RANCHO PALOS VERDES

MEMORANDUM

TO: CITY COUNCIL MEMBERS

FROM: STEVE WOLOWICZ

DATE: NOVEMBER 4, 2010

SUBJECT: PENSION REVISION

RECOMMENDATION

(1) Select and retain a retirement plan consulting firm to assist in the design of an alternative defined contribution retirement program similar to a standard 401(k) plan and cost-saving suggestions to modify the current defined benefit plan.

(2) Appoint a two-member subcommittee to (a) work with City Staff in the selection of the consulting firm. (b) Work with the consultant in the analysis and recommendation of the new retirement plan, and (c) By January 31, 2011 based on that analysis submit a recommendation for the new pension plan to the City Council

(3) Based on the information provided by the consultant and subcommittee The City Council will deliberate and select a new retirement plan for all new employees hired after July 1, 2011.

It is important to note that <u>no part of this recommendation is to change any part of the current plan for existing employees.</u>

BACKGROUND

Over the last decade the City's annual costs for the existing defined benefit retirement plan has dramatically increased. For the fiscal year ended June 30, 2010 the base cost was $814,205 which excludes an additional $1,661,376 paid to the "side-fund liability." The annual cost alone is $679,204 or 504% higher than the expense amount recorded during the fiscal year ended June 30, 2000. (See comparative costs on Exhibit A and Financial Statement Pension footnote on Exhibit B).

Our City's problem with the increasing retirement costs is similar to most all governmental entities sponsoring defined benefit retirement plans. These significant increases are primarily not due to increases in the number of participating personnel, but rather in the underlying nature of the defined benefit plans. As described in the CalPERS Member booklet "Three factors are used to calculate your service retirement: Service Credit, Benefit Factor, and Final Compensation." The service credit is earned for each year of partial year worked for the sponsoring employer (in our case as a participating CalPERS entity). The Benefit Factor is the percentage of pay to which employees are entitled for each year of service. That percentage is determined by age of the employee at retirement, which was contracted by the City. This formula is commonly quoted in terms of a percent and number. For our City that formula is stated 2.5% (at) 55 years of age.

The funding policy is described in the Notes of Financial Statements in the annual CAFR (Exhibit B). As with all defined benefit (DB) plans, the City's contributions decline when investment returns rise and increase when investment returns decline.

As explained by the Governor's Special Advisor for Jobs and Economic Growth, David Crane: "*When promises for deferred compensation such as pensions and retiree health care are made to employees, sufficient monies are suppose to be set aside at the same time and invested in order to grow large enough to meet the promises. The amount of money to be set aside is a function of how successfully that set-aside money is expected to be invested. The greater the assumed investment return, the lower the set-aside when the promise is made, and vice-versa. If those assumed investment earnings arise, all's well. But if not, money must be added in the future to meet the promise… At some point such promises come due and that's when their costs are revealed… By assuming unattainable investment returns, the state has been making promises but underfunding them, assuring massive demands on future general funds.*" The City has been exposed to the same problem resulting in the skyrocketing costs during the last decade.

However, the over-assumption of investment returns during periods of slow growth is not the only reason why the City's pension costs are now so high and disproportionate to covered payroll.

The rising and disproportionate costs related to DB plans were recognized in the private sector beginning in the late 1980's. The trend away from defined benefit programs began at that time and has continued to today. The rapidly increasing annual costs and the growth of unfunded vested benefits are the primary reasons for changing from DB plans. By the late 1990's, there were virtually no defined benefit plans used by most small and mid-sized businesses. In 1987 even the Federal Government introduced a defined contribution (DC)-type plan which depends in great part on employee contributions.

Defined benefit plans remain in place only in very large public companies and governmental entities which have a strong union presence.

Ultimately the amounts of those ultra-large unfunded liabilities were cited as a major factor in the financial failures of large business entities including various airlines and General Motors. The failures of several significant governmental entities are similarly attributed to the runaway costs combined with off-balance sheet unfunded liabilities.

