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# California Research Bureau Public Retirement System Survey

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## California Research Bureau Public Retirement System Survey

*By Grant Boyken*

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C A L I F O R N I A R E S E A R C H B U R E A U

**California Research Bureau  
Public Retirement  
System Survey**

*By Grant Boyken*

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I would like to thank the entire staff of the California Public Employee Post-Employment Benefits Commission (PEBC) for their assistance with this project and for lending their collective expertise; in particular Anne Sheehan, Executive Director, Jan Boel, Staff Director, Tom Branan, Policy Director, Stephanie Dougherty, Research Director, as well as Dave Christianson, Richard Krolak, Bob Palmer, and Ashley Snee. PEBC staff members Danny Chang, Crystal Robinson and Admas Kanyagia made numerous phone calls to ensure the highest possible survey response rate. Steve Keil, Director Legislative Services for the California State Association of Counties, was instrumental in securing the participation of the county retirement systems. John E. Bartel, President of Bartel Associates, LLC, and Paul Angelo, Senior Vice President and Actuary for The Segal Company, provided assistance to ensure that the interpretation of the data and the descriptions of actuarial concepts were technically accurate. Tim Lynn, Assistant Program Budget Manager, Department of Finance provided data on pension costs for the State of California.

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## **INTERNET ACCESS**

This paper is available through the Internet at the California State Library's home page (<http://www.library.ca.gov/>) under California Research Bureau Reports.

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# California Research Bureau Public Retirement System Survey

December 2007

## I. EXECUTIVE SUMMARY

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### Why did the California Research Bureau conduct this study?

In response to ongoing concerns about the cost of providing pensions and health benefits for retired public employees in California, on December 28, 2006, Governor Arnold Schwarzenegger established, by Executive Order S-25-06, the Public Employee Post-Employment Benefits Commission to address unfunded post-employment benefits.

The Commission requested that the California Research Bureau (CRB) conduct a survey of the State's public retirement systems in order to identify the amount of pension benefits that remain unfunded. The survey examined retirement systems' current funding status and employer contribution rates since 1990. Using data from the survey as well as data from the California State Controller's Office and Department of Finance, the report provides historical data on public pension plan funding progress and contribution rates.

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### Survey methodology and key findings

Responses to an electronic survey were received from officials representing 57 of the State's 85 public employee defined benefit plans. These 57 plans account for approximately 99 percent of public retirement system membership in the state and approximately 99 percent of pension system liabilities according to the State Controller's Office.

The study's key findings include the following:

- California's public retirement systems reported a combined unfunded liability of \$63.5 billion as of their most recent actuarial valuations (2006 for most systems).
- The survey found an aggregate funded ratio of 89 percent for all of California's public retirement system's combined. This is lower than the peak of 118 percent reached in 2000, but higher than in the early- to mid-1990's.

- Pension contribution rates have generally risen from 1990 to the present, but recent investment gains may cause rates to fall in the near future.
- Even though State pension contributions have risen substantially in the past decade, they have remained at a relatively stable three-and-a-half to four percent of total general fund revenues from the mid-1990's to the present. The exception is 1999 to 2002 when contributions were significantly lowered.
- On the whole, California's public pension plans are substantially funded, particularly when viewed in comparison to the large unfunded liabilities that exist for public employers' retiree health benefits.

## **II. BACKGROUND: OVERVIEW OF CALIFORNIA PUBLIC EMPLOYEE RETIREMENT SYSTEMS**

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### **How many public retirement systems are there in California?**

The largest are the state retirement systems. Although the majority of public agencies contract with the California Public Employees' Retirement (CalPERS) system to provide pensions, some of the larger counties, cities and special districts operate their own retirement systems. In total, the California State Controller's Office lists 85 defined benefit retirement systems in its most recent annual report on public employee retirement systems.<sup>1</sup> These include:

- The Public Employees' Retirement Fund (PERF) administered by CalPERS for state, public agency, and classified school employees;
- The Legislators' (for legislators serving prior to November 7, 1990) and Judges' Retirement Systems, also administered by CalPERS;
- The California State Teachers' Retirement System (CalSTRS) administers a plan for public K-12 and community college teachers;
- The University of California Retirement System for University of California employees;
- 20 systems operating under the County Employees' Retirement Law of 1937;

- Two independent county systems (San Francisco and San Luis Obispo Counties);
- 32 city systems;
- 25 special district systems;\* and
- One school district system.

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## **What type of pension benefits do California's public retirement systems provide?**

California's public retirement systems generally provide defined benefit plans as a primary pension benefit. In contrast to defined contribution pension plans in which retirement income depends on the amount accumulated in employees' individual accounts, defined benefit plans guarantee a specific level of retirement income that is calculated based on employees' age, years of service, and salary. For example, in a retirement system that provides two percent per year at age 55, members with 20 years of service may retire at age 55 and receive an unadjusted benefit of approximately 40 percent (two percent multiplied by 20 years of service) of their final salary.

Defined benefit pension plans remain the predominant type of retirement income benefit provided by public employers throughout the U.S. and in California. According to the U.S. Bureau of Labor Statistics, approximately 90 percent of U.S. public employees are covered by a defined benefit pension plan.

Plans typically allow members to opt for a reduced benefit in exchange for a continuing allowance for surviving beneficiaries. For most public employees in California, retirement income from defined benefit plans is indexed to inflation or adjusted on an ad hoc basis. Defined benefit plans also generally provide lump-sum death benefits and disability benefits that are determined based on employees' years of service and salary.

