

September 22, 2010

Stuart Drown
Executive Director
Little Hoover Commission
925 L Street
Sacramento, CA 95814

Re: California Public Pension Issues

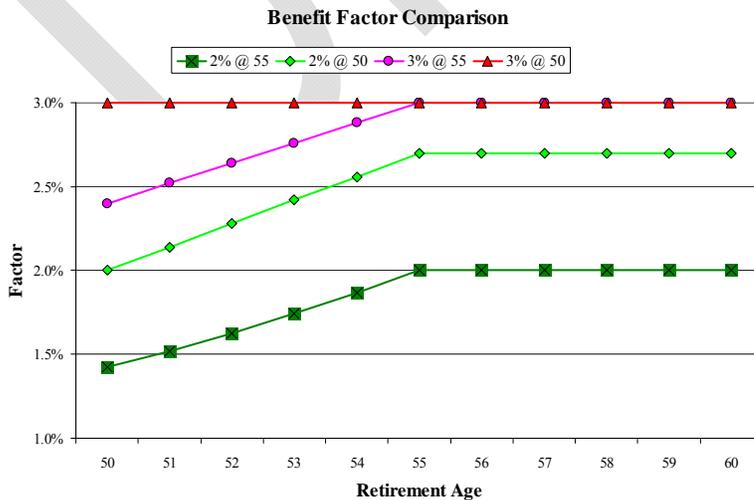
Dear Mr. Drown:

Thank you for the opportunity to testify at the September 23, 2010 Little Hoover Commission meeting. Bartel Associates, LLC is an actuarial consulting firm specializing in providing states, counties, cities, and other public agencies with actuarial consulting services including retiree medical plan valuations, pension plan valuations, retirement plan design, actuarial audits, and CalPERS retirement consulting. Our clients range from small special districts to small and large cities and states with tens of thousands of employees.

Your August 18th letter asked me to respond to three questions. Here are my responses:

1. **If the benefit increases ushered in by SB 400 had never happened, what would the scale of the problem be today?** Note: I've expanded my response to include some basic background and the non-safety AB 616 benefit increases.

SB 400 became effective January 1, 2000, allowing agencies to negotiate with safety employees to improve benefits from what was then generally the 2%@50 formula to either 3%@50 or 3%@55. The following graph shows the CalPERS safety benefit factors¹ (including those under the 2%@55 formula) at various retirement ages:

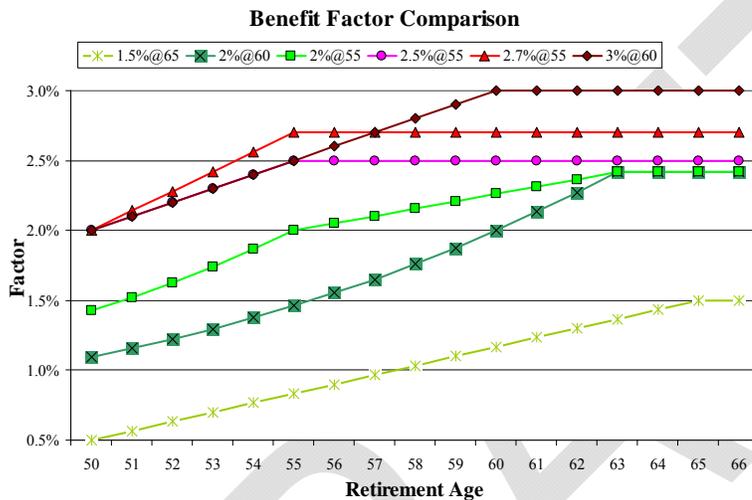


¹ Other system Safety benefit factors are generally similar to CalPERS factors.



As you can tell 3%@50 provides a substantial increase in pension benefits for those retiring earlier (e.g. age 50) and about a 10% increase for those retiring later (age 55 and above), while 3%@55 provides a more modest (although still substantial) increase compared to 3%@50.

AB 616 became effective January 1, 2002, allowing agencies to increase non-safety pension benefits to one of three new formulas, 2.5%@55, 2.7%@55 and 3%@60. Prior to AB 616 most agencies had the 2%@55 formula and some had the 2%@60 formula. The following graph shows the CalPERS non-safety benefit factors² (including those under the 1.5%@65 formula) at various retirement ages:



Both 2.7%@55 and 2.5%@55 are old safety formulas while 3%@60 is not.

For all formulas, an individual's pension benefit equals the product of three things: Benefit Factor, Final Average³ Pension Compensation and years of agency service, all at the individual's retirement age. California agencies are generally reciprocal with each other, meaning the same compensation (usually the individual's last employer) is used to determine Final Average Pension Compensation. Generally safety benefits have a percentage cap (e.g. 90% under CalPERS) while non-safety formulas are not capped under CalPERS but are usually capped under other systems.

