



# PENSION PRIMER

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## WHAT YOU'LL LEARN

This Pension Primer will help you better understand how defined benefit pension programs in California work, and will tell you more about Newport Beach's pension program and its problems. We will show you our funding status, which in July 2016 reflects a valuation date of June 30, 2014—a full two years prior. We also write about solutions—solutions already implemented, and more that could come if the law allowed it. You'll learn common terms and that pension law is rather complex, and limiting. A number of tools are at our disposal to continue to address our liabilities, but those tools come with their own challenges.

## FREQUENTLY ASKED QUESTIONS

### How are pension costs determined?

Employers must compensate employees for their service. Typically, public employee compensation combines three distinct elements, including salaries and wages, benefits provided during active service (for example, health care for active employees), and benefits provided following the completion of active service (retirement income and in some cases health care). Local government pensions are pre-funded, as opposed to pay-as-you-go retirement systems like Social Security. In pay-as-you-go systems, contributions from current employees are used to pay benefits for current retirees. In pre-funded systems, the employer and employee make contributions into a pension trust each year, over the course of an employee's working life. That money is invested and earnings on these funds are re-invested. By the time the employee reaches retirement, the accumulated assets in the trust are available to pay benefits. The objective of course, is to accumulate sufficient assets to pay the benefits over the remainder of the employee's life. To meet this objective, a pension plan should receive contributions in accordance with an actuarially based funding policy. The actuarially determined pension funding plan determines exactly how much the employer and employee should contribute each year to ensure that the benefits being earned will be securely funded in a systematic fashion.

### Funding a Pension Plan



**13¢** CalPERS members

**22¢** CalPERS employers

**65¢** CalPERS investment earnings

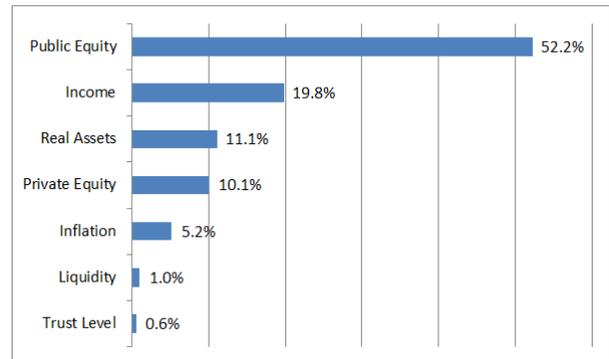
**The CalPERS Pension Buck**  
Pensions create jobs, boost state and local revenues, and keep retirees contributing to our economy. Every dollar spent on public employee pensions comes from the following sources\*:

with an actuarially based funding policy. The actuarially determined pension funding plan determines exactly how much the employer and employee should contribute each year to ensure that the benefits being earned will be securely funded in a systematic fashion.

**What is the City’s pension benefit plan and how is it administered?**

The City contributes to the California Public Employees Retirement System (CalPERS or “PERS”), an agent multiple-employer public employee defined benefit pension plan. PERS acts as a common investment and administrative agent for participating public entities within the State of California and provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. In a defined benefit plan, an employer promises future benefit payments based on an agreed-upon formula (for example, 2.5 percent of salary x the number of years of service = amount of pension payments) during retirement (See [Benefit Formula](#) in the Glossary of Terms).

**PERS Asset Allocation**



**What is the City’s pension funding policy?**

In July 2011, the City Council passed Resolution No. 2011-55 establishing a Compensation Philosophy which included a goal that employees share 50/50 in the cost of retirement benefits, which was the guiding principle in the 2012 and all subsequent labor negotiations. The labor contracts adopted since 2012 provide for employees paying the full member contribution and have employees paying a portion of the employer’s contribution. Through negotiations, the City and its collective bargaining groups have worked collaboratively toward a solution that would help to relieve the City’s growing pension burden. The City and its bargaining units also agreed to implement second tier (lower) retirement benefit formulas for future employees (2%@60 for Miscellaneous, 2%@50 for Fire and Lifeguards, and 3%@55 for Police), and changed the single highest year calculation to the highest three years for determining the actual pension benefit amount. These second tier benefits were negotiated in advance of adoption of the Public Employees Pension Reform Act (PEPRA), creating an “intermediate tier,” and ensuring that new employees, including those now deemed “classic” by PERS, will be hired under a lower benefit formula.

