Costa Mesa Pension Oversight Committee

CMPOC Fast Facts

# Pension Terminology

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*At a minimum, pension terminology can be challenging, at a maximum, it is outright confusing. In this edition of Fast Facts we attempt to define some of the more commonly used pension terminology. By sharing this basic terminology we hope to expand your understanding of complicated terms in an uncomplicated manner.*

**CalPERS -** Costa Mesa contracts with CalPERS, the California Public Employees Retirement System, to administer pensions for city employees. CalPERS administers pensions for over 1.6 million active employees and retirees including state, county, and municipal employees as well as public school and state university employees. While CalPERS is the administrator of our employee pensions, the payments are guaranteed by the taxpayers of Costa Mesa, not CalPERS.

**Defined Benefit Plans (DBP)** – Pensions are referred to as Defined Benefit Plans. DBP's establish a formula for pension payouts based upon age, years of service, and salary level. Costa Mesa benefit payments are guaranteed for the life of the employee and if a lesser benefit is selected, for the life of the employees' spouse. Pension benefits increase annually, and the pension benefits received by retirees are not affected by the investment results achieved by CalPERS.

**Defined Contribution Plans (DCP)** – Retirement plans funded by a set contribution formula, most commonly a percentage of salary. The most common DCP is a 401(k) plan where employers and employees contribute to an employee account, the employee directs the investment, and there is no guaranteed investment return.

**Employee Groups** – Costa Mesa employees are divided into three different groups. Safety Police ("on the street" police officers), Safety Fire ("on the street" fire personnel), and Miscellaneous employees (all other city employees, managers, and police and fire administrative employees). Through their bargaining units (union or association representation), each employee group has negotiated their own pension benefit formula.

**Pension Benefit Formulas** – Pension formulas are expressed as a percentage of salary for each year of service with a minimum retirement age. In the case of Safety Police and Fire Safety employees hired before January 1, 2013, the benefit formula is 3% at 50 (employees hired after 1/1/13 have a slightly reduced formula). To calculate their pension benefit, employees in these classes are eligible to retire at age 50 and they receive 3% of their salary for each year of service. The salary used to calculate their benefit is their highest single year of salary any time during their employment. Example: 50 year old employee with 24 years of service with a highest annual salary of $90,000; benefit formula = 3% x 24 years = 72% x $90,000 = $64,800 first year pension benefit. The benefit formula for Costa Mesa Miscellaneous employees hired before January 1, 2013 is 2-1/2% at 55.

**Service Credits** – Employees vest service credits after 5 years of employment and employees are not subject to mandatory retirement. If they continue working, they continue to accrue service credits (additional years of service). In the example cited above, if the employee continued to work until age 55, his pension benefit would grow to 3% x 29 years of service which equals 87% of his highest salary. Employees who retire before the age expressed in their stated benefit formula receive a reduced benefit and for all employees, the maximum benefit payable is 90% of highest salary.

**COLA**– All Costa Mesa pensions are subject to an automatic Cost of Living Allowance or "COLA" which increases the benefit annually. Historically, this increase is 2% per year throughout their lifetime. If the first year benefit is $60,000, the second year benefit is $61,200, the third year benefit is $62,424, etc.

**Contributions Rates** – Based upon salaries, past and estimated investment returns, and benefit formulas, CalPERS annually establishes the Contribution Rate for each employee group. The Contribution Rate is the percentage of salary (for each employee) that Costa Mesa must pay to CalPERS to fund the pension plan for that year. Contribution Rates consist of two elements: Normal Cost (the amount required to fund the benefit for each working employee) and Unfunded Liability (the amount required to make up for insufficient prior saving or poor investment return). Contribution Rates will be discussed in-depth in a future Fast Facts article.

**Discount Rate** –Contributions paid to CalPERS are invested to help fund benefit payments. The investment rate of return is called the Discount Rate. The current CalPERS discount rate is 7.5% which means that including market fluctuations, CalPERS has concluded they will average 7.5% return on investment per year.

**Actuaries** – Financial professionals who make projections on the value of assets based on historical performance, typically on a long-term basis. Some actuaries make conservative estimates and others make liberal estimates. This can lead to a wide disparity in their long-term financial projections.

**Smoothing** – A process that allows actuaries to apply a consistent discount rate over an extended period of time. In this process, the actuary makes their projection assuming assets that may have dropped in value will ultimately increase in value. Assets that have experienced an unusually high rate of appreciation are reduced in value in this process.

**Market Value of Assets (MVA)** – the current market value of an investment or group of investments.

**Actuarial Value of Assets (AVA)** – the projected value of an investment or group of investments as determined by an actuary after "smoothing".

**Funded Ratio -** The actuaries' estimate of AVA divided by the projected future cost of benefit payments. If the funded ratio exceeds 100%, the plan is designated "overfunded". If the ratio is less than 100%, the plan is designated "underfunded". In 2012, Costa Mesa pensions were underfunded with a funded ratio of approximately 65%.

**Unfunded Liabilities** – The difference between the amount of money that will be required to pay pension benefits and the amount that has been paid by the employer, as determined by CalPERS actuaries, to fund that benefit. Based on MVA, in 2012, Costa Mesa unfunded pension liabilities were $196,000,000.

**PEPRA** – Public Employees' Pension Reform Act – The California law that became effective January 1, 2013 which is intended to constrain pension benefits deemed excessive. Most provisions of PEPRA apply only to new employees who are hired after 12/31/12 and will not provide immediate savings to employers.

**Classic Employees -** Employees hired prior to January 1, 2013 whose benefit formulas are not subject the restrictions of PEPRA.

**Pension Spiking** – An intentional, late-career effort to maximize compensation to increase pension benefits. In Costa Mesa, policies to minimize "spiking" are in place.

**EPMC** – The City and Employees both contribute to the cost of pensions. The City also makes Employer Paid Member Contributions (EPMC's) which are payments that are added to the employees' highest year of pay for pension benefit calculation purposes.

**GASB** – The Governmental Accounting Standards Board (GASB) sets the policies for how public pension plan finances are evaluated and reported. Recently enacted changes by GASB will have a significant upward impact on the contribution rates paid by California CalPERS member agencies including Costa Mesa.

**OPEB** – Other Post-Employment Benefits (OPEB's) are fringe benefits such as retiree medical insurance paid partially or in full by the employer.