



LACERS
 LOS ANGELES CITY EMPLOYEES'
 RETIREMENT SYSTEM



Report to Ad Hoc Committee

From: Sally Choi, General Manager	Agenda of: SEPTEMBER 1, 2009 ITEM: V
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SUBJECT: AMORTIZING THE UNFUNDED ACTUARIAL ACCRUED LIABILITY ASSOCIATED WITH THE CITY'S PROPOSED EARLY RETIREMENT INCENTIVE PROGRAM

Recommendation:

That the Committee recommend to the Board that the Unfunded Actuarial Accrued Liability associated with the City's proposed Early Retirement Incentive Program (ERIP) be amortized over a time period that matches the actuarially-calculated salary savings period from the ERIP – 5 years (Method 2).

Discussion:

Background

On June 26, 2009, the City Council conceptually approved a Letter of Agreement that included an Early Retirement Incentive Program (ERIP) for eligible LACERS members. Subsequently, the Letter of Agreement [see Attachments 1 and 2 for information issued by the City Administrative Officer (CAO)] was ratified by the Coalition of Los Angeles City Unions (Coalition), which represents a majority of LACERS members. According to the CAO information, the stated intent of the ERIP is to “reduce annual ongoing costs to the City’s payroll by providing incentives for eligible LACERS members to retire in the form of benefit enhancements and separation pay incentives. The goal of the ERIP is to separate 2,400 employees from City service as quickly as possible.”

The City, as plan sponsor, can adopt any retirement benefits it chooses. Pursuant to Section 1168(a) of the Los Angeles City Charter (Charter), LACERS retirement benefits are established by ordinance and must be approved by not less than two-thirds of the City Council, subject to the veto of the Mayor and override by three-fourths of Council. Section 1168(a) also provides that no such ordinance may be finally adopted by the Council until the expiration of at least 30 days after its first presentation to Council. The Charter also requires a public hearing and information from an enrolled actuary prior to adopting retirement benefits. The California Government Code has similar requirements.

On August 4, 2009, Paul Angelo of The Segal Company (Segal), which serves as both the City’s and LACERS consulting actuary for retirement benefits, made a presentation (Attachment 3) to the Council. This presentation included the range of annual amounts the City, as plan sponsor, would be required to pay LACERS under 5-year and 15-year amortization periods. Councilmembers asked

several questions regarding the proposed ERIP, but did not vote on the proposed ERIP at that meeting or prior to their annual recess.

LACERS staff, as subject matter experts, has played a limited role in the ERIP-development process including providing data and information regarding: the successes and failures of ERIPs in other jurisdictions; ways to structure an ERIP to meet objectives stated by the negotiating parties; funding scenarios for LACERS given the recent investment losses; and best practice information regarding the amortization of ERIP liabilities. Staff made presentations to the Executive Employee Relations Committee, consisting of the Mayor, the Council President, the Council President Pro Tempore, the Chair of the Council's Budget & Finance Committee, and the Chair of the Council's Personnel Committee and, on June 26, 2009, to the full Council (Attachment 4). LACERS staff also took leading roles in bringing representatives together from other City departments to discuss communications issues regarding potential layoffs, furloughs, and the ERIP and in coordinating meetings to bring a collaborative effort to drafting the ERIP ordinance that may be considered by the Council.

Other Jurisdictions

As part of the process of developing a recommendation, staff conducted a survey of pension funds that are members of the California Association of Public Retirement Systems (CALAPRS) to determine whether they have faced similar amortization issues. The results varied greatly. Of the 37 systems surveyed, 4 indicated they had service credit-related early retirement programs since 2003 (Attachment 5). The number of participants retiring under those ERIPs varied from just a few up to 462. One system required the plan sponsor to pay for the benefits within the fiscal year, while another required immediate payment. The two other systems required payment within 16 and 20 years respectively.

Staff also received a recent staff report (Attachment 6) from the California Public Employees' Retirement System (CalPERS) recommending that the CalPERS Benefits and Program Administration Committee recommend to the CalPERS Board to extend the maximum time period of golden handshake liabilities for school employees from 2 years to 5 years. The report also indicates "that the time period for the repayment of golden handshake liabilities for state employees, legislative employees or school members can be made over a period not exceeding five years" and that for contracting agencies "the liabilities resulting from golden handshakes were amortized over a 20 year period in accordance with existing Board policies on amortization of benefit improvements."

