UCRS Advisory Board

Meeting of February 25, 2011

AGENDA ITEM C

UCRP - Discussion of Pension Reform Developments in California

Vice President and Associate Actuary John Monroe of the Segal Company (The Plan's Consulting Actuary) will lead a discussion on accounting and other financial developments within California related to public pensions and pension reform. The discussion will include an overview of recent measures taken by some public retirement systems in California as well as pension related proposals endorsed by Governor Brown.

Attachment

Current Pension Topics –

Accounting and Financial Issues

Pension Reform in California

University of California Retirement System
Advisory Board

February 25, 2011

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California Actuarial Advisory Panel (CAAP)

- Creation recommended by the Governor's Public Employee Post-Employment Benefits Commission
- Responsibilities of panel include:
  - Defining the range of actuarial model policies and best practices for public retirement plan benefits, including pensions and other postemployment benefits
  - Developing pricing and disclosure standards for California public sector benefit improvements
  - Developing quality control standards for California public sector actuaries
  - Gathering model funding policies and practices
  - Replying to policy questions from public retirement systems in California
  - Providing comment upon request by public agencies
- Panel consists of 8 actuaries appointed by specified entities
  - Paul Angelo was appointed by UC

Topics Covered

- Comparison of selected California public retirement systems
- Accounting/financing issues including:
  - Moody's treatment of unfunded pension liability like bond debt
  - Orange County Employees Retirement System (OCERS) "self borrowing" financing
  - Fitch ratings newsletter on public pensions obligations
- Pension reform in California:
  - Orange County as a sample of combination DB-DC plan
  - LA City plans
  - Schwarzenegger's 2010 pension reform deals with various bargaining units
  - Proposals from Governor Brown
  - Proposals from the California Foundation for Fiscal Responsibility (CFFR)
  - Legislative Analyst's Office (LAO)
- Budget gap/Brown proposal/special election for tax extension

Comparison of California Public Retirement Systems

	UCRP	CalPERS State Misc. First Tier	CalSTRS	OCERS[1]	LACERS
	2011/2012	2010/2011	2009 Valuation	2011/2012	2011/2012
Total Normal Cost	17.6%	14.4%	17.3%	24.4%	16.7%
Employer Cont. Rate	7.0%	17.5%	8.25% + 4.5% State	30.1%	21.2%
Employee Cont. Rate[2]	3.5%	8.0%	8.0%	10.8%	7.00%
Investment Return Assumption	7.50%	7.75%	7.75%[3]	7.75%	8.00%
Coordination with SS	Yes	Yes	No	No	No

[1] OCERS includes Safety members

[2] Subject to collective bargaining, excludes any applicable offsets and either most common or avg rate

[3] CalSTRS investment return assumption was adopted in December 2010 for use in July 2010 valuation

Accounting/Financing Issues – Moody's

- Moody's has begun treating unfunded pension liability like bond debt
  - Combined net tax-supported debt and unfunded pension liability for U.S. states
  - Pensions were previously factored in their analysis of states separately
  - Pension funding pressures continue to have negative impact on state credit quality
    - Moody's recognizes that reported pension liabilities may be understated
  - States with highest combined debt as a share of GDP:
    - Hawaii, Mississippi, Connecticut, West Virginia and Massachusetts
    - Similar states with highest combined debt as per capita
    - Some of these states have higher credit ratings because of sound budgets and strong tax bases
  - Some states with lowest credit ratings - Illinois and California - rank 8th and 22nd in terms of combined debt as a percent of GDP
    - Illinois has relatively little debt, but large unfunded pension liability
    - California is the largest borrower of debt, but its pension funds are in better shape than Illinois
  - States as a group are highly rated because of their control over revenue and spending that may help address recent growth in pension liabilities

Accounting/Financing Issues – Orange County

- OCERS "self borrowing" financing
  - County sells taxable pension-obligation notes maturing in 16 months to Orange County Investment Pool
  - Proceeds from sale would be used by County to make its annual pension fund payment ahead of schedule
    - Qualifying for a discount based on 7.75% per annum
    - Pay lump sum at March 15, 2011 instead of installments during 2011/2012
      - $307 million on March 15, 2011 versus $327 million during 2011/2012
  - Similar to STIP borrowing in many ways
    - One difference may be that STIP borrowing is paid back over a longer term

Accounting/Financing Issues – Fitch

- Fitch ratings agency
  - "One size does not fit all"
    - Recognizes that each plan and government's situation is different
  - Vast majority of governments will withstand pressures from pension obligations
    - May mean taking difficult steps to adjust contributions and/or benefits
  - Long-term nature of governments and tax bases
    - There is time to implement changes to control long-term liabilities
    - Beneficial impact will also be recognized over an extended period
  - Greatest risk are those with large unfunded liability who have not been contributing ARC
    - Some plans are below 70% funded (after recognizing deferred losses)
    - However, ARC payments are made and on path to 100% funding
    - Other plans have high funded level, but ARC is growing to unsustainable level
  - Long-term discount rate of 8% on average is "aggressive"
    - Estimating size of plans' liabilities under alternative discount rates
    - However, long-term returns close to treasuries are unrealistic

