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Retirement Benefits for Los Angeles City Employees

A Looming Crisis?

A Study
Prepared by
The League of Women Voters of Los Angeles

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Executive Summary

The City of Los Angeles provides generous pension and post-retirement health benefits to both its civilian and sworn employees. There is general consensus that civilian compensation – salaries plus benefits – is on average higher than that in the private sector. Because providing retirement benefits involves a long-term and somewhat unpredictable financial obligation for the City, it may be appropriate to look at ways to reduce that obligation through modifications to the City's retirement benefits.

Sources of Secure Retirement

In an ideal world, retirement benefits would be based upon a three-legged stool – Social Security benefits, a pension, and personal savings. The composite of the three should provide the retiree with at least 70-80% of his or her pre-retirement salary.

Retirement plans can be either Defined Benefit Plans or Defined Contribution Plans. In the former, a retiree receives a pension based on salary and years of service, with the employer assuming the financial responsibility for paying the benefit. In the case of a Defined Contribution Plan, the employer pays a specified percentage of the employee's salary into the plan each year that the employee works for the employer. However, the employee instead of the employer manages the plan and assumes the risk that he or she will have sufficient funds to support himself or herself after retirement.

Los Angeles City Retirement Benefits

Los Angeles City employees, who are part of the civilian Los Angeles City Retirement System (LACERS) program or the sworn officer Fire and Police Pension System (FPP), do not receive Social Security, because the City does not participate in that system. However, the City has a Defined Benefit Plan for both categories of employees. City retirees receive Cost of Living Increases (COLAs), subject to a cap, on their pensions. A voluntary deferred compensation plan is also available to city employees, but the City does not match employee contributions to that system. City employees hired after 1986 contribute to Medicare, and retirees receive city-subsidized health benefits both before and after age 65. The City Charter provides for both retirement systems, but all details for civilian employees, including the level of benefits, are determined by ordinances enacted by the City Council. In contrast, the details of the sworn officers' retirement benefits are set out in the City Charter.

Both pension systems are administered by pension boards which consist of individuals elected by members and individuals appointed by the mayor. The funds needed to pay the promised city retirement benefits come from contributions made by active employees, contributions made by the City, and investments made by the pension systems from the first two sources of money. The return on investments provides the vast bulk of the funds used to pay retirement benefits. When investment returns fall below the anticipated investment growth rate, the City must increase its annual contribution to the retirement systems. In contrast to many other public entities which pay retiree health benefits out of current revenues, the City of Los Angeles has pre-funded its retirement health benefits since 1989.

Private Retirement Benefits

As of 2008 only a small percentage of private employers provided Defined Benefit Plans. Many employers, who had DBPs in the mid to late twentieth century, eliminated them because of the financial risk and ongoing obligations associated with such plans. Many public agencies, like the City of Los Angeles, still provide Defined Benefit Plans.

How Retirement Benefits Affect the Los Angeles City Budget

Between 2000 and 2009, City contributions to the retirement plans, expressed as a percentage of payroll, varied greatly. In the case of LACERS, the combined pension and health contributions went from a low of about 5% of payroll in 2002 to a high of 25% of payroll in 2007. City contributions to FPP went from a low of about 7% in 2003 to a high of about 30% in 2008. Unless the financial downturn of 2008-2009 reverses quickly, City contributions to both systems will continue to increase. The City's retirement contributions in the last seven years, expressed as a percentage of the General Fund, have increased steadily from a low of about 5% in 2002 to a high of about 15% in 2008.

Possible Modifications to the City's Retirement Systems

There are a number of ways to reduce the cost of providing pensions and post-employment health benefits to City employees. These include:

- Changing from a Defined Benefit Plan to a Defined Contribution Plan and joining Social Security.
- Reducing subsidized health benefits for retirees who retire prior to Medicare age.
- Changing the Defined Benefit Plans by decreasing the rate of accrual of benefits and/or increasing the age at which an employee can retire without an actuarial penalty for early retirement.

Origin of Study and Methodology

At its June, 2005 Annual Meeting the League of Women Voters of Los Angeles approved a study of Los Angeles City finances, and formed a Study Committee. During the first phase of the study the Committee worked at educating itself and other League members on the basics of Los Angeles City finances – the budgeting process, revenue sources, and expenditures. Committee members attended two Budget Days that the Mayor held for Neighborhood Councils, and monitored City Council Budget Committee hearings on the 2006-2007 City Budget. The Committee's work became the basis for several VOTER[1] articles and presentations to Unit Meetings.

In the fall of 2006 the Committee proposed focusing on the financial impact of employee pensions and retiree health care on the City's budget. It proposed this topic because the financial solvency of retiree benefit systems had become an increasing issue for both public and private employers.

The Committee's approach to the study of retirement benefits was first to gather basic data and then to elicit various stakeholders' perspectives on whether the current City retirement system is sustainable and appropriate and what modifications of the system, if any, the individuals suggested. The Committee also sought to determine how the City's retirement systems compare in scope and sustainability with those of other public and private employees.

The Committee interviewed City employees, employees of the two City pension plans, and various other people with an interest in or expertise in employee retirement benefits. At least two members of the Committee were present at each interview. The fundamental questions were always whether existing retirement benefits are sustainable and appropriate, but the committee explored a variety of issues associated with these questions. The Committee thanks each person whom it interviewed for taking the time to discuss these issues and for sharing his or her knowledge and perspectives. Appendix A contains a list of those who were interviewed.

The Committee also reviewed a number of reports. These included Los Angeles Budget documents, the Annual Reports of LACERS and FPP, Pew Foundation reports on retirement, the Report of the California Commission on Public Employment Post-Retirement Benefits, materials on public employee retirement systems from the League of California Cities, and State Comptroller documents on the same topic.

[1] The League's Newsletter

1. Background

The question of how to provide retirement income and health care to the nation's citizens has been a subject of much public discussion in recent years. In part this reflects demographic trends. The first of the huge population of "baby boomers" – those born between 1946 and 1964 – became eligible for early social security benefits in 2008; they will be eligible for Medicare starting in 2011. Social Security and Medicare are structured largely as pay-as-you-go programs, so the decreasing ratio of active workers to retirees and continuing double-digit inflation in medical costs pose threats to the long-term viability of these two systems as currently configured.

1.1. Financing Retirement – The "Three-legged" Stool

Retirement planners often describe the underpinnings for providing income after retirement as a "three-legged" stool. Typically, the first leg is Social Security. The second leg is a pension plan provided by the employer, and the third leg is savings managed by the worker. These savings may take the form of an employer-sponsored, tax-deferred plan (401K for private sector or 457B for public sector employees), an Individual Retirement Account, or simply private savings. The three-legged stool should be viewed as a "best-practice" ideal; relatively few retirees receive income from all three sources.

1.1.1. Social Security

Most employees in the United States are covered by Social Security, and for many retirees Social Security benefits are their only source of income. Social Security is not a pension system, but a social insurance program,[2] which is funded on a pay-as-you-go basis by payroll taxes on current workers and their employers. However, Social Security has similarities to a Defined Benefit Pension Plan in that the government assumes the risk of providing a specific level of benefits. Its financial viability is threatened because the ratio of workers paying Social Security taxes to retirees receiving benefits has been declining for years. Social Security benefits are currently fully indexed to increases in the Consumer Price Index. Typically, full Social Security benefits range from 30-50% of a worker's highest three years of salary, with the higher percentage going to the less highly paid workers. Normal retirement age for Social Security for those born after 1959 is 67; workers can receive reduced benefits if they elect to retire at 62.