Estimated ERIP Costs

Because the employees who elect to participate in the ERIP will retire earlier than actuarially expected and, in most cases, will be given additional retirement and/or health benefits through the addition of age and/or service, LACERS Unfunded Actuarial Accrued Liability (UAAL) will increase. The actuarial cost study report (Attachment 7) commissioned by the CAO's Office and required by the Charter and Government Code prior to the adoption of retirement benefit changes, contains two different "take rate" assumptions with corresponding cost estimates. If 2,229 employees retire (Alternative 1), the UAAL created by the ERIP is estimated to be \$250 million (present value). If 2,763 employees retire (Alternative 2), the UAAL associated with the ERIP is estimated to be \$354 million (present value). As plan sponsor, the City would be obligated to pay LACERS the increased

costs associated with the ERIP. These cost estimates do not include the cash separation payments under the ERIP to be paid directly by the City to retiring employees nor the slight savings due to a reduction of the Normal Cost rate.

Paying for the Costs of the ERIP

The Letter of Agreement indicates the City will recoup all costs associated with the ERIP from employees. Part of this recoupment will be accomplished by increasing the retirement contribution rate for all active LACERS members beginning July 1, 2011 by 0.75% of pay for a period not to exceed 15 years. This contribution increase alone will not pay for the estimated costs of the ERIP, as shown below:

Present Value of Estimated ERIP Costs			
Alternative (Retirements)	Estimated Costs to City*/ Increase in UAAL (A)	Estimated Member Payment of ERIP Cost (B)**	Difference (A-B)
1 (2,229)	\$250 million	\$157 million	\$93 million
2 (2,763)	\$354 million	\$156 million	\$198 million

* Not including cash separation payments.

** The values have not been reduced to reflect the refundability of some of these member contributions.

Pursuant to the Letter of Agreement and the attached joint letter from the City Administrative Officer and the Chief Legislative Analyst (Attachment 8), the City is taking other factors into account to determine the cost neutrality of the ERIP to the City that is called for in the Letter of Agreement. The determination of cost neutrality between the City and the Coalition does not change the total cost of the ERIP.

The fact that the City agreed to terms with the Coalition for the recoupment of some of the additional contributions (including the period over which that recoupment would occur) is a separate issue from the amortization period over which the City pays for the enhanced benefits. In fact, there will be an inherent mismatch between the employee contributions, if found to be permissible, and the City's obligation to LACERS because the amount of the employee contributions are not sufficient to cover the full, estimated cost of the ERIP under either take rate scenario.

Discussion of Possible ERIP Amortization Periods

Under current Board policy, increases in the UAAL caused by general plan changes are amortized over 30 years. There is no explicit Board policy for changes in the UAAL caused by the implementation of early retirement incentives. The nature of early retirement incentives differ from general plan changes in that early retirement incentives apply to a relatively small percentage of the membership and encourage members to retire immediately. General plan changes apply to the entire active membership and there will be many more years of service, on average, expected from these members before retirement.

Staff has researched and discussed many possible methods for determining amortization periods for ERIPs. To the extent possible, staff attempted to devise a quantitative rationale for an amortization period under each of the proposed methods that provides some balance between the salary reductions achieved by the City or the payment of the additional retirement benefits paid by LACERS under the ERIP and the corresponding additional amortization payments received by LACERS. Based on its research and discussions, staff narrowed its focus to the following five methods:

Method 1 – Match the Amortization Period to the Salary Savings Period of the Most Realistic Default Scenario: Layoffs

Description of Method:

This method largely is based on a component of the Government Finance Officer Association's (GFOA) Recommended Practice on "Evaluating Use of Early Retirement Incentives – 2004" (Attachment 9) . One recommendation from that report states:

Regarding financially-driven ERIs, a cost/benefit analysis should compare long-term benefits and costs against the "default" scenario of a hiring freeze. Most financially-driven ERIs project financial benefits based on payroll savings related to staff departures. However, any such savings should be discounted, because a hiring freeze also creates payroll savings (owing to the normal rate of staff departures). Thus, the ERI benefit is limited to the marginal increase in staff departures attributable to the ERI. Governments that attribute all staff departures to an ERI would over-state the ERI benefit, thus distorting the cost/benefit analysis.

