The Local Challenges of Pension Reform

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Abstract

This paper is intended as an analytical report for elected and or administrative officials of local California governments including cities, counties, special districts, and schools. The information within this research paper will be helpful to all who are currently concerned with the decision process on pension reform including organized labor and consumer groups, but since the elected officials in these agencies may be the ultimate ones that are responsible for the decisions on pension reform the report is tailored to that audience. It is somewhat difficult to truly grasp the scope and history of governmental defined benefits systems in California so this paper covers the historical basis of how most defined benefits in California were established and how they have evolved to what they are today. Not all local government agencies are part of the California Employees Retirement System (CalPERS), but I chose to use the CalPERS system as a model for a reference and comparative analysis to properly illustrate historical and present examples.

The current environment in California and across the nation is one in which governmental defined benefit retirement systems are under scrutiny and in some cases under an all out attack. The paper addresses many of the issues that have caused such intense review of the defined benefit system and illustrates many of the alternatives that have or will be considered in the future. To consider the alternatives one must understand what is commonly accepted as the

definition for defined benefit plans as compared to alternatives like defined contribution plans or hybrid plans and the paper explains and illustrates each.

Defining Pensions and Retirement

As one seeks to understand a common definition of what a defined benefit plan is it might be timely to give thought to what the definition of retirement is. Retirement, as defined by the Encyclopedia of Human Health (EHD, 2010) can be where one withdraws from active work as undertaken by the older adults, but the Encyclopedia also makes the point that since it is a social construct it is constantly being redefined. If one pauses for a moment to consider what we think retirement truly is we might come to the conclusion it probably varies in opinion quite substantially by individuals and groups. My late father, as a long time working farmer, considered retirement was when he did not have to get up at 4:00 am to change the irrigation water but rather he could sleep in until 6:00 am.

EHD (2010) went on to state that social norms play a large part in what we as a community or society believe the definition of an older adult truly is. The baby boomers may be redefining what older is by returning to the work place and in some cases staying in the job longer than their predecessors. Elected officials, when studying the definition of retirement, should think about whose perspective they are considering and that there may be a variety definitions even within their own agencies. Since elected officials of local government represent both the employers (tax payers), and the employees (agency workers), a balance in thought is critical when identifying not just the definition but the consequences of the definition. An example would be having morning coffee with constituents at the local coffee shop on the corner, which many of us do, especially in a smaller rural county like mine. As the discussion builds about pension reform from stories that have been seen in the local newspaper almost weekly, one of the constituents asks you to explain what this 3% at 50 for the local police force really means. As the elected official explains that one must multiply the number of years served by 3% at the age of 50 and that number times your pay is your life time pension, it might have different responses depending on your perspective especially considering the condition of one's own 401K. The thought that someone could retire with 30 years of service at the age of 50 with 90% of their pay the rest of their lives might be hard to understand or in this case to swallow. On the other hand a police officer that was sitting at the table might weigh in with the point of how not many actual line officers get to retire with 30 years of service because they started their profession late in their twenties or early thirties and will not ever achieve the 90%. This is not meant to take issue with this formula at this point but it does give an example how retirement may mean different things to many different people.

Phased retirement or gradual retirement as defined by the Encyclopedia of Career Development (2010), has been when older workers remain at their current employer but gradually reduce their work time until they eventually fully retire. While analyzing this issue, I as an analyst and as an elected official, considered that some of the retirements I have seen in my own county are in a way a new version of this theory. The employees do not remain working at the same employer but choose to retire to maximize benefit or they may be concerned about the viability of the system. With their retirement in place they phase into another career and or job to supplement their retirement, or to be able to afford medical coverage until they are eligible for Medicare. My point with this entire discussion is that it is the elected officials responsibility to consider all possible scenarios of what retirement means if one is going to select, adjust, or reform existing or future retirement formulas. An additional consideration might be to think about some type of hybrid phased retirement formula that could work in government entities.

It is important to consider that the retirement definition between public safety employees and the miscellaneous staff might also be considered a different thought process. Safety that can retire at 50 or 55 may be considering a second career versus a miscellaneous employee that has a formula that requires one to work until 60 for full benefit and may choose to even work longer to have an adequate retirement to be fully retired. Without throwing too much in the pot here so quickly it must be noted that retirement with or without post retirement medical benefits also has a whole different twist to retirement. Both safety and miscellaneous employees that retire without post retirement medical, and they are too young for Medicare, possibly will consider the need to go back to work just to pay for their medical cost for themselves and or their families.

