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UNDERSTANDING PUBLIC SECTOR RETIREMENT BASICS

INTRODUCTION AND DISCLAIMER

This document was prepared to assist in understanding terms and issues regarding the Orange County Employees Retirement System and issues surrounding public sector retirement systems in general. It is intended to be a tool and is not an authority on the subjects covered. It is important to understand that public policy, including retirement policy, is an evolving and sometimes rapidly changing field that is likely to result in changes since the publication date of this document. Anyone desiring assured information on these topics is advised to consult with experts and legal counsel and not rely exclusively on this document. Accordingly, AREOC has made every effort to be as accurate and current (in relation to the publication date) as possible. However, AREOC accepts no responsibility or liability for the accuracy of the information presented herein.

The Orange County System Structure

The retirement system for County of Orange employees, as well as a few Orange County cities, the Orange County Fire Authority and the Orange County Sanitation District is called the Orange County Employees Retirement System (OCERS).

- 20 of California's 58 counties have retirement plans by means of the 1937 Retirement Act, including the County of Orange.
- It was established in 1945 under state law known as the County Employees' Retirement Law of 1937, commonly known as the 1937 Retirement Act. That Act has been amended numerous times by the State Legislature since 1937.
- The OCERS retirement plan is financed by a mixture of employer contributions, employee contributions and investment earnings

OCERS is governed by a Board of Directors consisting of 10 Trustees. Of the ten members, four are appointed by the County Board of Supervisors; four (including the Safety alternate) are elected by OCERS' active members. One is elected by the retired membership. The County Treasurer serves as an ex-officio member.

- The duties and responsibilities of the OCERS Board are prescribed by the 1937 Act and a voter approved initiative that appeared on the State ballot in 1992 as Proposition 162 – The California Pension Protection Act - which amended the California Constitution[1]. Highlights of that act include:
    - "The Retirement Board of a Public Pension System shall have plenary authority and fiduciary responsibility for investment of monies and administration of the system, subject to specified requirements of the Act. " Thus the Act assigned control of 1937 Retirement Act funds to the Board of Directors of those retirement funds, including OCERS.
    - The Act also specifies that each retirement board is to give highest priority to providing benefits to members and their beneficiaries.
- The OCERS Board does not have jurisdiction over county retirement benefit levels. That authority rests with the Orange County Board of Supervisors and governing bodies of other agencies participating in OCERS within the limits and requirements of the 1937 Retirement Act as well as other state laws governing collective bargaining in the public sector.

Categories of OCERS Members

There are two types of members: Safety Members; and General Members. The 1937 Retirement Act identifies several kinds of employees that the Board of Supervisors may designate as Safety Members. In general terms, a Safety Member is a person whose principal duties have been designated by the Board of Supervisors as active law enforcement, active fire suppression, active lifeguard services, active Probation or juvenile hall group counseling and supervision (Sec. 31469.3 and 31469.4). All other members of OCERS are General Members.

Retirement Plan Policy, Benefits for County of Orange Employees

Benefit levels for Orange County employees are approved by the elected governing body of the county which is the 5 member Board of Supervisors. The governing bodies of other agencies not governed by the Board of Supervisors approve benefit levels. A set of state laws prescribes what retirement plan options are available to the Board of Supervisors to choose to offer their employees.

[1] Public Retirement Journal http://www.publicretirementjournal.org/docs/capensionprotect.pdf
Ballotpedia -
http://ballotpedia.org/wiki/index.php/California_Proposition_162,_the_%22Pension_Protection_Act%22_(1992)

The Orange County Board of Supervisors currently requires its employees to participate in one of several plans it offers in retirement plan types known as defined benefit or defined contribution.

