Attachment 6

# Will Unfunded County Pensions Un-fund Our Future?

## SUMMARY

"Pay me now, or pay me later." The only problem is that "later" is "more," and in the case of County pension liabilities, it's "much more." And it threatens our plans for the future.

Our County's need for roads and building maintenance is well-known, and surely must be addressed. But pension liabilities are sneaky: we don't notice them until they build up to threaten our ability to pay for the roads, vital services and programs we want (and need).

The Humboldt County Civil Grand Jury (HCCGJ), decided to investigate the extent of the County's unfunded liability problem. We wanted to find out what must be done to manage the problem to a healthy solution.

The latest California Public Employees Retirement System (CalPERS) valuation report, dated June 30, 2015, records an amount of $232.3 million for Humboldt County's unfunded Pension Liability. This total is almost twice the County's annual General Fund Revenue ($118 million) that is used for Law Enforcement, Public Works, Courts, and current retirement benefits. Our unfunded pension liabilities threaten to reduce the funding of these vital public services, particularly if projected tax revenues do not materialize, or if we have a business recession that affects County revenues. Our County Administrative Officer (CAO) considers the problem of unfunded pension liabilities to be a significant threat to the financial viability of our County within 3-5 years.

There is an opportunity to address the pension liability issue, and to significantly reduce its potential harm. Possibly, we could even eliminate it over the next 15-20 years. The remedy must have commitment from the present Board of Supervisors (BOS), and from future Boards, to stay the course. This opportunity is addressed below in our Discussion and Findings.

## BACKGROUND

According to the State Controller's Office, the unfunded pension liability of California's 130 state and local government pension plans stood at $241.3 billion as of 2014. Our County pension liability is less than one-tenth of 1% of the State liability, but at $232 million, it is twice our annual fund revenues of $118 million. A Humboldt County bankruptcy would have no real effect on the State's unfunded pension liability problem, but could decimate many of our County services. So what is an "unfunded pension liability," and how did we get ourselves into this serious financial situation?

Simply put, an unfunded pension liability is the shortfall between retirement benefits that governments (in our case, Humboldt County) have promised to their workers and the current funding available to meet those obligations. How we got ourselves into this situation is much more involved.

### History of CalPERS

CalPERS originated from California's first attempt to create a public-sector pension system in 1932. California lawmakers wanted to provide workers with an incentive to stay on the job, and at the same time encourage "older" workers to retire with a paycheck. Initial retirement age was set at 65 years, and life expectancy was 66 years. At that time, employee pensions equaled 1.43 percent of the average of the last five year's salary, multiplied by the total years she/he worked. After 40 years of work the qualifying pension was about 57% of the ending salary. Pensions were funded by three sources: contributions from employers (state/county/city governments), contributions from employees, and money that the pension fund would gain by investing those contributions.

Over the years, CalPERS retirement benefits grew with cost-of-living adjustments (added in 1968), and with increases in the percentage-of-salary formula, as well as lowering of the retirement age. By 1970, a retiring employee, at age 60, received 2% for each year worked. In 1983, in view of increasing life expectancy, retiring public-safety workers were given 2.5% for each year worked with retirement starting at age 55.

Besides substantially increasing benefits, Proposition 21, passed in 1984, loosened the requirements for CalPERS investments. In addition to lower-risk bonds and "blue chip" stocks, CalPERS funds could be invested in more risky assets to earn higher yields.

In 1992, California voters approved Proposition 162, the "Pension Protection Act." This act gave CalPERS additional powers, including administering the system so as to assure prompt delivery of benefits to participants. CalPERS also retained the exclusive power to determine the size of state and local governments' contributions into the fund. In other words, if the CalPERS Pension Fund failed to generate the required funds to support the retirement benefits of its recipients, the state and local governments had to accept the liability of funding the benefits.

The tech boom of 1994-1998 produced very high yields, which prompted state and county governments to offer ever more attractive pension commitments to their employees, and prompted numerous changes to retirement formulas. By the end of the 90's, the retirement age for a public-safety employee was lowered to 50 years old, and the retirement age for all other ("miscellaneous") employees was reduced to 55 years.