When searching for the most common known definition of defined pension plans one of the best and easiest sources for elected officials is to go to InvestorWords.com. I mention this as quick sources of finding definitions of words, phrases, and acronyms are important tools to have while dealing with the complexities of modern government. In this particular case InvestorWords.com (2010) defines a defined benefit pension plan (DB) as "a company retirement plan, such as a pension plan, in which a retired employee receives a specific amount based on salary history and years of service, and in which the employer bears the investment risk. Contributions may be made by the employee, the employer, or both".

The defined benefit plans (DB) place the investment risk on the employer in contrast to the defined contribution plans (DC) that many Americans have where wages are collected and put into plans such as 401K's, 457's and other plans where the employee takes the investment risk. Those that work in this area of expertise, and as part of their careers the discussion about DB versus DC plans are tossed around like bean bags and lately it seems more like hot potatoes, but it is imperative to remember that not all employees, employers, fellow elected officials, and the general public are familiar with the terms and or the acronyms. As elected officials it is important when engaged in conversation in the general public one should give adequate time at the beginning of the discussion to explain the terms “defined benefit plans and defined contribution plans” and one should seek consensus that it is clear to all before continuing the meeting. As both an analyst and as an elected official I have made the mistake of not clearly explaining the definitions and their differences and it can cause irritation before the conversation has the time to really consider the subject.

Finally, as one considers definitions of retirement plans the term hybrid comes up more and more of recent. This hybrid definition as it infers is a blend and in this case it is a blend of both the defined benefit pension plans (DB) and the defined contribution plans (DC). What may be missed by many these days is that there are most likely a considerable number of plans of the hybrid design already in existence in California. If you are a Kings County employee and in a management position you currently have a 2% at 55 (DB) and you also have a 457 plan (DC) available in which you can contribute and the county will match a certain amount with a maximum limit (Picard, 2010). The hybrid that is being tossed around by some these days is more in the line of reducing the defined benefit pension (DB) formulas and adding a defined contribution (DC) component as a supplement. This idea would transfer some of the earnings risk back to the employee because the defined benefit portion is being reduced. The contribution match rate by the employer of the defined contribution (DC) portion would be bargained during contract periods but would not be vested. It is important to note any reduction of the defined benefit (DB) portion cannot apply to current employees under current statute and case law and this type of reduction plan would only be possible with new employees. This does not mean you could not add a 457 plan for existing employees but you could not reduce the defined benefit portion for existing employees in the process.

The word vesting in this context has two different meanings. In an interview with Peter Mixon (2010), the Chief Counsel for CalPERS, we discussed vesting and its definition in both uses when it comes to California pension law. When an employee is hired into a local agency that is a member of CalPERS they must work 5 years to be fully vested, which means qualified for full benefits, but Mr. Mixon (2010) made the point that after the first day of work they are part of the existing promise bargained and contracted for by employer and employee. The employee must complete their side of the pension contract by working and achieving the 5 year vesting requirement period (Mixon 2010). This is an important point that employees and some employers may not think about. Hiring a person to a job in local government in California is a very special decision as it is not just a place to work but it is part of a unique benefits system protected up by statute and case law. Counselor Mixon (2010) explained vesting rights as far as it is concerned about the requirement of promise made and promise kept is covered by sections of the California pension law but is supported in case law. The following is the recommended sources and information provided by Mr. Mixon (2010) that sums up the practice and law pretty concretely. There are very clear explanations in this text on how to understand the ramifications and rights of vesting and I recommend it be read carefully and please consider cutting and pasting this portion to share with colleagues as it seems infrequent that we elected officials get our hands on such clear explanations of law and precedence. The subsequent information by Mr. Mixon is from Miller v. State of California, 18 Cal.3d 808 (1977).

For the vesting schedules, please take a look at the following Government Code sections: 21060, 21061, 21062, and 21074. The general rule, including locals, is that a member must have at least five years of service credit to be eligible to receive a retirement pension. Section 21074 sets forth an exception for Tier 2, State Miscellaneous employees – ten years of service is required. "[I]t is well established that 'public employment gives rise to certain obligations which are protected by the contract clause of the Constitution, including the right to the payment of salary which has been earned.' (Kern v. City of Long Beach, supra, 29 Cal.2d 848, 853, 179 P.2d 799, 802.) Accordingly, this court has repeatedly held that '(s)ince a pension right is 'an integral portion of contemplated compensation' (citation) it cannot be destroyed, once it has vested, without impairing a contractual obligation.' (Id.) We have also held that the right to pension benefits vests upon the acceptance of employment (Dickey v. Retirement Board (1976) 16 Cal.3d 745, 749, 129 Cal.Rptr. 289, 548 P.2d 689; In re Marriage of Brown (1976) 15 Cal.3d 838, 845-846, 126 Cal.Rptr. 633, 544 P.2d 561; Kern v. City of Long Beach, supra, 29 Cal.2d 848, 855, 179 P.2d 799; Dryden v. Board of Pension Commrs. (1936) 6 Cal.2d 575, 579, 59 P.2d 104), even though the right to immediate payment of a full pension may not mature until certain conditions are satisfied. As we stated in Kern, 'It is true that an employee does not earn the right to a full pension until he has completed the prescribed period of service, but he has actually earned some pension rights as soon as he has performed substantial services for his employer. (Citations.) He is not fully compensated upon receiving his salary payments because, in addition, he has then earned certain pensions benefits, the payment of which is to be made at a future date. While payment of these benefits is deferred, and is subject to the condition that the employee continue to serve for the period required by the statute, the mere fact that performance is in whole or in part dependent upon certain contingencies does not prevent a contract from arising, and the employing governmental body may not deny or impair the contingent liability any more than it can refuse to make the salary payments which are immediately due.' (Kern v. City of

