# Report on Novato Pension Policy

The Novato Citizens' Budget Committee has undertaken this report to make recommendations to the City Council for adoption of a pension policy. Such a policy would be to provide guidance to the City in managing the pension plans and expense in the future.

The policy recommendations in this report are consistent with the principles and recommendations of the League of California Cities task force published in March 2005.

## RECOMMENDED RESOLUTION

The Novato Citizens Budget Committee recommends that the Novato City Council adopts a budget policy resolution with the following components:

- Level of Benefits: The level of employee pension benefits should provide a fair and adequate benefit for employees and fiscally sustainable contributions for the employees, the City of Novato and the taxpayers.
- Pension Reserve Funding: Establish "reserve funding" that will help stabilize the volatility of pension costs. In years where the plans are overfunded and the Required Contribution is less than the Normal Cost, the City of Novato will either:
    - Make a deposit to a City of Novato pension reserve fund in overfunded years. Fund balances of this pension reserve fund would be utilized in future underfunded years.
      Or,
    - Make additional payment to CalPERS in the amount of the difference between Normal Cost and the Required Contribution.
- Independent Review: An independent economic analysis and review is required for any proposed change in benefits or program features. This review would be independent of CalPERS and union bargaining units.
- Reporting of Pension Expenses: Pension and pension-related expenses should be clearly identified in financial and budget reports of the City of Novato. Specifically:
    - The expense of the Pension Obligation Bond (POB) payment should be recognized in the City's internal financial and budget statements and be recognized as a pension expense.
    - The Employer- paid employee contribution should be recognized in the City's financial and budget statements and be recognized as pension expense

## ADDITIONAL RECOMMENDATION

In addition to the formal budget policy resolutions, the Novato Citizens Budget Committee recommends that the Novato City Council form an ad hoc Study Group made up of Committee members, employees or their labor representatives, city management and interested citizens to explore mutually beneficial opportunities for pension reform with the objective of reducing the city's annual pension expense and future pension liability while providing employee pension benefits that are fair and adequate for employees. The Study Group would be charged with making recommendations by March 31, 2008.

Some areas that the Study Group may wish to explore include:

- Alternative pension/retirement structure for new employees.
- Adjustment of program design to account for changing demographic trends in life expectancy, retirement age and length of employment.
- Cost sharing of pension expense by employees.
- How "final compensation" is defined for purposes of calculating pension benefit.
- Remedies for any other perceived inequities or abuses in the current retirement program.

It would be expected that the Study Group would solicit and receive input from all stakeholders. Additionally, the Study Group should be granted a modest budget (not to exceed $25,000) for providing financial, HR or actuarial expertise, if necessary.

## BACKGROUND

The costs of public employee pensions plans in California have escalated significantly in the last several years, creating financial strain on the budgets of California cities and towns. The City of Novato was no exception.

Government entities in California, including the City of Novato, provide retirement benefits to their employees in the form of defined benefit plans that promise to make preset or defined future payments to employees upon their retirement or disability. The City of Novato provides a 3%@55 Safety Plan to its safety (police) officers and a 2%@55 Miscellaneous Plan to its non-safety employees. The plans are provided through and administered by CalPERS.

*Historical Costs*

The cost of Novato's plans increased dramatically from 2000 to the present.

**Pension History**
**City of Novato**

| Fiscal Year | Employer Contribution Rate: Safety | Employer Contribution Rate: Miscellaneous |
|---|---|---|
| 1999/00 | 4.81% | 0.00% |
| 2000/01 | 2.18% | 0.00% |
| 2001/02 | 5.83% | 0.00% |
| 2002/03 | 11.71% | 0.46% |
| 2003/04 | 18.68% | 4.18% |
| 2004/05 | 30.60% | 9.74% |
| 2005/06 | 27.92% | 12.08% |
| 2006/07 | 15.20% | 8.60% |
| 2007/08 | 15.28% | 7.86% |
| 2008/09 | 14.90% | 7.80% |

With the booming financial markets of the 1990s, public pension plans became so overfunded that employer contribution rates dropped to zero, creating "contribution holidays." Novato and other municipalities did not set aside these savings into a rainy day fund.