A related administrative issue surfaced several years ago when CalPERS announced their decision to discontinue disclosure of the City's specific amount of the unfunded vested benefits. That along with other unilateral actions by CalPERS, has reminded us of periodic difficulties in dealing with such a large entity as a service provider.

During the decade or so after the City adopted the DB plan, the costs were relatively nominal due to the investment rate assumptions included in the plan. However, as costs increased staff responded to council concerns by stating that the rising costs were merely the "balancing" of the favorable investment rates that were assumed during those earlier periods. However, the continual acceleration of costs has long offset any of the assumed benefits in the earlier years.

When pension reform was initially proposed in 2004, those Council members opposed to changes cited a number of arguments. These included assertions that any decrease in benefits or decrease in City contributions would expose the City to organization by unions, exposure to increased staff turnover and difficulty in hiring future employees. Further many City Staff joined them in the argument that the superior retirement benefits were need to offset the wage differentials compared with private industry. During the last half-dozen years the condition of our economy, the continuing 12.5% unemployment in California, and uncertainty of long-term stability in the private sector render those prior arguments moot or subject them to revaluation in light of the increased pension costs during the same period.

CURRENT REFORM TRENDS

A "two-tier" system

Each week we are learning of new pension reform proposals. Virtually all of the new plans are specifically designed for new employees who are not now covered by the existing defined benefit plan. This is commonly referred as creating a "two-tiered" plan. When first proposed to RPV in 2004, most existing City staff and the majority of the voting council members stated such a two-tiered plan would create an unequal benefit structure. However, as we have seen during the last year, this concept has been accepted by very large employee unions dealing with the State and Orange County. They too recognize that pension reform must be started at some time and this is proving to be an appropriate time and manner to initiate the process. The newly approved two-tier State plans include the California Highway Patrol.

Talks or action to reduce pension costs, including the adoption of two-tier systems are also underway in local government agencies. For example, the City of South San Francisco has adopted a two-tier plan. The City of Ventura has approved a two-tier plan, subject to negotiation of the details with employees. At least eight California cities and one County have pension measures on this month's ballot. Proposals in Bakersfield and Menlo Park would create two-tier systems with lower benefit formulas.

Action by the State of California

On October 20th the Governor signed SB 867 and SBX 622 which implements some major pension objectives. There were three major objectives reforms included in this action: (1) Rolls back expansion of pension benefits in 1999 under SB 400 will be rolled back for new employees. (s) Ended pension spiking by requiring employee retirement rates to be based on the highest consecutive three year average salary as opposed to the single highest year. (3) Increases transparency by requiring CalPERS to notify the Governor and others any time it adopts contribution rates. Also the Governor negotiated pension reforms with seven significant state employee unions resulted in retaining the basic structure of the existing defined benefit programs but significantly reducing the percentage benefits and extending various retirement ages.

During conversation with the Governor's principal advisor on these pension reforms, David Crane, he recommended that the recently passed plan in Orange County should be considered as an improvement over the state negotiated changes.

Action by Orange County

Adopted in May 2010 by Orange County, their new plan has been recognized as being innovative in dealing with the powerful Orange County Employee Association (Union). This is a hybrid defined benefit/defined contribution retirement plan (see article on Exhibit C and their Agenda Staff Report Exhibit D), which required special legislation approved by the State Legislature.

It is very important to note that the plan adopted by Orange County required state legislation. The format of this plan is not available to cities – however the innovative hybrid plan and underlying assumptions could be modified and considered by cities.

I spoke with the two Orange county Supervisors most responsible for these changes, Supervisor Bill Campbell, and supervisor John Moorlach (who is also a CPA) along with the county's Director of Human resources Carl Crown.

It was surprising to learn from the two supervisors that while they were pleased with the plan which their County had adopted given our City's circumstances they recommended that we pursue a defined contribution-type program similar to a 401(k) plan.