Long Beach, supra, 29 Cal.2d 848, 855, 179 P.2d 799, 803.) Although vested prior to the time when the obligation to pay matures, pension rights are not immutable. For example, the government entity providing the pension may make reasonable modifications and changes in the pension system. This flexibility is necessary 'to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system and carry out its beneficent policy.' (Kern v. City of Long Beach, supra, 29 Cal.2d 848, 854-855, 179 P.2d 799, 803; see also Wallace v. City of Fresno (1954) 42 Cal.2d 180, 183, 265 P.2d 884; Packer v. Board of Retirement (1950) 35 Cal.2d 212, 214, 217 P.2d 660.) In Wallace, referring to Kern, we again emphasized 'that a public pension system is subject to the implied qualification that the governing body may make reasonable modifications and changes before the pension becomes payable and that until that time the employee does not have a right to any fixed or definite benefits but only to a substantial or reasonable pension.' (42 Cal.2d at p. 183, 265 P.2d at p. 886.) The scope of permissible modifications of vested pension rights was established in Allen v. City of Long Beach (1955) 45 Cal.2d 128, 287 P.2d 765, and Abbott v. City of Los Angeles (1958) 50 Cal.2d 438, 326 P.2d 484: 'Such modifications must be reasonable, and it is for the courts to determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.' (Allen, supra, 45 Cal.2d at p. 131, 287 P.2d at p. 767.) '(I)t is advantage or disadvantage to the particular employees whose own contractual pension rights, already earned, are involved which are the criteria by which modifications to pension plans must be measured.' (Abbott, supra, 50 Cal.2d at p. 449, 326 P.2d at p. 489.)"

The information provided above , even in this legal format, if read carefully and with a mind set of common sense helps one to understand that the promises made in California governmental defined benefit plans (DB) seem to have legal standing and therefore employees have vested rights. If one accepts this premise then reform can be embraced with the knowledge that if savings and reduction of risks are sought it will come from new hires and modifications to other elements of efficiencies and employee cost. A possible exception however could be if it was agreed upon between agencies and employees they could modify contribution agreements where the employer has picked up the employees portion as long as that is in compliance with current California Law.

The Historical Perspective

As previously stated in the abstract this paper is not strictly based on the CalPERS model but since CalPERS is the nation's largest state government pension system both its historical record and its influence on other defined benefit trends it is important to spend some time here illustrating key historical events at CalPERS. CalPERS were established by law in 1932 and became operational for state employees later that year (Facts, 2010). To put this in perspective social security was not established until 1935 (Social Security, 2010). In 1939 local public agency employees and school classified employees were allowed to contract with CalPERS (Facts, 2010). The initial legislation determined the organizational structure of CalPERS but it also had incorporated fairly tight restrictions on how the trust funds could be invested. A public proposition (Prop 21) passed in 1984 substantially changed the game on investment strategies as it allowed CalPERS to invest up to 25% of the assets in public equities (stocks) (Facts, 2010). The change that allowed the board of administration to have absolute and exclusive powers over the administration and investment of the funds of CalPERS came in 1992 with the passing of Proposition 162 (Facts, 2010).

There has been many changes to the California Public Employees' Retirement Law through the years but the legal changes that I believe have directly affected the pension crisis today, and were the public policy decisions that set in motion the current focus and rethinking of asset classes, assumed rates of returns, and defined pension reform, were SB 400 passed in 1999 and AB 616 passed in 2001. In a written and oral testimony in April 2010, before the Little Hoover Commission of California, I went on the record to say that in my opinion these two laws may be considered as two of the worst public policy decisions in California's history. SB 400 did have some constructive clean up language in it that was helpful to State employees but the disaster was that it put in motion a safety formula for State safety patrol as rich as 3% at 50 years old and it would be retroactive to all years served when adopted. As an example this meant that those safety employees that were under 2% formulas for the last 20 years could have their retirement made retroactive to 3% at 50. This hard fought and negotiated law would further complicate the issue as by itself and following legislation would allow local agency employees, if they could bargain for it, to get the same 3% formulas. As an elected official of a local government that was serving at the time of this change I witnessed a bidding war that was real and or perceived for safety officers between state and local and local agencies against local agencies which caused most local safety formulas to move to 3% at 50 or 3% at 55. The possible unsustainable formulas that some agencies now face in public safety came from the action of SB 400 and the lack of good thought processes about the possible unintended consequences of risk. What adds to this poor public policy decision is that the legislation did not require agencies to have a public meeting to discuss the changes with the very citizens who in fact would be responsible for all the market risk and it did not require independent actuaries to study the impact of the financial risk to the agency.

