THE PUBLIC SECTOR

As CalPERS retirement costs continue to escalate, agencies contemplate their future

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Recently, the California Public Employees' Retirement System (CalPERS) Board of Administration followed through with a previously announced move to lower its expected investment return rate, also known as the "discount rate." The discount rate is the total of:

- Inflation projections;
- The rate of investment returns above inflation; and
- A margin for adverse returns.

Currently, CalPERS calculates the cost of pension benefits assuming a 7.5% annual rate of return—an optimistic (i.e., imprudent) assumption in light of actual investment yields in recent years and the forecast of economic and capital market conditions over the medium term. In an effort to eliminate risk from its portfolio and take on a more manageable level of volatility from year to year, CalPERS is reducing the discount rate from 7.5% to 7% over the next three years, beginning with the June 30, 2016, actuarial valuations that will determine employer contribution rates for fiscal year (FY) 2018-19.

Lowering the discount rate will result in an increase to both the *normal cost* (the cost of providing retirement benefits for active employees) and the amortization payment toward the plan's *unfunded liabilities.* The full impact of the reduction will not be realized until several years out (FY 2024-25). It is projected to add an additional 7.5% to the total employer rate for miscellaneous employee plans and 13% for safety employee plans—and those projected increases are on top of rates that are already rising because of prior actions by CalPERS that modified actuarial assumptions (including improved life expectancy).

While the change will help reduce volatility in return rates over time, it will result in additional costs for participating public employers. That's an added stress that will have long-term consequences for all CalPERS contract agencies and, indeed, for the public at large.

Two-pronged approach

Public employers need to ascertain the long-term financial consequences of CalPERS' action and plot out a long-term strategic plan. The first prong is to highlight the issue publicly—identifying long-term budgetary consequences and assessing, with actuarial assistance, options for reducing costs. Financially able agencies may seek to move to the higher rates early with a shorter amortization period to reduce long-term costs. Other options identified by actuaries, including the highly regarded firm Bartel & Associates, include establishing a pension rate stabilization fund or a supplemental pension trust.

The second prong entails negotiations with employee organizations. The Public Employees' Pension Reform Act of 2013 (PEPRA) began (modestly) to give employers more leeway to negotiate pension cost sharing. PEPRA set a "standard" that employees pay at least 50% of the normal pension cost and eliminated employer-paid member contributions (EPMC). This standard is absolute for employees hired after December 31, 2013, but it isn't a mandate for "classic" employees. Employers that still pay part or all of their employees' share of retirement benefits are free to negotiate the elimination of that practice as part of "successor" negotiations.

Since PEPRA was enacted, many agencies have eliminated EPMC but have added to personnel costs by giving employees offsetting wage increases. Given the escalating cost of CalPERS' action, the concept of offsetting wage increases in exchange for eliminating EPMC is probably now a thing of the past.

Employers are also free to propose in successor negotiations that "classic" employees pay up to 50% of the normal cost of their retirement benefit. However, PEPRA gives employers only half a loaf. It places an upper limit on employee contributions (8% for miscellaneous employees, 12% for police and fire employees, and 11% for other safety employees) unless something else is mutually agreed on. Given those maximums, the goal of having employees pay 50% of the normal cost will be impossible for many agencies to realize. And until July 1, 2018, employers may implement such an increase only with union consent.

The modest nature of PEPRA's reform efforts means that employers will need to do more than what's mentioned above to offset pension costs. The obvious frontal approach is to reduce salary increases (or reduce salaries altogether) commensurately with increases in pension costs. PEPRA doesn't limit that strategic option.

Many agencies are looking at broader options for cost containment. One controversial example is contracting out services, which can save labor costs but may degrade service quality and reduce public accountability. As a mandatory subject of bargaining, contracting work to save labor costs also implicates burdensome labor law rules, and contracting efforts are often challenged through the Public Employment Relations Board (PERB) or other litigation. Nevertheless, as California agencies contemplate their future in light of rising labor costs, contracting work out and other strategic options are under review.

Statewide reform is needed

Rising pension costs implicate an essential statewide policy matter. The reality is that agencies compete for personnel—especially for police officers. Any agency that is in front of the curve on pension reform (i.e., through innovative cost-containment vehicles in anticipation of the storm to come) will be at a competitive disadvantage vis-à-vis other agencies. That is a major disincentive for true pension reform at the local level.

The experience of the city of San Jose is an example. True reform under the city's local pension system caused the exodus of hundreds of police officers as well as significant litigation. Ultimately, a compromise was reached, resulting in a dramatic influx of the city's former officers.

The left-leaning legislature is not a reliable friend of true pension reform. Governor Jerry Brown's efforts were a laudatory first step, but only a first step. There is the specter that within a few years' time, the vast majority of public agency expenses will go toward employee pensions and retiree health benefits, sacrificing agencies' ability to provide the public services they were created to provide. Will it take a major economic catastrophe for local agencies for true legislative reform to be achieved?

Case law on 'vested' retirement rights is in flux

This may prove to be one of the rare situations in which courts are ahead of the legislature in effecting meaningful reform. The California Court of Appeal recently issued a groundbreaking decision that departed from the courts' historical stance on "vested rights" principles.

In *Marin Association of Public Employees v. Marin County Employees Retirement Association,* the court of appeal held that although a public employee has a "vested right" to a pension, the entitlement is only to a "reasonable pension"—not an "immutable entitlement to the most optimal formula of calculating the pension." A similar result was reached in another court of appeal case decided in December 2016, *Cal Fire Local 2881 v. California Public Employees Retirement System.* Both cases are now pending before the California Supreme Court.

Bottom line

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Analysts have expressed concern for some time that CalPERS' previous rate of return—7.5%—was unrealistic. Even as late as December 2016—when it was generally acknowledged that the projected rate of return was overly optimistic—CalPERS' website called it a "myth" that its 7.5% annual rate of return was too high and could not be achieved. Now, the "myth" has unquestionably become reality.

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