Addressing Rising Employee Benefits Costs Through the Sharing of Pension Contribution Rates

By Danielle DuCaine and Charles Sakai Renne Sloan Hotlzman Sakai LLP

As the 2009-10 fiscal year comes to a close, California's cities and counties continue to struggle to balance their budgets in an era of reduced revenues. While the economy begins to show signs of a rebound with anticipated growth in certain volatile revenue streams, such as sales and transient occupancy taxes, property values continue to shrink. Foreclosures and short sales have depressed property values in much of California and Proposition 13 will continue to hold those property taxes down even as the real estate market begins to revive.

As if the revenue picture were not sufficiently bleak, expenses will continue to rise. Despite dramatic reductions in service levels, wages freezes and other cuts California's public agencies now face a significant increase in the employer contribution rates for employee and retiree pensions. The rate increases are due primarily to the widely publicized investment losses that the California Public Employees Retirement System (CalPERS) experienced since in 2008. CalPERS began 2008 with $253.0 Billion in assets and ended that year with $183.3 Billion. By the end of 2009, PERS assets had grown to $203.3 Billion. However, during those two years, CalPERS' investment portfolio declined by 19.76% during a period when the agency assumed an increase in portfolio value of more than 16%. Former Chief Actuary Ron Seeling characterized these market losses as a "unique and catastrophic event" for the CalPERS system.

To cover these historic investment losses, CalPERS will substantially increase employer contribution rates, raising those rates to levels not seen in decades as early as July 1, 2010. Adding to the shock of the initial rate hike, on April 20, 2010, a CalPERS committee voted to recommend a second rate hike for employers based on the findings of the "CalPERS Experience Study 1997-2007" released in April. The Study of the CalPERS system and its members found that members are living longer, retiring earlier, and making more money. As a result, the new data could add to the employer contribution rates by as much as 10 to 12 percent. One CalPERS board member estimated that "the total for some local governments 'could be a 40 percent increase in contributions for local safety.'"

As employers struggle to prepare for these rate increases, employers must take steps to mitigate the impact of financial market volatility on employer contribution rates. Indeed, many employers have already proposed second tier retirement formulae, seeking a more sustainable benefit level for future employees. However, these changes in benefit formula will not have an appreciable impact on the employer's rate for many years.

Therefore, cities and counties have begun exploring other avenues for pension-related cost sharing. This article explores one of those avenues – increasing the employee contribution towards retirement. Although not commonly used, employee cost shares are becoming more popular, and have a number of advantages. Unlike the establishment of a second tier, increasing the employee contribution creates an immediate cost reduction for the City. In addition, the cost share has a rational justification – even though employees are receiving a substantial retirement benefit, they are also helping to pay for it.

Shifting Costs Between Employer And Employee

Most California employers are aware that the Public Employees Retirement Law (PERL) permits an employer to "pickup" all or a portion of an employee's mandatory PERS contribution. However, another, less well-known provision of the PERL permits employees to pay a portion of the employer's Normal Cost of providing the retirement benefit. Either of these provisions, or some combination of the two, provides a means of reducing employer contributions.

Reducing EPMC

Section 20691 of the PERL permits the employer to "pay all or a portion of the normal contributions required to be paid by a member." The payment must be the same for all employees in a group or class of employees and is generally identical for all members of a bargaining unit.

For those agencies which already pick up some portion of the employee's mandatory contribution, the path of least resistance may well be a reduction in EPMC. Section 20691also authorizes the "employer to periodically increase, reduce, or eliminate the payment." Therefore, a contracting agency may modify its contract with CalPERS to reduce the EPMC at any time.

...continue

Employees Picking Up the Employer's Share

Less commonly utilized is PERL § 20516, which provides that employees may pay a portion of the employer's normal contribution. Section 20516 requires a number of things. First, the employer and the exclusive representative of bargaining unit employees must agree, in writing, to share the costs. Second, the written agreement must specify the exact percentage of member compensation that shall be paid toward the current service cost of the benefits by the member. Third, the additional payment must be made for an optional benefit which the agency adopted after January 1, 1979. Fourth, the agency must amend its contract with CalPERS. Fifth, the cost share must be a "level percentage" of member compensation. Finally, although not specifically required by the statute, CalPERS interprets this provision to require a separate vote of the affected employees. Once established, a cost share under Section 20516 changes the employee contributions on an ongoing basis. While the employee contribution can be changed by future negotiations, it does not expire or otherwise change absent an amendment to the employer's contract with CalPERS.