AB 616 was passed in 2001 was the same type of change but in some ways much worse. This bill was more specifically to give local agencies the right to change their miscellaneous employee formulas to as high as a 3% at 60. The reason this has been so damaging, besides having the same retroactive consequence and a lack of transparency components, it put local agency managers in a precarious position to negotiate with the unions for the enhanced benefit, advise the elected body on the possible enhancement and the justification, and then receive the negotiated benefits themselves. A manger could negotiate the terms, is part of the process, work a few more months and could have enhanced their own personal retirement from a 2% formula to 3% at 60 and it was fully retroactive.

The economic woes of the nation and California have severely impacted the local government's ability to provide needed services but local officials in most part have stayed in favor by local citizens. The decisions to enhance retirements under the legislation of SB 400 and AB 616 have in some ways caused constituents to question the integrity of the process because the decision came with the lack of transparency, accountability, and the nature of the risk taken could have substantial impacts on local government finances. Gerald W. McEntee (2006), when writing on what he felt was the new crisis of public service employees, discussed several areas of concern with one of them being that of pension reform. McEntee (2006) related the pension reform crisis as kin with the past movement to privatize social security and the reaction after the down turn of the stock market in 2000-2003. The historical significance of past attempts to reform government pensions in California is important here as past reform movements have been more isolated to small groups and politicians that have not had a large citizen base to support their movement. It appears due to tougher economic times and more scholarly investigations the pension reform movement does have traction. Even Mr. McEntee (2006) stated that the main battle front on this pension reform movement is coming from public opinion.

Financial Crisis in Local Government

There is much speculation in California currently about the financial condition of local governments and how the pension systems are much of the problem. The current financial crisis of local governments certainly is with us but it might be over exaggerated to put the main thrust of blame on defined pension plans up to this point. As we look at the current formulas and promises made it might clearly demonstrate there are some real problems in certain agencies when one studies the employer contribution rates and where those rates will be headed in the future. It is however important to acknowledge that the financial problems in many local governments are not necessarily caused just by pension contributions. The Public Policy Institute of California (PPIC) in a report issued in December, 2009 and written by Neiman & Krimm (2009) began the report by acknowledging how hard local governments have been hit by the economic downturn in California. A premise that I consistently remind my colleagues in both State and local government is the fact, “unless you are incarcerated or deployed out of the state all Californians live in local government”. The old saying of how all politics are local should have went onto say “and so is the budget”. The state and local financial problems are therefore affecting the services to all Californians.

The State of California, because of the down turn in the economy and their own budget problems has had to borrow or appropriate revenues from local government (Neiman & Krimm, 2009). The report used surveyed data collected in 2009 and the survey was structured to measure how local governments were handling the budget crises (Neiman & Krimm, 2009). The following outline illustrates the key issues of the findings of the PPIC.

1. Seventy-five percent of those cities and counties that were surveyed had freezes and layoffs during the 2008-2009- budget year.
2. Counties had cut their planning and zoning departments budgets by an average of 7%.
3. Cites surveyed had cut their reserve fund contributions by almost half while some cities had cut the contribution out completely.
4. The respondents generally did not see a fall in property taxes in the first year of the recession but did see a fall in 2009-2010.

Nearly one fourth of the responding cities considered their financial situation to be rated poor while 50% as rated there condition to be fair (Neiman & Krimm, 2009). None of this by any means is meant to say that pension cost are not a contributor to the financial woes of local government but it is to illustrate that the problem has been critically influenced by the global down turn , the general California economic condition, and the management of the State budget. Neiman & Krimm (2009) closed their summary statement with the following, “We see little light at the end of the tunnel for local governments in the short term, since cutbacks in State services are likely to continue or get worse”. Unfortunately they were correct as the May revise recently announced by Governor Schwarzenegger could have a devastating result on the local governments of California especially to counties.

