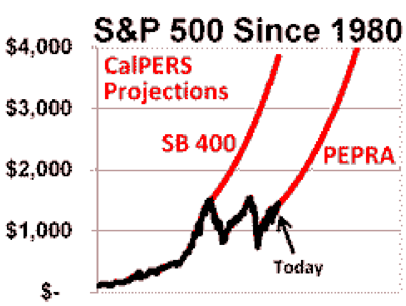
C. California Legislature's Real Bet – Huge Stock Market Profits and Increased Tax Revenue

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 that was not made public or provided to the Legislature 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?