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Public Plans Negotiations – Part 2 Of Pension Negotiations Seminar

Track: Pension

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Panelists: JOHN E. BARTEL
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Summary: An attorney and an actuary with experience in labor negotiations between employee groups and state or local governments discuss specific local collective bargaining processes as well as variations between jurisdictions. Attendees learn how the public sector bargaining process works and learn the role of the actuary in that process.

MR. PAUL ANGELO: This is part two of our three-part series on negotiated pension plans. Our focus today is on public sector negotiations and public sector benefit plans. As with this morning's sessions, we have a lawyer and an actuary. The lawyer is Bob Blum.

Bob was actually on one of the committees that either wrote ERISA or drafted ERISA. He spent many, many years with a big law firm, then went to work for a consulting firm and now is with Hanson, Bridgett in San Francisco, working public sector primarily, health, pension, everything.

MR. ANGELO: Next to him is John Bartel with Aon Consulting. I know John from his many years with KPMG, and he has been at Aon for a few years, doing public

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sector. I would occasionally meet John across various sorts of bargaining tables. He's done a lot of work with public employee retirement system (PERS) agencies in California, and that kind of work.

Bob is the lawyer and John is the actuary, so Bob's going to start with the lawyer side of public plan negotiations. Bob, it's all yours.

MR. BLUM: Is there anybody here who does not work in the public sector? One, two, three, four, five, six, seven, eight, nine. Okay. Well, welcome, Hopefully you'll learn a lot about this.

So here's what we're going to talk about—public sector issues. For those of you who have not worked in the California environment, California may have more varieties of public plans than any other jurisdiction in terms of organization, governance, and agencies that they cover. So we'll talk from the California perspective about types of plans, governance structure and negotiations. The governance structure is actually very important to the way that these plans deal with negotiations, or negotiations deal with them. We'll talk a little bit about the union environment, a little bit about the fact that the actuary is going to be in the middle. And then from my own perspective, the part that's most interesting, which is recent examples. These are real-life examples; each one of them occurred within the last 12 months. Some of them, you may find very interesting.

So what do we have? California has a wide variety, starting with a single-employer plan. It operates much like the private sector. It's usually a smaller agency and usually has a plan document that looks just like the kind of plan document that you would see in the private sector. In fact, people who are only accustomed to working in the private sector have drafted some of these documents. You get a lot of ERISA rules, and a lot of reference to ERISA and the Department of Labor, all of which is totally irrelevant and sometimes can be a little bit confusing. In California, there is a specific set of statutes that authorizes any local agency—local agency just being defined in a relatively broad way—to establish a retirement plan in this manner.

The next type is also single employer, but by charter approved by the voters. It varies very much with charter details and the need to go to the voters for changes. For example, in the city and county of San Francisco, you cannot change the governing plan document without going to the voters. As you would imagine, that is something that people do not want to do very often and try very hard to avoid. In the city of San Diego, which is also a charter city, there is, let's call it more of a broad constitution, a road map in the city charter for the rules that govern the retirement plan, the pension plan. In that circumstance, the charter specifically authorizes the city council to establish the details of the plan through city ordinance. So we have page after page of city ordinance, which is, from a lawyer's perspective, kind of interesting because it mixes both the way you draft an

ordinance—that is, a law—and the way that you draft a plan. Sometimes that has caused some problems, which we have actually seen recently in some jurisdictions.

The next one is a single employer under a state statute that sets out most of the details, including the approved benefit structures. The premier example in California is something called the 1937 County Employee Retirement Law. There are 20 counties out of 58 total in California that have what we call '37 Act plans. There are—I'm going to make a wild guess—100 pages of densely printed statutory rules that are extraordinarily conflicting and confusing that govern the '37 Act. So, what we find when we get lawyers, actuaries, administrators, whatever, into a room together, and we try and sort out what this thing means, is that if you have 20 lawyers, you'll have 22 interpretations, at least, of what a particular section means. Now, those are lawyers from different jurisdictions. If you get a lawyer and an actuary and the plan administrator from one jurisdiction in the room, you'll get a similar problem. It is not, by any means, the best-drafted statute.

I've had some conversations recently with people who are responsible for drafting this, and we joke about whether we could ever rewrite this thing so it would actually make some sense and have some cohesion. And the answer, we all know before we start the conversation, is, no chance, no way is that going to happen because in every one of these sections, there is history and there are little goodies that are hidden in them. If you were to ever try to rewrite this, you'd lose the history, you'd lose the goodies, and we'd really have many more problems than we have today.

So let's look at the next type, multiple-employer plan. Again, it's under a state statue that sets out most details, including approved benefit structures. And again, we use the '37 Act as the example because a number of counties have districts that participate in these plans. So, I believe Orange County, for example, has at least 12 districts that participate in the plan. Los Angeles County has a number of districts that participate in the plan; some of which are larger than most other agencies that exist throughout the state.

The next type, in terms of plan structure, is statewide multiple-employer with a single benefit structure. It's a little bit overstated, but it's good enough. A single benefit structure and a single rate structure set by statute. The premier example is the California State Teachers' Retirement System (CalSTRS). All of the roughly 1,200 public school districts in California are mandated into this plan for what are called their certificated employees—that is, all of their teachers and their administrators who have certificates to teach. There are roughly 350,000 active employees in this plan. For years and years, there was a single benefit structure. Relatively recently, there were some statutory amendments to allow some special extra goodies in particular circumstances that are negotiated by the unions. But they are so few, compared to the next example we're going to get, that for all

intents and purposes, it is a single structure. It's relatively easy to deal with from an actuarial perspective.

The last one that we have is statewide multiple-employers, with a menu of benefits. I recall, at last count, there were about 1,200 agencies with about 1,800 plans for valuations. Because you can choose from a menu of benefits, many, many, many of the 1,800 plans are different, so you have to do roughly 1,800 different valuations every year. The size of the agencies ranges from mosquito abatement districts, which are very, very small—one, two, or three employees—to the County of Santa Clara or the County of Riverside, one of which, I think, is probably the largest of what we call contract agencies. And then, of course, the state of California, which is a part of this and the largest employer in this. It also includes not only local agencies, which contract, but it also includes all school employees who are not certificated. So, all of the bus drivers and clerical workers are included. They have the wonderful opportunity also to deal with the judge's plan and the legislators' plan. Is there still a legislators' plan? It's frozen now.