Investment Returns an Asset Classes

One of the great challenges for defined benefit plans is that the system that manages the assets and makes the investment decisions must achieve the actuarial return from which the promises were made or the contributions by the employer must be increased. A good example would be that up to this point CalPERS has used a 7.75% return on invested assets that each agencies have in trust at CalPERS. This means that at the end of each year CalPERS, on average, must earn an amount of at least 7.75% from its investments in order to achieve the actuarial assumed rate of return. The way the return is best achieved to compensate for risk is to have what is called an asset allocation strategy that spreads the investment and risk across different asset classes. In the CalPERS asset class mix they use public equities (stocks), fixed instruments (bonds, etc.), alternative investments (private equities and other like investments), real estate, inflation linked assets (commodities, infrastructure, etc.), and cash.

If the return strategy does not work or if the global or the domestic economy has significant problems the fund will not achieve its annual return and the risk is born by the employer. The theory that establishes the risk and reward factors and used by many is the modern portfolio theory (CalPERS, 2010). The theory basically assumes a higher return premium for riskier assets (investments) (CalPERS, 2010). Elected officials should be concerned about the asset allocation and the investment returns strategy as it could have a profound consequence on employer contributions. The current movement by some to push for a more conservative approach could force some fund managers and boards to reduce their assumed rate of return and therefore causing higher contribution rates paid by the employer, but one must consider it would also reduce the risk. It is important to note that if a promise was made on certain criteria models of investment returns and those return rates are lowered they do have a direct influence on contributions rates. Local agencies should take an active role in the asset class workshops at CalPERS or at their own pension managers. These workshops are done every so often, usually determined in policy, and are to analyze the asset class and return strategies. It is imperative that the asset classes and the assumed rate strategies are set by transparent, scholarly, verifiable, and independent calculations that are not influenced by political pressure in any way.

At his point it might seem obvious that the up and down cycles of the markets and investments could play havoc with employer budgets because the contributions could vary substantially from year to year. CalPERS established a 15 year smoothing employer rate policy that spreads the ups and downs of markets returns over a 15 year period and reduces the volatility in employer contributions (CalPERS, 2010). Every three years CalPERS, as other investment systems do at some designated frequency, reevaluates both the asset class allocation strategy and the assumed rate of return. The rate of return of 7.75% has been challenged by some across the nation who do not think that CalPERS or other government pension plans can earn this return for a sustained period of time. As I discussed earlier this is important to remember that if the assumed rate of return is lowered there is a direct correlation to an increase of employer rates. This is because if the CalPERS actuary, who has the responsibility to set the employer contribution rates, evaluates the promises that are vested and the return on investment has been reduced, subsequently on an actuarial basis the employer rates must be adjusted to compensate for the difference unless negotiations and law allows employees to shoulder some of the increase. There are other actions of course that can cause an increase in employer rates including higher than assumed employee payroll adjustments and if actual returns on the portfolio are less than the 7.75 % assumed rate of return.

Due to the great recession and the consequences it has had on the returns of pension funds nationwide, there is an increasing pressure to focus on the viability of defined benefit pensions and especially on how the possible lower expected returns will influence the financial conditions of local governments. A good example of the sentiment by many across the nation are expressed in the remarks by FitzPatrick and Chu (2007) when they commented how that the once gold standard defined benefit system has fallen on hard times and may be an endangered species. The authors were writing about the corporate world but there are interesting parallels to the current local government situations in California. The parallels exist when you consider that if some government defined pension plans, that were contracted for but which may not be sustainable long term, then they share the same impact risk as their corporate counter parts which in both cases could cause a major restructuring of operations and or services. The promises made under SB 400 and AB 616 could, either directly or by perception, cause extraordinary pressure on the fund managers to consider investment strategies to achieve a rate of return to meet the promised benefits that are riskier than prudent. Trends and recommendations are discussed in other parts of this paper more thoroughly but it would be noteworthy to mention how some of the trends and alternatives that are being suggested will have a direct influence on strategies and employer contributions. It is also noteworthy at this point to provide a direct quote from Jeffrey R. Kamenir (2009), as it will set the stage for further discussion on return on investment strategies. Kamenir (2009) provided this opening statement “It is highly unlikely that many new defined benefit (DB) plans will be established under the current DB plan system, which is unfortunate given a DB plan’s ability to provide retirees with predictable retirement income that will not run out”. The reason this quote was important in the context of the discussion of investment returns and strategies is because the proposed new DB plans in the article demonstrate a shift in investment returns and therefore a change in returns and employers contributions.

