TESTIMONY OF RICHARD STENSRUD

Before

THE LITTLE HOOVER COMMISSION

April 22, 2010

Introduction:

Thank you for the opportunity to appear before the Commission and to share my thoughts regarding the health and sustainability of public pension plans in California, and the public pension plans operating under the County Employees' Retirement Law of 1937 (the 'CERL' or '1937 Act') in particular.

As you are aware, I have been invited to appear before your Commission because of my position as the Chief Executive Officer of the Sacramento County Employees' Retirement System ('SCERS') and my service as the Chairman of the Legislative Committee of the State Association of County Retirement Systems ('SACRS'). While these responsibilities have given me exposure to and allowed me to develop perspectives on the wide range of issues faced by public pension systems, I must note that both these written remarks and my oral testimony at the hearing represent my personal, professional judgment on the issues and do not reflect an official position of SCERS or SACRS unless expressly noted.

At the outset, I think it is important to articulate how SCERS, and the 1937 Act community generally, views our responsibilities: Our job is to serve as the fiduciaries responsible for administering the pension benefit plan adopted by our participating employers and employees. We do not advocate for or against particular benefits or benefit levels. Instead, we strive to be a resource for our stakeholders, serving as the 'honest broker' of information, thereby helping the parties to make informed and well-founded decisions. We also try to assure that the decision-makers understand the fiscal and administrative ramifications of a given decision or course of action.

In the end, maintaining an independent, fair and balanced position with respect to the stakeholders in our systems is critical to preserving our credibility and assuring that the retirement system is being managed in a reasonable and prudent manner.

My written comments and remarks at the hearing are intended to reflect this perspective and goal of serving as the 'honest broker' of accurate information regarding our pension systems.

To that end, in the discussion that follows I will endeavor to provide information on the various topics that I have been advised are of interest to your Commission.

Overview of the 1937 Act Retirement Systems:

The twenty county retirement systems that operate under the parameters of the 1937 Act are similar to the large statewide retirement systems in a number of respects. Those counties are Alameda, Contra Costa, Fresno, Imperial, Kern, Los Angeles, Marin, Mendocino, Merced, Orange, Sacramento, San Bernardino, San Diego, San Joaquin, San Mateo, Santa Barbara, Sonoma, Stanislaus, Tulare and Ventura.

- The focus of the systems is to provide a defined benefit pension plan under the parameters established by the County Employees' Retirement Law of 1937.
    - Plans provide a guaranteed pension benefit based on a benefit formula, final average salary, years of service, and age at retirement.
    - Pension benefits are funded by contributions from the employer and employee and from investment earnings on those contributions. Historically, 70% of the benefits paid to retirees/beneficiaries are generated from investment earnings.
    - Retirement system is a trust fund separate from the county. Trust cannot be accessed by the county and the funds in the trust must be used exclusively to provide benefits and to pay system expenses.

- There is a wide range of sizes (assets, active members, retirees) across the 20 systems, with the Los Angeles County Employees' Retirement Association at one end (approximately $34 billion in assets, 96,000 active members and 54,000 retirees/beneficiaries), and the Mendocino County Employees' Retirement Association at the other end (approximately $256 million in assets, 1300 active members and 1,000 retirees/beneficiaries).
    - The systems are geographically diverse, and are spread across California.

- Collectively, the systems provide pension benefits for more than 140 local government agencies.

- Collectively the systems manage more approximately $90 billion in assets.
    - Median size is about $1.7 billion.

- Collectively the systems cover more than 264,000 active employees.
    - Mandatory participation by full time employees.
    - Membership includes both General and Safety employees.
- Collectively pay monthly benefits to more than 152,000 retirees and beneficiaries.
    - Payments total more than $4.3 billion annually.
- All systems feature local control through a Retirement Board comprised of key stakeholders:
    - Four elected by employees (2 by General members, 1 by Safety members plus 1 Safety alternate).
    - One elected by retirees (plus 1 alternate).
    - Four appointed by the County Board of Supervisors.
    - County Treasurer (or equivalent position).
    - All serve 3 year terms.
    - Fiduciary duties owed to the retirement trust and participants in the system.
- State Constitution vests the Retirement Board with exclusive authority for management of the retirement system.
- Annual audits by independent, outside auditors.
- Annual actuarial valuations by independent outside actuaries.
- Subject to state open meeting/public record laws.
- Administrative costs limited to 0.18% of plan assets.
- Benefit formulas set at the local level by the County Board of Supervisors (or governing body of the participating employer) based on collective bargaining.
    - Options re benefit formulas and cost-sharing are established in 1937 Act.
    - Many counties (but not all) chose to enhance benefit formulas for both Safety and General members after the State enhanced the formulas for its members.
    - Some counties chose to enhance benefits prospectively but not retroactively.