Closed. From a lawyer's perspective, it is unclear if you really start to poke at these things, whether they are "multiple-employer" plans or whether they are "multi-employer" plans. For some purposes, there actually is an important difference, and if we were ever to get a problem with Section 415, for example, whether you're multiple employer or multi-employer makes a big difference.

Another difference is, how do you do the 415 testing? You do the 415 testing employer by employer, plan by plan. What do we have? Do we have a CalPERS situation? A single plan for the purposes of 415 testing? By the way, there is complete reciprocity between all the agencies. Or do we have 1,800 different plans, for the purposes of 415 testing? I don't know the answer. I don't know that anybody really knows the answer. But obviously, CalPERS has had to put a stake in the ground and make a decision on how they're going to do that.

So, the rules are complex. We deal with a significant number of programs that are different in terms of their structure. It's all about governance, because when we get to negotiations, we need to know how these things are governed. And there are two very basic governance structures: no board of retirement or board of trustees, whichever phrase you wish to use, or an independent board.

When do you have no board? You have no board, usually, in the small agencies that set up their plans under this section of the government code that allows an agency basically to draft its own plan. It looks and feels very much like a private sector plan. In fact, under the California constitution, people who are responsible for administering that plan are fiduciaries, and they have the same responsibility as fiduciaries as they do under ERISA—in fact, even more so. For the most part, we get them to pay attention to that when there is an issue. But it's very much

employer-driven, just as private sectors plans are very much employer-driven in terms of governance.

Now, independent boards exist for all the '37 Act plans, which include all the charter city plans that I'm aware of and certainly for CalPERS and the California State Teachers' Retirement System (CalSTRS). The members of these boards are mixed. They are elected in some circumstances by constituencies, active general members, active safety members or retiree members. They are elected officials in some circumstances.

The treasurer and controller of the State of California sit on both the CalSTRS and the CalPERS boards. Under the '37 Act, the treasurer of the county will sit on the board. In some circumstances, a member of the board of supervisors sits on the board. I have a little problem with that because of potential conflicts, but they do that. And then there are also members who are appointed ordinarily by the governing body of the agency, the county board of supervisors. The numbers of people vary anywhere from nine in the '37 Act to, I know of one situation in which there were 13. There are probably 16 on the CalPERS board. So we have a variety of governance structures, and they come from different constituents, which is very important in terms of the ways that boards work in practice.

As I said, the governance is by independent fiduciaries. The constitution states that the board, the fiduciaries who run the plan—lets just call them boards for now—have plenary authority to administer the plan. Plenary is a magic word that basically means "complete." They must act solely for the benefit of members and retirees. And Prop 162 is a reference that we use. This was an initiative passed by the voters.

Independence works in different ways with respect to negotiations. We will talk about that when we get to examples.

How about the union environment? There are two member categories with distinct benefit structures, for the most part, in California. There are safety members, and there are general or miscellaneous members. Safety members are always treated better and for good reason. Frankly, the last thing in the world I want to do is be a highway patrolman or a firefighter. You've got to rush into a burning building. It doesn't happen very often, but boy when it does, it's really ugly work. So, good for them, as far as I'm concerned.

But because you are treated better as a safety member, there's a lot of push to be counted as a safety member. So, in San Diego, lifeguards are safety members. Okay, it may be quite appropriate. Parole officers are now safety members in many jurisdictions. There is a bill that's being run in Sacramento that would say that district attorneys and public defenders are safety members. Some people think that to put a lawyer in the same category as the firefighter is a little bit of a stretch.

MR. JOHN BARTEL: Animal control, Bob.

MR. BLUM: Animal control…are they?

MR. BARTEL: Yes.

MR. BLUM: That's the other one we continually hear about is animal control officers.

Note that "safety member," under the statute that sets the benefits, is not necessarily "safety" for purposes of Section 415. That is very important, and because of the significant increase in the number of safety member benefits throughout California, this is becoming a problem. Now all of the sudden, we have a number of jurisdictions that are worrying about whether the qualified plan can, in fact, pay the full benefits that these folks have earned. And if they cannot, what do you do about it?

In terms of the union environment, new benefits roll through the state. What happens is, you get one jurisdiction or two jurisdictions or one board that endorses some new higher benefit structure, and the one that is now running through the state is three percent at 50 for safety members with no actuarial reduction. And the pressure on the employer with bargaining can become inexorable. Those guys got it. If they have it and there's a shortage of cops, I can move from this jurisdiction to that jurisdiction easily. You have to give it to me.

Then, when the cops get it, the firefighters get it. If the cops get it and the firefighters get it, well, the parole officers are there too. In fact, in some circumstances, the statute mandates that all employees in a particular category of membership—that is, all safety members—receive the same benefit. So, if the cops get it, the firefighters get it. Or through negotiations, and we'll talk about this, the cops who negotiate for it aren't going to get it because the firefighters will not go that far. They want cash in their pocket instead.

The other example, but it's a somewhat more interesting example, is a drop benefit. I assume you all know what a drop benefit is, is that right? Drop benefits are really hot tickets on the East Coast and particularly in the Southeast, for some reason. There are only two jurisdictions that I know of in California that have adopted drops. They are what people call forward drops. They are in the City of Fresno and for both safety and general members in the City of San Diego. The City of San Diego benefit is, let's call it a highly enhanced drop benefit.

There have been a number of bills in the legislature to authorize drop benefits for the other systems, but they have not been approved. It is very much a cost issue. There is another issue underlying drop benefits, and that is the perception of double dipping. There are some safety members, not a lot of them, but some, who I would

call leaders in the safety retirement community who have actively fought adoption of drop benefits because they think that the perception is awful.