**How much has the City set-aside (assets) for employee pensions and how much does it owe (liability)?**

The City’s unfunded liability (UL) as of June 30, 2014 (the “date of value” for our most up to date actuarial valuation from the California Public Employees Retirement System or “PERS”) is \$253 million on a market value basis. Starting in the 2014-15 financial statements, the City’s “net pension liability” must be posted to the City’s Government-wide balance sheet per Governmental Accounting Standards Board (GASB) Statement 68. As of June 30, 2014, the market value of the City’s pension assets and liabilities is as follows:

**Pension Assets and Liabilities**

City of Newport Beach PERS Plan	June 30, 2013	June 30, 2014
Funded Portion of Plan (Market Value Basis)	\$496,592,365	\$567,303,448
Unfunded Portion of Plan (Market Value Basis)	\$257,952,421	\$252,566,995

**Pension Facts:**

- ⇒ The Percent of the normal retirement cost being paid by Newport Beach employees is now 55%. That now exceeds where Governor Brown wanted all cities to be by 2018.
- ⇒ City employees are funding a record \$8.2 million of the City’s pension costs through payroll deductions.
- ⇒ The FY 15-16 budget provides for a \$21.5 million payment towards the unfunded pension liability.

The City’s annual payments to PERS to fund the Normal Cost of pensions and the Unfunded Liability have risen significantly over time, as has the amount contributed to the Plan by City employees:

**Annual PERS Cost**

Annual Payment to PERS	FY 12-13	FY 13-14	FY 14-15	FY 15-16 (est)
by City	\$18,150,000	\$19,440,000	\$20,177,467	\$28,321,136
by Employees	\$4,700,000	\$6,060,000	\$7,137,360	\$8,246,740
<b>Total Payments</b>	<b>\$22,850,000</b>	<b>\$25,500,000</b>	<b>\$27,314,827</b>	<b>\$36,567,877</b>

A reason for the higher cost in recent years in part is due to an acceleration of pension funding. In 2014, the City addressed the escalating nature of UAL costs to bring the City’s funded status higher than the current funded ratio, similar to paying a mortgage or car payment quicker. Although annual costs are higher, the new funding schedule will save the City \$129 million over 30 Years. This represents a savings of \$47 million in today’s dollars when discounted at 3%.

**How does Newport Beach’s unfunded liability compare to other cities?**

This isn’t easy to determine—but we’re certainly on the high side. It’s nearly impossible to compare cities’ pension liability on an apples-to-apples basis. Cities that provide a lot of services on their own (without contracting with other agencies) will have the liability show up clearly—like us. But cities that contract with the Sheriff’s Department for police services, or that have the OC Fire Authority providing Fire/EMS, can have those employees’ pension costs off of their books (not nefariously, of course). Further, cities that have special districts providing library, water or wastewater services will also have those pension liabilities—if they exist—appear off the city’s books.

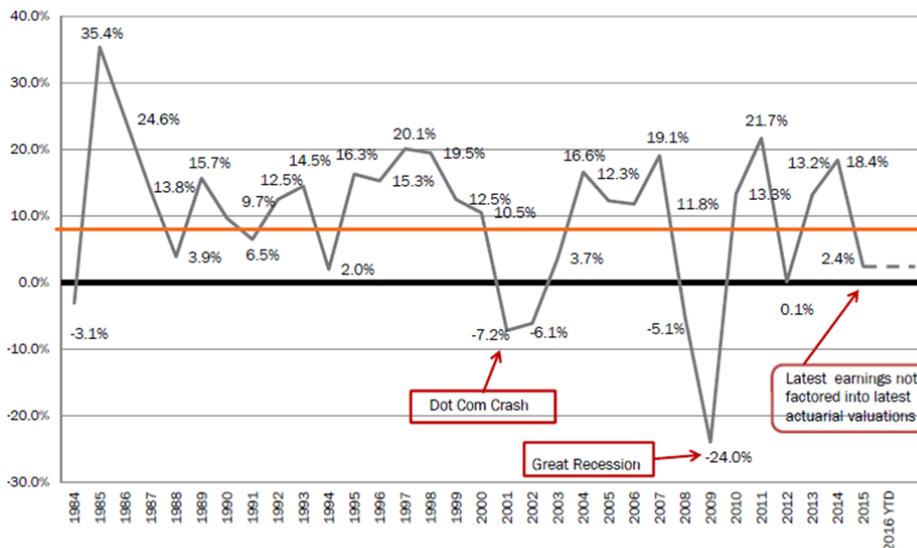
**What caused the jump in unfunded liability?**