Employer-sponsored pensions that are funded wholly or partially by employers are one component of what has historically been described as the three-legged stool of post-employment income that also includes personal savings and Social Security benefits.

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\* Special districts are a form of local government created by a community to meet a specific need such as park services, police and fire protection, pest abatement, libraries, cemeteries, management of water and natural resources, and the provision of utilities. According to the California Special District Association there are approximately 2,300 independent special districts in California.



With respect to personal savings, California's public employers generally offer some form of tax advantaged deferred compensation plan such as a 401(k), 457, or a 403(b) plan. Unlike private sector employees, however, not all public employees participate in Social Security. Approximately 36 percent of CalPERS active employees are not covered by Social Security. However, Social Security coverage levels for miscellaneous members vary among CalPERS state, schools, and public agency member groups. Approximately two-thirds of state miscellaneous employees are covered, as are nearly all school miscellaneous employees. Less than half of public agency miscellaneous employees are covered. Very few safety members are currently covered by Social Security. No CalPERS state and school safety employees are covered. Only three percent of CalPERS public agency safety members are covered.<sup>2</sup>

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### **How are defined benefit pension plans funded?**

Defined benefit retirement system funds are typically held in some form of trust that can only be used to pay member benefits and the costs of administering the pension plan. Defined benefit retirement systems receive income from returns on invested assets and contributions from employers and employees. The majority of retirement systems' income generally comes from investment returns. As an example, during the five-year period from fiscal year 2002 through 2006, investment returns accounted for approximately 67 percent of the income in the CalPERS Public Employees' Retirement Fund.<sup>3</sup> Employer and employee contributions during that period averaged 20 percent and 13 percent of the fund's total income, respectively.

Because pension plan trust funds typically invest greater than half of their assets in foreign and domestic stocks, their funding status (the measure of assets in the pension fund relative to the costs for pension benefits that the fund is obligated to pay) rises and falls with the financial markets. This volatility has been the cause of much of the scrutiny to which pension plans have been subjected in recent years.

For example, as a result of the bull market of the late 1990s, some plans experienced a surplus funding situation where plan assets surpassed obligations. In response, pension plan trustees pushed for enhanced benefits, reduced the amount that employers needed to contribute to the plans each year, or both. These decisions were criticized as examples of irresponsible pension plan governance in the aftermath of the subsequent downturn of the financial markets that occurred in the early 2000s, which led to a decline in pension

plan funding status and increases in the amount that employers were required to contribute to the plans.

Unlike private sector defined benefit plans which tend to be “non-contributory” (i.e., do not require employees to contribute), public employees generally contribute to defined benefit plans at a fixed rate (typically a percentage of salary) that varies among different types of employees and retirement systems. In some cases, collective bargaining agreements may specify that employers pay employees’ contributions for a period of time.

Employer contributions vary from year to year depending on investment returns and actuarial calculations determining the size of the pension fund that will be needed to pay current and future benefits. Actuarial calculations are based on projections of fund investment earnings, mortality, the number of retirees and beneficiaries, and other factors. Actuaries calculate the contribution amount needed to cover the liability that accrues each year and the amount needed to pay an installment on any unfunded liability. If the fund’s assets are less than the projected liabilities, the plan is generally considered to be under-funded.

In some cases, bonds are used to finance unfunded pension liability. Pension obligation bonds are generally issued by the plan sponsor and backed by tax revenues. Proceeds are made available to pension fund managers for investment. However, because there are no guarantees that a pension system will remain fully-funded after the sale of a bond, some governments may end up paying both pension bond debt service and new unfunded liabilities.<sup>4</sup>

According to the State Controller’s Office, pension obligation bond debt for the counties, cities, and special districts was approximately \$10 billion as of June 2005. The State currently has no pension bond debt.

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## **How much income do California public employee pension plans provide to retirees?**

Many of California’s public retirement systems do not regularly publish data on the average retirement allowances that retirees receive. However, this data is available for members of the California Public Employees’ Retirement System (CalPERS) and the California State Teachers’ Retirement System (CalSTRS). These two systems account for nearly 75 percent of state public employee retirement system membership.<sup>5</sup>

Table 1 displays the average monthly retirement allowances for new CalPERS and CalSTRS service (i.e., non-disability) retirees in the fiscal year that ended June 30, 2006, as well as the average age and years of service for new retirees in that year.

State Highway Patrol members received the highest average monthly allowance upon retirement and also had the highest average years of service at retirement. Classified school members, many of whom are part-time employees that accumulate fewer years of service credit, receive the lowest average monthly retirement allowance.

**Table 1. Average Age, Years of Service, and Monthly Allowance at Retirement for New CalPERS and CalSTRS Service (i.e., non-disability) Retirees, Fiscal Year 2005/06**

| <i>Employee Category</i>           | <i>Average Age at Retirement</i> | <i>Average Years of Service at Retirement</i> | <i>Average Monthly Retirement Allowance at Retirement</i> |
|------------------------------------|----------------------------------|---|---|
| <b>Highway Patrol</b>              | 54                               | 28  | \$5,872   |
| <b>Public Agency Safety</b>        | 55                               | 25  | \$5,553   |
| <b>State Safety</b>                | 57                               | 23  | \$3,967   |
| <b>CalSTRS (teachers)</b>          | 61                               | 26  | \$2,617   |
| <b>Public Agency Miscellaneous</b> | 59                               | 20  | \$2,589   |
| <b>State Miscellaneous</b>         | 60                               | 24  | \$2,564   |
| <b>State Industrial</b>            | 59                               | 21  | \$1,912   |
| <b>Classified School Members</b>   | 61                               | 17  | \$1,350   |

Source: CalPERS Annual Board Member Report, June 2006; CalSTRS 2005 Actuarial Valuation.