Actions by Cities

While there is a great deal of change discussed by cities, the changes thus far adopted by cities has been to modify now existing defined benefit plans through lowering benefit formulas and extending retirement ages for new employees.

CONCLUSION

Again, there is to be no change to the existing defined benefit plan for current employees.

Given our City's increased pension costs during the last decade we should retain pension consultants to help us design a DC plan similar to a 401(k) pension plan to be adopted only for new employees beginning July 1, 2011.

ALTERNATIVES

Retain pension consultants to help modify the existing defined benefit program in a manner similar to those modifications adopted by other cities and even consider some of the hybrid features adopted by Orange County.

Make no change.

Exhibit A

RANCHO PALOS VERDES
PENSION COSTS

Fiscal year	Base cost	Paid to side-fund liability	Add'l. side fund payment	Pension cost	Change Amount	Change percent	Covered Payroll	Pension cost % of Payroll
2009-10	$ 814,205	$ 180,000	$1,481,376	$ 2,475,581	$967,277	64%	$ 4,630,020	53%
2008-09	$ 808,304	$ 700,000		$ 1,508,304	$761,121	102%	$ 4,650,530	32%
2007-08	$ 747,183			$ 747,183	$115,963	18%	$ 4,239,406	18%
2006-07	$ 631,220			$ 631,220	$ 40,629	7%	$ 3,490,159	18%
2005-06	$ 590,591			$ 590,591	$179,179	44%	$ 3,621,822	16%
2004-05	$ 411,412			$ 411,412	$143,728	54%	$ 3,663,957	11%
2003-04	$ 267,684			$ 267,684	$100,261	60%	$ 3,242,093	8%
2002-03	$ 167,423			$ 167,423	$ 22,640	16%	$ 2,904,427	6%
2001-02	$ 144,783			$ 144,783	$ 11,323	8%	$ 2,455,956	6%
2000-01	$ 133,460			$ 133,460	$ (1,541)	-1%	$ 2,086,935	6%
1999-00	$ 135,001			$ 135,001			$ 2,102,848	
1998-99	na						$ 2,064,127	
Totals last 10-years	$4,716,265	$ 880,000	$1,481,376	$ 7,077,641			$ 34,985,305	20%

CITY OF RANCHO PALOS VERDES

NOTES TO FINANCIAL STATEMENTS

JUNE 30, 2009

NOTE #7 – PENSION PLAN

Plan Description

The City provides a defined benefit pension plan that includes retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. The City participates in the Miscellaneous 2.5% at 55 Risk Pool of the California Public Employee's Retirement System (CalPERS), a cost-sharing, multi-employer public employee defined benefit pension plan administered by CalPERS. CalPERS provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. State statutes, within the Public Employees' Retirement Law, establish benefit provisions and other requirements. The City selects optional benefit provisions from the benefit menu by contract with CalPERS and adopts those benefits through local ordinance. Copies of the CalPERS annual financial report may be obtained from the CalPERS Executive Office at 400 P Street, Sacramento, California 95814 or downloaded from their website at www.calpers.gov.

Funding Policy

The contribution requirements of plan members are established by State statute and the employer contribution rate is established and amended by CalPERS. Active City employees are required to contribute 8% of their annual covered salary. The City pays 6.5% of the contribution for all the full-time positions, and 1% of the contribution for part-time employees. The City is required to contribute the actuarially determined remaining amounts necessary to fund the benefits for its members. The FY08-09 rate was 15.275% of covered payroll. The City's contributions to CalPERS for the years ending June 30, 2009, 2008 and 2007 were $1,508,304, $747,183 and $631,220, respectively, and were equal to the required contribution for each year.

As a result of having less than 100 active members as of June 30, 2003, the City was required to participate in a risk pool. The City's pooled employer contribution rate is the same as the stand-alone employer contribution rate. At the time of joining the mandatory pooled plan, CalPERS established an employer side fund to account for the difference between the funded status of the pooled plan and the funded status of the City's plan. The amortization of the side fund is included in the determination of the City's annual required contribution.