Then the poor performance of the stock market in 2000-2002 reversed the situation dramatically, but the impact on rates did not begin to be felt until FY2003/04 due to time lags and smoothing formulas built into CalPERS rate calculations. At the same time that financial markets were declining, Novato and other municipalities were increasing plan benefits in agreements with the employee unions. The Novato Miscellaneous Plan was increased to 2%@55 in April/May, 2000. The Novato Safety Plan was increased to 3%@55 in June/July of 2001.

All of these factors created dramatic rate increases by FY2004/05. Without any action, Novato's contribution rates in FY2005/06 would have been 36.9% for Safety and 13.2% for Miscellaneous. The City of Novato has taken two actions in the past two years to mitigate the high rates.

- In June 2005 the City opted for a CalPERS "30 Year Fresh Start" option which recalculated the amortization of the unfunded liability on a 30 year basis instead of the 13 year and 20 year bases previously used in the Safety and Miscellaneous programs. This stretched the payments over a longer period, reducing the annual payments in the early years.

- In June, 2006 the City of Novato issued a pension obligation bond (POB) which refunded our UAAL. This action eliminated the payroll costs associated with the UAAL and replaced it with lower debt payments.

*Opportunities for Cost Control*

While the ability of Novato municipal officials to control or reduce pension costs is limited, there are some aspects that can be managed. The opportunities for management action relate to the three separate components of pension costs:

1. Normal Cost - Normal Cost is the annual charge that would be incurred if plan provisions don't change, actuarial assumptions turn out to be correct and the actual asset investment returns are as expected

2. Amortization of Unfunded Liabilities - This is the annual amortization charge for an unfunded liability reflecting the plan's underfunded status. For example, if investment returns are below the expected amount, future contribution rates are increased to make up the deficiency in asset growth.

   In municipalities such as Novato who chose to eliminate their unfunded liability by issuing a POB, the cost of the unfunded liability is in the form of debt payments on the POB.

3. Employee contributions picked-up by the employer - In addition to Normal Costs and the cost of unfunded liabilities, the third component of pension costs is the employee contributions that are often picked up by the employers. All municipalities in Marin except San Rafael pay the employee contribution on behalf of the employee. For Novato, this is 7% of payroll for Miscellaneous Employees and 9% for Safety Employees.

The components that make up Novato's total pension costs are displayed below. Though not normally accounted for as a pension cost, the cost of the POB is included since it represents the cost of extinguishing the unfunded liability.

**Components of Pension Cost**
**(Including Cost of Pension Obligation Bonds)**
**2006/2007**

| | Miscellaneous Plan | | Safety Plan | |
|---|---|---|---|---|
| | Dollars | % of Payroll | Dollars | % of Payroll |
| Normal Cost & Optional Surcharges | 924,563 | 8.44% | 785,868 | 14.70% |
| Cost of Unfunded Liability | | | | |
| Amortization of UAAL | 18,084 | 0.17% | 26,680 | 0.50% |
| POB Payment | 395,861 | 3.61% | 482,018 | 9.02% |
| Employer paid Employee contribution | 767,181 | 7.00% | 481,203 | 9.00% |
| Total Employer Cost | 2,105,689 | 19.21% | 1,775,769 | 33.21% |

## DISCUSSION OF RECOMMENDATIONS

The following sections discuss the potential opportunities for the City of Novato to reduce or control the costs in each of the three cost components.

***Normal Cost***

Normal Cost differs among plans because of variations in benefit provisions as indicated by differing plan descriptions. For example, a 3% @ 55 plan will have a higher Normal Cost than a 2% @ 55 plan since the benefit provisions to the retiree are richer. The estimated Normal Costs and of pension plans currently offered by CalPERS are presented in Table 2.