They think that the perception is that it looks like double dipping: you're both "getting your retirement benefit," and you're getting your salary. And they're saying, "Whoa, there's just so far we can go, and if we go too far, we're going to kill the goose," et cetera. I think that's one of the reasons, but only one, That the drop has not gone as far in California as it has gone in other states.
I mentioned that some plans have to have uniform benefits within each category. So what's the actuary's role in all of this? With independent boards, the board's actuary determines the cost and the contribution rates. It doesn't make any difference what those people over at the bargaining table think it might cost. The board determines the contribution rates, period, under the California constitution, after negotiations are completed, often without being able to assist the negotiators.

In some circumstances, the retirement board will make their actuary available, usually on a limited basis, to the negotiators to help them rough out the cost. But it really is rough out the cost, and those of you who have been involved in negotiations know that, in any event, you've got to do this stuff very fast, Sometimes in a few minutes, sometimes in a few hours. Sometimes you're lucky, and you get 24 hours to do it. But in this circumstance, there is no way, from my perspective, that the negotiators can claim fair reliance on what the board's actuary tells them to make up. This is just a matter of courtesy that the board offers the negotiators. It causes trouble, obviously, and the more sophisticated negotiators will in fact try to get their own actuaries.

But the actuaries that they use have a difficult time. They don't have access to full data. They're not the ones that the board relies on. They do the best they can, but I've watched this process, and they, properly so, caveat everything that they say. And just from negotiation perspective generally, what I've also seen—and this will be no surprise—is they only have half of the information about what's going on. Negotiators just don't happen to tell them everything that's going on.

The closer the negotiators are to the governing board, the more difficult the situation for the board and its actuary. What do I mean by that? If the negotiators who actually sit at the bargaining table also sit on the governing board, and they go bargain something over there at the bargaining table, then they are more inclined, when they come back and sit on the retirement board, to try to do whatever they can to make this deal work economically.

This is a very awkward situation. And I will describe one in modest detail to you that is currently going on in this state. Now, when we talk to boards we say, "If you have your fiduciary hat on, and they're sitting behind that table, your sole responsibility is to act for the benefit of members and the beneficiaries." We always give them the lecture, and they always nod their heads. But this is not an easy

thing for many people on any side, whether you're the employer-negotiator or whether you are the union negotiator. And frequently you find that the president of the union who negotiated the deal sits on that board. Now, this is much more the case in local situations: county, city, et cetera. I think it's not quite the case with the statewide PERS. Now clearly you have union folks who are elected by the unions and who sit on the boards, but they're not that close to the negotiation. They may have other political pressures they have to deal with, but they have not sat there at the negotiating table, and they do not report to somebody who has sat at the negotiation table, so they're able to step back a little bit more.
I will not tell you that there are no politics at the PERS and the STRS board level. I will tell you that they're not quite as up close and personal as they are in the local situation.

We can have situations in which the actuary becomes what I call the magician or the scapegoat. You have a negotiation. You're worried with the costs. The agency made some assumptions about what the costs are. We are in very difficult economic circumstances right now, and then what happens when the board decides on the contribution rate?

Is the board going to decide on a contribution rate that fits with what the negotiators thought it was going to be, both sides? Both sides are really negotiating about a single pot of money, and it's going to retirement benefits or to some other benefits or to cash in pocket. Is the actuary's ultimate rate going to come out in accordance with what negotiators thought? Is it going to come out higher, in which case, these people are going to be very, very unhappy.

While the agency may have to pay to dole out initially, you know and the union knows it's going to come back and bite the union in the next round. He says, "Sorry, guys. You know we negotiated three years ago for these benefits and this pay raise. The benefits cost us twice as much as we thought, and we are not giving you a pay raise the next time up because we can't afford it, and it's that actuary that did it. Go talk to the board of retirement if you have a problem." And the actuary knows this.

So the pressure on the actuary can be rather large. What is it that gives the actuary the backbone? I think it's only professional standards. I think that it's the internal professional compass. Now there's another part of it, which is that the actuary, in most cases, is reporting to an independent board, and I've got a mix of people on the board, and I've got some people who are going to push very hard professionally.

And boards, where there is any significant amount of money involved, or there is any significant controversy involved, will also have a lawyer sitting there and doing his or her best to be sure that, in fact, the actuary keeps down the trend. All that is nice and theoretical, and I've watched that actuary put on the spot, very tough

spots, and seen him or her asked, "When you get down to it, what is your professional, actuarial opinion of what the contribution rate should be under the valuation that you have completed? What liability should be included?" We have one where there is $85 million worth of liabilities, and the question is, are these contingent or are they not? Well, the actuary wants to give it to us, and actually, that's no problem. We'll take that. But that happens to be a very significant issue in a particular valuation that is going on right now.

On Friday, this guy was standing up in a room in which we had 150 employees. The room was packed with 150 employees who were there to be sure that they got their benefits. Their union leaders where there, and their union leaders had turned these people out. We had a contentious situation on the board, and it came down to the actuary's professional opinion, which we helped him with a little bit.

So, the actuary's role is not easy.

FROM THE FLOOR: Bob, in your experience in the negotiation process, how often do the actuaries actually really talk? Go back, for example, to your three percent at 50 safety formula. How often do the actuaries really talk about how much the numbers they're providing rely on the underlying assumptions and what those assumptions mean?

MR. BLUM: I think it depends on the particular situation, but let's put it this way: For good or for bad, because I spent nine years at Mercer and did a lot of work with actuaries, I have enough knowledge to know to ask the questions. So if you get somebody involved, like me, whose role is to ensure that the issues are discussed, I'll push on that, and I'll have discussions with the actuary beforehand to see what it is. We'll go through the report together, and I will ask him, what's going on here, what's going on with the underlying assumptions? Why are you using projected unit credit (PUC) , for example, in this circumstance? What changes have occurred? Is there anything here that is really bothering you?