The City's ERIP was developed as an alternative to layoffs (not a hiring freeze as is contained in the GFOA's recommendation). Therefore, the costs and savings of retiring 2,400 employees early under ERIP should be compared against the "default" scenario of laying off 2,400 employees. Under this methodology, there are no true savings under City's ERIP because any ERIP savings can be similarly achieved by layoffs. The savings period from implementing the ERIP, therefore, would be zero, and the costs of the ERIP should be funded as soon as the actual ERIP participation is known and the actual cost is ascertained.

Resulting Amortization Period: 0 years (City pays all ERIP costs upon adoption of actuarial cost analysis after the close of the ERIP window period).

Advantages of this Method:

- This method is consistent with the GFOA recommendation regarding matching the savings period with the most realistic default scenario of layoffs.
- This method is consistent with the general concept of prefunding retirement benefits on or before retirement.
- The ERIP liability is paid off up front so that the funds are available to LACERS to pay benefits for what is a fairly front-loaded payment stream (Attachment 10).

Disadvantage of this Method:

- Can be perceived to create an unnecessarily large first year obligation for the City, when some of the funds would not be needed until future years to pay ERIP-related benefits.

Actuary's Opinion on Method and Resulting Amortization Period: Method and resulting amortization period are reasonable.

Method 2 – Match the Amortization Period to the Actuarially-calculated Average Salary Savings Periods

Description of Method:

The GFOA's Recommended Practice on "Evaluating Use of Early Retirement Incentives – 2004", in part, states that:

The incremental costs of an ERI should be amortized over a short-term payback period, such as three to five years. **This payback period should match the period in which the savings are realized** (emphasis added).

This is one of two proposed methods (the other being Method 3) that attempts to match the amortization period to a definable period of salary savings.

Under the ERIP, the City would realize short-term salary savings associated with the decrease in the City's active member payroll due to increased retirements. This savings period is short-term in that it only lasts until the time ERIP members would have retired anyway. Under this method, the amortization period for the ERIP costs would match this actuarially-calculated average salary savings period.

For example, a member who, according to actuarial assumption, would have retired 3 years from now takes the ERIP offer and retires immediately; the City's salary for this member will be eliminated. However, the salary savings for this now-retired member will last for only 3 years because the member presumably would have retired in 3 years anyway, even if the ERIP did not exist.

At staff's request, Segal calculated the average number of years of the salaries that will be eliminated and thus saved as a result of the ERIP - beginning from the early retirement date in the report through the actuarially-determined retirement date without the ERIP. The calculation indicates that the savings brought by the ERIP on salaries will last for an average of 4.3 to 5.1 years for Alternative 1 and 4.7 to 5.4 years for Alternative 2.

The emerging industry best practice points toward a short amortization period for costs of benefit enhancements resulting from early retirement incentives. One evidence of this emerging best practice is that, in its response to the Government Accounting Standard Board's (GASB) Invitation to Comment on Pension Accounting and Financial Reporting (Attachment 11, Page 20) dated July 31, 2009, a group of public sector actuaries commented on this issue as follows:

For early retirement incentives or other termination benefits which take the form of enhanced pensions, we would support amortizing the change over a substantially shorter period, possibly as short as five years.

Resulting Amortization Period: 5 years.

Advantages of this Method:

- The ERIP liability is paid off during the time period that LACERS is expecting to payout a relatively high percentage of the ERIP-related benefits (Attachment 10) and is the only proposed method other than Method 1 (0-year amortization) that provides sufficient cash inflows to fully cover the expected benefit payments throughout the amortization period.
- This method is consistent with the model practices contained in the actuarial community's comments to GASB and the recommended practice from GFOA.

Disadvantage of this Method:

- This method creates larger City payments over the short-term than some of the other methods.

Actuary's Opinion on Method and Resulting Amortization Period: Method and resulting amortization period are reasonable.