Pension Reform in California - City and County

- OCERS
  - DB-DC combo tier adopted in 2010
  - New hires have choice of old tier (DB only) or new tier (DB-DC combo)
  - DB-DC combo new tier shifts some of the risk from employer to member
- LA City plans
  - LA Fire and Police
    - Modifications to:
      - » Retirement factors (age factors)
      - » Final salary period
      - » Member contributions toward retiree medical
    - Must be approved by LA voters on March ballot
  - LA City
    - Various proposals still under discussion
- Other systems
  - Some are considering new tiers and/or higher member contributions
  - Few may consider modifications to funding policies
  - Layoffs, salary and other budget controls

Pension Reform in California - CalPERS and Brown Proposals

CalPERS

- Agreements with many bargaining units in 2010
- Generally rolls back benefits to pre-SB 400 (2% @ 60 formula)
- Member contribution rate generally increases to 8% to 10% of pay

Governor Brown proposals

- While campaigning -
  - Increase member contributions for current and new employees
  - Increase retirement age for new hires
  - Eliminate spiking by removing bonuses, overtime and unused vacation
  - Use a three-year final average salary
  - Cap payment at “reasonable” level (undefined)
  - Bar retroactive payments if benefits enhanced
  - Ban contribution “holidays”
- While Governor, many of the above plus -
  - Longer vesting periods and more member contributions for retiree health
  - Monitoring by state finance director of earnings forecasts and investments

Pension Reform in California - CFFR Proposals

- California Foundation for Fiscal Responsibility (CFFR)
- Drafted two alternative pension reform proposals and a set of reforms that work with both alternatives
  - Reform initiatives planned for June 2012 ballot
  - Constitutional amendment would be necessary to enact these reforms
  - Would apply to all public pension systems in California
- Alternative A
  - Members pay half the normal costs for both retirement and retiree health
  - Public employers may not contribute member's share of costs
  - Defined retirement benefits shall not exceed median statewide household income ($56,344 in 2009) for new hires on or after July 1, 2013
  - Defined Contribution (DC) plan available for new hires on or after July 1, 2013
    - No lifetime or formula retiree medical benefits prior to age 65 for new hires
    - Life insurance and disability benefits provided through insurance polices, etc.
  - Contribute full actuarial cost of pension and retiree medical benefits no later than January 1, 2020 without increasing taxes for this purpose

Pension Reform in California - CFFR Proposals

- Alternative B
  - Freeze current Defined Benefit (DB) plans at state and local government agencies
  - Amend State Constitution to declare level of UAAL in DB plans a fiscal emergency
  - Suspend further accruals to plan that are less than 90% funded until funding above 100% is maintained for three consecutive years
  - Accrual rates of 1.25% at 65 until current plan is unfrozen (1.6% at 55 for Safety)
    - Same accrual rates apply to new hires (max of $40k annually – adjusted 2%/yr)
  - All employees would have access to DC plan with match up to 5% of salary
  - Some conditions on member and employer contributions from Alternative A apply

Pension Reform in California - Legislative Analyst's Office

- Pension reform recommended due to problems with current system
  - Not fully funding costs as they accrue/deferring costs to future generations
  - Inflexible benefits – despite the need for state and local fiscal flexibility
  - Employers and taxpayers bear almost all of the financial risk
  - Employer costs subject to considerable volatility
  - Defined benefits are very generous

- Options for the future
  - Programs with more cost sharing ("hybrid", but really DB-DC combo)
  - End retroactive retirement benefit increases
  - Pay costs as they accrue
  - Clarity about employer obligations (at hire know which benefits can be modified)

- "…And for the UC retirement benefits, there is probably the likelihood that the state would need to resume voluntarily giving UC funding to help it address its unfunded liabilities within a few years. As a condition of providing that money, the state can specify that UC employees in the future will only receive the types of benefits allowed for the state, and local, and school district employees as well…"

Budget Gap/Brown Proposal/Special Election for Tax Extension

- Current projected California 18-month budget gap ~ $25 billion

- Governor Brown budget proposal needs legislative simple majority to pass (Prop 25)

- However, due to Prop 26, all fees and taxes must be approved by a 2/3 vote of the legislature
  - Governor Brown has called for a special election to extend the temporary taxes, which requires a 2/3 vote of the legislature. A simple majority of voters is required for the tax extension to pass