A possible opportunity for the City of Novato to lower the Normal Cost of their retirement plan is to switch to a plan with a lower benefit level for new employees, a two-tier approach.

**Normal Costs**
**CalPERS**

| Plan Description | Normal Cost (% of Payroll) |
|---|---|
| Miscellaneus Plans | |
| 2.0% @ 60 | 5.8% |
| 2.0% @ 55 | 6.6% |
| 2.5% @ 55 | 8.2% |
| 2.7% @ 55 | 8.5% |
| 3.0% @ 55 | 10.1% |
| Safety Plans | |
| 2.0% @ 55 | 8.4% |
| 2.0% @ 50 | 11.5% |
| 3.0% @ 55 | 13.6% |
| 3.0% @ 50 | 15.3% |

As indicated in the Normal Cost table, lowering the benefit level of a Miscellaneous Plan from 2.0% @ 55 to 2.0% @ 60 would decrease the Normal Cost by 0.8% of payroll. Similarly, reducing the benefit level in Novato's Safety Plan would reduce the Normal Cost by 2.1% of payroll.

Since the benefit levels of public employees in California are legally protected, the only possibility for cost relief on Normal Costs is to establish a two-tier approach with lower benefit levels for new employees. This action would draw major resistance from employees and their unions. In view of the above cost considerations and the City's commitment to provide a fair and competitive overall compensation package to its employees, we recommend the following policy statement.

*Recommendation:*

Level of Benefits: The level of employee pension benefits should provide a fair and adequate benefit for employees and fiscally sustainable contributions for the employees, the City of Novato and the taxpayers.

Additionally, we recommend that the City of Novato should take meaningful steps to collaboratively explore changes in the structure and level of benefits for new employees.

*Recommendation:*

Explore a two-tier approach: The City Council should initiate a collaborative process to explore meaningful change in the structure and level of benefits for new employees. The process would include participation by all stakeholders. The use of an outside expert on pensions and benefits should be considered as part of the process.

An additional opportunity for meaningful change to the current pension program is for Novato officials to negotiate the elimination of the One Year Final Compensation formula and revert the final compensation formula to a Three Year Final Compensation formula. CalPERS estimates that the elimination of the One Year Final Compensation benefit would reduce the estimated employer cost by 0.7% to 1.7% of payroll for Miscellaneous plans and 1.3% to 2.9% of payroll for Safety plans. Switching to a three-year calculation will also reduce the opportunity for abuse that is associated with final year spiking.

*Recommendation:*

Three Year Final Compensation: The City of Novato should attempt to incorporate a three-year average formula as the method for calculating final compensation in place of the current one-year formula.

### *Amortization of Unfunded Liabilities*

The annual cost of amortization of unfunded liabilities is the most significant portion of the current high cost of public sector pension costs and is also the most volatile component of pension costs. The increases in unfunded liabilities have been the reason for increased costs of pensions in recent years. The City went from being $7.8 million overfunded in 2000 to being $17.2 million underfunded in 2005.

**Unfunded Liabilites**
**City of Novato**

| | UAAL | | |
|---|---|---|---|
| Year Ending | Safety | Miscellaneous | Total |
| 6/30/2000 | (1,157,339) | (6,677,850) | (7,835,189) |
| 6/30/2001 | 1,624,056 | (4,126,490) | (2,502,434) |
| 6/30/2002 | 6,331,696 | 605,565 | 6,937,261 |
| 6/30/2003 | 9,087,130 | 4,987,381 | 14,074,511 |
| 6/30/2004 | 9,627,230 | 7,725,362 | 17,352,592 |
| 6/30/2005 | 9,669,245 | 7,554,453 | 17,223,698 |
| 6/30/2006 (Expected) | - | (369,038) | (369,038) |

In June 2006 the City of Novato issued a Pension Obligation Bond to extinguish the liability to CalPERS. POBs are bonds issued in capital markets by states or local municipalities in order to refund all or a portion of the unfunded liability that is owed to the pension plan. A local municipality can issue POBs and use the bond proceeds to extinguish the unfunded liability with CalPERS. This payoff reduces the annual pension contribution to CalPERS by eliminating the portion of the cost associated with amortizing the unfunded liability. At the same time, the municipality begins making annual bond payments to the issuer of the POB.