Los Angeles City employees, like some other public employees, are not subject to Social Security taxes since they belong to a qualified pension plan. If a City worker is eligible to receive Social Security benefits through non-City employment, those benefits will be

[2] The Social Security Program includes disability insurance and survivor's benefits.

subject to reduction under the "Windfall Elimination" provision of Social Security.[3] Although City pensions provide for COLAs, they are not fully indexed to the Consumer Price Index the way Social Security benefits are.

1.1.2. Defined Benefit versus Defined Contribution Plans

There are two fundamentally different ways in which employers can help finance retirement benefits for an employee – with a Defined Benefit Plan (DBP) or with a Defined Contribution Plan (DCP). A Defined Benefit Plan is one in which the employer promises to provide the employee with a pension based on the employee's years of service, earnings, and age at retirement. The employer assumes the risk of providing this benefit regardless of economic conditions.

In contrast, a Defined Contribution Plan is one in which the employer agrees to contribute a defined amount – usually a percentage of the employee's salary or a percentage of the employee's own contributions – to a personal retirement account for the employee. The money in this account is invested and available to the employee at the time of retirement. With a DCP the employee assumes the responsibility for selecting an investment vehicle from the choices provided and the responsibility for contributing enough of his or her own funds to the plan so that the account will be large enough to support himself or herself after retirement.

An employee participating in a DBP receives no further benefits once he or she and any surviving beneficiaries have died. However, with a DCP, any funds left in the retirement account after the employee's death will be distributed to his or her heirs.

Private Defined Benefit Plans are provided for only a small minority of workers in the United States. Private DBP plans typically are funded exclusively by the employer. In general, they do not provide COLAs. Private pension plans are becoming increasingly rare because they have led to large liabilities for the corporations that provide them. Some employers have replaced their Defined Benefit Plans with Defined Contribution Plans, sometimes providing matching money for an employee's contribution to a 401K, 403B[4], or 457B plan.

In contrast, many public employers (state governments, city governments, school districts) offer Defined Benefit Plans, often with guaranteed COLAs, although not necessarily fully indexed to the Consumer Price Index. Normally both the public employer and the employee contribute to these plans.

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[3] This is intended to avoid allowing workers already receiving a public pension to benefit from the fact that Social Security replaces a higher percentage of income for lower-paid workers than for the most highly compensated workers.

[4] A 403B plan is a tax-sheltered annuity that is available to employees of public schools, employees of certain non-profit organizations, and certain ministers.

1.2. California Commission on Public Employment Post-Retirement Benefits

In 2005 concern about the long-term costs of public retirement plans in California led Governor Arnold Schwarzenegger to propose a constitutional amendment which would have eventually eliminated Defined Benefit Plans and replaced them with Defined Contribution Plans. Opposition from public safety unions scuttled this plan. Subsequently the Governor created a Commission on Public Employment Post-Retirement Benefits. Post-retirement benefits include not only pensions but also other post-employment benefits (OPEB) such as health insurance. The Commission was charged with estimating the collective liability for OPEB and for identifying ways to deal with the unfunded liabilities for both pensions and OPEB. The Commission issued its report in late 2007.[5] This report contained a series of recommendations for best practices in terms of funding and administering post-retirement benefits, and for providing transparency as to costs. It did not make recommendations about the level of benefits. It is worth noting that the City's retirement systems had already implemented almost all of the Commission's recommendations.

[5] The Commission's final report is available at http://www.pebc.ca.gov/images/files/final/080107_PEBCReport2007.pdf

2. Overview of Los Angeles City Pension Systems

This study looks specifically at retirement benefits provided by the City of Los Angeles to its employees.

2.1. LACERS and FPP

The City of Los Angeles has three retirement systems. All include a Defined Benefit Plan and post-employment health care benefits. The Fire and Police Pension system (FPP) provides retirement benefits for sworn firefighters and police officers. The Los Angeles City Employees Retirement System (LACERS) provides pensions and other post-retirement benefits for civilian employees. Two of the City's three proprietary departments – the Harbor Department and the Airport Department – provide retirement benefits to their employees through LACERS. The Department of Water and Power, the third proprietary department, has a separate retirement system. This study was limited to LACERS and FPP, as the two have a more direct impact on city finances.

Both LACERS and FPP are mandated in the City Charter. The City Charter contains no provisions as to the level of benefits provided by LACERS – all aspects of the civilian employee retirement benefits, including employee and City contribution rates, etc., are determined by the City Council and implemented in the Municipal Code.

The FPP has had five significantly different benefit plans – called "tiers." The major features of these tiers are contained in the Municipal Charter, and cannot be modified without changing the Charter. Change requires approval by the voters of Los Angeles. Tier 3, approved in 1980, reduced benefits for new employees by capping the cost of living increases that retirees were entitled to. Tiers 4 and 5, approved in 1997 and 2001 respectively, changed benefits for new employees and offered existing employees the opportunity to switch to the newly created tier. Tier 5 raised the maximum pension benefit for sworn officers to 90% of the employee's final salary after 30 years of service. There are retirees in all five tiers; about 85% of active employees are enrolled in Tier 5.

2.2. Level of Benefits

Members of LACERS accrue a pension benefit at the rate of 2.16% per year for each year of service and a health insurance subsidy at the rate of 4% per year of service. For LACERS, the final compensation used to determine retirement benefits is the average of the highest 12 consecutive months of compensation during the employee's City career. This means, for example, that if a civilian employee with 30 years of service retires at age 55 (the minimum retirement age with 30 years of service), he or she will receive 30 x 2.16% = 64.8% of his or her final compensation as a pension. He or she will also receive the maximum possible health insurance subsidy, as the subsidy accrues at the rate of 4%

for each year of service. Currently the maximum subsidy is targeted to be approximately the full cost of two-party coverage for a Kaiser Health Plan. In 2008, the maximum subsidy was $1022[6] per month.

Benefits for firefighters and police officers are more generous. Under Tier 5, a member of FPP will receive a pension benefit of 50% of his or her final average salary after 20 years of service.[7] If he or she works for more than 20 years, this percentage increases by 3% for each additional year of service, except in the thirtieth year, when it is 4%. The maximum pension benefit for a uniformed officer is 90% of final salary, reached at 33 years of service. As with LACERS, FPP retirees receive a health insurance subsidy which accrues at the rate of 4% per year of service.

For FPP, final average salary is normally the average of the monthly compensation received during the last twelve months of service, including hazard pay, assignment pay, and special pay, but not overtime. Thus, a police offer retiring at age 55 after 30 years of service would receive 81% of his or her final average salary and the maximum health care subsidy. In 2008 this subsidy was $895.81[8] per month.

Both systems make adjustments to a retiree's pensions when there is inflation. The COLA is the same as the increase in the federal Consumer Price Index (CPI) up to a maximum increase of 3% per year. If the increase in the CPI is greater than 3%, the difference is "banked," and is used to increase the COLA up to the maximum of 3% in years in which the increase in the CPI is less than 3%. For example, if the CPI increases by 4.0%, 3.6%, and 2.6 % in three successive years after an employee's retirement, the retiree's COLA on his or her pension in subsequent years would be 3%, 3%, and 3%. In the first two years, the employee would receive the maximum allowable COLA of 3% and bank 1.6%. In the third year, 0.4% of the banked balance would be applied to bring the COLA to 3%; leaving his or her balance in the COLA bank at 1.2%.