- Defined Benefit Plan

  This is a plan in which the employer promises to pay a specified benefit upon the employee's retirement. That benefit is a vested, lifetime benefit. The employer pays contributions into a trust that is administered by the Retirement System and bears the entire risk of adverse investment performance. An exception to this definition is applicable to the County of Orange due to special legislation obtained by the County to amend the 1937 California Retirement Act. That legislation was Assembly Bill No. 1992 (Correa) signed into law in 2002. That exception allows the Orange County Board of Supervisors to require, subject to negotiations pursuant to the Meyers-Milias-Brown Act, employees to contribute additional funds to cover some or all of any pension enhancement that was applied retroactively. This legislation enabled the County of Orange to require employees to help pay for enhanced retirement benefits that were applied retroactively for current employees. In a Defined Benefit Plan contributions are made by the employer, employee or both.

- Defined Contribution Plan

  The OCERS web site defines this type of plan, such as 401(k) and 457 plans, as savings accounts. Benefit payments (withdrawals) under these plans stop when your money runs out. In these types of plans the employee decides how to invest the funds (from a menu of options) and bears the risk of adverse investment performance. Benefit amounts in defined contribution plans are determined by investment performance and the amount of contributions. Contributions may be made by the employer, the employee or both.

Studies have shown that defined benefit plans are operated at a lower cost and with a greater investment income yield than are defined contribution plans, while defined benefit plans are usually more expensive for the employer and employee during the employee's working career.[2]

Retirement Cost of Living Adjustments (COLAs)

The County of Orange defined benefit plan provides for an annual cost of living adjustment to retiree pay of a maximum of 3% if the local cost of living has risen by 3% or more in the

[2] Studies by Towers Watson and CEM Benchmarking show that returns for defined benefit plans consistently outperform 401(k) plans by an average of 1.03 percent and 1.8 percent respectively - "State Guaranteed Retirement Accounts", Demos, November 28, 2012. http://www.demos.org/publication/state-guaranteed-retirement-accounts Also, a study by the National Institute on Retirement Security (NIRS, www.nirsonline.org) "Better Bang for the Buck", defined benefit plans deliver benefits at half the cost of a defined contribution plan primarily due to higher investment returns, optimal portfolio diversification and longevity risk pooling.

previous calendar year. This is referred to as a COLA. In some years a 3% increase occurs, in some years it has been less or even 0. When annual deflation occurs and the local cost of living declines, the monthly retirement payment to retirees is reduced by up to 3% a year. This feature is sometimes referred to by retirees as the un-COLA. Some County of Orange retirees experienced such a reduction in 2010 based upon the cost of living for 2009.

In years in which the local cost of living increase exceeds 3% OCERS retirees receive a 3% COLA and the difference between the cost of living increase and the granted 3% COLA goes into a COLA bank to be applied in future years should the cost of living increase be less than 3%.

Employee Share of Cost

The California pension reform legislation known as the California Public Employees Pension Reform Act (PEPRA) enacted in late 2012 requires that government employers and employees hired on or after January 1, 2013, each pay 50% of the required pension fund normal contributions. For current employees hired on or before 12-31-12, the new PEPRA allows employers to bargain for a 50/50 split of normal cost between employers and employees with the ability to impose this change on or after January 1, 2018. Until then government employers have offered many different cost sharing approaches to funding employee pensions.

Some groups of County of Orange employees, such as managers, have in the past negotiated a different financing responsibility by the Board of Supervisors in which the County paid, or picked-up, some or all of the employee share of the monthly contribution amount. This is commonly known as a “pick-up” and has at times been negotiated with groups of employees instead of a raise.

The retirement contribution pick up has been a useful tool for public agencies as it allowed them to increase an employee’s take home pay at a lower cost than a direct raise. However, the new California Public Employees Pension Reform Act with its 50-50 funding ratio requirement may put an end to this practice.

Most Orange County employees (the General Member category) that participate in the defined benefit plan currently pay into the retirement system under a special state law that applies to Orange County that includes paying part of what would normally be the employer share as well as the employee share. This is called a reverse pick up.