Both SB 400 and AB 616 allowed formulas to be changed either prospectively only (new formula applied to future service only) or both prospectively and retroactively (new formula applied to future and past service). Actuaries refer a pension plan's annual (and prospective) cost as the Normal Cost and the retroactive (or prior service) cost as the Actuarial Accrued Liability. Prospective benefit improvements would only increase the Normal Cost while retroactive and prospective benefit improvements would increase both the Normal Cost and Actuarial Accrued Liability. Providing improved benefits retroactively is much more expensive than just providing them prospectively. Normally the increase in the Actuarial Accrued Liability is amortized over a period of time.

² Other system non-safety benefit factors are generally similar but not the same as CalPERS factors.
³ Average of highest three years or highest year.



CalPERS required that agencies implementing these benefit increases do so retroactively for all service. CalPERS policy is to amortize benefit improvements over 20 years. However, recent events have resulted in most CalPERS' unfunded liabilities, including benefit improvements, being amortized over 30 years.

Table 1 shows the estimated impact⁴ SB 400 and AB 616 formulas had on CalPERS agency employer contribution rates:

Table 1			
Estimated CalPERS Contribution Rate Impact of SB 400 and AB 616			
Formula	Employer Contribution Rate Increase		Member Contribution Rate Increase
	Prior Service Increase Amortization Period		
	20 Years	30 Years	
Safety⁵:			
3% @ 50	10-15%	9-13%	0%
3% @ 55	5- 7%	4- 6%	0%
Miscellaneous⁶:			
3% @ 60	7-13%	6-11%	1%
2.7% @ 55	5-10%	4- 9%	1%
2.5% @ 55	3- 6%	3- 5%	1%

You might note we are showing ranges for employer contribution rate increases because demographic differences from one agency to the next result in different benefit improvement costs. For example an agency with a large portion of their employees close to retirement and with significant prior service will usually have a higher benefit improvement cost than one with younger, shorter service employees. Ranges do not imply a lowest and highest possible, but rather a reasonable range within which most agencies fall.

However, one size does not fit all....some agencies negotiated with bargaining groups to pay for all or a portion of the benefit increases. Sometimes this resulted in lower pay increases and sometimes this resulted in a direct pick up of employer contributions.

⁴ Estimates based on data compiled by Bartel Associates from CalPERS Contract Amendment Cost Analysis for agencies across the State.

⁵ Shows estimated increase assuming the prior formula was the 2% @ 50 formula.

⁶ Shows estimated increase assuming the prior formula was the 2% @ 55 formula.



Table 2 shows information CalPERS has used in presentations to various groups recently:

Table 2		
CalPERS Average 2010/11 Public Agency Employer		
Formula	Contribution Rates	Increase over 2% @ 50
Safety:		
3% @ 50	29%	9%
3% @ 55	24%	4%
2% @ 50	20%	-
Miscellaneous:		
	Contribution Rates	Increase over 2% @ 55
3% @ 60	19%	8%
2.7% @ 55	16%	5%
2.5% @ 55	14%	3%
2% @ 55	11%	-

Table 1 implies rates would be 9-13 percentage points lower if agencies that went to 3% @ 50 had not, while Table 2 indicates the actual impact has been somewhat offset by lower pay increases and employee cost sharing resulting in a 9% difference.

2. **How bad is the problem going to get? In general, what percent of payroll will communities need to devote to pension costs in coming years?**

This is a very difficult question to answer accurately, in part because:

- Some California retirement systems have recognized investment losses into their funded status more rapidly than others. Similarly some systems are paying recent investment losses over a shorter amortization period than others. A system that recognized investment losses over a short period (e.g. 5 years) and pays losses over a short period (e.g. 15 years), absent future gains and losses, will have a relatively high contribution rate for the immediate future but will have a lower rate in the long run. Conversely a system that is recognizing the investment losses over a long period (e.g. 15 years or longer) and pays losses over a long period (e.g. 30 years or longer), absent future gains and losses, will have a relatively low contribution rate for the immediate future but will have an increasingly high rate in the long run.
- The single biggest impact on future contribution rates is investment return. Since we are in a highly volatile investment environment, contribution rates will be much higher if future investment returns are poor and may be somewhat lower if investment returns are good.
- Many systems, including CalPERS, are reviewing their current long term investment return assumptions. We anticipate many will lower their real rate of return (above inflation). For example preliminary indications, from reviewing CalPERS' investment committee agenda information, are CalPERS will lower their real rate of return by ¼% or more, with the impact reflected in 2012/13 contribution rates. Lowering investment return assumptions will, absent other changes, increase contribution rates.
- Systems are constantly reviewing other actuarial assumptions (inflation, future salary increases, retirement rates, mortality rates, etc.). CalPERS has recently completed an



experience analysis that will be reflected in 2011/12 contribution rates. The pattern over the past ten years or so is that assumptions have required some strengthening. If this trend continues, assumption changes will increase contribution rates. However, lower pay increases and later retirements might offset this trend.