The funded status of the pooled plan may be obtained from CalPERS.

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Pensions & Investments

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Pension Funds

Orange County offers a combo plan to new union employees

By Robert Steyer

Orange County, Calif., has adopted a novel retirement plan in which new union employees can choose between participating only in the $4.7 billion defined benefit plan, or participating in both the DB and a new defined contribution plan.

Those choosing the combination pay a lower contribution to the defined benefit plan, but also get reduced benefits. On the DC side, they get a small employer match.

Although some state government plan sponsors and a few municipal ones offer defined contribution plans, Orange County's version — where all new employees participate in the defined benefit plan — is rare.

More common approaches include closing the DB plan to new employees and allowing them to participate only in a DC plan, or giving them a choice between a defined benefit or a defined contribution plan.

An analysis last year by the Center for Retirement Research at Boston College found that 18 of 126 mostly state plans studied had some form of DC component for new employees, said Jean-Pierre Aubry, a research associate at the center.

In Orange County, the Orange County Employees Retirement System, Santa Ana, administers the plan, but the new approach was developed by executives of the union — the Orange County Employees Association — and management.

Officials from both sides say the new design will reduce the county's defined benefit plan expenses.

William Campbell, vice chairman of the Orange County Board of Supervisors in Santa Ana, said an actuary hired by the county calculated the new plan could cut annual costs by about 2% over time, assuming half of the new employees choose the combination of a DB and a DC plan.

Keith Brainard, research director for the National Association of State Retirement Administrators, Baton Rouge, La., noted that plans with a defined contribution component "present lower, long-term liabilities for the employer." The problem, however, is usage. Mr. Brainard said he believes most new employees select traditional DB plans over other types.

William Campbell

The new plan is unique to California, and required passage of a state law last year to authorize it. The county and the union agreed to the plan in June 2009; enrollment began last month.

Neither Mr. Campbell nor Lisa Major, assistant general manager for the union, could recall who made the first move toward proposing the new approach when union and county negotiators starting discussing a new contract in the spring of 2009.

"It seemed like we came to it at about the same time," Ms. Major said said.

"It was both of us," said Mr. Campbell. "We wanted to reduce the (DB) plan for new employees. The union wanted to give new employees a choice."

The defined contribution portion was developed — and will be administered — by TIAA-CREF, New York.

The DC component "works in tandem with, rather than supplements" the defined benefit plan, said Richard Hiller, vice president for government and religious markets at TIAA-CREF. "The overall pension plan is structured to help employees replace 70% or more of their income in retirement. The DB (formula) doesn't accomplish that on its own, so the DC plan is layered on to help achieve the necessary income in retirement."

The standard employer match is 50% on up to 2% of the employee's contribution. In the plan's first year of operation, however, the match is 100% on up to 2% of the employee contribution. On the defined benefit side, those choosing to enroll in the DC plan will make a smaller contribution to the DB plan. In exchange, the benefit payment will be less. In addition, they must work until age 65 to get their full benefit payment. Those sticking with the original DB-only approach may retire with full benefits at 55.

Benefit to county

Mr. Campbell said that change also benefits the county because "the county can retain employees 10 years longer and thereby reduce costs associated with training and recruitment."

Costs could be reduced further if existing employees are given the same choices that new employees get, something both the county and the union support. So far, however, that move has been blocked by the Internal Revenue Service.

"Mandatory employee contributions to public employee retirement plans are considered 'picked up' employer contributions for federal income tax purposes," said Mr. Campbell. "The employee is not taxed when the contributions are made but is taxed on the benefits when (they) are received."

The IRS is questioning if allowing current employees a one-time chance to switch to the new plan "will cause their contributions to lose their pre-tax status and whether this loss will apply to all ... current employees ... including those who do not elect the lower formula," he said.

Mr. Campbell said the county has been discussing this issue with the IRS since September 2009. He hopes for a ruling later this year.