Both LACERS and FPP offer disability retirement benefits, but the disability benefits for FPP are significantly higher than for LACERS. A civilian employee retiring with a disability pension receives approximately one-third of his or her highest 12 month average salary.[9] A sworn officer receives a percentage of his or her highest 12 month average salary, based on at least 2% for each year of service, up to a maximum of 90%.[10] One advantage to the employee of a sworn disability pension is that it is exempt from federal income tax.

Los Angeles City employees do not pay Social Security taxes, although retirees may receive Social Security benefits based on non-city employment. However, under federal

[6] Based on calculation at http://www.lacers.org/RetiredMembers/HealthCalc/healthcalc2008/medcalc.cfm
[7] http://www.lafpp.com/LAFPP/plan_pension_ben_tier5.html
[8] http://www.lafpp.com/LAFPP/plan_health_sub_members.html
[9] LACERS Disability Brochure - http://www.lacers.org/AboutLACERS/_FormsPublications/GuidesBrochures/DisabilityBrochure.pdf
[10] Fire and Police Pension Plan, Tier 5 – Disability Retirement http://www.lafpp.com/LAFPP/documents/forms/dis_retire_tier_5.pdf

law, their Social Security benefits will be reduced based on their receipt of a City pension.

All City employees hired since 1986[11] have been required to pay Medicare taxes. For retirees over 65, the health insurance plans are coordinated with Medicare. The health insurance subsidy that a retiree receives is applied to the payments for Medicare Parts B and D as well to supplemental benefits.

2.3. Financing and Administration of City Retirement Benefits

2.3.1. Administration of the Pension Systems

The Fire and Police Pension System and the Los Angeles City Employees Retirement System are independent charter departments overseen by citizen commissions.

The Board of Administration of LACERS consists of seven members, four of whom are appointed by the mayor and confirmed by the City Council, two of whom are elected by active LACERS members (i.e., City employees covered by LACERS), and one who is elected by the retired LACERS members. The General Manager is appointed by the Board of Administration. With a handful of exceptions, other employees are subject to Civil Service.

The Board of Fire and Police Pension Commissioners for FPP has nine members – five appointed by the mayor and confirmed by the City Council, two elected by active members (one elected by firefighters and one by police officers), and two elected by retired members (again, one elected by firefighters and one by police officers). As with LACERS, only the General Manager is appointed by the Board.

Under the State Constitution, these Boards have fiduciary responsibility over the pension systems that they oversee and the responsibility to ensure that the benefits that have been promised can be paid. This authority was granted by Proposition 162, passed in 1992.[12]

Nominally, terms for appointed Commissioners overlap mayoral terms, but in practice a Commissioner usually serves only during the term of the Mayor who appointed him or her.

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[11] http://www.ssa.gov/slge/faqs.htm

[12] Article XVI, Section 17 (a) states: The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system.

2.3.2. Financial Basis for Pension Systems

The principle behind the financing of most retirement systems – including FPP and LACERS – is that money is put aside during an employee's working years. These contributions become part of the retirement system's assets. These assets are invested and the proceeds used to pay an employee's pension and other retirement benefits (e.g., health insurance) when he or she retires.

Calculating the amount of money required to pay these benefits is the job of actuaries – professional statisticians who evaluate risk and uncertainty. In a Defined Benefit Plan, there is not a separate pot of money for each employee, but an aggregate pool of assets to pay for retiree pensions – for those who live a long time and those who die soon after retirement – and to pay for retirees' health care – for those are healthy as well as those who are sick. These calculations are complex and involve a number of assumptions. Assumptions are demographic and economic. Examples of demographic assumptions include the life expectancy of retirees and their eligible beneficiaries, if any. Examples of economic assumptions include the expected rate of return on investments, the expected rate of inflation, projected salary increases for City employees, etc.

Based on these assumptions, the actuary computes the amount of money that must be set aside each year in order to provide projected cost of benefits that employees have accrued during the year. This is called the "normal cost" of the retirement plan.

The ratio of assets to liabilities (the amount required to pay the accumulated benefits) is called the "funding ratio." If the assets of the retirement system are sufficient to pay the benefits that have been promised, then funding ratio is 100%, and the system is said to be "fully funded." A funding ratio less than 100% means that there are not enough assets currently set aside to pay the liabilities. The shortfall is called an Unfunded Actuarially Accrued Liability (UAAL). When one of the retirement systems incurs a UAAL, then the City must pay money into the system, beyond the normal cost, in order to pay off the liability. UAALs are amortized over 15 years (for economic losses) or 30 year (for demographic changes).

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All of this sounds more precise than it actually is. That is because the underlying assumptions may turn out to be wrong. Inflation rates – especially inflation in the cost of medical care – may be higher than anticipated. Investment returns may be greater (as happened in fiscal years 1995-2000) or less (2001-2003) than projected.[13] The life expectancy tables that go into the actuarial computations were changed in recent years for LACERS and FPP because long-term data showed that retirees were living longer than anticipated.

Those managing and overseeing the retirement systems take a long-range view (30 years) when analyzing whether the system will have sufficient assets to make payments to the beneficiaries when they retire. This is because the retirement system manages assets over

[13] http://www.lacers.org/Investments/Investment%20Performance/annualreturns.htm

the long term for many individuals and accounts for a variety of factors, including its beneficiaries' different life spans, the fact that investments will be made for individuals who leave before retiring from the system, and the ongoing long-term nature of its investments. This long-term view contrasts with how an individual saving for retirement must plan. While the individual might start with a long-term horizon, this horizon necessarily shortens as the individual ages, and the individual must save sufficiently to cover a potentially long life. The individual worker cannot average his or her life span with that of other retirees, and must adjust the nature of investments as retirement approaches to assure that retirement assets that have grown are not significantly reduced during a market downturn close to the individual's retirement date.

2.3.3. City and Employee Contributions

Retirement benefits for City employees are financed by a combination of employee contributions, employer (City) contributions, and return on investments. The employee/employer contributions are made to the appropriate department, which is then responsible for investing the funds and administering the pensions and other post-employment benefits.

Employees covered by Tier 5 of FPP (about 85% of sworn officers) pay 8% of their salaries to FPP, with an increase to 9% when the system is not fully funded. These rates are specified in the City Charter. Most civilian employees (all hired since 1983) pay 6% of their salaries to LACERS. This rate is set by ordinance, but is also subject to union contracts.

The contribution of the City to the pension systems varies depending on economic conditions. The following chart shows the City contribution as a percentage of payroll over the last few years.

	City Contributions to Retirement Plans as a Percent of Payroll				
		2005-2006	**2006-2007**	**2007-2008**	**2008-2009**
LACERS	Normal Cost	10.88%	13.89%	13.50%	13.34%
	Total	19.70%	24.78%	23.67%	20.90%
FPP	Normal Cost	16.68%	19.19%	21.91%	22.75%
	Total	15.69%	25.59%	30.60%	28.17%
Sources:	LACERS Combined Annual Financial Reports FPP Annual Financial Statements				