Interestingly, Section 20516(f) provides that it is not intended to preclude any contracting agency and its employees from "independently agreeing in a memorandum of understanding to share the costs of any optional benefit or when initially entering into a contract, any benefit, in a manner inconsistent with this section." However, such an agreement will not be reflected in a contract amendment with CalPERS.

Subsection (f) allows what may be the most interesting option in establishing an employee cost share – the flexible share. Because a cost sharing arrangement entered into between a contracting agency and its employees outside of the provisions of Section 20516 is not subject to the restrictions of the section, it can take almost any form: it can "float" and change based on the employer's rate; the money can be drawn from a variety of sources, or the contribution could be a fixed dollar amount rather than a percent of pay. For instance, one of our clients entered into a memorandum of understanding with one bargaining unit which directly reduces the base pay of bargaining unit members by an amount which varies based on the employer rate. Another has a sliding scale which reduces the employer's contribution to health insurance. Another has a flat percentage reduction in employee pay based on the Normal Cost difference between Tier 1 and Tier 2 benefits. Yet another has a cap on the employer contribution rate, with employees picking up all of the employer contributions in excess of that cap.

There is a further distinction between cost sharing agreements established under Section 20516 and those allowed by 20516(f). Because Section 20516 provides that contributions made pursuant to that section are deemed normal member contributions, they are subject to the same rules as other member contributions, including the possibility that they could be cashed out by the member. Cost sharing arrangements outside of Section 20516 do not change the character of the contributions – they are employer contributions (even though they are paid by the employee) and are credited to the employer's account.

Collective Bargaining Overlay

It likely goes without saying that employees picking up a portion of the employer's CalPERS contribution falls within the scope of representation. The Public Employment Relations Board has long held that retirement is sufficiently related to wages as to fall within the scope of representation. Cost shares of the type described in this article have a direct impact on compensation and are therefore almost certainly subject to the meet and confer requirements of the MMBA.

Conclusion

Governor Schwarzenegger stated in a recent weekly radio address that the "crisis" in the public pension system is the "single biggest threat to our state's fiscal health and future." While the Governor urges the Legislature to make pension reform its "top" priority, one thing is certain- California's cities and counties must act now to contain costs associated with public employees' salaries and

...continue

[i] A second, and less well known cause of rate increases is that CalPERS has also suffered actuarial losses occasioned by early retirements due in large part to wage and benefit reductions.

[ii] CalPERS Facts at a Glance: Investment (May 2010).

[iii] CalPERS assumes a 7.75% annual investment return

[iv] "City Advocate Weekly, CalPERS Board Debates Methods to Ease Economic Pressures on Employer Contribution Rates (May 15, 2009) available athttps://newsletter.cacities.org/e_article001436923.cfm?x=bdk41Pl,b102Tph3,w.

[v] CalPERS Actuarial Office, CalPERS Experience Study 1997 to 2007, (April 2010) available at https:www.calpers.ca.gov/eip-docs/about/board-cal-agendas/bpac/201004/item03b-01.pdf.

[vi] Ed Mendel, *A Second CalPERS Rate Hike for Employers*, Calpensions, Apr. 21, 2010, https://calpensions.com/2010/04/21/a-second-calpers-rate-hike-for-employers/.

[vii] "Id.

[viii] Cal. Gov't. Code §20692. This provision is commonly known as "EPMC."

benefits, and they must look to creative solutions to immediately address the ballooning cost of pensions. This article merely scratches the surface of the possibilities in one such solution. As California's public employees continue to live longer, earn higher salaries and retiring earlier, cost sharing is one way to address the dramatic rate increases facing public employers.

[ix] Cal. Gov't Code §20691.

[x] Id.

[xi] Cal. Gov't Code §20516(a).

[xii] Id.

[xiii] Cal. Gov't Code §20516(a),(b).

[xiv] Cal. Gov't Code §20516(c).

[xv] Cal. Gov't Code §20516(e)

[xvi] "The member contributions shall be normal contributions over and above normal contributions otherwise required by this part and shall be treated as normal contributions for all purposes of this part." Cal. Gov't Code §20516(a).

[xvii] Cal. Gov't Code §20516(f).

[xviii] Cal. Gov't Code §3504 provides that the scope of representation shall include "all matters relating to employment conditions and employer-employee relations, including, but not limited to, wages, hours, and other terms and conditions of employment."

[xix] Arnold Schwarzenegger, Governor of CA, Weekly Radio Address (Apr. 17, 2010) available at http://www.californiapensionreform.com/?p=881.