How Retroactive Pension Increases and Low Investment Returns Have Blown-up Sonoma County's and Other Pension Systems at the State and Local Levels

By Ken Churchill

We should all care deeply about pension costs and the 400% increase in the costs over the past decade in Sonoma County. Why? Because every dollar going to over generous, retroactively enhanced pensions is taxpayer money that is not creating jobs, helping our fellow citizens, educating our children, or maintaining our roads and parks.

Most people know there is a pension problem, but don't know how it was created or how big it is. Many, including our elected officials, don't understand the options for making pensions sustainable again. The purpose of this paper is to answer those questions.

How Defined Benefit Plans Work

Our tax dollars provide our government employees with defined benefit retirement plans. These plans are designed so that the employer (government agency) and employee each contribute a specific percentage of payroll into the plan each year. This money is then invested by the plan administrator. Sonoma County's plan is administered by the Sonoma County Employee Retirement Association (SCERA) the State and many other city plans are administered by CalPERS.

The plan contributions are calculated by actuaries each year with contribution levels adjusted so that when an employee retires, there will be enough money in their account to pay for their retirement. It is called a defined benefit plan, because the retiree gets a set amount each month during retirement from their account. Up until the last decade, the contribution was 5-7% of pay from the employer and 5-7% from the employee. If a fund lacks the money to pay the benefits that have already been earned, it is called the "unfunded liability" and becomes the responsibility of the employer.

Here's an example: if an employee makes a $100,000 salary at retirement and they worked for 30 years under a 2% at 60 plan, which was common until 2004, when they reach 60 and retire they received 60% (2% x 30) of their salary ($60,000) each year during retirement. Some plans also provide an annual or optional cost of living adjustment.

The Cost of Changing From 60 to 90 Percent of Pay in Retirement

Let's take the example above and change the formula retroactively back to the date the person was hired to 3% at 60 as was done for Sonoma County for employees retiring in 2005 and beyond. Now an employee making $100,000 per year would receive $90,000 per year (3% x 30), $30,000 per year more than what he received under the previous plan. If this person lives to 80, he would receive an additional $600,000 ($30,000 x 20) under the new plan, even without cost of living adjustments. A cost of living adjustment could add on an additional 50%. The problem is for all previous years the employee was paying into the 2% plan and now at retirement the plan does not have the money it needs to pay the employee's 3% retirement benefits. And since he is retired, neither he nor the employer are contributing to his retirement account.

Another problem is that the new benefits lowered the retirement age and enabled employees to retire an average of 5 years earlier. Instead of retiring at an average age of 62, employees in Sonoma County started retiring at an average age of 57. This means there were 5 fewer years paying into the plan and 5 more years taking money out for a 10 year swing.

Options for Correcting the Unfunded Liability and Earlier Retirement Problem

So how do we correct the underfunding and earlier retirement problems? What SCERA did was ask their actuary to come up with what additional contribution going forward would be required to pay for the benefit increase. The answer the actuary came up with was an additional 3%. SCERA and the Board of Supervisors passed the increase. The understanding was that the employees would pay the additional 3% and therefore essentially pay for the entire cost of the increase and everyone would live happily ever after.

The only problem is, that 3% was way, way off and now instead of the employees paying for the benefit increase, the County is using our tax dollars to pay for it. Essentially taking tax revenues and putting them towards something they were never authorized to do while cutting services to try to balance the budget. The current supervisors understand this is a problem, but have not offered any solutions.

The only real way to pay for the increase, would have been for the employer and employee to contribute a lump sum amount to the account of the employee upon retirement to cover the unfunded liability. However, that was not something the employees or the County could afford to do and instead decided to amortize the additional cost over 30 years. So now the cost for pensions in Sonoma County have grown from $27 million in 2002 when the changes were enacted to $107 million in 2011, a 400% increase. And since the benefits are vested, the County is essentially stuck paying for pension benefit increases it cannot afford. And even though the County's required contributions have grown, so has the unfunded liability of the plan. To date, Sonoma County sold has sold $600 million in pension obligation bonds with an outstanding balance of $515 million and the pension plan is still about $400 million underfunded.