### III. SURVEY METHODOLOGY

The purpose of the California Research Bureau Public Retirement System Survey was to determine the funded status of California's defined benefit retirement systems by examining how pension plan assets compare with liabilities (the pension benefits that the retirement system is obligated to pay).

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#### Who responded to the survey?

In May and June 2007, an electronic questionnaire was sent to all 85 of the state's defined benefit retirement systems listed in the most recent State Controller's annual report on retirement systems.<sup>6</sup> Fifty-seven systems responded. This includes all of the state and county retirement systems and all of the large city and special districts. These 57 systems accounted for approximately 99 percent of all public pension system members and 99 percent of pension system liabilities at the end of fiscal year 2004/05, the most recent year covered by the State Controller's Office annual report on public retirement systems. The systems that did not respond tended to be the smaller systems with a median of 349 members compared to median membership of 5,576 for the systems that did respond.

**Table 2. Characteristics of Survey Respondents**

| <i>Type of Retirement System</i>           | <i>Retirement systems that responded to the survey</i> | <i>Retirement systems that did not respond</i> |
|--|--|--|
| State                                      | 6  | 0  |
| County                                     | 22   | 0  |
| City                                       | 19   | 13   |
| Special District                           | 9  | 15   |
| Other                                      | 1  | 1  |
| <b>Total</b>                               | <b>57</b>  | <b>29</b>                                      |
| <b>Median Retirement System Membership</b> | 5,576  | 349  |

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## How timely is the survey data?

The survey requested data from retirement systems' actuarial valuations. These valuations typically lag by one year. A valuation completed in June 2007, for example, includes data on the retirement system's experience during the fiscal year that ended in 2006. The survey asked for retirement systems' "most current" actuarial data, which in most cases was as of June 2006. Four retirement systems indicated that the data they provided was from 2005.

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## What did the survey measure?

### *Pension Plan Funded Ratio and Funding Status*

The survey was designed to examine retirement systems' funded ratio (assets divided by liabilities) and funded status, which is the amount of over-funding or under-funding (assets minus liabilities).

If assets are greater than liabilities:

- The funded ratio is over 100 percent.
- The funded status is the amount of over-funding, sometimes referred to as "surplus."

If assets are less than liabilities:

- The funded ratio is under 100 percent.
- The funded status is the amount of under-funding, and is called the "unfunded liability" or, more formally, the "unfunded actuarial accrued liability" (UAAL).

### *Actuarial Value versus Market Value of Assets*

The survey asked retirement systems to report the actuarial value of their assets, which is the same figure reported annually to the State Controller's Office. This made it possible to track funding progress over time using data from this survey together with data from the State Controller's Office.

Recall that pension funds consist of invested assets, the majority in stocks. As the markets go up and down, so too does the value of assets. This, in turn, affects the funded status of a pension plan and the amount that employers need to contribute to the plan each year. In order to stabilize the rates against volatility caused by financial market fluctuations, actuaries spread, or "smooth," investment gains and losses over a period of time. Thus, the actuarial value of

assets used to determine contribution rates may be higher or lower than the actual market value of assets available to pay benefits.

Highlighting the difference between actuarial and market values, one survey respondent noted that: “in 2001 [our] funded ratio was based on [the actuarial] value of assets which resulted in a 94.2% funding ratio. If we had been using market value of assets in 2001 our funded ratio would have been 114.3%.”

Because changes in actuarial methods and assumptions can have a significant impact on a plan’s reported assets and liabilities in a given year, a plan’s funding progress is more accurately viewed over time rather than at a single point in time. The comments of one survey respondent illustrate this point: “These two changes [actuarial assumptions about the rate of salary increases and investment earnings] alone added \$65 million in calculated UAAL.”

## IV. SURVEY RESULTS

### Respondents reported a total unfunded liability of \$63.5 billion

Table 2 shows pension plan funding status aggregated into employer categories of State, schools, and public agencies. The smallest unfunded liability is for the State plans, including the University of California Retirement System as well as state and California State University employees covered by CalPERS.

**Table 3. Funding Status by Employer Type, for Fiscal Year Ending in 2006  
(\$ in billions)**

|  | (1)<br>Assets<br>(Actuarial<br>Value) | (2)<br>Liability | (3)<br>Unfunded<br>Liability<br>(2) – (1) | (4)<br>Funded<br>Ratio<br>(1) / (2) |
|--|---------------------------------------|------------------|---|-------------------------------------|
| <b>State</b> (includes CSU and UC)   | \$149.7                               | \$163.4          | \$13.7                                    | 91.6%                               |
| <b>Schools</b> (includes school and community college districts that contract with CalSTRS <sup>†</sup> and CalPERS) | \$142.3                               | \$165.5          | \$23.2                                    | 86.0%                               |
| <b>Public Agencies</b> (counties, cities, special districts – includes CalPERS and independent)                      | \$221.9                               | \$247.8          | \$25.9                                    | 89.5%                               |
| <b>Estimate</b> <sup>‡</sup> (for city and special district retirement systems that did not respond to the survey)   | \$2.1                                 | \$2.8            | \$0.7                                     | 75.0%                               |
| <b>Total</b>   | <b>\$516.0</b>                        | <b>\$579.5</b>   | <b>\$63.5*</b>                            | <b>89.0%</b>                        |

Source: 2007 California Research Bureau Public Retirement System Survey

<sup>†</sup> The State of California is responsible for funding the State Teachers' Retirement System (CalSTRS).