The key benefit of issuing pension obligation bonds is the net reduction of the carrying costs (interest costs) of a pension plan's unfunded liability. An unfunded liability with a CalPERS pension program is being charged the equivalent of 7¾% interest annually. The Novato POBS were issued at an average interest rate of 6.1% which is lower than the 7¾% effective interest rate being charged by CalPERS.

Now that Novato has taken actions to soften the impact of the unfunded liability, the policy issue that remains is what can we learn from past events so that Novato does not repeat the history of another unfunded liability.

Our learning experience begins with the booming financial markets of the 1990s. Public pension plans became so overfunded that employer contribution rates dropped to zero, creating "contribution holidays." Novato and other municipalities did not set aside these savings into a rainy day fund.

Then the poor performance of the stock market in 2000-2002 reversed the situation dramatically. But because of the lags in calculation of contribution rates, Novato and other municipalities were increasing plan benefits in agreements with the employee unions even after the markets had declined. The Novato Miscellaneous Plan was increased to 2%@55 in April/May, 2000. The Novato Safety Plan was increased to 3%@55 in June/July of 2001.

Unfortunately, the lack of outside independent analysis in 2000 and 2001 allowed the City Council to approve these actions without full knowledge of the potential cost impacts. In analyzing the impact of the switch from a 2@60 to a 2@55 plan in April, 2000 the staff report stated, "Based on the PERS valuation there will not be any rate increase for the City for the next 17 years." (That Deputy City Manager is no longer with the City.)

These experiences give rise to two recommendations.

*Recommendation*

Pension Reserve Funding. Establish "reserve funding" that will help stabilize the volatility of pension costs. In years where the plans are overfunded and the Required Contribution is less than the Normal Cost, the City of Novato will either:

- Make a deposit to a City of Novato pension reserve fund in overfunded years. The amount of the deposit will be the excess of Normal Cost above the Required Contribution. Fund balances of this pension reserve fund would be utilized in future underfunded years when the Required Contribution is greater than the Normal Cost.
  Or,
- Make additional payment to CalPERS in the amount of the difference between Normal Cost and the Required Contribution.

The choice between the two funding methods is primarily an investment decision. The CalPERS option is less restrictive on investment options and promises a higher yield. But, there is more investment risk.

*Recommendation*

Independent Review. An independent economic analysis and review is required for any proposed change in benefits or program features. This review would be independent of CalPERS and union bargaining units.

### *Pick-up of Employee Contributions*

The third component of pension costs is the employee contributions that are paid by the employers. In Novato this is 7% of payroll for Miscellaneous Employees and 9% for Safety Employees. These arrangements are the result of negotiated labor agreements and are part of a total compensation package. A reversal of this pick-up arrangement would be perceived as a reduction in total compensation to employees.

This negotiated contribution pick-up was an outgrowth of the "contribution holidays" of the 1990's. As employer contributions declined below the Normal Cost rate, it was perceived as unfair that the employees continued contributing the fixed 7% or 9% while employer contributions declined. As a consequence, Novato and every other municipality in Marin negotiated labor agreements whereby employers picked-up the employee contributions.

The situation is now reversed. Employer contributions have increased to well above the Normal Cost. It is not unreasonable that employees be asked to resume the burden for their own contribution. San Rafael accomplished this reversal in negotiations with its various labor unions. Virtually all employee pick-ups in San Rafael were gradually phased out over a period from July 1, 2002, to June 30, 2005.

> *Recommendation*
>
> Employer-paid Employee Contribution: The City of Novato should seek to have employees share a portion of the financial responsibility for pension costs by elimination or phasing out of the employer pick-up of the employee contribution.