In the proposed DB plan example, plan sponsor contributions would be invested in instruments such as money market accounts where the intent is to have a stable value of principal, and the value of the liabilities would be calculated utilizing a mandated stable asset-type interest rate assumption published by the IRS (Kamenir, 2009). Even though these recommendations were for the private sector it parallels those that feel government pension plans should be based on return strategies with little to no risks that come from fixed instruments such as (bonds). The outcome of course of lowering the expected investment return, to say a bond return of 5%, could have a profound result on what type of defined pension agencies could offer to new employees. It could cause a substantial increase in contribution rates by the employer to maintain the current type of plans contracted in California for existing employees. The lowered return strategy by most of those considering the approach seems to be to reduce retirement formulas to match the lower and less risky rates of return. It would seem obvious if one reduced the assumed rate of return on existing assets it would have a direct impact on the employer contribution rates because the existing plans are vested and the pension plans cannot be altered to adjust to the lower assumed rates of returns and since the employer assumes the risk of investment returns their contributions would go up accordingly. It was my initial thought that since the actuaries set the rates by contributions going forward to meet the commitment of retires and that of active employees, then the employers are contributing to maintain the assets to cover the liabilities (promise of the pension) and it also would make sense that the assumptions are based on that the entity will continue into the future and there will be ongoing contributions both by the existing employees and new hires. I however tested that assumption by interviewing the interim Chief Actuary for CalPERS, Alan Milligan. He stated that the assumption of liabilities and assets returns and therefore the employer contribution rates are established on a closed system. In other words the employer rate of contribution is based on promises made to existing employees and retirees only and not on new hires but he did admit that a small portion of the assumption might be considered by the premise there will be new employees to contribute (Milligan, 2010). I mention this as local government agencies should be asking their actuaries to assist in calculating the consequences and benefits of layoffs, which is usually by seniority, and therefore the younger employees who would be paying in but were terminated might alter the assumption calculations.

As local government faces unprecedented financial difficulties in California there will be ever increasing criticism about the defined pension promises but more acutely the cost of the contributions from the local general funds. I believe it is imperative before local government takes any action that they have their contracted pension plans analyzed for cost going forward, that they consider their financial ability to absorb increased contributions, and to understand the consequences, good or bad, if the assumed rate of return is lowered. I make this comment because there are many out there that believe that pension plans like CalPERS should lower their return assumptions to a much more conservative model but I warn the decision makers of local government to understand the consequences of that action. The assumed rate of return should not be artificially adjusted due to political pressure but rather based on an independent validation of what is reasonable for the amount of risk the fund is willing to take.

The CalPERS asset class makeup is currently weighted by public stocks holding about 49% of the portfolio. The stock market has been a place for reasonable returns and has the added benefit of being liquid as compared to fixed investments like real estate and infrastructure but stocks have their challenges. It has been a traditional thought that investors with long term horizons would invest heavily in stocks as the premise has been based on the thought that the riskiness of stocks diminishes with time (Bodie, 1995). Bodie (1995) in his study however draws conclusions that the risk of holding stocks increases with time. This finding and other more recent data indicates that returns of public stocks may not return as expected in the past. In a report by Wilshire Consultant group (2010), to the CalPERS board in May 2010, they illustrated that between the years of 1926 to 2009, the historical return on stocks was 9.8 % but between 2000 and 2009 it was a minus 1%. It is true that this period captures the great recession but also captures part of the recovery in 2009. I make this point as there are those out there who feel the new global investment returns will be lower than the past assumed rates of 7.75%. This is the time however not to use panic or politically motivated assumption models, but rather to ask experts in the field to give sound advice of where it seems the trends may be heading. Local agencies that are in CalPERS should take active roles in the asset class workshops and studies and should give input to the assumed rate of return decision process. This can be accomplished by agencies attending the process, having a third party specialist participate on their behalf or by using organizations such as the California Association of Counties, League of Cities, Special Districts Association, School Boards Association, or any other organizations that represent employers of California local Governments.

Trends

Given the historical significance of how the defined pension system came into its current status for California public employees and the current financial crisis that has hit most of the local governments it would seem to be important to review what trends are taking place that might influence the pension reform movement. I think from my perspective it is no longer if there will be pension reform it is how far it goes and who will become the key players in the reform. As a county supervisor I of course see the financial condition of my own county and because of my positions as the President of the California State Association of Counties, and as a board member of the California Employees Retirement System (CalPERS) I get to interact with the financial conditions of other local governments and the key players of pension reform.

One would think that this type of reform will come from consumer groups, political leaders in the State legislature, and of course leaders in local governments who truly understand the current conditions of their employer contributions. I believe shortly there could be a new sheriff in town and that will be the Federal Government. At a briefing in May, 2010 by the Federal lobbyist for CalPERS, Tom Lussier (2010), the board of admistration heard him state that after the financial reform legislation was handled he felt the next major reform issue that Congress would take on was pension reform. Most of the discussion thus far has been about the government pension problems in California but Federal interest may be an indication indeed the problem is wide spread across state and local governments in the United States.