When the tech stock bubble deflated in the years after 2000, CalPERS investments began to experience large losses, that is, a large share of its funding for pension benefits. Over the course of the next ten years, CalPERS would fail to produce investment returns needed to continue paying promised benefits.

State and local government retirees, who might have lost benefits as the result of CalPERS losses, were rescued by the 1992 Pension Protection Act. By the executive power contained in this Act, CalPERS had the authority to increase the allotments the state and local governments were required to contribute to the pension funds for both their current retirees and their present workers. This additional allotment has become an unfunded pension liability. For Humboldt County, that unfunded liability has been identified by CalPERS as being $232.3 million.

## History of Humboldt County Retirement Benefits

Today, the County employs approximately 2,200 individuals all of whom belong to one of two CalPERS retirement systems. The first system, which employs the majority of the County employees, is called the "Miscellaneous Plan." The second retirement system is called the "Safety Plan." This Plan includes all County law enforcement employees and some County field service investigators. It is important to note that the retirement benefits differ between these plans, as well as between counties, cities, and Joint Power Authorities (JPA).

We have limited our investigation to Humboldt County government only, thereby excluding the cities of Arcata, Blue Lake, Eureka, Fortuna, and JPAs from our scope. It is worth noting that each of these cities and JPAs have their own unfunded pension liability. Those interested in learning their city's or JPA's estimated unfunded pension liability, these can be found at "http://www.pensiontracker.org/."

This Grand Jury did not determine when Humboldt County first participated in CalPERS, but we do know that the Miscellaneous Plan, offered first in January 1946 and ending in July 2012, covers the bulk of the County's employees. The contract Humboldt County signed with CalPERS allows the employee to retire at age 55 and receive 2.7% of his/her salary for each year worked, since June, 2006. Prior to June 2006, each employee received 2% of his/her salary. An individual who was 55 years old, retiring after 30 years of service, would therefore receive 67% of his/her highest three-year average salary for life.

In July 2012, Humboldt County signed a new Miscellaneous Plan agreement with CalPERS and local unions. This Plan remained in effect for only 6 months, ending in January 2013. Those County employees hired during this period are allowed to retire at age 55 and will earn 2% for each year worked. These employees, choosing to retire at age 55 after working 30 years, would receive a lifetime benefit of 60% of their highest three-year average salary.

The Miscellaneous Plan, currently in effect since January 2013 for all new hires, includes a retirement age of 62 years with a payout of 2% per year worked, again based on the highest three-year average salary. The requirement of working an additional 7 years has the effect of both the County and employee paying more into CalPERS, and lengthens the time before funds are paid out of CalPERS.

The Safety Plan benefits for law enforcement personnel hired before January 2013 include retirement at age 50 with 3% of salary for each year worked. A qualified law enforcement employee retiring at age 50, with 25 years of work, would therefore receive 75% of his/her highest three-year average salary.

In January 2013, Humboldt County signed a new Safety Plan agreement with CalPERS and local unions. Employees hired since January 2013 now must work until they are 57, at which time their retirement is based on 2.7% for each year worked. Again, their retirement is based on the highest three-year average salary.

## METHODOLOGY

In preparation for this report, the Humboldt County Civil Grand Jury:

- Conducted interviews with representatives from the Humboldt County Administrative Office.
- Conducted an interview with a representative from the Humboldt County Department of Health and Human Services, Financial Services.
- Researched the Federal and State Laws as they apply to CalPERS.
- Reviewed documentation provided by the Humboldt County Administrative Office relating to County pension plans, fiscal budgets, and irrevocable trusts.
- Researched CalPERS history and responsibilities to manage California's public pension system.
- Researched numerous publications relating to CalPERS and unfunded pension liabilities.