At least three major things:

- 1) Especially in 2008-2010, investment returns fell well short of expectations (see chart below). In part because of this, PERS last year revised the investments earnings or “discount rate” down from 7.75% to 7.5%. Both the CalPERS action and the markets’ actions increased the unfunded liability, but painted a truer picture of our net pension obligation.
- 2) When market returns were high in the early 2000s, many public entities including Newport Beach, increased pension benefits. The increases were retroactive, meaning that a new higher benefit applied to all of an employee’s years of service with the City.
- 3) Studies are showing that people have retired earlier (in some cases due to industrial disability) and retirees are living longer than expected.

In 2013, CalPERS made administrative changes (good ones) that asks cities to pay more money faster to improve the unfunded liability more quickly.

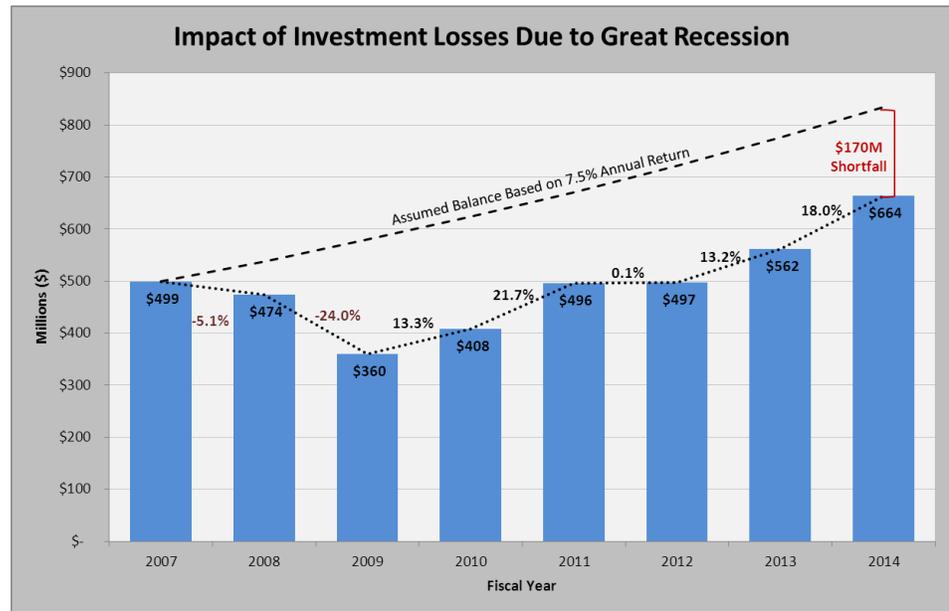
CalPERS Historic Investment Returns



Investment earnings affect how much of future benefit payments can be funded by investment income rather than by contributions. If lower investment earnings occur, future contributions must increase to make up the expected difference. As can be seen from the chart to the left, the significant drop in the PERS investment returns from 2008 to 2009 means that current assets well underperformed during the actuarial period. The decrease in funded status is largely due to the low investment returns booked in 2009 and 2012.

**Haven't we regained the investment losses incurred during the Great Recession?**

No. While the equities markets have gone up (then down, then up) and are now above the levels in 2007, they still fall short of the where investment balances would have been had they continued to grow 7.5% annually since 2007. The chart shows that our assumed balance of funds at CalPERS still falls below where a 7.5% annual rate of return would have brought it had there not been a market collapse starting in 2008. Please note that the chart below is for illustrative purposes only. It does not fully reflect what the Plan's assets and unfunded liability is or was (as assets and unfunded liability are affected by factors besides market changes such as Plan contributions, benefit distributions, and actuarial assumptions). Two months ago, CalPERS announced that it will reduce its expected rate of investment returns in years after the fund outperforms its 7.5 percent target by 4 percentage points. The goal is to ultimately reduce the rate to 6.5 percent, although that could take decades under the new policy.