Basic Statistics of the OCERS System

Number of retirees from all agencies (county, cities, special districts) as of April 10, 2013 - approximately 13,289

Number of retirees of the County of Orange as of April 10, 2013 – approx. 11,444

Average age of current retirees	69
Average age at retirement	General members – 60.65 years Safety members – 54.56 years
Average years of service at retirement -	General members - 20.82 years Safety members - 25.27 years
Average retirement payment to retirees –	General members – $ 2,714 mo. Safety members - $ 5,297 mo.

Health Insurance, Medicare and Social Security

Orange County retirees do not receive free county provided health insurance.

- County retirees may choose to purchase health insurance from the county.
- Less than half of the retired county employees do purchase that health insurance.
- Until January, 2007 county retirees and active employees were in the same County of Orange health insurance risk pool. Starting in January, 2007 the Orange County Board of Supervisors, following negotiations with the various labor organizations, split the risk pool in to two groups – active employees and retirees. There were no negotiations with retirees who were significantly impacted by this action which removed a health insurance subsidy for retirees and to date (May, 2013) has added millions of dollars in health insurance costs to the group of county retirees.
- Beginning in 1993 the County of Orange provided retirees with a financial contribution, referred to as a health grant, to offset a portion of the retirement health insurance cost. In addition to the monthly cost of health insurance that retirees pay, starting in 1993 to January of 2007 all employees were required to contribute 1% of their pay to finance this county contribution toward retiree health insurance coverage. Thus, many retirees contributed to this benefit.

Orange County employees do not qualify for Social Security as a result of their county employment, and if hired prior to 1988 they also do not qualify for Medicare as a result of their county employment. There are therefore currently many county retirees for whom health insurance they buy from the County is their only major medical coverage and their retirement check is their only on-going income.

After a Retiree Dies

A retiring county employee eligible for a defined benefit retirement can choose among several retirement income options. Some include a level of continuing benefits for survivors and some do not.

- The majority of Orange County retirees under a defined benefit option choose an option that provides for some level of continuing benefits for their survivor.

- Under one of these options the eligible survivor receives 60% of the retirement income that the deceased retiree would have received if living. There are other options that provide a 100% continuance or a 50% continuance with a reduced benefit paid to the retiree. There is also an option to choose multiple beneficiaries with varying percentages, if approved by the OCERS' actuary.

- Eligible survivors are a surviving spouse of the retiree if they were married for at least one year prior to the date of retirement, or two years prior to the retiree's death and are age 55 or older; or a surviving life partner if they were legal partners for at least one year prior to the date of retirement, or two years prior to the retiree's death and age 55 or older.

As mentioned, there are several other options a retiring county employee may choose. For information contact OCERS.

Collective Bargaining

A California law known as the Meyers-Milias-Brown Act enacted in 1968 and signed into law by then Governor Ronald Reagan allows employees of counties, cities and special districts to form unions and requires the public agency employers to engage in collective bargaining regarding wages, benefits and working conditions. This is often referred to as meet and confer.

Generally, the parties – for the County of Orange it is the public sector unions and the Board of Supervisors - seek to negotiate a compromise that both can agree to. If however agreement cannot be reached the Board of Supervisors may impose its last, best and final offer without the concurrence of the union. However, such an approach rarely occurs.

The Defined Benefit Retirement Fund and Actuarial Studies

Employers and employees contribute a monthly amount to the defined benefit fund for each enrolled employee in order to fund each employee's eventual retirement (See also discussion under the heading "Employee Share of Cost " on page 4).

The amount the employer and employee each contribute is determined by an actuarial study guided by State law that specifies employee and employer contribution amounts.

- An Actuary **i**s defined by the U.S. Department of Labor Bureau of Labor Statistics as a person who analyzes the financial costs of risk and uncertainty. They use mathematics, statistics, and financial theory to assess the risk that an event will occur and to help businesses and clients develop policies that minimize the cost of that risk. Actuaries use database software to compile information and advanced statistics and modeling software to forecast the cost and probability of an event.[3]

- An actuarial study as it relates to a defined benefit retirement system is a study by an actuary to determine the estimated cost over a 30 year or shorter period of what funding will be needed for the workforce to retire. Such studies must make assumptions on such factors as how many county employees will stay employed with the county long enough to retire and at what age; years of service and pay level when they retire; the estimated life span of retirees; inflation; investment rate of return and other factors. (See discussion of compensation earnable on pages 8 and 9)

- The OCERS Board of Directors contracts for an actuarial study annually and approves a set of assumptions presented in the study. This results in the actuary then calculating the required employer and employee contribution rates for the next year and submitting them to the OCERS Board for approval.