In some circumstances, frankly, the actuary is a little bit reluctant to talk about it. But one of our roles is to be sure that stuff is on the table, so we really do work very much on cooperation with the actuaries because, in awkward situations, from my personal perspective, it is a very bad idea to put the actuary out there hanging all by himself. It's of enormous value to our client and the board for us to work in cooperation, in tandem, with the actuary so that the actuary doesn't think that he or she is out there all alone. The actuary can turn to us at critical times and get our support—not on an actuarial matter. Everybody at Mercer used to grab the calculator away from me and wrestle me to the ground if they ever saw me with one. I don't do numbers. But what I do is, as I said before, insure that the questions and the issues that need to be discussed with respect to, in this case, contribution rates, valuation assumptions, et cetera, are before the board of retirement, and they are discussed, or at least the board has the opportunity to

discuss them. If they don't want to discuss them, that's fine. That's up to them. Our role is to get that stuff out there, so we do work with the actuary in that way.

So, let's talk about a few examples.

FROM THE FLOOR: Do negotiators set both the contributions and the benefits?

MR. BLUM: The short answer is, in the ordinary case, the negotiators set the benefits, and it's up to the board to determine the contribution rate. That's the ordinary case.

In the worst case, negotiators are out there flying blind or maybe with one eye open, in terms of what the contribution rates might be. And you only get both eyes open when you finally come back to the board, and the board's actuary does a valuation and sets the contribution rates.

FROM THE FLOOR: Doesn't a large actuarial firm have standards for its own actuaries to adhere to group of standards within the company, so he's not out in left field? How do you say that he's exposed to these tribulations?

MR. BLUM: The question is, doesn't the large actuarial firm have set standards that the actuary adheres to, so why in the world would the actuary be out in left field?

For lack of another analogy, let me point you to the accounting field, where there are standards that all the large accounting firms adhere to. Yet, within those standards, there can be a lot of very legitimate discussion and dispute. I would suggest that the same kind of thing occurs with actuarial standards.

MR. BARTEL: Similarly, Bob, when you're saying "the actuary," you could be talking about the actuary or the actuary's firm.
So, when you're saying that this heat comes to bear on the actuary, that doesn't necessarily mean it's on the individual practitioner. Whether the heat is brought to Mercer's actuary or Mercer, it's the same thing. That's what I'm saying.

MR. BLUM: Maybe I have a jaundiced view of the world, but I do not believe that actuarial science is pure and cut precisely on the edges.

Let's talk about some examples. California, for many of its funds, has what a lot of people think is a very peculiar concept, and that is "surplus earnings." Here's generally what surplus earnings means. Surplus earnings are earnings in a year by the fund that are in excess of the actuarial funding rate, plus some cushion.

For some funds, these are based only on realized gains. For some funds, they are based on unrealized, as well as realized. For some funds, these are year by year,

and for some funds, these are smoothed. But it is this difference between actual, whatever actual may be, and the funding assumed rate, plus some kind of cushion. So that's what they are. The question, of course is, do they really exist, and for whose benefit can they be used?

Let me tell you what happens with these, and it happens with a number of funds. There are what we call contingent retiree benefits. Retiree health benefits is a good example. Extra cost of living adjustment (COLA) benefits is another example. If, in fact, there are sufficient surplus earnings, either in a year or accumulated, depending upon how that particular fund operates, then the board of retirement gets to spend that money, not the plan sponsors, for some specified types of retiree benefits. You can imagine, during the '90s, particularly the late '90s, we had a lot of this, and today we don't have very much at all, if any. But we have a whole batch of people who have become accustomed to receiving extra benefits or health benefits. And health benefits, perhaps, are the most difficult because you know what's been going on with cost of health care.

So, the issue for the actuary then is, do we have them? How do you count them? What do you do with them? We have had several circumstances recently where we have had to work through some very difficult situations. We have retirees and unions and boards who will die to get these surplus earnings. And we have, properly so, actuaries as well as folks like me, lawyers, who are saying, "Folks, it does not exist." You have a governing statute. This is the way it operates. This is its history. Here's how you've always dealt with it. I'm sorry, but you just don't have that money to spend anymore.

Now that's not a circumstance where the actuaries pulled from one to another. In fact, calculations are ordinarily relatively straightforward. I won't go through the details, but there are situations where, as I said before, it can be a matter of judgement. Then, you really have to get down deep into it and see not only what the judgment call is, but also what the consequences are to the fund, both in the short- and long-run.

So here's another example. We have had circumstances in which benefits have been increased through negotiation, and the deal was explicit. The deal that the negotiators brought to the retirement board was, we're going to give these increased benefits, sometimes significant increase benefits, on the condition that you "stabilize" the contribution rate for the agency. Stabilize is a euphemism for "reduce." You had a retirement board that really, really wanted to do this. They had a fiduciary council. At that particular time we were not really concerned about it. And it all turned on the opinion of the actuary, given the particular structure of the deal. Would the actuary be willing to give his opinion that it meant that that particular set of contribution rates and that contribution structure met professional actuarial standards?

That was a very unusual structure. That was a very difficult situation for that actuary. By the way, that precise deal is being revisited right now because the structure, as we have learned in bad times, was doomed to fail. Now we are dealing with what I consider to be a failed structure.

The last example, and I'll stop with this one, is that in one jurisdiction—and perhaps others, but the one that I know best—drop was established on the condition that it was cost-neutral. There was a testing period, and if it wasn't cost-neutral, then the city could eliminate the drop benefit. I have a basic question: how in the world can a drop benefit be cost neutral? I suppose you could imagine some circumstances in

which it could be. When would it be tested? What are the standards for determining what cost-neutral is? A whole lot of things change between the beginning and the time of testing. Again, we're in a circumstance in which there could be significant pressure on the actuary. And, of course, this benefit was a negotiated benefit. Thank you.

MR. BARTEL: How many walked in here with any expectation in terms of what you were going to get? Whatever expectation that was, great. This is probably going to be a little bit different, and let me tell you why. When I was putting together my discussion outline, I pictured a lot of relatively junior actuaries in the room who might like to learn a little bit about what actuaries do as part of the negotiation process. So, I put together my discussion outline with that in mind.