The Double Whammy

The other critical aspect of a defined benefit pension is investment returns. They need to average a certain assumed rate to fund the plan. Up until the mid 80's, funds were conservatively invested with 65% allocated to bonds and 35% to stocks, with an assumed rate of return of 5%. But that all changed in the mid 80's when the voters approved a measure they were told would save money by allowing pension fund administrators to invest 65% of pension fund in the stock market. This change also seems to have allowed pension fund administrators the ability to increase the assumed rate of return from 5% to 8%. This new rate of return created an immediate surplus on paper for the funds and enabled employee unions to argue that since the pensions now had a surplus, the new higher benefit levels were affordable. It also had the effect of making the County guarantee an 8% versus 5% rate of return, and be obligated to pay for any investment shortfalls.

Investment income is supposed to provide 66% of the retirement benefits. In the past, poor returns over a single or a couple of years were offset by gains in other years. But with a decade of below average returns the County's pension fund has racked up huge unfunded liabilities. For the pension funds to have achieved their 8% assumed returns, today the Dow would have to be at 29,000. Instead it just reached 13,000.

Over the past decade instead of an 8% return SCERA has only averaged 4.9%, 3% less than was assumed. CalPERS returns have been 4.5% over the past decade. And that 3% shortfall has a HUGE impact on the unfunded liability of the plan. For each 1% the plan misses the assumed rate of return, the employer, if they were to fully fund the plan each year, would need to contribute 10% of payroll to make up for the shortfall. This means a 3% decade long shortfall requires an additional 30% of salary each year over the past 10 years to be contributed to the plan. That did not happen, so the unfunded liability will be paid over the next 20-30 years with interest.

Even though we have seen Sonoma County's contributions to the plans and debt service on the bonds increase from 7% in 2002 to 32% today, the County estimates that the pension costs over the next 10 years will double from $97 million in 2010 to $209 million in 2020.

The Combined Financial Impact of Low Investment Returns and Retroactive Increases

So how bad is it? In July of 2004, the new 3% per year benefit level for General employees became effective in Sonoma County. The chart below demonstrates the problem.

For all of the calculations, the following assumptions were used for a typical employee earning $100,000 at retirement at 60:

In 2005 his benefits went from 60 to 90% of salary
He received a 2% annual COLA in retirement
He was hired at 30 years of age and retired at 60 years of age
He lives until 80 years of age
14% of his pay was contributed to the fund for years worked before the benefit increase
He received a 3% average annual salary increase and 1% annual merit increase (for promotions) over his 30 years of employment.

Additional Contribution Required for New Benefit Level Annually Before Retirement to Fund the Plan

Period and Number of Years	5% Investment Return	6% Investment Return	7% Investment Return	8% Investment Return	Additional 3% Employee Contribution
2007-2008 (1)	$850,000	$675,000	$475,000	$270,000	$3,000
2007-2009 (2)	$450,000	$347,000	$250,000	$140,000	$3,000
2007-2010 (3)	$300,00	$226,000	$165,000	$95,000	$3,000
2007-2011 (4)	$225,000	$175,000	$125,000	$75,000	$3,000
2007-2012 (5)	$180,000	$145,000	$102,000	$62,000	$3,000
2007-2013 (6)	$155,000	$120,000	$85,000	$53,000	$3,000
2007-2014 (7)	$135,000	$102,000	$75,000	$46,000	$3,000
2007-2015 (8)	$118,000	$88,000	$67,000	$42,000	$3,000
2007-2016 (9)	$104,000	$82,000	$60,000	$38,000	$3,000
2007-2017 (10)	$96,000	$72,000	$55,000	$35,000	$3,000

The chart shows that the 3% additional contribution, the cost estimated by the County's actuary to pay for the increase does not come close to providing the required funding. As the chart shows, everyone who retires the first 1 to 10 years after the 90% pension requires a substantial contribution of money the years prior to retirement to fund their plan. In Sonoma County about 1500 people have already retired under the new formula, and have ended up paying only a small percentage of the cost of the enhanced benefits, not the full cost as was agreed to when the increase was approved by the Board of Supervisors. That cost needs under the agreement to fall onto current and future employees. But if they pay the cost of their fellow employees, how will their pension fund grow?