Investment Rate of Return

One of the assumptions in an actuarial study is the estimated investment return, or rate of return, that the funds in the defined benefit retirement system will earn from investments.

The actuary recommends a rate of return assumption based upon such factors as the asset allocation and capital market projections from several investment consultants to the OCERS Board of Directors and presents several different rates of return to that Board with a probability analysis. The OCERS Board then adopts a rate of return to be assumed for the following year.

- The higher the assumed rate of return the lower the amount needed to be contributed by the employer and employee and the lower any amount of unfunded liability. A lower rate of return has the opposite effect.

[3] United States Department of Labor, Bureau of Labor Statistics, Occupational Outlook Handbook. http://www.bls.gov/ooh/math/actuaries.htm

- The achieved OCERS annual rate of investment return reported to the OCERS Board of Directors as of May 31, 2013 has been:

    - 1 year 14.56%
    - 3 year 10.27%
    - 5 year 4.31%
    - 7 year 5.94%
    - 10 year 7.68%
    - 15 year 6.55%
    - 20 year 8.18%

- The current assumed OCERS annual rate of return for 2013 is 7.25%. This rate was adopted by the OCERS Board on a 5-4 vote, lowering it from the 2012 assumed rate of 7.75%. (See discussion below to understand an impact of this change.)

<u>Unfunded Liability in a Retirement System</u>

As used in this paper, the term unfunded liability means that the assets of a defined benefit retirement fund are below what actuaries estimate is necessary to fund the employees' retirement benefits over a period of time (often 30 years). Such an estimated unfunded projected liability can be the result of adopted fund investment and economic assumptions not being met.

Currently, according to media reports, most public sector defined benefit retirement funds appear to have an unfunded liability. In the OCERS defined benefit system the unfunded liability as of December 31, 2012 is estimated to be $ 5.68 billion dollars, meaning the funded ratio is 63%. New accounting standards established by the Government Accounting Standards Board (GASB) require government agencies to report any unfunded liability of their defined benefit retirement system on their financial balance sheets.

- This is bringing about increased visibility of the unfunded liability issue in public sector defined benefit retirement plans and has helped spark movements for pension reform designed to reduce or eliminate any unfunded liability.

- Advocates for reducing public sector defined benefit pension benefits (pension reform) in order to reduce or eliminate the unfunded liability tend to view the unfunded liability as debt. Noteworthy is that in an Orange County lawsuit (Board of Supervisors vs. Association of Orange County Deputy Sheriffs) the California Court of Appeals ruled in January, 2011 that an unfunded liability is not legally a debt, but rather an estimate of a future obligation.[4] Even so, the unfunded liability is often referred to as a debt in the media and by advocates for pension reform.

[4] Orange County Board of Supervisors vs. Association of Orange County Deputy Sheriffs", California Court of Appeals, January, 2010

Calculating Retirement Pay – Compensation Earnable, the Ventura Decision and Spiking

Part of the controversy driving the momentum for public sector defined benefit pension reform is the amount of pay a public sector employee receives that is counted as compensation earnable when retiring in a public sector defined benefit retirement plan.

- Compensation earnable is defined as the amount of pay that is used to determine the retirement benefit when an active employee retires.

- Compensation earnable has generally included more than base pay because of a California Supreme Court ruling in 1997 commonly known as the Ventura Decision.[5]

- In that 1997 decision the California Supreme Court ruled that such payments, consisting of regularly recurring pay for special skills or shifts, payouts for leave accruals, and certain allowances, should be included in determining the compensation earnable figure of employees. This decision applied not just to Ventura County and its employees, but to all 1937 Retirement Act government employees in California.