The new structure reflects employees' evolving attitudes about work and retirement, Ms. Major said. "If I'm 25, I don't know if I'll be working in the same place until I'm 55," she said. "People move around a lot more. A defined benefit plan is the most reliable (retirement investment), but some people want more control over their money" through a defined contribution plan. ■

Steve Wolowicz

From:	Crown, Carl [carl.crown@ocgov.com]
Sent:	Thursday, August 12, 2010 9:23 AM
To:	Stevew@rpv.com
Cc:	Johnson, Michael [D3]
Subject:	1.62% @ 65 formula
Attachments:	1.62 ASR.doc

Steve

Attached is the item that went to the Board to adopt the new retirement formula. It is a good description of the plan and issues surrounding the tax implications for current employees. Let me know if you need anything else and, as discussed, I would be happy to meet with you to discuss further.

Carl Crown

Human Resources Director

County of Orange, Ca.

(714) 834-2836

<<1.62 ASR.doc>>

Agenda Item

AGENDA STAFF REPORT

ASR Control 10-000296

MEETING DATE:	04/20/10
LEGAL ENTITY TAKING ACTION:	Board of Supervisors
BOARD OF SUPERVISORS DISTRICT(S):	All Districts
SUBMITTING AGENCY/DEPARTMENT:	Human Resources Department (Approved)
DEPARTMENT CONTACT PERSON(S):	Robert J. Franz (714) 834-4304 Carl H. Crown (714) 834-2836

SUBJECT: Approve Resolution for "1.62% at 65" Retirement Formula

CEO CONCUR	COUNTY COUNSEL REVIEW	CLERK OF THE BOARD
Concur	Approved Agreement(s) and Resolution(s)	Discussion 3 Votes Board Majority

Budgeted: N/A **Current Year Cost:** N/A **Annual Cost:** N/A

Staffing Impact: No **# of Positions:** **Sole Source:** N/A
Current Fiscal Year Revenue: N/A
Funding Source: N/A

Prior Board Action: N/A

RECOMMENDED ACTION(S):

1. Approve and adopt the resolution implementing the "1.62% at 65" retirement formula as detailed in Exhibit A.

2. Approve and adopt Side Letter Agreements between the County and applicable labor groups implementing the retirement formula election as to new employees, as detailed in Exhibits B, C and D.

3. Approve and adopt the Amendment to the Personnel and Salary Resolution, adopting the election of the "1.62% at 65" retirement formula for unrepresented employees, as detailed in Exhibit E.

SUMMARY:

In an effort to address increasing pension costs, the County initiated steps towards implementing a new lower retirement formula "1.62% at 65" combined with a Defined Contribution Plan. The implementation of the proposed retirement program required legislation to be approved through the State legislative process. On October 11, 2009, Senate Bill 752 was approved, which permits in Orange County, the board of supervisors, or the governing body of a district within the county, by resolution adopted by majority vote, to require certain employees to make a written election between two specified retirement formulas.

The lower formula, combined with the Defined Contribution Plan will result in a significantly lower cost to the County and to the employees than the current 2.7% at 55 retirement formula. Approval and adoption of the Resolution before your honorable Board today will allow the County to implement the new "1.62% at 65" retirement formula.

MOUs with the Orange County Employees Association (OCEA), Association of Orange County Workers (AOCW) and the International Union of Operating Engineers (IUOE) currently contemplate offering to both current and new employees the election between the two retirement formulas. Issues have arisen with respect to the possible tax impact of implementing the retirement formula election for current employees. Until these issues are resolved, we believe it is best to proceed with implementing the election for new employees only. We have entered into Side Letter Agreements with each of these collective bargaining associations whereby they acknowledge and agree with implementing only for new employees and postponing the election for current employees.

The attached amendment to the Personnel and Salary Resolution extends the election of the new retirement formula to unrepresented new employees, which includes Elected Officials, Executive Management and Executive Aides and Executive Assistants of elected officials, and is included in Exhibit E.