## DISCUSSION

### What does this all mean to Humboldt County's unfunded pension liability?

There are three sources of revenue for funding County pensions. The employee contributes about 13%, the County contributes 25%, and the remaining 62% comes from investment earnings handled by CalPERS. Investment earnings are based on "average performance." In good years they may exceed the average, but in bad times (such as a recession) they will not meet forecasted revenues.

Since the Pension Protection Act requires state and local governments to make up the shortfall if the CalPERS Pension Fund fails to generate the required retirement funds, CalPERS simply adds its investment shortfalls to the County's unfunded pension liability. Similarly, in "good years," funds are added to offset the pension liabilities. This is why our County's unfunded pension liability fluctuates.

CalPERS actuaries have provided a 30+ year method to bring Humboldt County's unfunded pension liability to zero. It involves two basic approaches. First, retirement plans are being adjusted such that employees are working longer and receiving less benefits for each year worked; and second, the County is given a "bill" each year to make up for any loss of investment earnings. This bill is in addition to the 25% of salaries the County is required to pay.

Humboldt County has been able to adjust its retirement plans over the last four years such that new hires are now required to work more years and earn less retirement per year worked before being eligible to retire (see "History of Humboldt County" above). In addition, the County has been able to make the required payments to CalPERS. For the fiscal year 2017-2018, those scheduled payments total $16,830,000.

With new retirement plans in place, and assuming no significant changes to the economy/markets, the County CAO estimates that all Humboldt County pension liabilities will be paid off within 17 years. However, the CAO also stated that, based on historical market behavior, it expects a mild recession within the next 2-3 years. In the event of a moderate to severe recession, Humboldt County can expect CalPERS to ask for significantly more than the $16-$17 million dollars it is presently required to pay. This will have an impact on all County programs in the future.

On December 21, 2016, CalPERS Board of Trustees agreed to reduce its investment portfolio's projected return average from 7.5% to 7%, phasing in the reduction over the next three years. Projecting lower returns increases the budgetary impact on counties and cities across the state.

### Is there a possible solution to better manage Humboldt County's Unfunded Pension Liability?

The short answer is YES, but the County has a long way to the finish line.

During the 2015 calendar year the Humboldt County Board of Supervisors examined options for reducing our unfunded pension liability. The objectives were 1) to hedge against future periods of declining revenues, and 2) to comply with the Government Accounting Standards Board (GASB) requirements issued for implementation in June 2014. GASB now requires that government employers who sponsor defined-benefit pensions, such as CalPERS, must include their accrued liability on their balance sheets. Showing these unfunded liabilities will lower the County's credit rating thus impacting future borrowing interest rates.

The BOS investigated four different options to reduce its unfunded pension liability and decided to set up an irrevocable trust as a "pension savings account" that could be used to offset rate increases in the future.

On September 15, 2015, the BOS authorized participation in a Public Agency Retirement Services (PARS) Section 115 Trust, based on a provision of the IRS Code that allows for accrued interest to be tax-exempt. Officially, Humboldt County's retirement trust fund is known as the Public Agencies Post-Employment Benefits Trust. The Trust agreement provides that assets are held by the Trust for the exclusive purpose of funding participating employers' benefit obligations and defraying the reasonable expenses of the Trust. When and if Humboldt County's unfunded pension liabilities are totally paid off, all remaining Trust funds would be returned to the County.

The HCCGJ supports the BOS' September 2015 decision to create the PARS Trust fund. We see this as a positive step to provide more local control of our pension liability. The true value of the PARS Trust lies in securing funding today in order to offset future variations in the County's contribution to CalPERS during times of poor market performance.

### How is Humboldt County's PARS Trust performing today?

The HCCGJ realizes that the Board of Supervisors and the County Administrative Office are just beginning to develop the budgeting process for the PARS Trust. As of December 2016, the County had placed $750,000 from the General Fund into this Trust.