As the chart shows, a person retiring 1 year after the increase in 2007 with a 5% average investment return over his 30 years worked would require an $850,000 contribution their final year of work. Remember, there are no more contributions after retirement. And if the investments returned 8%, the contribution required would be $270,000. But he only paid $3,000 towards it (3% x $100,000) so there is a $267,000 to $847,000 shortfall in this person's pension account.

A person retiring 5 years after the increase in 2012 with a 5% return would require an $180,000 per year contribution, an amount 2 times his annual salary each year. If investments returned 8%, the contribution required would drop to $62,000.

A person retiring 10 years after the increase in 2017 with a 5% return a year would require a $96,000 contribution for each of the 10 years prior to his retirement (his entire salary) or $35,000 with an 8% rate of return.

As you can see, even a 3 percent change in investment returns, from 8% to 5%, created a 200% to 300% increase in the contribution required to fund the plan. And under the current rules, the County or public agency, not the employee is required to make this additional contribution. Where is this additional money coming from?

How to Fix the Problems

There are two big problems to fix. First, the County should have the power to change benefit levels going forward simply because it may be required to prevent the County from going bankrupt. The current interpretation of the law is that promised benefits cannot be reduced and when a benefit is increased, they are immediately vested. However there is a CalPERS document that states that vested benefits are the benefits that were in effect when the employee was hired creating the possibility that the retroactive part of the increase could be rolled back to the old level for future service.

Also, some legal experts argue, that in a financial emergency, public agencies can legally change benefit formulas for existing employees going forward. The argument is that it is ridiculous that a legislative body can't make changes that will prevent the insolvency of the pension fund or the bankruptcy of the government agency.

The second problem that needs to be fixed is the County needs to find a way to reduce pension costs for people who have retired. These retirees are now receiving benefit levels they and their employer never properly funded i.e. the retroactive part of the increase. The California Constitution prohibits making a gift of public funds or wasting public funds. There is a very good argument for rescinding the retroactive benefit increase, which essentially pays a person again for work already performed and this is clearly a "gift". Hopefully this issue will be decided by the courts though the California Supreme Court recently refused to take up the case.

In the meantime, until these legal issues are ultimately resolved, the County (and other government agencies) should be doing the following to reduce pension costs:

> 1) Lower or freeze all salaries. Salaries are one of the two multipliers in the pension formula and lowering or freezing them will save money today and reduce pension costs when people retire. Currently, Sonoma County with average salaries of $82,000 per year for General employees and $99,000 for Safety employees, pays salaries that are 27% higher than those of the 20 other Counties under the County Employee Retirement Laws.
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> 2) Raise employee contributions to cover at least 50% of the total contribution, as was the practice before the benefit increases, or do what the City of Pacific Grove decided to do and have the employees pay all costs in excess of 10% of salary. Today, most public agencies, as well as Sonoma County, are paying 32% of salary for general employees and even more for Safety employees who can retire at 50 with 90% of their pay. The current employee contributions range from 8-12%.
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> 3) The County should create a second tier for new employees that either just provides a 10% of salary contribution to a 401k plan and eliminates the defined benefit plan, or the formula for the

defined benefit plan should be changed to a 2% per at 65 plan for general employees and 2% at 60 plan for Safety.

It is way past time to solve these problems. Every day the problem is not addressed, more people retire with pensions that are underfunded and the public agency/taxpayers are stuck with the bill.

All of us should be calling, writing letters and sending e-mails to our State and Local representatives telling them that we support comprehensive pension reform. We should also tell them we will not vote for any tax increases until salaries of public workers are reduced to comparable county or private sector levels and retirement benefits are reduced to sustainable levels.

To accomplish this we need to elect new representatives that understand the pension problem and have the financial expertise to understand and combat this problem. We need to elect people who will put the interests of the people who elected them ahead of the employee unions. We do not seem to have those people in office anywhere except for a few places right now. This was demonstrated by the recent City of Santa Rosa Police Contract where the City Council essentially traded a 9% employee contribution with an 8% raise in salary and did not create a second tier that went back to the old 2% formula for new hires.

The County is about to enter contract negotiations with its employees and it will be interesting to see what happens. This is why it is important for all of us to demand change so that the County can restore its financial health and we can once again receive the services we deserve for our tax dollars.

Please e-mail them to the addresses below or call them at 707-565-2241 to tell them how you feel about the current pension situation.

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