Method 3 – Match the Amortization Period to the Average Projected Salary Savings Period Based on Backfill Limits

Description of Method:

Staff recognizes that other ERIP-related salary savings periods could be determined such as the salary savings due to the position backfill limits that are to be imposed on the positions vacated by ERIP retirements.

The City's ERIP actuarial cost study assumes that 7% of the ERIP-vacated positions will be backfilled in the first year and 6% per year thereafter. Accordingly, 91% of the ERIP-vacated positions would be backfilled at the end of the 15-year period. The salary savings period under such method would not be the full 15-year period because not all of the positions would be held open for the full 15-year period and savings would diminish each year as positions are backfilled. Therefore, staff calculated (and Segal validated) the savings period in terms of full-year equivalent savings or, said differently, the average duration of the salary savings to be 8.11 years as reflected in the following table:

Year	Backfill%	Cumulative Backfill %	Savings	Full Year Conversion
1	7%	7%	93%	0.97
2	6%	13%	87%	0.90
3	6%	19%	81%	0.84
4	6%	25%	75%	0.78
5	6%	31%	69%	0.72
6	6%	37%	63%	0.66
7	6%	43%	57%	0.60
8	6%	49%	51%	0.54
9	6%	55%	45%	0.48
10	6%	61%	39%	0.42
11	6%	67%	33%	0.36
12	6%	73%	27%	0.30
13	6%	79%	21%	0.24
14	6%	85%	15%	0.18
15	6%	91%	9%	0.12
				8.11

Resulting Amortization Period: 8 years.

Advantages of this Method:

- This method results in a relatively short amortization period which seems consistent with the model practice contained in the actuarial community's comments to GASB.
- To the extent that this method matches a period in which savings are expected to be realized, it is consistent with part of the recommended practice from GFOA.

Disadvantages of this Method:

- The early year payments resulting from the application of this method do not provide sufficient cash inflows to fully cover the expected benefit payments for those years (Attachment 10).
- ERIPs that are successful from a cost savings perspective have a common characteristic in that there is careful management of the backfilling of positions vacated due to the ERIP. While the draft ordinance attempts to limit the backfill of vacated positions by statute, the backfill rates are difficult to monitor, difficult to enforce, prone to circumvention (e.g. by creating new positions instead of backfilling the vacated positions), and can be negated by higher than expected salary increases or superseded by new ordinances during the long 15-year period. Therefore, adopting a methodology that is based on a period of savings that could change or be circumvented might not be desirable.

Actuary's Opinion on Method and Resulting Amortization Period: Method and resulting amortization period are reasonable.

Method 4 – Match the Amortization Period to the Average Projected Additional Benefit Cash Flows Out of LACERS

Description of Method:

Although it is not as much of an actuarially-related approach as the previous proposed methods, another method for defining an appropriate amortization period is to look solely at the projected cash flows out of LACERS due to the increased benefits under the ERIP. Staff has created a cash flow analysis (Attachment 10) which shows the additional amounts LACERS will be paying over the next several years due to the benefits attributable to the ERIP.

Similar to the Method 3 approach, it would not be appropriate or, in this case, even feasible to use the whole period of payments as the proposed amortization period because the benefit payments are front-loaded and because such a long amortization period would cause negative amortization, under which the City would not even be making the full principal payment to LACERS in the early years. Therefore, staff calculated the average duration of the benefit cash outflows to be 9.93 years.

Resulting Amortization Period: 10 years.

Advantage of this Method:

- To the extent that this method matches increased payments to be received by LACERS with increased cash flows out of LACERS in the form of increased benefit payments, it creates a reasonable basis for an amortization period.

Disadvantage of this Method:

- The early year payments resulting from the application of this method do not provide sufficient cash inflows to fully cover the expected benefit payments for those years (Attachment 10).

Actuary's Opinion on Method and Resulting Amortization Period: Method and resulting amortization period are reasonable.

Method 5 – Set the Amortization Period to a Period Frequently Recommended for General Benefit Changes

Description of Method:

As evidenced in their comment letter to GASB, Segal and others in the actuarial community have indicated that a 15-year amortization period for benefit improvements attributable to retirees is generally reasonable (Attachment 11, Page 20). While the GASB comments encourage a shorter amortization period for early retirement benefits as noted in proposed Method 2 above, the appropriate amortization period for different types of benefit changes is an evolving area. Industry best practice that addresses the differentiation between the types of benefit increases and their corresponding recommended amortization periods was not developed until fairly recently.