**Can pension benefits be further reduced?**

Most legal experts say that pension benefits are a protected contractual agreement under California's Constitution, and that prohibits employers from reducing benefits for current employees (either retrospectively or prospectively) except for having the employees pay more towards pension costs. For new hires, less-generous benefit tiers have reduced benefits from the day an employee starts work.

**Can the City terminate the Pension Plan altogether?**

Yes, but plan termination costs are astronomical.

**Why not move all employees into a defined contribution (401k) Plan?**

It's not allowed by state law right now. The City can only offer retirement benefits that PERS itself allows us to offer. The City does have a 401k-style plan for part-time employees who are generally outside of the PERS system. All full-time employees MUST be placed in the PERS system and offered a defined benefit pension as the law stands today.

**What has the City done to address the unfunded liability and to lower pension costs to the taxpayer?**

- Established two new lower benefit tiers (one for employees who transfer here from other agencies and one for employees brand new to the PERS system).

- Negotiated to eliminate the Employer-Paid Member Contribution (EPMC). This practice previously allowed cities to pay both the City's expected contribution to PERS and the contribution that PERS indicates that employees (the "members") should pay.
- Employees are now or will contribute up to **54.8%** of the total cost of their pensions. Most employees pay between 15.2% and 43.7%. Each increase must be negotiated under California law, and equates to between 10.5% and 14.6% of their salary being deducted and going to PERS. Most employee contributions in Newport Beach in 2016 exceed Governor Brown's employee contribution goals for 2018.
- Reduced the overall amount of staff at the City (from 833 full-time positions in FY 2009-10 to 730 in the FY 2015-16 budget). This does not affect the unfunded liability but it can stop additional liability from accruing.
- Accelerated the funding of the City's unfunded liability. Simply put, this means that the City will invest more dollars earlier to fully fund the unfunded portion of the pension plan by a date certain. Under the 19-year unfunded liability payment plan, the City will pay down the liability at a net present value cost of \$375 million (including interest) and realize present value savings of \$47 million from the 30-year plan. Under this plan, the City is estimated to reach an 80% funded status in 2020 (Miscellaneous Plan) and 2024 (Public Safety Plan).

#### **Why not pay down more of the liability now, and do it faster?**

That can be a good choice, but it should be done carefully. If you place a lot of money into the PERS account at the high end of a bull market, we risk losing some of the benefit of those dollars should the market fall. Arguably, the best way to invest more cash now is a bit more methodically, such as the Fresh Start method we are using now where additional contributions are invested on a dollar-cost-average basis, an accepted method of mitigating market risk.

Using cash now to pay off the UL also has an opportunity cost. What services, programs, facilities, or beautification might the community desire now that would be foregone? And does paying more now negate the current partnership between the City and its employees, where the employees pay a growing share of the annual payments?

#### **What does pension liability per capita tell me?**

When someone uses pension liability per resident, they leave information out. Pension costs are paid by employees (as noted) as well as residents, visitors, and businesses. Every visitor who uses a parking lot, eats at a restaurant, or stays at a hotel contributes to the overall tax base, and thus the pension payments. The employees themselves are paying nearly a quarter of the annual cost. So to us, pension liability per capita is a rather useless metric. Further, for cities that use county police or fire services, pension costs are not reported separately. These costs are contained within the overall cost of the contract services.

#### **What more can be done to address this significant concern?**

Today, Newport Beach has done all that we know the law allows in terms of pension reform, and done so primarily through civil negotiations. Imposition of more significant contributions or pay reductions on City staff has consequences in terms of attracting and retaining good staff. Outsourcing can help, but it doesn't remove the vested pension rights of a city employee who might be replaced by a private provider. A 401k-style plan for new hires is a possible next step, but PERS and the Legislature need to allow us to do that. To us, further statewide reform is essential – in large part because it levels the playing field between agencies that compete against each other for employees. If you have other ideas we've missed, please feel free to suggest them.