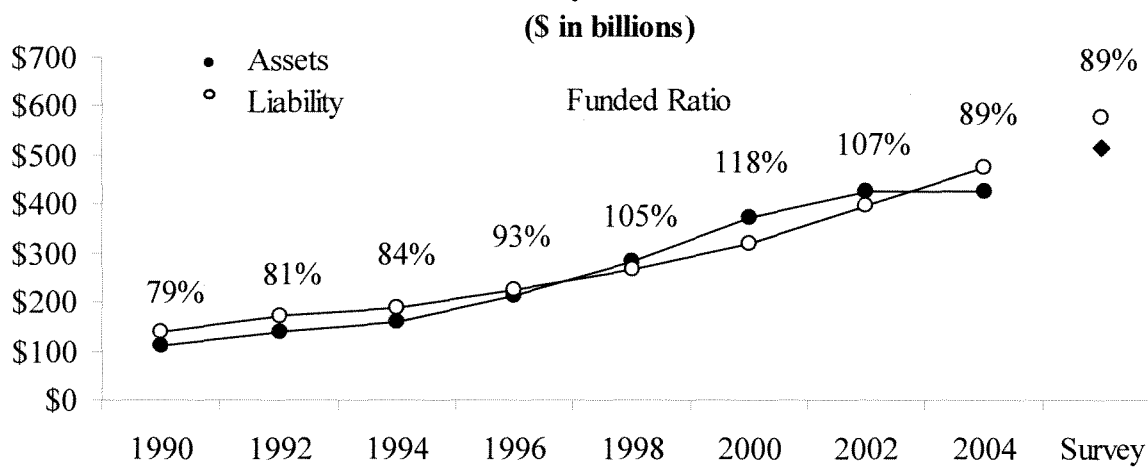
<sup>‡</sup> For the systems that did not respond to the survey, an estimate was calculated based on the assumption that these systems accounted for the same proportion of total retirement system assets (0.4 percent) and liabilities (0.5 percent) as they had in the three most recent State Controller's Office Annual Reports on retirement systems.

\* This figure does not include pension obligation bond debt which was approximately \$10 billion as of June 2005.

### California's defined benefit public pension plans reported a combined funded ratio of 89 percent.

This is lower than during the late 1990s through 2002 when the aggregate assets for all of the state's public systems combined exceeded liabilities, but about the same as it was in the mid-1990s.

**Figure 1. Aggregate Funded Status for California Public Pension Systems**

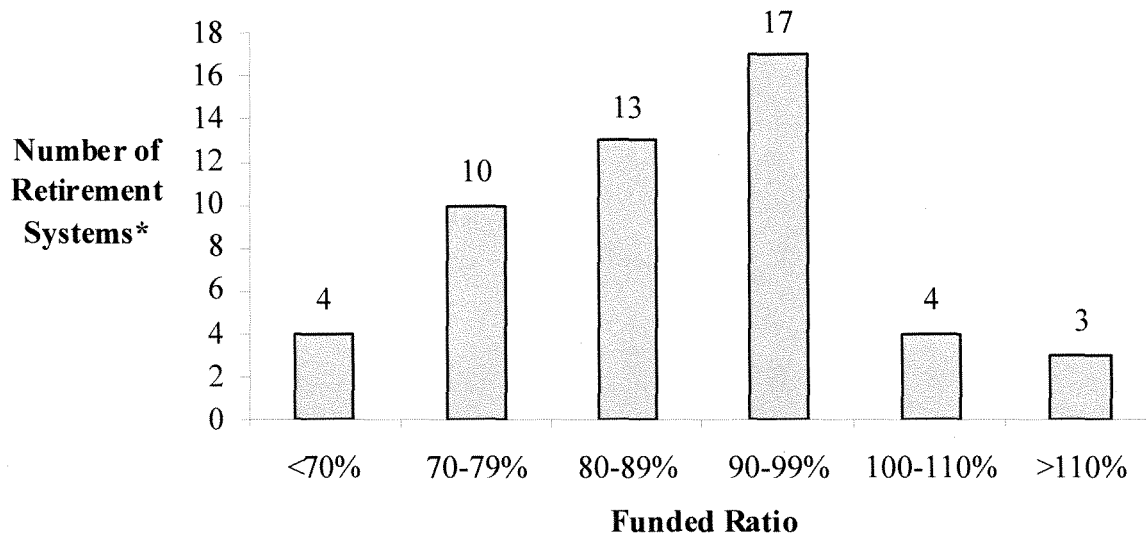


Source: California State Controller's Office Public Retirement Systems Annual Reports and CRB Public Retirement System Survey.

It is important to note that the funded status of many of the systems may have improved since the most recent actuarial valuations were completed. Since 2004, for example, CalPERS and CalSTRS have experienced annual investment returns in the double digits, significantly higher than their actuarially assumed rates of return. As a result, in July 2007 CalPERS officials announced that the majority of its plans were fully funded on a market-value basis.<sup>7</sup>



**Figure 2. Distribution of Retirement Systems by Funded Ratio  
(as of the end of fiscal year 2005/06)**



Source: California Research Bureau Public Retirement System Survey.

\* n=51; Six systems are not included either because they are closed and funded on a pay-as-you-go basis with no UAAL reported, or because two or more were reported together as a single system.