When employer contribution rates exceed the "normal Cost Threshold" as they have in recent years, it is not unreasonable to expect employees to take some of the financial responsibility for their pension plan by paying some or all of the Employee Contribution.

### *Administration Recommendations*

Until recently, pension issues have flown under the radar. The public and most City Councils were poorly informed. Some of this was due to the complexity of the issues. But it was also due to the lack of visible financial reporting on pensions. There is no line item for pension expense in Novato's budget and financial reporting documents. The only reference to it in the annual audited financial statements is as a footnote (Note 9 on page 53 in 2005).

Pension expense has now become a major expense item. And it will remain a major item for the next 30 years while the City is paying off the Pension Obligation Bond. When Marin County issued their pension obligation bond in 2003 they began reporting the POB cost as a personnel expense in all departmental and budget documents. They display it as a separate line item next to the line item for pension costs.

*Recommendation*

Reporting of Pension Expenses: Pension and pension-related expenses should be clearly identified in financial and budget reports of the City of Novato. Specifically:

- The expense of the Pension Obligation Bond (POB) payment should be recognized in the City's internal financial and budget statements and be recognized as a pension expense.
- The Employer- paid employee contribution should be recognized in the City's financial and budget statements and be recognized as pension expense

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# APPENDIX
# Comparison to Marin Municipalities

## Plan Descriptions & Rates

**2006/07 Employer Contribution Rates**
**Miscellaneous Plans**

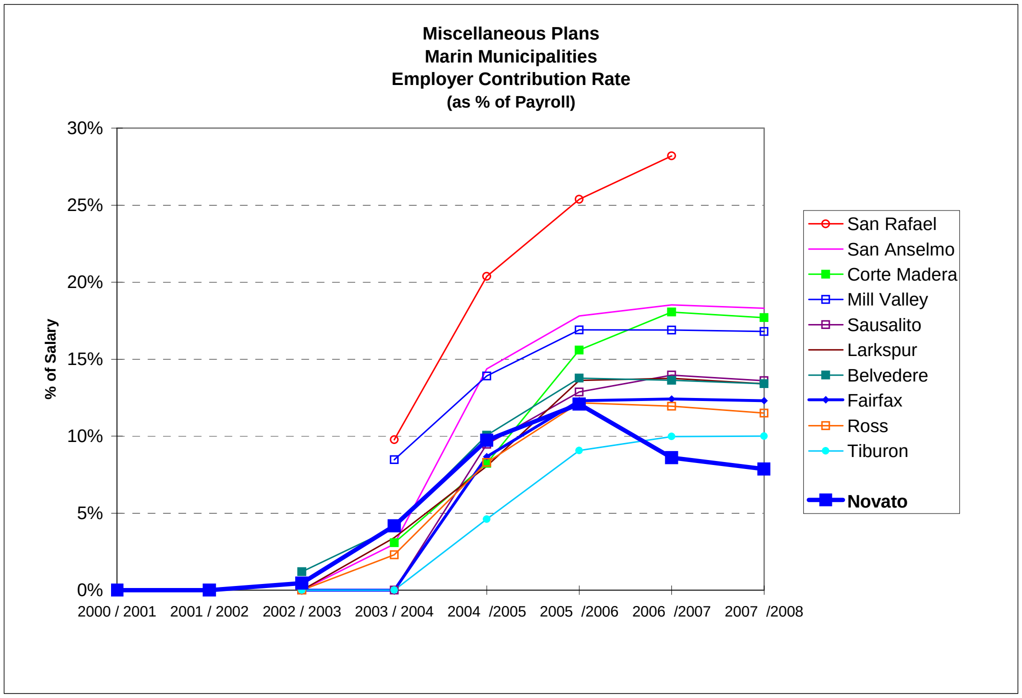
| | | Rate as % of Payroll | | | |
|---|---|---|---|---|---|
| | Plan Description | Employer Contribution | POB Payment | Employee Contribution paid by Employer | Total Paid by Employer |
| San Rafael | 2.7% at 55 | 28.2% | | - - | 28.2% |
| Corte Madera | 2.5% at 55 | 18.1% | | 8.0% | 26.1% |
| San Anselmo | 2.7% at 55 | 18.5% | | 7.0% | 25.5% |
| Mill Valley | 2.5% at 55 | 16.9% | | 7.0% | 23.9% |
| Sausalito | 2.5% at 55 | 14.0% | | 8.0% | 22.0% |
| Larkspur | 2.0% at 55 | 13.8% | | 7.0% | 20.8% |
| Belvedere | 2.0% at 55 | 13.6% | | 7.0% | 20.6% |
| Fairfax | 2.5% at 55 | 12.4% | | 8.0% | 20.4% |
| **Novato (without POB)** | **2.0% at 55** | **13.0%** | | **7.0%** | **20.0%** |
| **Novato (with POB)** | **2.0% at 55** | **8.6%** | **3.6%** | **7.0%** | **19.2%** |
| Ross | 2.0% at 55 | 11.9% | | 7.0% | 18.9% |
| Tiburon | 2.0% at 55 | 10.0% | | 7.0% | 17.0% |