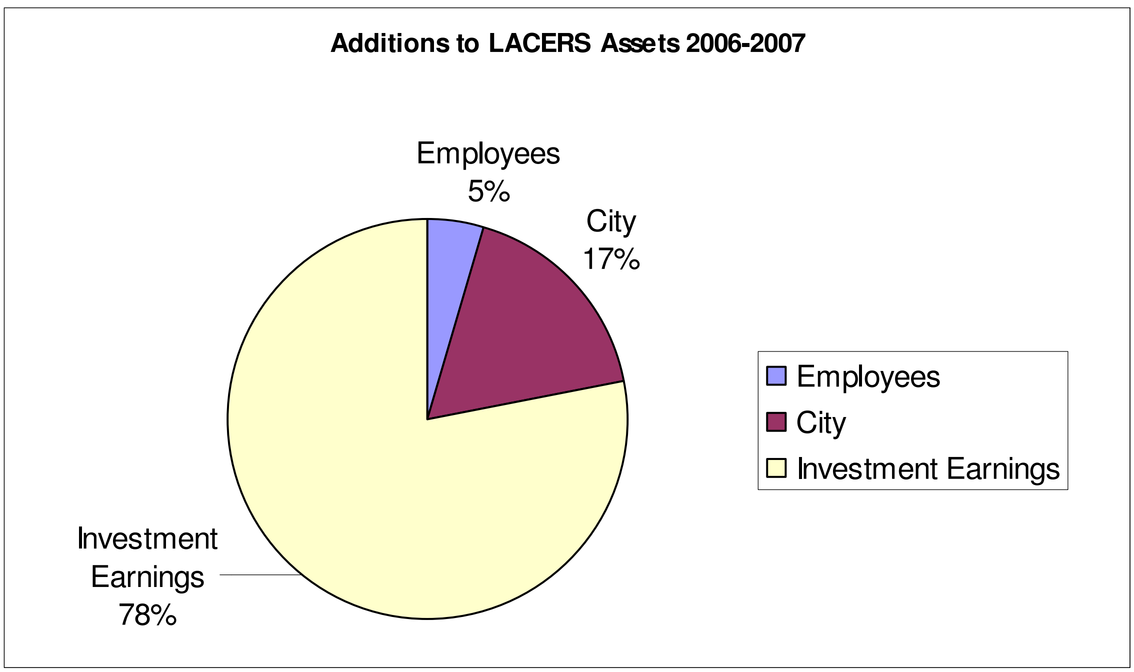
Table 1 – City Contributions to Retirement Systems as % of Payroll

As this chart indicates, the City's contribution to the pension systems, even the amount attributable to normal cost, has been greater than the employee's contributions – roughly twice as much. The City is also responsible for paying off (amortizing) any unfunded liabilities, which increases its contributions further. Currently the City contribution is somewhat more than three times the employee contribution. Part of the City's contribution amortizes unfunded liabilities for people who have already retired.

2.3.4. Investments

The funds the City and employees pay into the retirement systems become part of their assets, and these assets are invested. Each pension department has a Chief Investment Officer. Management of most funds is done by outside investment managers who are selected by the Board of the pension system. The Board also approves the distribution of assets. As of June 30, 2008, the market value of LACERS assets was $10.4 billion dollars, a decline of $700,000 from assets of $11.1 billion as of June 30, 2007.[14] The market value of FPP assets as of June 30, 2008 was $14.4 billion versus $15.5 billion as of June 30, 2007.[15] The market value of these assets has declined significantly in the eight months since then.

Normally most of the income of pension systems comes from earnings on investments. Figure 1 and Figure 2 show the sources of income for FPP and LACERS for the latest year (2006-2007) for which information is available. In Fiscal Year 2008 both systems had a negative return on investment, and there was a net decrease in assets.



[14] *LACERS Comprehensive Annual Financial Report for the Fiscal Year Ending June 30, 2008*, http://www.lacers.org/AboutLACERS/_FormsPublications/Reports/CAFR2007-08.PDF

[15] Los Angeles Fire and Police Pension Plan, *Actuarial Valuation and Review of Pension and Other Postemployment Benefits (OPEB) as of June 30, 2008*, http://www.lafpp.com/LAFPP/documents/financial_reports/2008_Valuation.pdf

Figure 1 – Additions to LACERS Assets

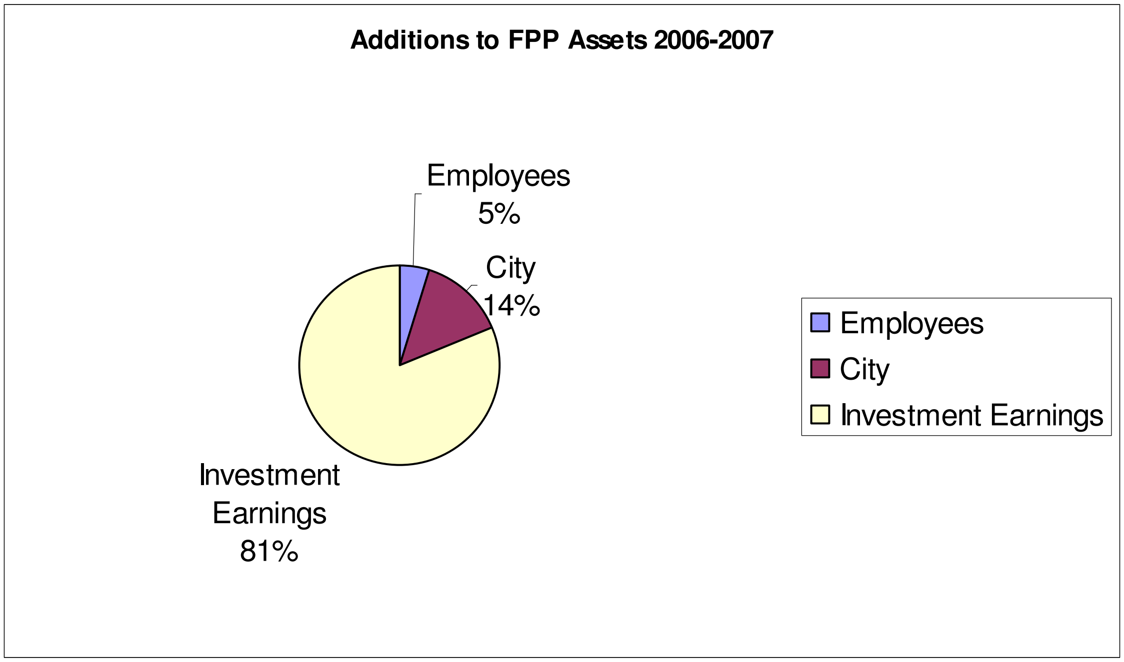


Figure 2 – Additions to FPP Assets

2.3.5. Financial Health of Los Angeles City Pension Systems

As indicated in Section 2.3.2, one measure of the financial health of a pension system is the funding ratio – that is, the ratio of the system's assets to it liabilities. As of the end of the last year for which data is available, funding ratios for the two systems were as follows:[16]

	Funding Ratio – Pensions	**Funding Ratio – OPEB**
LACERS (FY 2008)	84.4%	69.7%
FPP (FY 2008)	99.1%	41.8%

Table 2 – Funding Ratios for Los Angeles City Pension Systems

[16] *LACERS Actuarial Valuation for 2008*, http://www.lacers.org/AboutLACERS/_FormsPublications/Reports/2008_Annual_Actuarial_Valuation.pdf and *FPP Actuarial Valuation for 2008*, http://www.lafpp.com/LAFPP/documents/financial_reports/2008_Valuation.pdf Ratios are based on valuation value of assets

In general, the professionals we interviewed suggested that funding ratios above 80% were acceptable. Both LACERS and FPP met this level of funding at the end of Fiscal Year 2008.

The actuarial position of LACERS is worse than that of FPP, as reflected in its funding ratio for pensions. In addition, the method that LACERS uses to compute its liability is not as conservative as that of FPP. If the two systems used the same method, the funding ratio for LACERS would be lower and its UAAL would be higher.

These figures do not reflect the results of the economic crisis that engulfed the entire country in 2008. Return on investment for the two retirement systems was negative in Fiscal Year 2008, and that can be expected to be the case of 2009. As a result, the funding ratios for these systems will decline.