Now, looking around the room, I'm guessing half the room been involved in the negotiation process. So I'm hoping all of you participate in this discussion In fact, in addition to the Society of Actuaries' ground rules, I'm going to give you one ground rule, and that is, absolutely interrupt me as we go through this. What I really want you to do, when you're looking at this, is to think about it. Does this make sense?

I've broken out the roles of the actuary in the negotiation process into two very separate and distinct roles. Of course, reality never fits into this bright-line test, but the bright-line test that I have is, are you really providing independent advice, or are you a hired gun? Are you really coming in to sell a particular point of view, or are you coming in to educate, provide information, and provide that independent advice?

For an independent actuary, communication is mandatory. I feel very strongly about this. Most actuaries didn't become actuaries because of their ability to communicate. Most of us became actuaries because we were math majors, and we love math. Few of us became actuaries because we love to talk with people.

Yet, if you're sitting in the negotiation process, and you're an independent actuary and people don't understand what you're saying, you may as well be doing

something else. It has to be understandable and it has to be to the point. It has to be related to the bargaining process. That really means that you have to understand a little bit about the folks with whom you're working, to understand a little bit about the public sector environment. For me, that means California. But you have to understand the pressures under which the public sector entities work. You have to understand a little bit about the union point of view. And if you don't, you're going to be in trouble.

You can't be an advocate for a particular position. Clearly, you have to draw the line, and you have to talk about actuarial standards. You have to draw the line and say, "This is acceptable. This is not acceptable." But if you become an advocate,

then obviously you're not independent. And really—I like these words—this is a

fiduciary-like responsibility because you're really not a fiduciary to this process. But your role in this process is probably as valuable as an actuary will really ever be.

Let me take a step back. Years ago, I was doing some work with the actuary that I thought was probably the best actuary with whom I ever worked. We were coming back from a meeting. It happened to be a very large client, and I had done what I thought was a particularly good job. I was kind of full of myself, and he knew it. We were driving back to the office, and he asked, "John, how did the meeting go?" I said I thought it went pretty well. He said, "Let me just put things into perspective here. If it's against the law to be an actuary tomorrow, these guys will go along just fine. Society will figure out a way to survive. But if it's against the law tomorrow to pick up the trash, society will come to a screeching halt. So, don't get too full of yourself. Don't think that your job is too important."

In point of fact, he was absolutely right. In some ways, this sort of work— working with public sector entities, being involved in the bargaining process, helping public sector entities know what's going on—is a very small way that you all can really give a little bit more back than you would if you were working for large corporate entities. So that's a crucial piece, in terms of being an independent actuary. If you love what it is you're doing, and you think about it, you'll be much better at the process. That's really why I say fiduciary responsibility because in point of fact, when you're dealing with the public trust, you have a responsibility to make sure that this is done right. So that's my soapbox.

It's crucial that people understand key definitions, and actuarial terminology clearly falls into that category. So, one of the things I try very hard to do is to take actuarial definitions and translate them into English, and we'll go through a couple of those. My least favorite word, when you're going through a negotiation session, to help people understand is the word "cost." The example that I always give is, in the Bay area now, people are advertising brand-new cars, with no car payment for a year. I always ask for a show of hands. Who believes the cost of that new car is

zero? Not a single hand goes up. My hand is up. In point of fact, if you define cost as what checks are you writing for that car over the next 12 months, then the cost of that new car is zero.

One of the difficulties of the negotiation process arises if you have two people sitting on two different sides of the table who have different definitions of cost. If one of them thinks that no cost means no cash-flow impact until the next year, then the cost is zero. So their hand would be up in that situation. Guaranteed, you will have somebody at the bargaining process whose thought process is along those lines. Well then, if the cost of that new car is not zero, how do you translate it into something that people can use and understand? That's the art, if you will, of

actuarial science.

So, walking through that same definition and the cost of the car, if you change that definition a little bit and you say, "We're going out and buying this brand-new car. It's a $20,000 car, and I have $30,000 in the bank. So I write a check for $20,000. If I write that check so that I have no car payment, how many people think the cost of the car is zero? Again, it gets back to the definition of cost.

We've pulled money out of the bank, so clearly we're spending something. But in point of fact, when we're looking at cash-flow impact to my budget, the cost of that car, by one definition, could be zero. So one of the things that's crucial is talking about definition of terms.

When I sit down and talk with bargaining groups and management, people always want to know the answer to their question of what's the cost. They don't care about actuarial present values. They don't care about actuarial liabilities because, when you're talking about benefit changes and quantifying that, they can't put the present value of benefits down on the bargaining table. They can't negotiate for that, so they want one number. They want to know the cost, and they want a single answer. Getting them away from a single answer is really part of the bargaining process.

I actually had a call several years ago from a city that was considering a benefit improvement. And at the height of the market returns, it looked like they had built up such a surplus that the surplus would accommodate their required contribution for 20 or 30 years into the future. And during the phone call, the client said, "Is this really true because we're going to build a new library." I wanted to just cry through the phone and say stop. You know there's no way, and now they're probably contributing 12, 14 percent three years later.

The dilemma facing the actuary is, how do I put this in a long-term perspective that they can understand without taking three months and doing $30,000 to $40,000 worth of Monte Carlo simulations, to get across to them that there is very little

chance that the answer I'm giving them is actually going to be the answer that plays out. To me, there's a tremendous responsibility on the shoulders of the actuary in trying to get that across to all the parties involved. It's almost an impossible task.

MR. BARTEL: The question really is, how do you communicate in a fashion in which people understand all of the things and the fact that the numbers you have on the page, even if they understand what those numbers are, are the best guess. I don't think I have a great answer for that at all. I think in lots of ways that is probably, for the public sector actuary, the most challenging thing we do. I can tell you what I do again and again. Let me take a step back. One of the things I used to do, years ago, was long-term projections. You talk about Monte Carlo simulations: what

happens if this happens, and what happens if this happens? You end up with lots of graphs and charts, and nobody understands a single word of it. You have 20-year projections, and they see in that 20-year projection, here are the numbers. They say, "Okay, so Bartel is guaranteeing that the rate is going to be 22 percent, 18 years from now." No, no, no, no.