The trend of reform of defined benefit plans in some ways is tracking what took place in the private sector but the private sector of course was playing by different rules and had its own avenues to deal with pension cost if they became too burdensome for the companies to support. Friedberg and Web (2005) when illustrating how defined benefits plans have been changing in the private sector stated that in the last 20 years the percentage of full time employees with defined contribution plans (DC) was 40% in 1983 and by 1998 it had changed to 79%. The defined benefit (DB) covered employees went from 87% in 1983 to 44% in 1998 (Friedberg & Web, 2005). These trend percentages of change however in the private sector have come about by the decisions of new companies making decisions about their plans, employees making choices to have a more portable plan, and of course some companies dumping their plans. In a book titled, Pension Dumping, by Fran Hawthorne (2008) the author explored how corporations have used ERISA, bankruptcy, negotiations, and the courts to dump pension and promises to employees that were staking their retirements on those promises. Hawthorne (2008) did state that there was a silver lining in the dumping of defined pensions by corporations, at least to stockholders, and that was the potential recovery from bankruptcy by shedding the pension liability. Hawthorne (2008) however went on to say that corporations were reluctant to admit it but getting rid of their promises of guaranteed retirement for its employees turned out to be one of the easiest debts to get rid of. Only history will tell but this perceived and real betrayal by corporations towards their employees could have a lasting consequence on how employees feel about loyalty to a company, a product, and a cause.

Even though many corporations have dumped their defined benefits for defined contribution plans in order to reduce cost and risk does not mean that the trend will necessarily go that far in government defined pension plans. Even though many, including myself, that feel that pension reform is happening this does not by any means change my mind on how valuable and efficient defined benefit systems are as compared to defined contribution plans. In a report released by the National Institute on Retirement Security authors Beth Almeida and William B. Fornia (2008), they put together thoughts on the value and efficiencies of the defined benefit system. The values of defined benefits is pretty much universally recognized by employees as being something that is secure and a predictable retirement system that cannot be outlived (Almeida & Fornia, 2008). What may be overlooked however when analyzing the defined benefit system is the value to the employer and in this case, the local government agency? Due to the nature of the grouping of the benefits and the way in which they are administered it is a very cost effective system to administer (Almeida & Fornia, 2008). Due to the longevity of the plan risks and the pooling of the risks of large number of individuals the defined benefit plan avoids the over saving dilemma that can happen in DC plans and therefore do more with less (Almeida

& Fornia, 2008). These types of facts are essential for local officials to study as there are many reactionary comments these days and one might lose perspective on the real value of the DB plans and why they encourage a loyal and stable workforce. The trends that have emerged from the corporate world do not make the trends valid or beneficial. It would be keen to realize that negative trends can grow in some cases faster than positive trends especially if the negative external forces become greater than the internal forces of equity and understanding. The ability to operate local government through many years of uninterrupted service is one of the great strengths of the United States, and the local governments of California have performed gallantly. Some of the general bashing that goes on lately about government and the people that work in government is certainly part election rhetoric but it has had a damaging effect on the morale with some agencies and their employees. Business leaders and elected officials recognize that we are only as good as the people who run and work in our businesses and in our governments. There certainly is a trend for reform but that trend of reform may need to be defined as a real tune up but not an overhaul. For a more numerical justification for defined benefits I end this section with a quote by Almeida & Fornia (2008) who are specialist in the area of pension assumptions and evaluations and who have calculated the efficiencies of the DB versus the DC systems. “Specifically, our analysis indicates that the cost to deliver the same level of retirement income to a group of employees is 46% lower in a DB plan than it is in a DC plan” (Almeida & Fornia, 2008).

Recommendations

Pensions are a vital part of what makes up the local government benefit package which has been instrumental in encouraging many of those working in public service to make it a life time commitment. There is that discussion that maybe the new generation of public service workers will want something more portable and transferable to employment outside of government employment. This line of thinking would make one believe that the new employees coming to government would look back on the recent track record of 401K's and somehow conclude that DC plans have been the best and most risk free investment for their effort and investment. I am one that believes that there will be many combinations of retirement plans that emerge but the defined pension plan will hold its place as the platform retirement plan for California governments and their employees.