Other Post-Employment Benefits (primarily health care benefits) are less well funded than pensions. This reflects the fact that pre-funding retiree's health care benefits began later than pre-funding pensions, that there has been continuing double-digit health care inflation, and that an accounting change made a few years ago increased the required funding level.

The City's position relative to other municipalities is relatively good. Table 3 and Table 4 in Section 6.2 show the funding ratios for the Los Angeles City Pension systems compared to those of other California cities. The tables indicate that Los Angeles has a somewhat lower funding ratio than San Francisco and Long Beach for safety pensions and lower than all four comparison cities for civilian pensions. However, none of these cities pre-fund health care benefits for retirees; they budget these benefits each year on a pay-as-you-go basis. The liability of the City of San Francisco for its OPEB in 2007 was more than two and one half times that of the City of Los Angeles.[17]

[17] "*You Dropped a Bomb on Me, GASB*," Credit Suisse Report, March 22,2007 - http://online.wsj.com/public/resources/documents/DroppedB.pdf

3. Public / Private Sector Comparisons

3.1. Public and Private Retirement Benefits

Some of the differences between retirement benefits offered public and private employees were outlined in Chapter 1. Basic differences include:

- All employees in the private sector are covered by Social Security; many public sector employees, including Los Angeles City employees, are not.
- Most private employers no longer offer Defined Benefit Plans. If they do, these benefits usually do not include Cost of Living Adjustments. Many public employers, including the City of Los Angeles, offer Defined Benefit Plans with COLAs, although these COLAs are usually subject to a lower limit than the COLA for Social Security.
- Most private employers offer no or less extensive post-retirement health care benefits than the City of Los Angeles and other public employers.
- Private sector employees born after 1959 must reach age 67 before they can draw full Social Security benefits. However, employees of the City of Los Angeles can retire at age 60 (or at age 55 with 30 years of service) and receive full benefits.[18] In general, public employees can receive full retirement benefits before age 67.

3.2. Overall Public / Private Employee Compensation

Employee compensation includes not only the employee's salary, but fringe benefits such as health insurance, workers compensation, disability insurance, and pension benefits. Historically, civilian public employees tended to receive somewhat lower salaries compared to those performing comparable work in the private sector; in return, they had greater job security because of civil service protection, good health benefits, and more generous pension benefits than those in private employment. Virtually without exception the people the Study Committee interviewed both inside and outside of government felt that the public employee salaries are no longer lower than those in the private sector, except in a few employment categories – e.g., accountants – and for upper-level managers.

All full-time City employees are covered by a pension plan. In contrast, statistics from compensation surveys by the Bureau of Labor Statistics show that that 71% of private

[18] Benefits are calculated based on years of service, but the level of benefits is the same regardless of the employee's age at retirement provided the employee has reached age 60 or age 55 with 30 years of service.

industry employees have access to an employer-sponsored retirement plan,[19] which may simply be an employer-sponsored 401K plan to which employees contribute.

The City's Budget for 2008-2009 includes projected salaries of $3.049 billion[20] for Budgetary Departments, with contributions to pensions of $665 million (21.8%) and Human Resources Benefits of $462 million (15.1%)[21], for total fringe benefits of 37%. In contrast, fringe benefits in the private sector are in the 25-30% range.

These statistics support the view that on average total compensation of City employees exceeds that of employees doing comparable work in the private sector.

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[19] http://www.bls.gov/news.release/pdf/ebs2.pdf
[20] http://mayor.lacity.org/budget/pdf/Budget_Summary_FY08-09.pdf p 16
[21] http://www.lacity.org/ctr/abu1/AdoptedBudget2008-09.pdf (Exhibit G)

4. Impact of Retirement Benefits on the City Budget

As explained in Chapter 2, funding for pension and retirement benefits comes from three sources – employee contributions, employer (City) contributions, and income from invested assets.

4.1. City Contribution Rates to LACERS and FPP

The employee contribution rates for FPP are fixed in the City Charter; voters would have to approve a charter amendment in order to change these rates. Employee contribution rates to LACERS are determined by a vote of the City Council, but are also subject to union contracts. In either case, rates could be changed only for future employees.[22] The City is required by law to provide enough financing to keep the systems solvent. This means making the normal contribution to each plan, as well as amortizing the cost of any unfunded liabilities. That is, if a fund's investment performance does not meet expectations, the City is required to make up the difference.

The City's contribution rate has varied widely over the past sixteen years. Figure 3 shows City contribution rates to LACERS for the period from 2002 to 2009. City contribution rates have varied from a low of 4.7% of payroll in 2002 to a high of 23.0% of payroll in 2007. Figure 4 shows the same data for FPP, with the lowest contribution rate of 7.1% in 2003 and the highest of 30.6% in 2008. In other words, the contribution rates for both LACERS and FPP increased by more than a factor of four in a period of five years. Obviously, such fluctuations have a negative effect on budget planning.

How did this happen? The very low contribution rates at the beginning of the decade reflect the above-average investment performance in the period 1995-2000. In those years, investment performance exceeded expectations, creating a ***negative*** unfunded liability – that is, the systems had a funding ratio above 100%. This allowed the City to contribute less than its normal contribution. This period of above-average investment performance was followed by two years of negative investment performance, which resulted in the large increases in the rate of required contributions from 2004 forward. It took some time for the effect of these years of poor investment returns to be felt, because the full effect of any investment loss or gain is phased in over a five year period – a practice that is designed to reduce the fluctuation in City contributions from year to year.

[22] See Section 6.1, Legal Limitations.