Discussions are underway with the Orange County Managers Association (OCMA) and Orange County Attorneys Association (OCAA) regarding the implementation of the election of the "1.62% at 65" retirement formula for new employees, under the terms of the respective contract extension agreements. We anticipate that we will return to your Board in the near future with implementation agreements for OCMA and OCAA upon completion of those discussions.

BACKGROUND INFORMATION:

In an effort to address increasing pension costs, the County initiated steps towards implementing a new lower retirement formula "1.62% at 65" combined with a Defined Contribution Plan for non-safety employees. The lower formula, combined with the Defined Contribution Plan will result in a significantly lower cost to the County and to the employees than the current 2.7% at 55 retirement formula. The implementation of the proposed retirement program required legislation to be approved through the State legislative process, which was approved on October 11, 2009.

The bill requires an employee who elects the lesser of the two specified retirement formulas be eligible to receive a contribution to a defined contribution program from the County based on the employee's contribution to a defined contribution program.

Employees who elect the new, lower retirement formula will be eligible to participate in a Defined Contribution Plan in which the County will provide a one-hundred percent (100%) match of the employee's contributions during the first year of the plan up to two percent (2%) of the employee's salary, and in subsequent plan years will provide a fifty percent (50%) match of the employee's contributions up to two percent (2%).

An issue has arisen regarding the possible tax impact of offering the retirement formula election to current employees. The Internal Revenue Service (IRS) has indicated that doing so would result in the employee contribution paid by the current employees offered the election to no longer be excludable from gross income. We are pursuing this issue with the IRS. Until this tax issue is resolved, we recommend proceeding with the implementation of the election for new employees only. Memoranda of Understanding with OCEA, AOCW and IUOE are currently contemplating offering to both current and new employees the election between the two retirement formulas. Attached are Side Letter Agreements with each of these labor associations whereby they acknowledge and agree with implementing only for new employees and postponing the election for current employees. When the tax issues are resolved, we will return to your Board with a Resolution adopting the election of the new Tier III 1.62% at 65 formula for the current employees.

The Human Resources Department, the County Executive Office, the Auditor-Controller, OCERS staff, OCEA and other labor representatives have worked together on implementation efforts, including system modifications, employee communications, pre-employment seminars, website information and updated forms so new employees will be properly informed of the requirement to elect their retirement benefit formula. Additionally, tracking and reporting mechanisms will be available for use by departments to assist in following up with any new employees who have not made an election before the 45 days provided for has expired.

Government Code Section 7507 requires that the County engage an actuary to provide a statement of the actuarial impact upon future annual costs, including normal cost and any additional accrued liability, of any changes in retirement benefits or other postemployment benefits prior to the Board of Supervisors authorizing such changes. The required report is attached hereto as Exhibit F. Section 7507 requires that the actuary's report be made public at a public meeting at least two weeks prior to the adoption of any changes in public retirement plan benefits or other postemployment benefits. The report was made public at the meeting of the Board of Supervisors held on December 15, 2009. Finally, Section 7507 requires, with respect to any such changes, that the County Executive Officer (CEO), acknowledge in writing that he or she understands the current and future cost of the benefit as determined by the actuary. That acknowledgement is attached hereto as Exhibit G.

FINANCIAL IMPACT:

There is no immediate financial impact; potential future savings from implementing of the new pension program.

STAFFING IMPACT:

No

REVIEWING AGENCIES:

County Counsel

EXHIBIT(S):

Exhibit A – Resolution Adopting Election and "1.62% at 65" Retirement Formula
Exhibit B – Side Letter Agreement with OCEA
Exhibit C – Side Letter Agreement with AOCW
Exhibit D – Side Letter Agreement with IUOE
Exhibit E - Amendment to Personnel and Salary Resolution

Exhibit F – Bartel Actuarial Statement of Cost Impact of the "1.62% at 65" Retirement Change dated December 1, 2009
Exhibit G - Acknowledgement Pursuant to Government Code Section 7507