Figure 2 shows that 30 of the 51 retirement systems reported funded ratios of 80 to 99 percent during their most recent actuarial valuations. Seven reported funded ratios greater than 100 percent including:

- Three closed systems with 80 or fewer members
- City of Fresno Employees' Retirement System (138%)
- City of Fresno Fire and Police (125%)
- San Francisco Employees Retirement System (109%)
- University of California Retirement System (104%)

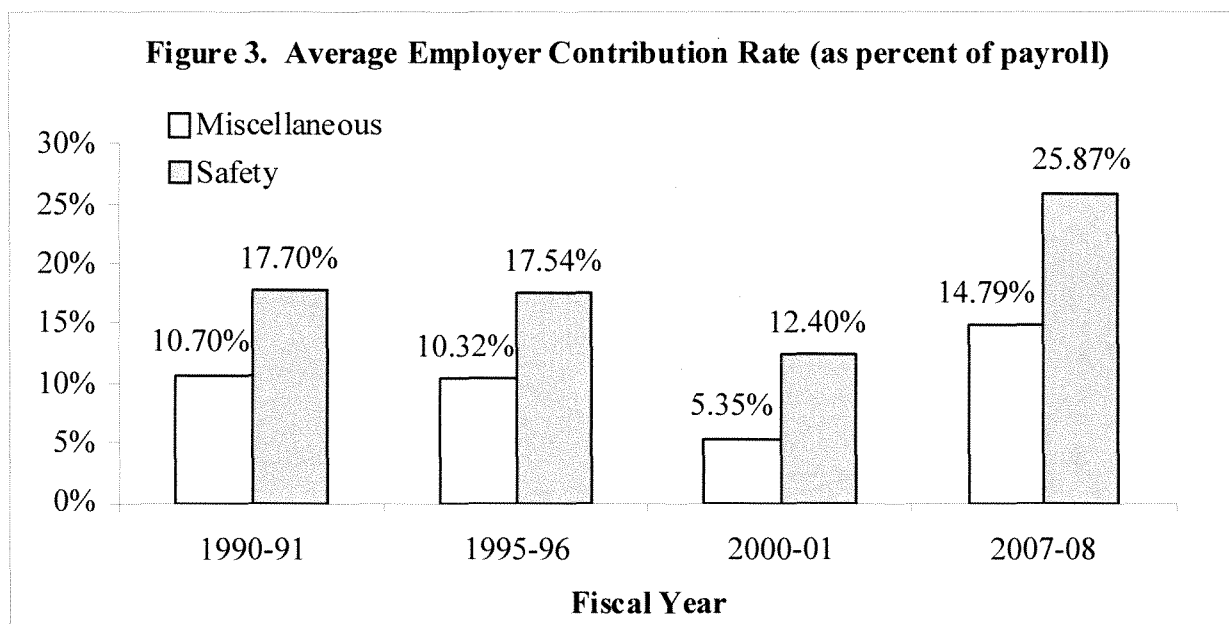
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### **Average employer contribution rates**

Average contribution rates were lowered during the late 1990s as pension fund investment returns rose, but have since increased as a result of the market downturn that occurred in the early 2000s.

While funding ratios provide comparisons of a retirement plan's assets to its liabilities, contribution rates reflect the actual cost that employers pay to provide pension benefits. A contribution rate is the percent of total payroll that employers are required to contribute to the plan each year. The CRB survey asked responding retirement systems to report contribution rates for their

largest plans for miscellaneous employees and their largest plans for safety employees. Thirty systems provided contribution rates for public safety members and 40 provided this data for general, or miscellaneous, members. The results are shown in Figure 3.



Source: California Research Bureau Public Retirement System Survey.

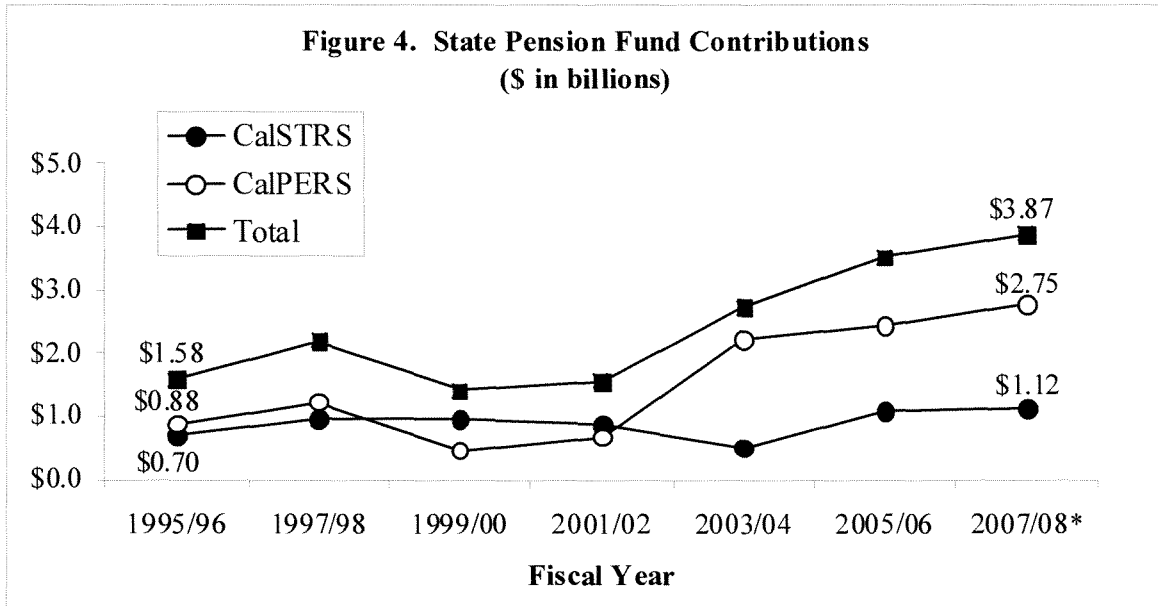
## State pension contribution rates

State pension contribution rates have risen substantially in the past decade. This is due largely to the downturn in the financial markets that decreased the value of pension fund assets. Nonetheless, state pension contributions have remained at a relatively stable three-and-a-half to four percent of total general fund revenues.