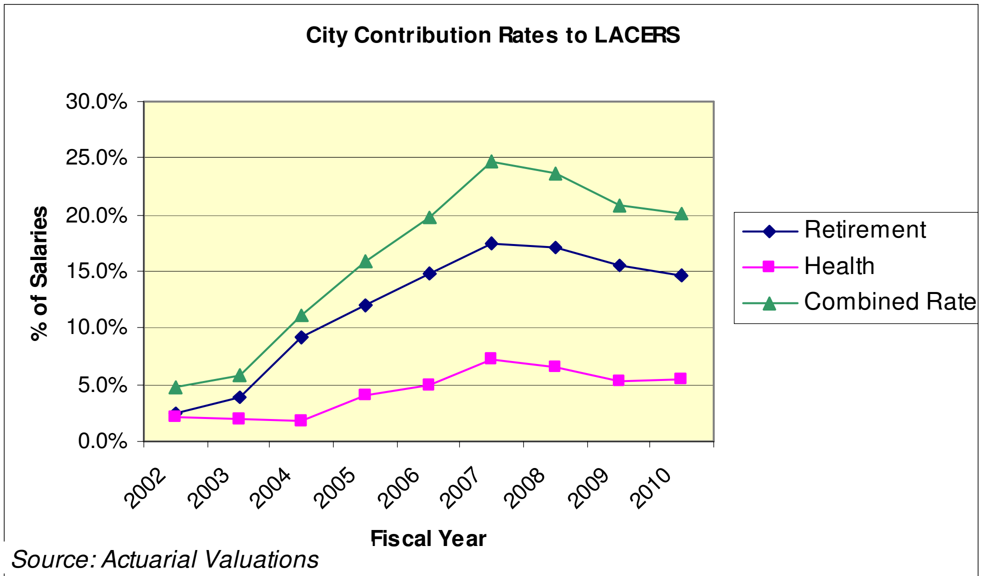

Figure 3 – City Contribution Rates to LACERS

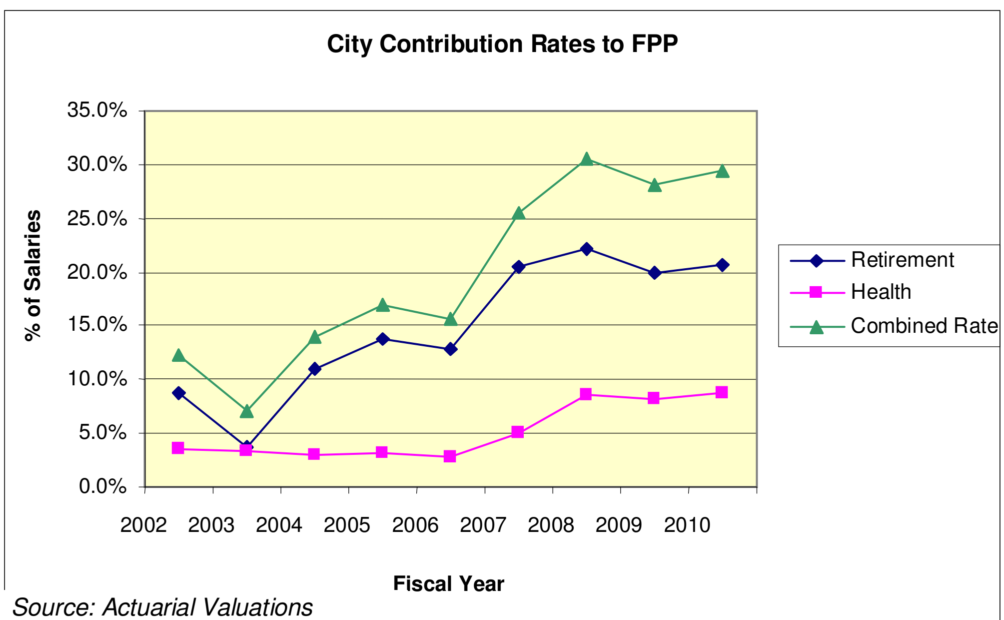

Figure 4 – City Contribution Rates to FPP

The below-average returns would have caused far less fluctuation in the contribution rate had the City chosen to make normal contributions during the good years rather than taking the opportunity to reduce its contribution rate to the minimum allowed. Since that time, the City has stated that it will be its policy in the future to always make the normal contribution. Clearly, the opportunity to test this policy has not yet arisen. Although this would seem to make good fiscal sense, one of the former City employees we interviewed suggested that allowing a pension system to become more than 100% funded created the temptation for employee unions to demand and the City Council to accede to an increase in benefits.

Another reason for the increase in contribution rates during this period is an unfunded liability that came from LACERS adopting a different, more conservative, way of calculating the liability for post-employment health care benefits. The new policy accounts for the potential liability for an employee's retirement health care benefits from the date of employment rather than from the date at which he or she actually becomes eligible for these benefits, which is after ten years of service. This change created a large unfunded liability for LACERS.

4.2. Importance of Retirement System Contributions in the City Budget

The bulk of the City's expenditures are personnel expenses – salaries (about 62% of the budget) and fringe benefits. Almost all of the City's contribution to the retirement systems comes from the General Fund; Figure 5 shows retirement system contributions as a percentage of the General Fund for the period from 2000 to 2008.[23] This percentage has ranged from a low of 5.4% in 2002 to a high of 15.3% in 2008.

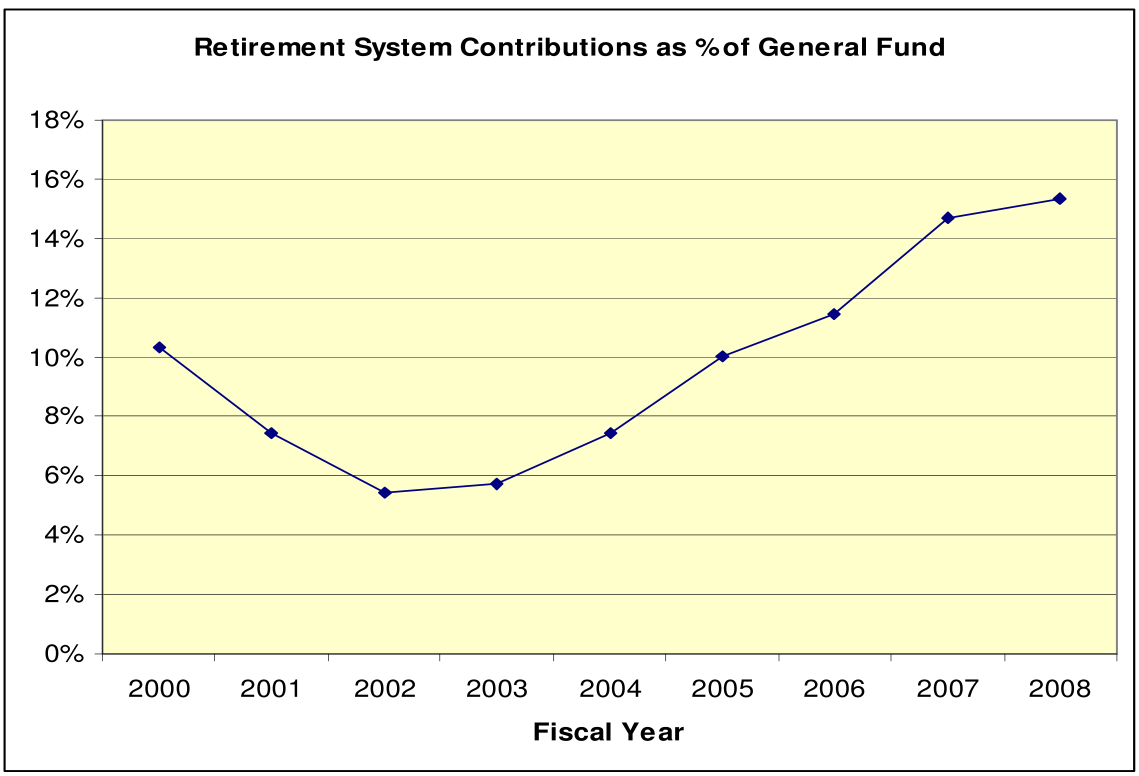

Figure 5 – Retirement System Contributions as a Percent of the General Fund

[23] Source: CAO, City of Los Angeles

5. Should City Retirement Benefits Be Modified?

There is no question that the City of Los Angeles faces a structural budget deficit – that is, the City's existing revenue streams (e.g., property tax, sales tax, documentary transfer tax, etc.) have not been increasing fast enough to keep pace with the cost of providing the same City services. Mayor Antonio Villaraigosa acknowledged this in preparing his first budget for Fiscal Year 2005-2006. During his term, he has succeeded in increasing revenue in a number of ways, including the imposition of increased sanitation fees and modifications to the City's utility tax. However, as this report is being written, the impact of the crash of the housing market bubble in Southern California as well as the general financial meltdown make the budget situation in Los Angeles dire. Revenues from the documentary transfer tax have declined; revenues from other sources such as the sales tax and property tax will probably decline as well. Thus the City is compelled to look at ways of reducing expenses.

The largest portion of City expenditures goes to personnel expenses (82 %).[24] Given the consensus that total compensation (salaries and fringe benefits) for City employees exceeds that of employees in the private sector, it seems reasonable to consider reducing that compensation. Changes to the pension systems may be an appropriate way to do this for several reasons.