- Since the 1997 Ventura Decision and through 2012 compensation earnable in OCERS has included payments to employees such as annual vacation buy out, sick leave buy-out, uniform allowances, executive car allowances, and other taxable payments to employees.

Pension spiking is the process whereby the public agency's compensation structure permits public sector employees to receive raises or otherwise increase their compensation in the years immediately preceding retirement in order to receive larger pensions than they otherwise would be entitled to receive. This increases the pension payments to the retirees and, upon retirement of the "spike", transfers the burden of making payments from the employee's employer to a public pension fund, although the employer remains liable for any unfunded liabilities in the pension system.

- Many techniques that fit the definition of pension spiking in the public sector have been perfectly legal, while a few well publicized cases appear legally questionable.

- Some well publicized cases of pension spiking, such as in the City of Bell, have intensified the public's awareness of the potential for excessively high pensions through a spiking manipulation process that has apparently been possible in some California government entities and fostered a public backlash against not only spiking, but also against public sector employees and local elected officials in general.

- Pension reform legislation known as the California Public Employees Pension Reform Act (PEPRA), Assembly Bill 340, was enacted in California in September of 2012 and became effective January 1, 2013. Allowable components of compensation earnable are specified in this law for employees hired on or after January 1, 2013. PEPRA also

[5] Ventura County Deputy Sheriffs Assn. v. Board of Retirement of Ventura County Employees Retirement Assn. (1997) 16 Cal.4th 483

reaffirmed the definition of compensation earnable for current members hired on or before December 31, 2012. At this writing different 1937 Act Retirement Boards are interpreting the impact on what does and does not count as compensation earnable differently for members hired both before and after December 31, 2012, and in at least one county an employee group has filed a lawsuit challenging the interpretation made by that county's Retirement Board for its employees hired on or before December 31, 2012. It is expected it will take some time to sort out the impact of this legislation on the definition of compensation earnable. Clean-up legislation and court decisions may decide the matter at some time in the future.

The Pension Reform Movement

The unfunded liability issue (See page 8) and pension spiking (See pages 9 and 10) in public sector defined benefit retirement plans have become a concern throughout the nation.

There are wide variations in estimates of individual pension fund unfunded liability depending on what actuarial assumptions are used. Those very assumptions, particularly the assumed rate of investment return, have become controversial and politicized.

Advocates for reducing public sector defined benefit pension benefits often view the unfunded liability as debt. However, as mentioned in the section of this report titled "Unfunded Liability" on page 8 a California Court of Appeals ruling found that an unfunded pension liability is not legally a debt, but rather an estimate of a future obligation[6] Even so, the unfunded liability of public sector defined benefit pension funds is often referred to as a debt in the media and seized upon by advocates for pension reform as evidence that further reform is needed.

As mentioned in the section on pages 8 and 9 of this paper titled "Calculating Retirement Pay – Compensation Earnable, the Ventura Decision and Spiking", the Public Employees Pension Reform Act (PEPRA), Assembly Bill 340, enacted in September of 2012 and effective January 1, 2013, is applicable to employees hired on or after January 1, 2013[7]. It attempts to place a cap on compensation earnable and reduce or eliminate the impact of the Ventura Decision. It also increases eligible retirement age and other limiting changes. Some reform advocates have stated that these reforms are not enough and that more reforms will be pursued in California legislatively or at the ballot box, while in one northern California county some public safety employees have launched a legal challenge to some parts of this new law.[8]

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[6] "See footnote No. 4, page 8.

[7] There are differences of opinion as to whether some of this legislation applies also to current (hired before January 1, 2013) employees; this may ultimately be decided by clean-up legislation and/or court decisions.

[8] Oakland Tribune, Nov. 29 and Dec. 3, 2012, "Editorial: Brown must defend pension laws he signed". http://www.insidebayarea.com/opinion/ci_22091528