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Please go to:  
[www.newportbeachca.gov/pensions](http://www.newportbeachca.gov/pensions)  
to find additional information, including actuarial valuations, about the City of Newport Beach pension plans.

*The City of Newport Beach Finance Department's primary purpose is to act as the chief financial steward over all public resources and to provide a wide variety of financial, technical and support functions generally encompassed by treasury, accounting, budget, long-term financial planning, auditing and revenue administration. The City places a high value on transparency and full disclosure in all matters concerning the City's financial position and results of operations. To this end, Finance strives to provide superior disclosure in all documents including but not limited to the City's Budget, Quarterly Financial Reports, Comprehensive Financial Report and compliance filings.*



## NEWPORT BEACH WINS AWARDS FOR ITS PENSION REFORM PROGRAMS

The City of Newport Beach (City) won a Rose Award in 2013 for its pension reform program from the Orange County Taxpayers

“classic” members, are hired under a lower benefit factor. The City Council elected not to phase-in expected CalPERS rate

and replicate the precise amortization methods used in the actuarial valuation of pension cost. City staff was then able to develop an analytical framework that allowed for accurate and quantifiable savings associated with various alternative payment options when comparing



Association (OCTax). Rose Awards are given to individuals or organizations that have programs consistent with OCTax's mission that “Taxes and tax-supported programs must be fair, understandable, cost-effective and good for the economy.” Labor contracts were negotiated with nearly all bargaining units that included significant increases in employee contributions toward retirement benefits. The City also adopted lower benefit formulae (second tier) for all groups, ensuring all new employees, including lateral

increases and instead opted to accelerate payment of the City's unfunded liability by amortizing payments on a fixed declining schedule, rather than a rolling 30-year amortization schedule. Paying over a fixed and shorter time period will help the City to potentially avoid \$113 million of interest expense over the next 30 years.

In 2015, the Association of California Cities of Orange County (ACCOC) recognized Newport Beach with the Golden Hub of Innovation Award. With no out-of-pocket costs, City staff was able to work with CalPERS' actuaries to understand



each to the default payment schedule. As the result, City staff was able to identify and recommend a new funding schedule, adopted by the City Council that saved the City \$129 million over 30 years. This represents a savings of \$47 million (in today's dollars) when discounted at 3%.

## GLOSSARY OF TERMS

**Actuary:** A person professionally trained in the technical and mathematical aspects of insurance, pensions, and related fields. An actuary estimates how much money must be contributed to a pension fund each year in order to support the benefits that will become payable in the future.

**Actuarial Assumptions:** Assumptions made about certain events that will affect pension costs. Assumptions generally can be broken down into two categories: demographic and economic. Demographic assumptions include such things as: mortality, disability, and retirement rates. Economic assumptions include: investment return, salary growth, payroll growth, inflation rates, and health care inflation rates.

**Actuarial Gains or Losses:** Gain or loss arising from the difference between estimates and actual experience in the City's pension plan. Actuarial gains and losses are used when accounting for pension plans because of the need to make assumptions about the future rate of salary increases, the length of employee tenure, an appropriate discount rate for the plan obligations and the expected rate of return on plan assets

**Actuarial Valuation:** A mathematical analysis of the financial condition of a pension plan which requires making economic and demographic assumptions in order to estimate future liabilities. The assumptions are typically based on a mix of statistical studies and experienced judgment. An actuary prepares an actuarial valuation at least once every three years.

**Amortization:** This term refers to the process of reducing a recognized liability systematically by recognizing revenues or reducing a recognized asset systematically by recognizing expenses or costs.

**Annual Required Contribution (ARC):** The actuarially determined level of employer contributions that would be required on a sustained, ongoing basis to systematically fund the normal cost and to amortize, over a period not to exceed thirty years, the unfunded actuarial accrued liability

**Assets:** Employer contributions and accumulated earnings on the investment of these contributions to be used to pay retirement benefits to retired employees.