First, it is pension and post-employment health care benefits that account for the largest portion of the discrepancy between private and public compensation. Lowering City salaries would probably have a more adverse effect on recruitment and retention of qualified personnel than reducing retirement benefits. Second, because pensions represent a commitment to future payments, they represent continuing obligations which cannot easily be modified year-to-year. Third, and perhaps most significantly, demographic and economic trends lead to the conclusion that the cost to the City for retirement benefits will increase. Increased longevity means longer payout of pensions to retirees with the concomitant COLAs. Additionally, health care costs have been skyrocketing. Once an employee has retired, the City has very little control over the payouts it is required to make.

As will be explained in the next section, the City is required under the California State Constitution to provide promised pension benefits to existing employees at the established contribution rates. This means that changes to the City's pension systems that lowered the City's required contributions would start to be experienced immediately, but that it would take many years for the full effect of any reduction in benefits to be felt.

The next two chapters discuss various considerations that should be taken into account in making modifications to the City's retirement benefits and what some possible modifications might be.

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[24] Office of the City Administrative Officer, City of Los Angeles

6. *Considerations in Making Changes to the City's Pension Systems*

6.1. Legal Limitations

There are legal constraints to changing benefits for current employees. In general, changes that reduce benefits can be made only for future employees.

In 1981, the City of Los Angeles introduced a Charter amendment to reduce future benefits for Police and Fire employees who were on the payroll at that time. The amendment (Proposition H) adopted by the voters was litigated. The courts ruled the amendment to be illegal, thereby establishing the principle that benefits cannot be changed for current employees without a corresponding benefit of equivalent value provided in its place.

The issue of modifying post-retirement health insurance benefits for current employees has not been tested in the courts. While eliminating "promised" benefits may be problematic, there is some degree of discretion since the pension boards must approve the level of health care subsidy on an annual basis, within the limits of a formula established by ordinance. Therefore, the specific amount of the subsidy is not guaranteed in the same manner as the pension formula.

6.2. Labor Market Considerations

A public policy factor that requires consideration in the analysis of possible changes to pension benefits in the City of Los Angeles is the impact of any change on the City's ability to compete in the local labor market.

Around the year 2000 the California Public Employees Retirement System (PERS) and other local agencies improved pension formulas for public safety personnel. A severe police recruitment and retention problem at that time placed pressure on the City to add a new tier to the Fire and Police Pension Plan (Tier 5) in order to compete with the "3% at 50" formula that was becoming popular throughout the State. For example, the cities of Beverly Hills, Burbank, Culver City, Pasadena, and Long Beach, among others, all provide a 3% at 50 pension benefit for police officers.[25] Table 3 compares FPP benefits to those of the next three largest cities in California, as well as the smaller city of Pasadena. FPP has a slightly more generous provision for COLAs, but less generous accumulation of benefits during the first twenty years of service.

[25] *Public Retirement Systems Annual Report for the Fiscal Year 2005-2006,* Office of the California State Controller.

Therefore, even if it were considered fiscally prudent to change benefits for new safety hires, it would be difficult to do so without similar action by other agencies with which the City competes for new employees.

The same pension system – FPP – covers both uniformed firefighters and police officers. However, labor market considerations are dramatically different for these two types of employees. While the Los Angeles Police Department has had recruitment problems in recent years, with authorized positions going unfilled, there is typically no difficulty at all in recruiting firefighters. This was noted by several of our interviewees. One observed that a city in Orange County recently had 400 applicants for a single open firefighter position.

Table 4 provides a similar comparison for civilian employees. In this case, the benefits that the City of Los Angeles provides are more generous than those of two comparison cities – Pasadena and San Francisco – but less generous than those of Long Beach and San Diego.

Note that these tables show funding ratios for the comparison cities. However, as noted in Subsection 2.3.5, these funding ratios are for pensions only. The other cities do not pre-fund retiree health care benefits, but must budget these benefits each year.

Pensions – FPP Compared with Other California Cities – 2005-2006

	FPP, City of Los Angeles (Tier 5)	Pasadena (PERS)	Long Beach	San Diego Employee's Retirement System (Safety)	San Francisco City and County Retirement System (Safety)
Employee Contribution	8%[26]	9%	9%	12.64% (see note 1)	7.50%
Employer Contribution	10.31%	22.05%	15.69%	40.97%	6.58%
Normal Cost	15.07%			19.21%	7.54%
UAAL Amortization	-4.76%			21.76%	-0.96%
Benefits per year of service	50% after 20 years (2.5% per year), then 3% per year	3% at 55	3% at 50	3% at 50	3% at 55
Minimum retirement Age	50	55	50	50	50 (reduced benefits)
Funded Ratio	94.6% (all tiers)	83.80%	103.00%	68.9% (entire system)	107.6% (entire system)
UAAL as % of Payroll	63%			235%	-44%
COLA	3%	2%	2%	2%	2%

Note 1: This is based on entry at age 25 and offset by a 4.1% City contribution.

Source: ***Public Retirement Systems Annual Report for FY Ended June 30, 2006***

[26] The employee contribution rate is currently 9%.

Table 3 – FPP Pension Benefits Compared with Other California Cities

Pensions – LACERS Compared with Other Southern California Cities – 2005-2006					
	LACERS	**Pasadena (PERS)**	**Long Beach (PERS)**	**San Diego City Employees' Retirement System**	**San Francisco City and County Retirement System**
Employee Contribution	6%	7%	8%		7.50%
Employer Contribution	14.21%	8.63%	11.87%	21.34%	6.58%
Normal Cost	8.44%			12.04%	7.54%
UAAL Amortization	5.77%			9.30%	-0.96%
Benefits per year of service	2.16%	2% at 55	2.7% at 55	3% at 60	2% at 60
Minimum retirement Age	55 with 10 yrs			50 (reduced benefits)	50 (reduced benefits)
Funded Ratio	77.80%	95.30%	95.50%	83.60%	107.6% (entire system)
UAAL as % of Payroll	127%			126%	-44%
Maximum COLA	3%	2%	2%	3%	3%

Source: ***Public Retirement Systems Annual Report for FY Ended June 30, 2006***

Table 4 – LACERS Pension Benefits Compared to other California Cities

There have been attempts in recent years to amend California's Constitution to require public agencies to provide only Defined Contribution Plans[27] or to limit the level of benefits provided by Defined Benefit Plans.[28]

The issue of competition for employees with other public agencies is less crucial for civilian employees than for uniformed officers. The City has resisted the trend of other public agencies to improve benefits for civilian employees when its plans were fully funded. However, while maintaining the current level of benefits has not had adverse consequences for the City, a drastic reduction in pension benefits for new hires could affect recruitment and retention in a normal economy.

6.3. Impact of Organized Labor

Since the 1970s organized labor has gained influence in establishing employee compensation. The City's Employee Relations ordinance, enacted in 1971 – a couple of

[27] A measure to replace pubic Defined Benefit Plans with Defined Contribution Plans was originally part of Governor Schwarzenegger's package of initiatives that went to the voters in the special election of 2005.
[28] For example, in 2007 a group called Citizens for Fiscal Responsibility proposed an initiative, "The Public Employees Benefits Reform Act," that would limit the level of benefits that could be offered by public agencies.

years after the enabling State legislation – changed the methods of establishing salaries and benefits. Previously, the City participated in multi-agency salary surveys to determine wage and benefit comparability, and the City Administrative Officer reported and made recommendations to the City Council on annual wage and benefit adjustments. With the formal recognition of unions, the collective bargaining process (known as "meeting and conferring" in the public sector) became the mechanism for setting salaries and benefits. This process increased pressure to improve overall compensation. Private sector and media observers argue that the current compensation package for the majority of City employees generally exceeds that of most private sector businesses, with exceptions mostly at professional and top management levels.