Resulting Amortization Period: 15 years.

Advantage of this Method:

- This method provides the City with lower annual ERIP-related contributions.

Disadvantages of this Method:

- The early year payments resulting from the application of this method do not provide sufficient cash inflows for the first 7 years to cover the expected benefit payments (Attachment 10).
- This method is not consistent with the emerging trend of short amortization periods for early retirement benefits.
- The City would pay a significantly larger amount of interest over a longer amortization period (approximately \$180 million under Alternative 1 and \$255 million under Alternative 2).

Actuary's Opinion on Method and Resulting Amortization Period: Method and resulting amortization period are acceptable.

ERIP Contributions under the Five Described Methods

The following table shows the amortization periods for the UAAL increase under each of the described methods along with Segal's calculation of the resulting ERIP costs, in terms of additional contributions required by the members and/or the City, expressed both as percentages of pay contribution amounts and as dollar amounts:

Amortization Period	ALTERNATIVE 1 (2,229 Retirements)			ALTERNATIVE 2 (2,763 Retirements)		
	Contribution Rate Increase (first year)	Contribution Amount* (first year)	Total Contribution for ERIP UAAL with Interest	Contribution Rate Increase (first year)	Contribution Amount** (first year)	Total Contribution for ERIP UAAL with Interest
0 years		\$250m	\$250m		\$354m	\$354m
5 years	2.86%	\$54.0m	\$292m	4.10%	\$75.7m	\$413m
8 years	1.85%	\$34.9m	\$328m	2.64%	\$48.8m	\$464m
10 years	1.51%	\$28.5m	\$354m	2.15%	\$39.7m	\$502m
15 years	1.07%	\$20.2m	\$430m	1.51%	\$27.9m	\$609m

* based on a covered payroll of \$1,886,829,000

** based on a covered payroll of \$1,847,154,000

Summary

While any of the methods described above would provide for acceptable amortization periods for the City's proposed Early Retirement Incentive Program, staff recommends that the Unfunded Actuarial Accrued Liability associated with the ERIP be amortized over a time period that matches the actuarially-calculated average salary savings period from the ERIP – 5 years (Method 2) for the following reasons:

- This method is consistent with the model practices contained in the actuarial community's comments to GASB and the recommended practice from GFOA.
- The ERIP liability is paid off during the time period that LACERS is expecting to payout a relatively high percentage of the ERIP-related benefits and is the only proposed method other than Method 1 (0-year amortization) that provides sufficient cash inflows to fully cover the expected benefit payments in years 2 through 4.
- This method does not create an unnecessarily large first year obligation for the City (as does Method 1), when some of the funds would not be needed until future years to pay ERIP-related benefits.
- The early year payments resulting from the application of Methods 3 through 5 do not provide sufficient cash inflows to fully cover the expected benefit payments for those years.
- This method is based on a savings period that is actuarially-determined and is more reliable than the savings period based on the position backfill rates as proposed in Method 3.

Submitted by:

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SC:TM:LH

Attachments:

- 1) [Employee Relations Bulletin Dated July 24, 2009](#)
- 2) [Employee Relations Bulletin Revised August 24, 2009](#)
- 3) [Council Presentation by Paul Angelo of The Segal Company dated August 4, 2009](#)
- 4) [Staff Presentation to the City Council dated June 26, 2009](#)
- 5) [Results of Service-Based ERIP Survey of California Association of Public Retirement Systems Member Pension Funds](#)
- 6) [Staff report from the California Public Employees' Retirement System](#)
- 7) [Segal's Early Retirement Window Study #4 dated July 30, 2009](#)
- 8) [Joint letter from the City Administrative Officer and the Chief Legislative Analyst dated August 25, 2009](#)
- 9) [Government Finance Officer Association's Recommended Practice on "Evaluating Use of Early Retirement Incentives – 2004"](#)
- 10) [LACERS Cash Flow Analysis](#)
- 11) [Actuaries' response letter to the Government Accounting Standard Board's Invitation to Comment on Pension Accounting and Financial Reporting](#)