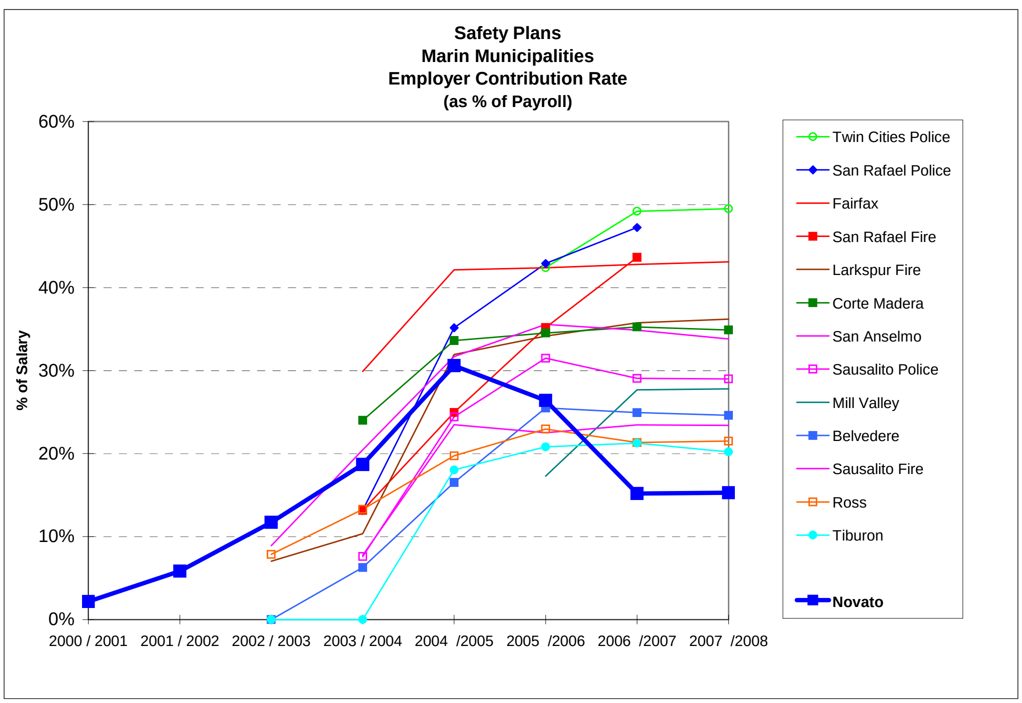
**2006/07 Employer Contribution Rates**
**Safety Plans**