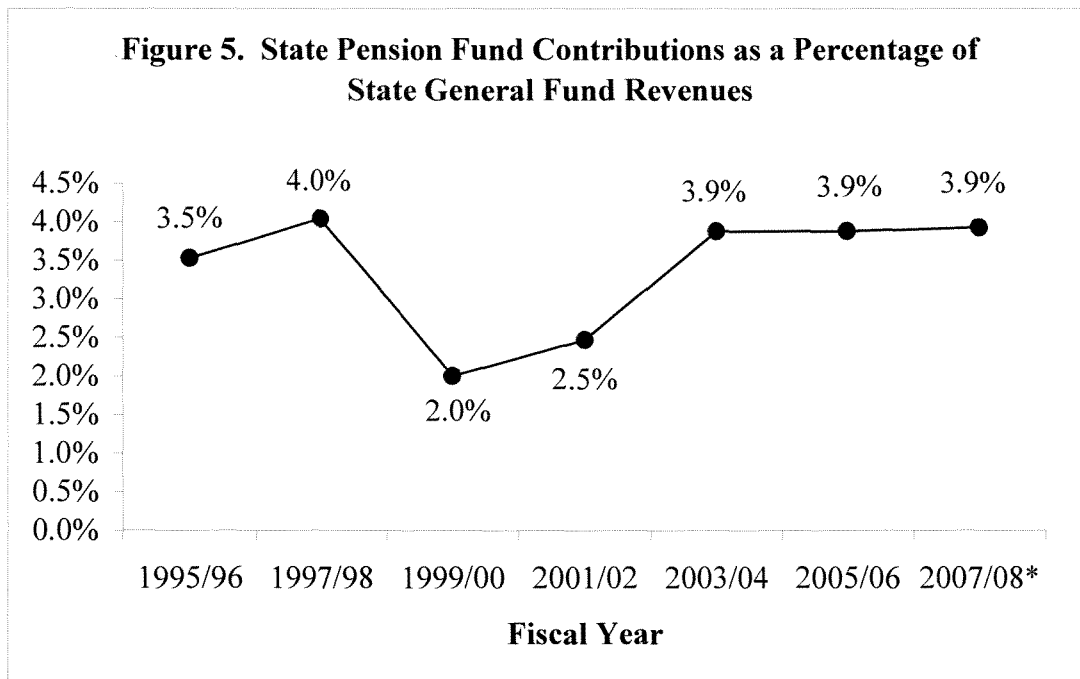
Figures 4 and 5 are based on data provided by the California Department of Finance and are included to show the State's CalPERS and CalSTRS contributions both in terms of cost and relative to total State General Fund revenues.

Figure 4 shows that despite a significant drop in the late 1990s, the State's total CalPERS and CalSTRS contributions have risen by 145 percent from about \$1.58 billion in the fiscal year that ended in 1996 to a projected \$3.87 billion in fiscal year 2007/08. During that period, that State's CalPERS contribution rose by about 213 percent compared to 60 percent for CalSTRS contributions.

Figure 5 illustrates that despite the rising cost, State pension contributions have remained at a relatively stable three-and-a-half to four percent of total general fund revenues from the mid-1990's to present. Again, the exception is 1999 to 2002 when contributions were significantly lowered.



Source: California Department of Finance.  
\* Estimate.



Source: California Department of Finance.  
\* Estimate.

## IV. SUMMARY

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### Wither the pension storm?

In recent years, the financial situation of public employee pension plans in California and throughout the United States has been described by various observers as a tsunami<sup>8</sup> or a perfect storm.<sup>9</sup> Questions have been raised about whether actuarial policies adopted by trustees allowed pension plans to recognize investment

***[Unfunded pension liabilities] are swamping us. We are going to drown in this debt.***

**Marcia Fritz, Vice President,  
California Foundation for Fiscal Responsibility**

returns too quickly in the late 1990s and to imprudently use those gains to reduce required contributions and pay for enhanced benefits.

But despite a number of high profile cases of severely underfunded and mismanaged pension plans, and in contrast to the meteorological metaphors, the evidence does not suggest that, on the whole, public pensions in California or across the United States are experiencing a sudden, severe, or worsening crisis. California's

***This notion that somehow we're drowning in unfunded liability is total nonsense.***

**Ron Seeling, Chief Actuary,  
California Public Employees' Retirement System**

public retirement systems are reporting a combined funding level that is higher than it was in the mid-1990s and that has been improving.

Decreasing unfunded liabilities have also been seen for public pension plans across the nation according to a recent report that summarizes a survey of more than 100 of the largest retirement systems in the U.S.<sup>10</sup> The report, which was released by the National Association of State Retirement Administrators, attributes the trend to several factors including fewer benefit enhancements, fewer early retirement incentives, fewer discretionary cost-of-living increases, lower inflation assumptions, and increasing investment returns.

In terms of pension plan funding, the evidence suggests that to the extent that there ever was a public pension storm gathering on the horizon, it appears to have largely dissipated.

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### What about retiree health benefits?