**Assumed Rate of Return:** An estimate of the annual rate of investment returns to be generated by the retirement fund. This amount is approved by the governing body of the retirement system, and the assumed rate of return has a significant impact on the actuary's estimate of the cost of funding a defined benefit pension plan. An assumed rate of return is also used by an actuary to determine the investment earnings on assets set aside in an irrevocable trust to prefund pension liabilities.

**Benefit Formula:** The formula used to determine the amount of a benefit that an eligible participant receives upon retirement. Each formula specifies a percentage rate based on the member's age at retirement, and either statute or a collective bargaining agreement specifies which formula will be applicable to an individual member. The retirement benefit calculation typically includes three factors: a percentage rate based on the age at retirement and benefit formula applicable to the member, the member's length of credited service, and the member's final compensation. Typically, retirement formulas are titled in such a way as to describe how a retirement benefit would be calculated, such as "2% at age 55." In this case, the retirement benefit for a member retiring at age 55 would be: 2% (the formula percentage) X years of service X average monthly pay rate.

**California Public Employees' Retirement System (CalPERS):** The retirement system established under the California Government Code (Section 20000 et seq.) for state employees, classified (non-teaching) school employees, and employees of California public agencies that contract with CalPERS for retirement coverage.

**Defined Benefit (DB) Plan:** A traditional pension. A plan designed to provide eligible participants with a specified lifetime benefit at retirement. The benefit is based upon the following three factors: a percentage rate based on the member's age at retirement and benefit formula applicable to the member, the member's length of credited service, and the member's final compensation. Defined benefit plans also typically provide disability and death benefits. The plans are funded by member contributions, employer contributions, and income earned from the investment of accumulated contributions.

**Defined Contribution (DC) Plan:** Like a 401k. A plan that provides an individual account for each participant. Benefits are based solely on (1) the actual amount contributed by the participant, as well as any employer contributions made on the participant's behalf, plus (2) any income, expenses, gains/losses, and forfeitures that may be allocated to the participant's account. The account value can increase or decrease due to stock market variations and the performance of chosen investment vehicles. The lump-sum value of the plan is available to the employee upon retirement for annual withdrawals as he or she deems appropriate, but total withdrawals cannot exceed the account balance.

**Discount Rate:** The rate at which the U.S. Federal Reserve will lend short-term funds. For pension accounting, this discount rate must reflect either the market rates currently applicable to settling the benefit obligation or the rates of return on high quality fixed income securities.

**Fully Funded:** A specific element of pension cost (for example, past service cost) is said to have been fully funded if the amount of the cost has been paid in full. A retirement plan is fully funded when the funded ratio equals 100% or greater.

**Funded Plan:** A plan whose benefit promises are backed by a fund of assets set aside and invested for the purpose of meeting the plan's liability for benefit payments as they arise.

**Funding:** The provision in advance for future benefit liabilities by setting aside money in a trust, which is separate from the employer's business, to finance the payment of pensions.

**Funding Level:** The relationship, usually expressed as a percentage, between the actuarial value of a plan's assets and its actuarial liability.

**Funding Method:** The approach used by an actuary in an actuarial valuation. A variety of methods can be used, but whatever method is employed should be adequately described in the valuation report.

**GASB (Governmental Accounting Standards Board):** Independent, non-governmental organization that establishes the accounting standards for state and local governmental entities. The standards of financial accounting and reporting are intended to provide concise, transparent, and understandable financial information.

**Industrial Disability Retirement (IDR):** Retirement that results from an injury or illness that prevents the employee from performing job duties. The cause of disability does not need to be related to their employment.

**Liabilities:** The obligations of a plan to pay amounts of money either immediately or in the future. Liabilities whose payment is dependent on unpredictable future events (such as the death of a member) are called "contingent liabilities."

**Market Value of Assets:** The price that would be received to sell an asset in an orderly transaction between market participants at the measurement date (sometimes referred to as fair value).

**Normal Retirement Cost:** A plan's normal cost represents the present value of benefits that have accrued on behalf of the members during the current plan year.

**Unfunded Actuarial Accrued Liability (UAAL):** The amount by which actuarial accrued liability exceeds the actuarial value of assets; or, in other words, the present value of benefits earned to date that are not covered by plan assets.