One of the things that I've tried very hard to do, particularly when you look at how

well funded the public sector retirement systems are today is, from my perspective, prioritize the things that will most likely impact where the contribution rate is going to go—not in the long term, but in the shorter term. 1) One of the things I try very hard to do is to do short-term cash flow projections—five-year projections, six-year projections—not a 20-year projection. I've backed way off on that. 2) When you look at how well funded public sector retirement system is, the single biggest factor, I think—and I think it's really true of CalPERS and lots of other entities— is what's going to drive these rates is investment return.

Then look at the components of the plan. For safety plans, the second-biggest component is disability retirement at younger ages, or with short service because the benefit is so generous. And then maybe even for safety, the third factor is retirement, and I try very hard to talk about those three things. For miscellaneous plans in California, I think without exception the single biggest factor is investment return. It just so outweighs every other factor that it isn't even funny. But how do you communicate that? I think it's brutally difficult.

MR. ROBERT MCCRORY: I think it's important to keep in mind the difference between what people understand and what may serve their purpose. They may understand in great detail what you say, but what they're thinking may not serve their purpose.

MR. BARTEL: Let me see if I can repeat this. Your point is, often the people who listen, particularly as part of the negotiation process have preconceived ideas in

terms of what they want the answer to be and how they want that answer to sort fit the solution that they have.

MR. MCCRORY: No, I'm not saying that.

MR. BARTEL: Then come up to the microphone and say it again then.

MR. MCCRORY: What I'm saying is that we may be communicating perfectly. They may understand the long-term costs, but it may not serve their purposes to pay attention to the long-term costs. It may serve their purposes only to pay attention to the cost in the next year or over the next budget cycle or over the next contract cycle.

MR. BARTEL: Let me add to that. I've sat in negotiation sessions a lot, and I really used to go into these negotiation sessions thinking the cost of a benefit improvement is the increase in the present value of benefits if all the assumptions are met, etc. I've come out now, after having done a lot of these, believing that public sector entity after public sector entity after public sector entity looks at cash flow over some period of time. What will this do to my cash flow? That's just the way public sector entities do business.

MR. RONALD SEELING: I'd like to continue the concept of the dilemma that the actuary faces, and Bob's comment that they're only looking at the short term. I guess another aspect of the public sector is that the people you're talking to, who only want to look at this year, might be different from the people that you will be talking to three years from now and who want to look at that year. Then it's, "Why didn't you tell me this was going to happen?" This seems to me to indicate that our job is, if we think that something can happen, we should disclose that.

I've just heard vague rumors of a drop plan in Milwaukee, and this current group of supervisors or whatever are firing the last group of supervisors, who oversaw the installation of a drop plan. Once people starting getting their checks for $300,000, it didn't seem like such a cash-neutral, wonderful idea any more. Now, they're all out on the street and being chased down. So, it seems to me that long-term projections and the iffiness of things are as much to protect ourselves as to give the client, the current client, what they're looking for.

FROM THE FLOOR: This one-year cash flow or two-year cash flow or bargaining cycle cash flow, very often is the perspective of the employer—and often, the employer in combination with the unions. But when you are advising the retirement board that has a responsibility of the long-term funding of the retirement program, then the short-term cash flow is not what most of them are interested in. In any event, they should not be interested only in that. They certainly should be

interested in it to some extent, but absolutely not only that.

So a lot depends on whom you are advising. If the actuary is the advisor to the employer, find out what the employer is interested in and tell them about it and tell them the rest of it as well. But I think your emphasis is going to be very different if you're advising the retirement board.

MR. BARTHUS PRIEN: Doesn't PERS require a certain funding, and it's so set in cement that you can't play games with it?

MR. BARTEL: What you said is right. Let me just give you an example. One of the things the CalPERS board did was make an increase in the actuarial value of assets contingent on a benefit improvement. Just to be a little overly simplistic, a few years ago the ratio of actuarial to market value of asset for the CalPERS plans, for

the various agencies, might have been 90 or 91 or 92 percent. The board said, "If you improve your benefits, we will automatically increase the actuarial value of assets to 95 percent." In situation after situation, you had increases in the actuarial liability that were offset by increases in the actuarial value of assets. So, you might actually have decreases in the contribution with a benefit improvement. All I'm suggesting to you is that not everybody understood that communication the same way.

MR. BLUM: John, I guess another piece that I know you and I worked on together is that during those years, we had a lot of systems that were overfunded, and had a surplus under CalPERS. They would get their cost study, and it would show that, before the plan amendment, they had zero contributions for 12 years. After the plan amendment, they would only have zero contributions for seven years. This put the bargaining parties in a difficult spot because they didn't know how to put five years of zeros on the table against something else. So, something of a cottage industry arose of taking those numbers and converting them into something that is more like the kind of cents-per-hour value that people normally negotiate. I don't know if you want to elaborate on that.

There's a case where just because the CalPERS folks have a procedure for determining costs doesn't necessarily mean that that's the only answer or even a useful answer for people at the bargaining table. That is an opportunity, actually, for consultants to help them understand different ways of viewing John's least favorite word, the word "cost," and finding one that is more useful in the negotiation setting.

MR. BARTEL: There is nothing magic to what I tell clients. I always go back to this car example, and the car example is, if you're making your car payment over three years or five years or seven years, you have different dollar amounts based on amortization period. You have different dollar amounts based on the interest rate

that you're paying.

So the experience you're going to have is really going to have an impact as well. But all of it is a way to finance the benefit. It's a way to change or structure the cash flow, but it's a financing deal. I try my darndest not to use the word "cost," but I try to communicate cost into two pieces. This kind of gets to the definition of actuarial terms. The two pieces are, what's the change in the normal cost rate? This is after I walk through definition of terms, talk about what the normal cost rate is, and help them understand it, as well as change or pay off because of the increase in the actuarial liability. Then I try to translate that into something they understand. Then I say, now here's what happens if you change your financing, if you change your amortization period. So, some people walk away from that with one answer to the definition of cost, and other people walk away with a different answer. But I really always go back to definition of terms and definition of cost and that simple little buy-a-car example.