| | | Rate as % of Payroll | | | |
|---|---|---|---|---|---|
| | Plan Description | Employer Contribution | POB Payment | Employee Contribution paid by Employer | Total Paid by Employer |
| Twin City Police | 3.0% at 55 | 49.2% | | 9.0% | 58.2% |
| Fairfax | 3.0% at 50 | 42.8% | | 9.0% | 51.8% |
| San Rafael Police | 3.0% at 55 | 47.2% | | - - | 47.2% |
| Larkspur Fire | 3.0% at 55 | 35.8% | | 9.0% | 44.8% |
| Corte Madera | 3.0% at 50 | 35.3% | | 9.0% | 44.3% |
| San Anselmo | 3.0% at 50 | 34.9% | | 9.0% | 43.9% |
| San Rafael Fire | 2.0% at 50 | 43.6% | | - - | 43.6% |
| Sausalito Police | 3.0% at 55 | 29.0% | | 9.0% | 38.0% |
| Mill Valley | 3.0% at 55 | 27.7% | | 9.0% | 36.7% |
| **Novato (without POB)** | **3.0% at 55** | **26.4%** | | **9.0%** | **35.4%** |
| **Novato (with POB)** | **3.0% at 55** | **15.2%** | **9.0%** | **9.0%** | **33.2%** |
| Belvedere | 2.0% at 50 | 24.9% | | 8.0% | 32.9% |
| Sausalito Fire | 3.0% at 55 | 23.5% | | 9.0% | 32.5% |
| Ross | 2.0% at 50 | 21.3% | | 9.0% | 30.3% |
| Tiburon | 3.0% at 55 | 21.3% | | 9.0% | 30.3% |

## Employer Contribution Rates

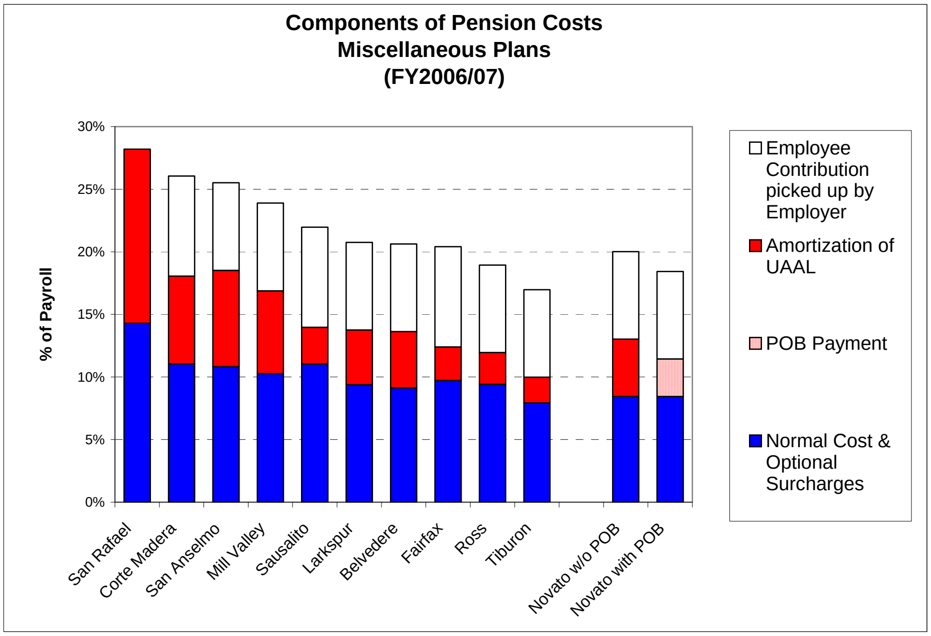
The costs of public employee pensions plans in other Marin County municipalities have escalated in recent years. The same factors which caused the increases in Novato were also present in other municipalities. Recent Novato rates have declined due to Fresh Start reamortization in 2005/06 and the POB in 2006/07.