Before we get in to specific scenarios of how the reform movement might go or more importantly what is the plan that individual local governments should adopt it would be important at this time to begin by taking inventory of where your agency is, what you can do, and how to form a collaboration of labor, citizens, and government to accomplish those goals. It is imperative that agencies take the time to truly understand their current vested contacts and what that promise truly means and what it is costing them now and what it will cost them going forward. The reason this analysis is so important is that with all the economic pressures taking place at local governments there is going to be continual demand for cash requirements, eliminating cost to stay afloat, and unfortunately as many of us know the eventual cutting of some services. All this pressure will cause more attention than ever to the cost drivers within agencies. Elected officials must have a real handle on those costs and in this case what the pension contribution is and as mentioned earlier, what will the cost most likely be going forward. Those agencies in CalPERS are well aware of the losses in 2007 and 2008 which if combined total about 29% for the two years. When considering that it requires 7.75 % positive to maintain the promises made then a negative of 24% in one year, as it was in 2008-2009, has the effect of a real minus 31.75% of goal. Taking the 15 year smoothing into account of course the losses were spread over a number of years but it will have a significant effect starting on July 1st 2011 for local governments and on July 1st 2010 for schools.

Agencies should begin by getting an analysis of where they are as far as their pension liabilities and funded status from their fund manager and should consider having an independent actuary to validate what the scenario may be going forward. The independent actuary along with the agencies financial team should analyze their employer contributions as they stand today and given much of what has been said in this document and certainly considering the knowledge base the actuary will have, establish a plan going forward of how the increased cost can be mitigated. I state increased cost going forward as the die has somewhat already been cast for agencies in CalPERS. As previously mentioned most local governments in CalPERS will get their first significant increase in rates, due to the losses of 2007 and 2008, starting July 1st 2011. CalPERS took action this past year to ease the burden for local governments over three years starting in July of 2011, but it will resume its full impact at the end of the third year. The information can be obtained from your CalPERS actuary but one should consider the advice of independent experts confirming the assumptions and also giving you independent advice if they feel the assumptions will hold going forward given the possible changes in assets class allocations and or assumed rates of return.

The two questions I get wherever I speak are what the second tier alternatives that are available now and if we need additional legislation to put them in place? To be able to answer the question it is important to first look at what is actually available in second tier plans. CalPERS has published a booklet which it is also available on line, and it is called the Optional Benefits Listing (Optional, 2010). The booklet gives the existing options that local agencies have that are already part of the pension law. It is my own belief that every elected official where their agency is in CalPERS should have a copy of this currently sitting on their desk. The pamphlet is a gold mine of ideas of what the different options cost and of course what the different options can save. Below are the options as contained in the pamphlet for both safety and misc.

Miscellaneous:

2% @ 60 2% @ 55 2.5 @ 55 2.7% @ 55 3% @ 60

Note: There is a 1.5% at 65 that no agency currently uses and it has special provisions assigned to the election but it is included in the options.

Safety Members

2% @ 55 2% @ 50 3% @ 55 3% @ 50

As illustrated above there are several options already available for agencies to go to second tiers which some have already done. I have visited agencies that have formulas of 3% at 50 for safety and 3% at 60 for miscellaneous and one can see the tremendous difference if that agency had a second tier of 2% at 55 for safety and 2% at 60 for miscellaneous. I am not suggesting that by any means but it does show how much latitude there is on the table right now. Given this information the second recommendation is to have your CalPERS actuary give you estimates of the cost or savings it would mean for you moving to whatever second tier you are considering. You will discover, as I am sure many of you have already done so, that it will take many years for it to make a substantial difference and that is for a couple of reasons. First, as we all know, we are not currently hiring many new people, in fact we are doing the opposite and many agencies are laying people off right now. But for those that say it will take too long to make a difference I would advise that if your agency falls into the category that the promises of the past are not sustainable in today’s economy and or the near future, than you must take action or someone might do it for you. By that I mean the State government, a referendum by the people, or the Federal government. “We have met the enemy, and he is us” (Kelly, 1972).

Once you have determined the potential savings from an actuarial basis by going to second tiers make sure that the actuaries and your financial personnel give you a clear understanding of the savings and how long it will take to see improvement. I believe it is imperative that a collaboration of the actuary, financial personnel, human resources, labor, and the leadership can concur about what it means. This is not to say the action should be taken or can consensus be agreed upon, but at least agree on the facts and consequences of the decision. It is imperative that at this point we do not make the mistake we made with SB 400 and AB 616 and leave the public out of the study process. I have recently witnessed public study sessions across the State in open forum that clearly are intended to be transparent and make decisions that are prospective. The decisions of the past are vested and we should move forward to positive actions. There are some agencies that are in discussions that might modify previous decisions that required the employer to pick up the employees share and if that was reversed that can have somewhat of a more immediate financial result.

The third recommendation is to use some real lateral thinking on what the pension plans of the future can be. It is very easy to fall in the trap of reacting right now because things are tough economically and public opinion is growing for decision makers to take some kind of action. The California public should not be under estimated by us or the media on how they understand the importance of a sound workforce and the importance of a dependable retirement. The meetings I have attended clearly show a pattern of having understanding for a retirement system that is transparent, fair, and is economically sustainable.

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