It didn't really occur to me that Tables 1 and 2 were controversial until I sent this to Paul, who said, "This is really not a strict actuarial definition." It occurred to me that I'm talking to a bunch of actuaries, and here I am putting in a definition of terms that's really not a great actuarial definition. It doesn't include formulas and all of the underlying assumptions and all of that.

Table 1

Actuarial Terminology

- PVB - Projected Value of all Projected Benefits:
  - **Discounted value, at measurement (valuation date), of all future expected benefit payments**
  - **Expected benefit payments based on various (actuarial) assumptions**

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Table 2

Actuarial Terminology

- AL - Actuarial Liability:
  - **Discounted value, at measurement, of benefits earned through measurement**
  - **Portion of PVB “earned” at valuation date**
- Normal Cost:
  - **Portion of PVB "earned" during current year**

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But it is an attempt to put down into English really what, in this case, the present value of benefits says. The example that I always use— you guys know this example as well—is, if you had this much money in the trust, and all the assumptions were met, then the last dollar you pay out is the last dollar that comes out of the trust, right? Everybody has that definition. That’s really all this is.

Now we get to the controversial part, and that is, what’s the definition of the actuarial liability? You guys probably looked at the definition of present value benefits, and thought, "What’s controversial about that?" Let’s talk about the actuarial liability. I try my darndest to get people to understand, to first of all not talk about actuarial funding method. I know it’s hard to do if you're an actuary. But I try to get them to understand that the actuarial liability is the actuary’s representation in this funding process of the value of benefits earned, with quotes around the word "earned" because it’s not really how much people have earned. But it’s kind of using the actuarial funding method. That’s really what it is.

Furthermore, the normal cost rate is the actuary’s representation of the value of benefits being attributed or earned to the population in the upcoming year. And look, if you have assets equal to the actuarial liability, then your contribution is the normal cost rate. So, I e-mailed this off to Paul, and he said that people are going to be bothered by that."

Is Paul right? Are you bothered? No, not so much?

MR. ANGELO: I think part of our conversation was that I've spent much of my career trying to convince people that it's not the benefit earned and using terms such as allocated and all of that.

MR. BARTEL: Absolutely.

MR. ANGELO: But I can also admit that , depending on the context, this might be close enough. I hope you don't find yourself in a place where what they're battling over is changing funding methods.

MR. BARTEL: No.

MR. ANGELO: In which case you might have a little difficulty with the definition.

MR. BARTEL: No, no, no, that's a different deal. Then I would have to go through explaining why earned means two different things.

Paul suggested a show of hands. How many would do what I do, and how many would not do this? So who would do it, or has done it? About three people.

MR. ANGELO: So this is close enough, at least at most levels, for an understanding of the ideas and the difference between earned and allocated, and you don't have to worry about that. How many people would agree with that?

MR. BARTEL: Would agree with that? Me, I agree. How many would disagree? Interesting. Strongly disagree? I know you want to put your hand up. I can see it going up.

MR. BARTEL: Whenever I'm in a negotiation process, that picture that was up there (Figure 2), that I learned as a young actuary 25 years ago—the circle chart, not always the words—is there. It's there every single time.

MR. BARTEL: For the record, the comment is: Is there really a need to go into this sort of detail? My comment is that if you're talking with a retirement system board, a more sophisticated group, I think I agree with that.

However, I have found it to be unbelievably useful in talking with unsophisticated groups. They understand the word "earned." Public sector entities are concerned that one set of taxpayers may be paying for another set of taxpayers' services. So, that whole issue is really a big deal. They understand that, and unsophisticated people understand that concept. So I found this to be far more helpful when the people didn't understand than when they do. When they do, I don't think you need this sort of thing.

MR. JEREMY GOLD: I just wondered, does it bother you, any of you, that in a

world that is increasingly demanding transparency, we can't answer a simple question like what's the cost of the benefits we're providing?

MR. BARTEL: I'll give you my answer. It bothers me greatly. My two cents' worth is, I think it is very problematic for the actuarial profession that we can't answer that question. And that's one of the reasons, if you want to take a step back—again, I'm a little biased about this—if you go back and look at the way the accountants have promulgated their standards, they have taken—FAS 106 is a great example—some of our job because we didn't do a very good job of saying what the heck we do.

So, I think it's very problematic. Frankly, I don't know whether very many actuaries agree with me or not, but I think it is.

MR. GOLD: You and I had a discussion about this before. The question becomes, would the public better appreciate us saying things like 'I'm 95 percent sure that the answer is between two enigmas.' Would that give them greater confidence? Because, well, I don't want to.

MR. BARTEL: The question really is, would the public or the buyers of the services or whomever appreciate what we say more if we phrased things in a fashion that had confidence intervals or confidence levels? I think that's a great question, I really do. Pension actuaries don't think in those terms. We typically look at each assumption and we say, "I think that's the best assumption." Best assumption sometimes means half the time you're wrong, and the other half of the time you're wrong. It's just that one is high and one is low. You look at that and you determine contributions. Not very often are you ever going to be right.

On the other hand, if we take a step back and look at the way—I'm not an expert on this—the casualty actuaries present their information, they say ,"You tell me, what confidence level do you have that the number will not be greater than this?" And if the answer is 50 percent, it's at one level, and if it's at 95 percent, then you get a different answer. I'm not going to suggest to you that we ought to all go off and do valuations in that manner, but I absolutely think we ought to think about it.

MR. GOLD: I had a client that was 100 percent funded. And I said okay, what does it mean? And so I simulated it four times, and got funded statuses from 50 percent to 150 percent. So the problem is, the range can be really broad.

MR. BARTEL: That's really an important point, and the comment really is, if we did do what I just suggested, the level of confidence and the range of funded status or contributions may be so large as to be useless. And you may very well be right.

PANELIST: I wanted to tie in your idea of given what we invest in, and your remark that that's a financing element. Might it be reasonable to say, for example,

that the cost of a benefit is what you could buy it for in the marketplace—say, a deferred annuity from a competitive insurer—and that everything else is a financing, that everything else amounts to going short bonds and long equities and trying to predict the result of that? No wonder we don't predict it all that well.