In interviews, CAO staff expressed hope that future budgets would include higher funding, but a specific method of budgeting had not yet been developed. One possible budgeting technique involved increasing, by either a specific amount or a percentage, the contribution rate charged for each employee hour worked. In this way all programs would be contributing to the PARS Trust and thus paying down their unfunded pension liability. In more than one interview, however, the HCCGJ was told that the Department of Health and Human Services stated that the Federal and State funds they receive cannot be used in this way.

However, DHHS financial personnel told the Grand Jury that they know of no legal reason why salary rates cannot be increased. They did indicate that funds received for a specific program must be spent on that program. Increasing the hourly charge rate of an individual working within a specific program seems to meet this requirement, with the additional collected funds going to pay down the employee's retirement liability through PARS.

Establishing and funding a PARS trust alleviates the need to respond to CalPERS "emergencies," and helps the County plan for and accelerate the payoff of its unfunded liabilities. But, **this is not free** money. It will require discipline in spending, and may have a dampening effect on desired increases in a given year, such as for new hiring or raises.

The reward to our citizens is worth the effort. If our unfunded pension liabilities were eliminated, our County would not be required to include current expenses for them in our budget, so that money would be available for crumbling roads, inadequate social programs, and repair of dilapidated county buildings. We have no choice but to "pay the Piper," but funding the PARS "savings account" Trust can alleviate much of the uncertainty and pain.

## FINDINGS

F1. Humboldt County has a CalPERS unfunded pension liability of approximately $232 million. If not addressed, continuing pension payments will become an increasingly larger percentage of our budget, and could jeopardize vital programs, even Humboldt County's solvency.

F2. Through Proposition 162, Humboldt County is responsible for paying its share of any loss of revenue caused by CalPERS investment strategies, resulting in lack of predictability of future program budgets.

F3. Humboldt County has reduced its pension liability requirement by negotiating new retirement plans with its "Miscellaneous" and "Safety" employees which have provided some positive benefits in addressing the unfunded pension liability issue.

F4. Any recession, whether at the County, State or Federal level, will seriously impact Humboldt County's unfunded pension liability problem.

F5. If Humboldt County's unfunded pension liability remains unchecked, it will have a devastating effect on our County government, roads, facilities, and infrastructure.

F6 Although Humboldt County's Board of Supervisors and the County Administrative Office have begun to address the unfunded pension liability issue by creating a Section 115 Trust with Public Agency Retirement Services (PARS), which currently contains $750,000, future impacts cannot yet be determined. The Trust agreement provides that assets are held by the Trust for the exclusive purpose of funding participating employers' benefit obligations.

F7. The Humboldt County Administrative Office is investigating ways to fund the PARS Trust fund beyond simply depositing General Funds.

F8. The failure of the Department of Health and Human Services to contribute to the PARS Trust fund significantly undermines the County's efforts to address the unfunded pension liability issue.

## RECOMMENDATIONS

R1. The Humboldt County Civil Grand Jury recommends that the Humboldt County Board of Supervisors continue to add funds to the Public Agency Retirement Services Trust. For the upcoming Fiscal Year 2017-2018, we recommend that the Board of Supervisors contribute a minimum of $2 million, or just under 1% of the outstanding unfunded pension liability ($232 million). (F1, F2, F4, F5 & F6)

R2. The Humboldt County Civil Grand Jury recommends that the Board of Supervisors direct the County Administrative Office to develop a method of equitably deducting funds from all County programs, including the Department of Health and Human Services, such as a collection of fees for hours worked. The accumulation of these fees should then be placed in the County's Public Agency Retirement Services Trust. (F6, F7, F8)

## REQUIRED RESPONSES

Pursuant to Penal code section 933.05, the Humboldt County Civil Grand Jury requires responses as follows:

- Humboldt County Board of Supervisors **(R1, R2)**
- Department of Health & Human Services **(R1, R2)**
- Humboldt County Administrative Office **(R1, R2)**

Reports issued by the Grand Jury do not identify individuals interviewed. Penal Code section 929 requires that reports of the Grand Jury not contain the name of any person or facts leading to the identity of any person who provides information to the Grand Jury.

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