Although the focus of this report is pension liability, the contrast between the funding situation for pensions and for "other post employment benefits" (OPEB; which includes retiree health,

*An urgent responsibility rests upon the state to see that any retirement system which it may sponsor is placed upon a sound financial basis, where liabilities are provided for as they are incurred, rather than when they mature...Any system which proposes to provide funds only as they are needed to meet disbursements is inviting disaster; the unseen liabilities continue to mount, and the time will come when they will begin to mature in such volume as to cause serious embarrassment to the state, forcing it either to make staggering appropriations, or to default in its obligations to members of the system.*

**Final Report of the Commission on  
Pensions of State Employees,  
Sacramento, California,  
December 31, 1928, p. 9**

vision, dental and other non-pension benefits) provides useful insights about the advantages of paying for post-employment benefits on a prefunded rather than a pay-as-you-go basis.

Based on a strong recommendation issued by California's 1928 Commission on Pensions of State Employees, the State adopted prefunding as the mechanism to pay

for public employee retirement benefits. As a result, its public pension plans are substantially funded today. Investment returns have compounded over time and have been sufficient to pay for the majority of the cost of benefits. In the past decade, investment returns have paid for approximately 75 percent of the cost of benefits for public employees in CalPERS plans.<sup>11</sup>

The funding status of public pension plans appears quite favorable in comparison to funding for OPEB. Although the total unfunded OPEB liability for all public agencies in California is not currently known, the State's unfunded OPEB liability is estimated to be approximately \$48 billion.<sup>12</sup>

To understand the roots of the current OPEB funding problem, it is useful to look at the history of retiree health benefits for public employees in California. Historically, the majority of public sector employers that have provided retiree health and other post employment benefits have done so on a pay-as-you-go basis; paying for benefits as the costs come due with little or no money set aside to pay benefits in future years.

***The Assembly Committee on Civil Service and State Personnel forcefully recommends that the State should forthwith establish, administer and partly finance a long-delayed basic medical care insurance program for state employees...to enable the state to attract and retain qualified employees by providing health benefit plans similar to those commonly provided in private industry and in other public jurisdictions...The State's contribution should be sufficient to cover the costs of a basic health benefits plan, or \$5 per month for each employee, whichever is the lesser amount.***

**The California Assembly Interim  
Committee on Civil Service and State Personnel,  
December 1960**

Given the relatively low cost of health benefits at the time that many public sector health plans were established, it is understandable that the idea of prefunding retiree health benefits did not take hold. For example, the 1960 Assembly committee whose recommendations led to the establishment

of the Public Employees' Medical and Hospital Care Act (PEMHCA)\* also recommended that "the State's contribution should be sufficient to cover the costs of a basic health benefits plan, or \$5 per month for each employee, whichever is the lesser amount."<sup>13</sup>

Recently there has been growing interest in prefunding OPEB due, at least in part, to rising medical costs that have made it increasingly more costly to provide retiree health benefits on a pay-as-you-go basis. Between 2000 and 2007, for example, annual premium increases for CalPERS health plans have averaged more than 12 percent.<sup>14</sup> The monthly premium for CalPERS HMO plans in 2007 was more than \$800 to cover an employee and one additional family member.

In addition to rising medical costs, new accounting standards issued by the Governmental Accounting Standards Board (GASB) have focused greater attention on government employers' OPEB liability. The purpose of the standards is to make accounting methods more accurately reflect the cost of providing public services by recognizing the costs of the benefits at the time that they are earned, rather than when they are paid. As a result of the new standards, public agencies are beginning to report large unfunded OPEB liabilities on their balance sheets that they were not previously required to report.

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\* PEMHCA was established in 1961 to provide health benefits for state employees and retirees and was later expanded to allow public agencies to participate. The program is administered by the California Public Employees' Retirement System (CalPERS).

The provisions of the new GASB standards do not require governments to prefund OPEB plans, but they provide a framework – and the impetus – for doing so. Prefunding would mean establishing some form of trust similar to those that currently exist for pensions. Annual costs paid into an OPEB trust would be based on actuarially determined amounts that, if paid on an ongoing basis, would generally provide sufficient resources to pay benefits as they come due.

Although the State of California has not yet developed a formal plan to prefund retiree health benefits for state employees, a number of local governments have begun to do so. Several have begun to contribute to the California Employers' Retiree Benefit Trust Fund that CalPERS launched in March 2007.\* Initially, the fund was open only to employers that contract with CalPERS to provide health benefits under the provisions of PEMHCA. New legislation (Hernandez, AB 554, Chapter 318, Statutes of 2007) expands the program to allow non-PEMHCA employers to use the trust to prefund OPEB. A number of public employers have also established, or are examining the possibility of establishing, OPEB trust funds of their own.

If public employers had begun prefunding retiree health benefits at the time when \$5 was viewed as a reasonable monthly employer contribution for health benefits, they would likely be in a very different situation today with respect to OPEB liability. Actuarial assumptions and contribution rates would have responded to increases in medical costs, and over time, investment gains would have paid for a substantial portion of the cost of retiree health benefits.

Because prefunding allows employers to generate investment returns that pay for benefits, and because the objective of prefunding is to pay for the costs of retirement benefits during the working career of the employee, many view it as the preferred solution for funding OPEB benefits.

It is important to recognize, however, that even though prefunding may be preferable, and certainly more cost effective in the long-term, it is far from certain that most, or even many, public employers will be able to pursue this solution in the near future.

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\* Legislation passed in 1988 did establish a fund that allowed public employers to prefund retiree health benefits through PEMHCA (Elder, AB 1104, Chapter 331, Statutes of 1988). However, the fund remained dormant until recently when CalPERS formally launched the Retiree Benefit Trust Fund.