MR. MCCRORY: My answer would be no, that would not be right because no market exists for the kinds of annuities, deferred annuities, that we give in public plans. There's no insurance company in the world that's going to sell the kind of formula that Ron sponsors, that's related to pay and fully cost-of-living adjusted.

MR. BARTEL: With the unknowns built in. What are pay raises going to be?

MR. MCCRORY: Right. And without a real market, there is no market rate. You may try to infer a market from insurance deferred annuities, but that is not a real market for these annuities.

MR. BARTEL: I know you're going to respond, but let me add a little bit to that. My opinion is that if you took that approach in the public sector market, it would look like you were coming down because of the magnitude of the numbers opposite the labor side, and you would probably not get much further business.

I'm not saying that's a bad thing, I'm not saying that should change your answer, I'm just saying that I think that would be the end result.

MR. GOLD: I couldn't agree more. And nobody in the public sector pays me, which makes me pretty independent. First, I would tell you that I don't consider future salaries, although they're difficult to estimate, as having anything to do with the liability that I define, which is the cost of buying the deferred annuity for what's accrued.

However, I would say, regarding the comment that the CalPERS folks have designed some extraordinarily difficult-to-match liabilities compared to public markets, that maybe if we had more transparency, we would design benefits that were not so hard to match the public markets. And what, other than satisfying political demands, is the virtue of designing benefits that are impossible to hedge or price in public markets?

MR. BARTEL: Because I find this interesting, at the risk of continuing this, I think you're right on point in terms of designing benefits. The problem is, that's not the world we live in. In the world we live in, benefit formulas are driven by the legislative process, they're driven by the bargaining process; they're not driven by actuaries. You could argue that maybe they should be, and you could argue that we

should be doing more. I will absolutely be one that argues for that, but that's not the reality. The legislative process is just not an area that we do well in.

MR. GOLD: Changing the subject slightly back to how do you communicate this terminology, something that I've found over the years is that the lay population is much more adept with insurance terminology than they are with pension terminology. So, using terms like "premium" somehow rings a chord with them, and they catch on real quickly. If you say, "You've been paying these premiums since this guy was hired. If you improve benefits, not only do you owe me these increased premiums prospectively, but all the past increases in premiums that should have been paid." They say, "Ah-ha," and you never have to mention accrued liability and normal costs. So, just for what it's worth, the insurance terminology seems to work so much better.

MR. BARTEL: I think that's an excellent suggestion. I really do agree with that.

FROM THE FLOOR: Let me follow a question. None of this is for Ron or for John because I like that idea as well. This isn't true so much now, but in the late '90s, when we had overfunded plans—and I guess CalPERS is a good example—what is the premium analog for the fact that the insurance company says, "You don't have to pay any premiums for five years because blank." How do you fill in "blank" without using the term liability? I don't know, do you call it cash value or what?

FROM THE FLOOR: I guess, again, not having been brought up in the insurance business but sort of in universal life products, it's somewhat similar to being invested in the market. If it builds up a surplus, they'll let you take the premium, the paid-up benefit kind of thing.

PANELIST: Sure, if your cash value grows to a certain level, you can pay your premiums out of the cash value, right?

FROM THE FLOOR: Right, so in this case, cash value sort of becomes the analog, I can see where it might go. Okay.

MR. BARTEL: In the interest of time, I have to cover this point because this morning in the Taft-Hartley section, there was a comment made by somebody that was vital to the negotiation process and public sector. They were the exact same words, and those words are, who owns the assets?

The bargaining groups know who owns the assets and typically, the employers know who owns the assets. It's just that their knowledge doesn't always coincide. It's an important question that will absolutely be asked. It's also a question that will never be answered. You can't answer it.

MR. ANGELO: I guess the one comment I would make—I'll let the lawyer correct me here—and this is slightly oversimplified, but we have three markets with three very different answers. On the corporate side, when you get down to actually who gets to spend the money, the company owns it, and they can do whatever they

want with it. On Taft-Hartley's side, again by law, it goes to pay benefits, period. In public sector, it is clearly established in law that there is no answer.

MR. BARTEL: Yes, that's right.

PANELIST: And that's the beauty of it.

MR. BARTEL: Yes.

PANELIST: Did I get that right? Is there an answer?

MR. BLUM: Well, there's the legal answer, and there's a practical answer. The legal answer is real simple: it's the trust that owns the assets. The question is, for whose benefit must they be used? That's what you argue about.

MR. BARTEL: I think that's an answer people absolutely will understand. I wanted to take two minutes in talking about interest arbitration. I know it's not unique to California, but what is interesting to me about interest arbitration is, in California, the way the process works. Typically, you have three people who sit on a panel, and issues that are part of the negotiation process, that have been, for the sake of argument, at impasse, are put to the panel.

The way the panel is set up, usually the employee group picks one member, so you know how that person is going to vote. Then, the management picks somebody else, and so you know how that person is going to vote. Then, they agree on an independent arbitrator. The very first time I actually did this, I testified at an interest arbitration hearing. The attorney turned to me 15 minutes before we went in, we'd gone through all the prep work, and he asked, "So, have you ever testified in an interest arbitration case before?" He knew the answer to that, and my answer was no. He said, "Let me just tell you, you're going to have fun with this process because it's like court in the Old West, except people don't sit around with six shooters, and your odds of being alive at the end are pretty good." Understand that the primary arbitrator is the one who controls the process, so it's different than testifying in court. But it's a kick. Your job, if you're doing this sort of work, is to help the arbitrator understand so that he or she can make an informed and intelligent decision.

FROM THE FLOOR: What side might hire an actuary?

MR. BARTEL: Either side can hire an actuary. I can only tell you in my experience,

the entity that hires the actuary more often than not is the agency. The bargaining groups, in my experience, don't always go out and hire an independent actuary.

MR. ANGELO: I think we're out if time. I want to thank John and Bob for sharing their insights with us. Thank you very much.