It is also widely felt that term limits have exaggerated the influence of unions. The claim is that elected officials are discouraged from taking a long-range view when approving benefits because they seek union support for reelection or election to new offices when "termed out." The significant impact of organized labor on decisions of the City Council and other elected officials was mentioned by many of the individuals the Committee interviewed and has been noted in numerous newspaper articles.

Public employee labor unions push for the best deal possible for their members. However, they are aware of the growing discrepancy between the retirement benefits that their members receive and those received by retirees from private sector companies. Unions have also shown some flexibility when convinced that a public employer is incapable of maintaining the current level of benefits.

7. Potential Changes to City Retirement Benefits

There are a number of steps that the City could take to reduce the cost of retirement benefits for employees hired in the future. They include the following:

- Replace the City's Defined Benefit Plans with a Defined Contribution Plan.

  This means that the City would no longer guarantee its retirees a pension based on years of service, but would make contributions into an individual retirement account. Such a change would require the City and its employees to pay Social Security taxes.

  The ***advantages*** of such a change include:
    - Predictable expenses for the City – there would be no such thing as an unfunded liability because once the City made its annual contribution to the employee's retirement account, it would have no further obligation for that year of service.
    - Portability of the retirement account for the employee – i.e., the contributions to the plan could be rolled over into another retirement plan if the employee left his or her job.
    - The retirement assets accumulated in an employee's account, if not exhausted at the time of the employee's/retiree's death, become part of his or her estate and can be left to the retiree's heirs.

  The ***disadvantages*** of such a change for the employee are:
    - The employee assumes all of the risk. If there is a significant economic downturn, the assets may decrease in value, and the income available at retirement may be reduced.
    - The administrative fees for individual accounts tend to be greater than for pooled assets.
    - For a retiree to assure that he or she will not "outlive his or her money," he or she must plan for the "worst-case" scenario of living significantly longer than average. This requires more assets per individual than in a Defined Benefit Plan, where the risk is averaged among a group of individuals.

If Defined Benefit Plans are retained, the following measures could reduce costs:

- Increase the age at which employees can receive full retirement benefits.

  This is the change with the most impact on DBP costs. Increasing the age for full retirement benefits has an impact in three ways:

    - Both the employee and the City make contributions on the employee's behalf over a longer period of time, increasing the total amount of contributions.

- There is a shorter period of time on average between the employee's retirement and his or her death. This reduces the total assets that need to be accumulated to pay the defined benefits.
- The return on the invested assets accumulates over a longer period of time. For example, at an average rate of return of 8% (the assumed rate of return for both LACERS and FPP), existing assets will double in 10 years.

Of course, employees' salaries tend to increase with time on the job, which may increase current employment costs somewhat, but this effect is relatively minor compared with the effects described above.

It is worth noting that safety employees have traditionally had lower retirement ages than civilian employees, reflecting the fact that more physical fitness is required for these jobs.

- Increase the age at which a post-retirement health care subsidy becomes available, while allowing retirees below that age to purchase insurance at group rates.

  This change would have an impact for all of the reasons described above. In addition, for retirees not yet eligible for the subsidy, the City would be paying health benefits for only one employee (the retiree's replacement), rather than two.

- Reduce the formula for accumulation of benefits – e.g., reduce the 2.16% accrual per year of service to a lower percentage.

  Clearly, this would reduce costs, because the final pension payments for the same amount of service would be smaller. Such a change could put the City at a competitive disadvantage with respect to other public employers.

- Take steps so that employees contribute a larger percentage of the actuarial cost of their retirement benefits – e.g., increase the LACERS and FPP employee contribution rate if the funded status of a retirement plan falls below a specified level or require retirees to pay for a larger share of the health insurance premium.

  Currently, FPP Tier 5 employees pay 8% of their salaries when the system is fully funded and 9% when it is not. LACERS employees hired after 1983 pay 6%, with no increase if the system is not fully funded. Obviously, any increase in the contribution rate for employees would provide a dollar-for-dollar decrease in the amount the City would have to contribute. The impact of this change would be much less than the impact of the other changes suggested above.

- Require employees purchasing service credits for time not worked for the City (e.g., unpaid medical leave, time worked for another government entity) to pay the full actuarial cost of the increased benefit rather than only a portion of the cost.

Currently, LACERS members can purchase service credit (years worked) for far less than the actuarial cost of this credit.

The effects of this change would clearly be far less than the previously suggested changes.

- Take steps to reduce the possibility of salary "spiking" immediately prior to retirement by, for example, basing pension benefits on the last three years' salary instead of only the final year of salary.

  Salary spiking occurs when an employee is granted a promotion or salary increase shortly before retirement with the intention of increasing that employee's benefits. For example, a 10% increase in salary for the last year an employee works will result in a 10% increase in that retiree's pension. When this happens, the cost to the City is significant because it creates an unfunded liability which the City is required to finance. While the Committee has heard anecdotally that this situation occurs, it has no information about its frequency.

  The quantitative impact of such a change may be unknown, but it seems appropriate based on the perception and reality of fairness to all employees and to taxpayers.

- Provide lower retirement benefits to firefighters than to police officers.

  Firefighters and police officers are both covered by FPP and currently receive pensions on the same terms.

  This suggestion was mentioned by those interviewees who view the pension system from the point of view of economics. They contend that in general there are many more applicants for the position of firefighter than there are open positions, so that the City could offer reduced compensation and still have no recruitment problems.

  It is not clear that the voters, who would have to approve such a change, have the same perspective. Firefighters probably have as much or more public support than police officers, and voters have tended to be supportive of improving public safety pensions.

Appendix A – List of Interviewees

City of Los Angeles
Bernard Parks – Councilman, City of Los Angeles
Sally Choi – Former Deputy Mayor (Budget), currently General Manager, LACERS
Ray Ciranna – Acting City Administrative Officer (CAO), City of Los Angeles
Keith Comrie – Former CAO, City of Los Angeles
Mary Jo Curwen – Deputy City Attorney for LACERS and FPP
Royce Menkus – Former Assistant CAO (Employee Relations), City of Los Angeles

Fire and Police Pension System
Michael Perez – General Manager
Thomas Lopez – Chief Investment Officer
Greg Mack and Anthony Torres – Health Benefits
Paul Angelo – Actuary for FPP (The Segal Group)

Los Angeles City Employees Retirement System
Robert Aguallo – Former General Manager
Thomas Moutes – Assistant General Manager
Dan Gallagher – Chief Investment Officer
Linda Aparicio – Public Information Director

Marcus Allen – Former Deputy Chief of Staff to Mayor, Former Chief Deputy Controller, City of Los Angeles
Beth Barrett – Reporter, *Los Angeles Daily News*
Julie Butcher – General Manager, Service Employees International Union Local 347
David Brodsly – Managing Director, KNN Public Finance
Joseph Czyzyk – Chairman and CEO, Mercury Air Group, and Director, Los Angeles Area Chamber of Commerce
Steven Frates – Rose Institute of State and Local Government at Claremont McKenna College
Richard W. *Goss* – Administrator, California Association of Public Retirement Systems
Alex Rubalcava – Rubalcava Capital Management
Keith Richman, MD, MPH – former California State Assemblyman and Executive Vice President, Corporate Development, Lakeside Community Healthcare
Gary Toebben – President and CEO, Los Angeles Area Chamber of Commerce

Appendix B – Study Committee Members

Jane Goichman, Co-Chair
Elizabeth Ralston, Co-Chair

Jo Anne Aplet
Richard Dickinson
Nancy Martin
Royce Menkus