One potential obstacle to prefunding retiree health benefits is the uncertainty of medical costs. Health care costs are arguably much less predictable than the factors that determine the costs of pension benefits (e.g., benefit formulas, rate of salary increases, service credit accrual, etc.). From an actuarial perspective, this makes it difficult to accurately determine the amount of contributions required to fund the benefits. Current actuarial models generally

***The rationale for the declining rate is that health care costs must ultimately slow; otherwise they will overwhelm the economy.***

**A senior public sector actuary from a national firm,  
via e-mail correspondence with CRB**

predict that annual increases in health costs will decrease in the next few years. It is not evident, however, that this prediction is based on data as much as simply a belief that current annual

increases in health costs are simply unsustainable.

Even assuming that current actuarial models are reasonable, to fully prefund OPEB would require employers to pay not only the annual cost of benefits, but an additional amount to pay down the unfunded liability. Experts predict that, at least initially, actuarially determined annual contributions for OPEB could be five to 10 times greater than current annual expenses that governmental employers pay to provide those benefits.<sup>15</sup>

For the State of California, the payment due in fiscal year 2007/08 under a full funding policy for retiree health benefits would be \$2.59 billion – about 90 percent more than the \$1.36 billion cost to continue the current pay-as-you-go policy.<sup>16</sup> And, given that the current projected state budget shortfall for the fiscal year that ends in June 2008 – a shortfall that is estimated to be in excess of \$10 billion – does not take into account any additional funding beyond pay-as-you-go for retiree health benefits, the state has little budget capacity to begin prefunding these benefits.

Likewise, for many local governments, it would be impossible to begin fully prefunding retiree health benefits without making substantial reductions in services provided to the public, the level of benefits provided to employees, or both.





## NOTES

- <sup>1</sup> "Public Employee Retirement Systems Annual Report, FY 2003/04," California State Controller's Office, July 31, 2006, <http://www.sco.ca.gov/ard/local/locrep/retirement/reports/retirement0304.pdf>.
- <sup>2</sup> E-mail correspondence from Kenneth W. Marzion, Assistant Executive Officer, Actuarial and Employer Services, California Public Employees' Retirement System, November 21, 2007.
- <sup>3</sup> CalPERS Comprehensive Annual Financial Reports, FYs 2001/02 through 2005/06.
- <sup>4</sup> Mason, Joseph D., "Reversal of Fortune: The Rising Cost of Public Sector Pensions and Other Post-Employment Benefits," Fitch Ratings Special Report, September 18, 2003.
- <sup>5</sup> "Public Employee Retirement Systems Annual Report, FY 2004/05," California State Controller's Office, July 31, 2007, <http://www.sco.ca.gov/ard/local/locrep/retirement/reports/retirement0304.pdf>.
- <sup>6</sup> "Public Employee Retirement Systems Annual Report, FY 2004/05," California State Controller's Office, July 31, 2007, <http://www.sco.ca.gov/ard/local/locrep/retirement/reports/retirement0304.pdf>.
- <sup>7</sup> Testimony of Ron Seeling, Chief Actuary, California Public Employees' Retirement System, California Public Employee Post-Employment Benefits Commission Meeting, Burlingame, CA, July 12, 2007, p. 139, <http://www.pebc.ca.gov/images/files/Minutes-071207.pdf>.
- <sup>8</sup> See, for example, <http://www.pensionsunami.com/>.
- <sup>9</sup> "The Gathering Pension Storm: How Government Pension Plans are Breaking the Bank and Strategies for Reform," George Passantino and Adam B. Summers, Reason Foundation Policy Study 335, June 2005; <http://www.reason.org/ps335.pdf>.
- <sup>10</sup> "Public Fund Survey Summary of Findings for FY 2006," Keith Brainard, Research Director, National Association of State Retirement Administrators, October 2007, <http://www.publicfundsurvey.org/publicfundsurvey/pdfs/Summary%20of%20Findings%20FY06.pdf>.
- <sup>11</sup> Testimony of Jason Dickerson, Principal Fiscal and Policy Analyst, California Legislative Analyst's Office, California Public Employee Post-Employment Benefits Commission Meeting, Rancho Cucamonga, CA, May 31, 2007, p. 77, <http://www.pebc.ca.gov/images/files/Minutes-053107.pdf>.
- <sup>12</sup> "State of California Retiree Health Benefits Program: Actuarial Valuation Report," California State Controller's Office, May 7, 2007, [http://www.sco.ca.gov/eo/pressbox/2007/05/OPEB\\_actuarial\\_report.pdf](http://www.sco.ca.gov/eo/pressbox/2007/05/OPEB_actuarial_report.pdf).
- <sup>13</sup> "Medical Care Insurance for State Employees and Other Civil Service Problems," Assembly Interim Committee on Civil Service and State Personnel, Assembly of the State of California, December 1960, p. 9.
- <sup>14</sup> "Eight Year History of Premiums: 2000-2007," CalPERS Health Benefits Branch, California Public Employees' Retirement System.
- <sup>15</sup> "The Not So Golden Years: Credit Implications of GASB 45," by Joseph D. Mason, Amy S. Doppelt, Amy R. Laskey, and David T. Litvack, Fitch Ratings, June 22, 2005.
- <sup>16</sup> "State of California OPEB Valuation (as of July 1, 2007)," California State Controller's Office, May 7, 2007, [http://www.sco.ca.gov/eo/pressbox/2007/05/OPEB\\_actuarial\\_report.pdf](http://www.sco.ca.gov/eo/pressbox/2007/05/OPEB_actuarial_report.pdf).