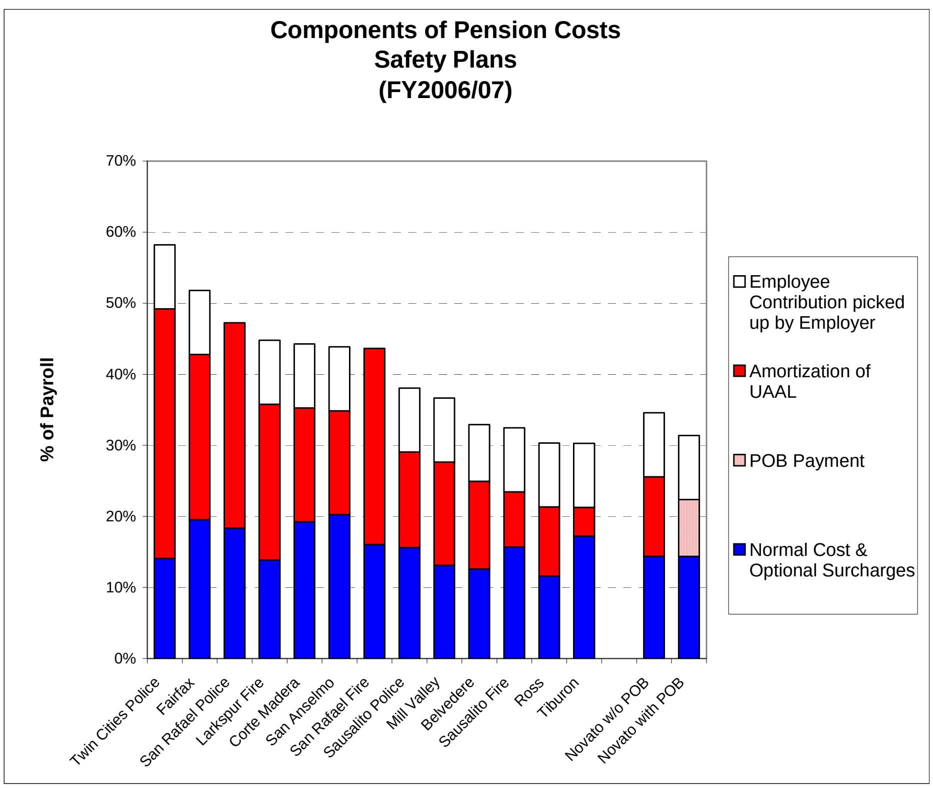


## Components of Pension Costs

These figures show the components for the Miscellaneous Plans and Safety Plans for Novato and other Marin municipalities for fiscal year 2006/2007.



## Unfunded Liabilities

The pension plans for all Marin municipalities have developed unfunded liabilities in recent years.

**Unfunded Liabilities as of 6/30/2004**

| | Miscellaneous Plans | Safety Plans | Total |
|---|---|---|---|
| San Rafael (*) | $ 24,121,975 | $ 45,385,057 | $ 69,507,032 |
| **Novato** | **7,725,362** | **9,627,230** | **17,352,592** |
| Corte Madera (**) | 1,505,343 | 5,787,374 | 7,292,717 |
| Mill Valley | 3,658,289 | 3,208,421 | 6,866,710 |
| Sausalito | 739,761 | 4,524,286 | 5,264,047 |
| San Anselmo | 2,083,739 | 2,230,585 | 4,314,324 |
| Fairfax | 281,468 | 2,176,509 | 2,457,977 |
| Ross | 106,586 | 1,045,834 | 1,152,420 |
| Belvedere | 588,990 | 538,195 | 1,127,185 |
| Larkspur (***) | 903,618 | - | 903,618 |
| Tiburon | 347,834 | 326,081 | 673,915 |
| Totals | $ 42,062,965 | $ 74,849,572 | $ 116,912,537 |

* San Rafael UAAL as of 6/30/2005
** Corte Madera includes Twin Cities Police
*** Larkspur Fire UAAL unavailable for 6/30/2004