- The practice of who pays member contribution rates varies significantly around California. Some agencies pay the entire member contribution rate, some pay a portion of the member contribution rate, still others pay none of the member contribution rate and some require members pay a portion of the employer rate in addition to the full member rate. Member contribution rates vary from one system to the next but range from approximately 9% for Safety to 7-8% for non-safety. Many agencies are talking with employee groups about employees paying the full member contribution rate and/or members paying a portion of the employer contribution rate.
- Many agencies are not hiring new employees to replace those leaving. This decreases the dollar cost of pensions but increases contribution rates because contributions are usually designed to be a level percent of payroll assuming payroll (not the number of employees) continues to grow.
- Contribution volatility varies significantly from one agency to the next. For example a mature Safety plan (agency has had a stable active population for a long time, with a high ratio of retirees to actives) might have a high amount of volatility while a young non-safety plan (relatively new agency with a low ratio of retirees to actives) will have much lower volatility. Higher volatility results in more contribution rate variance over time.

Having said all of the above, we believe it is likely employer rates will increase over the next few years. CalPERS contribution rates, in particular, are likely to increase and remain high for a very long time. This will be exacerbated if investment returns are below expectations Table 3 provides some indication of general trends, however individual employer rates will vary greatly:

Table 3				
Formula	CalPERS Average Public Agency Employer Contribution Rates			
	2010/11	2015/16 Rates⁷ Based on Anticipated Investment Return		
		Good⁸	“Assumed”⁹	Poor¹⁰
Safety:				
3% @ 50	≈29%	≈37%	≈41%	≈49%
3% @ 55	≈24%	≈31%	≈34%	≈41%
2% @ 50	≈20%	≈26%	≈29%	≈34%

⁷ Projected rates include the estimated impact of CalPERS new experience study and an anticipated 0.25% decrease in CalPERS assumed investment return effective with 2012/13 contribution rates.

⁸ CalPERS investment return from July 1, 2010 through June 30, 2013 is in low double digits.

⁹ CalPERS investment return from July 1, 2010 through June 30, 2013 equals their assumed investment return.

¹⁰ CalPERS investment return from July 1, 2010 through June 30, 2013 is in low single digits.



Table 3				
CalPERS Average Public Agency Employer Contribution Rates				
Formula				
Miscellaneous:				
3% @ 60	≈19%	≈25%	≈28%	≈32%
2.7% @ 55	≈16%	≈22%	≈25%	≈30%
2.5% @ 55	≈14%	≈20%	≈23%	≈27%
2% @ 55	≈11%	≈16%	≈18%	≈23%
2% @ 60	≈ 9%	≈14%	≈16%	≈21%

The above does not include member contribution rates, nor does it reflect any employee payment of employer contribution rates.

3. **Please describe the best practices being developed by the California Actuarial Advisory Panel, as well as the limitations to implement them.**

Table 4 shows the California Actuarial Advisory Panel's (Panel) 2010 and 2011 work plans

Table 4	
Item Description	Due Date
1. Report to the Legislature	February 1, 2011
2. Prepare response to Governmental Accounting Standards Board's Preliminary Pension Views	Completed
3. Define the range of model funding policies and practices	2010
4. Develop disclosure standards for public sector actuarial valuation reports	2010
5. Report to the Legislature	February 1, 2012
6. Develop pricing and disclosure standards for public sector benefit improvements	2011
7. Develop quality control standards for California public sector actuarial work	2011
8. Develop educational materials including model presentation for funding and accounting disclosure	2011
9. Reply to policy questions from California public sector retirement systems	Ongoing
10. Provide comment upon request by public agencies	Ongoing

Actuaries generally don't believe there is a single "best" way to prepare actuarial valuations or studies. Instead, there is a range of reasonable policies and practices. Consequently you should expect we will refer to "model" policies and practices rather than "best" practices. It is important to note the Panel has no ability to set rules, regulations or law; we only have the ability to recommend that the legislature do so. Similarly we reside in the State Controller's Office (SCO) and, as such, have been very ably supported in conducting meetings. However, the SCO has no budget to provide technical support and/or staff. This means the Panel's technical questions and issues must be supported by Panel members and their employers.

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Again, thank you for the opportunity to testify. We hope the above information is helpful and would certainly be happy to respond to any questions the Commission has.

Sincerely,

John E. Bartel
President

jb: JEB:

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Beth Curda, Little Hoover Commission
Alan Milligan, California Actuarial Advisory Panel

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