- Systems generally do not administer health care benefits for active employees or retirees.
    - Some systems provide a subsidy toward retiree health care costs.

- Each system invests its assets through a professionally managed, diversified investment portfolio.
    - Investment programs are comparable to and have returns similar to those achieved by the statewide systems.

Differences Between the 1937 Act Systems and the State Systems:

There are some important differences in the structure of and the law governing the 1937 Act systems as compared to the statewide systems.

- Local control means that employers and employees are able to develop a benefit plan that speaks to the circumstances of the local workforce. Since there are fewer key parties than with statewide systems, local plans can be modified more quickly and easily to address changes in circumstances.

- Local control means local impact and local accountability. Plan members or stakeholders can express concerns to the local retirement system (as opposed to a larger, statewide entity) and/or to local officials or labor organizations.

- Local control means the systems are able to develop programs and policies that are consistent with the local perspective on issues and/or the local comfort level with risk or controversy.

- While the 1937 Act systems are independent legal entities, the county has a higher level of involvement than the lead employer in the statewide systems.
    - The county is the dominant participating employer, by a larger margin, with 90% or more of the members working for the county. In contrast, in statewide systems a single employer comprises less than 50% of members.
    - The county is the largest 'debtor' of the system and the county's financial situation and ability to pay is critical to the soundness of the plan.

- Through its appointees and ex-officio representation on the retirement board the county has the ability to maintain de facto control.
    - Most systems continue to process expenditures (including the payment of monthly benefits) through the county.
    - The county continues to control the job classifications and compensation levels for most employees of the retirement systems.

- Given the high level of involvement of the lead employer, the 1937 Act systems do not have the same ability to dictate terms, impose requirements and/or have an adversarial relationship as the statewide systems have with their participating employers.

- The 1937 Act systems operate under a different set of rules governing what counts as compensation for the purposes of determining retirement benefits.

    - What qualifies as 'retirement compensation' is determined based on the rulings in two court decisions (generically, 'the Ventura' decisions). The court decisions changed the previous practice that limited permissible compensation elements. Now, almost all cash remuneration received by the member qualifies as retirement compensation.

        - For example, most regular, recurring pay differentials (e.g. uniform allowances, education incentives, bi-lingual pay, etc.) are considered for retirement benefit determination purposes. Overtime pay is excluded.
        - Up to certain limits, lump sum cash-outs of sick leave or vacation leave prior to termination of employment are considered for benefit determination purposes. Cash-outs at retirement (i.e., via termination pay) are excluded.

    - A further complicating factor is that several 1937 Act systems settled their Ventura litigation before the final court decisions and in some cases those settlements directed that certain types of compensation be counted for retirement purposes even though the subsequent court decisions ruled differently.

        - Those systems are trying to determine how best to 'unwind' such policies.

- Efforts to change the Ventura rules for existing employees presents substantial exposure to potential litigation on the theory that the compensation treatment set by Ventura (or a Ventura settlement) is a 'vested right.'

Bargaining Activity re Pensions at the Local Level:

As suggested by my introductory comments, the 1937 Act retirement systems have a limited role with respect to bargaining – i.e., we do not participate in bargaining per se, we simply serve as a neutral resource for the employer and employees in their bargaining discussions. Accordingly, the comments that follow reflect information that has been shared with me by local participants in the bargaining process. Please note, however, that at this juncture discussions between the employer and employees in Sacramento County is 'pre-bargaining' as the contracts still have a few years to run.

- There appears to be a greater interest in and willingness to discuss pension-related issues at the local bargaining level than at the statewide level. This may be due to the more immediate impact being felt at the local level from the combination of the broad economic recession and the projected future retirement costs resulting from the global market meltdown.

- Both employers and employees appear to be equally motivated to discuss pension issues.

  - The employers appear to be largely motivated by near and long term cost considerations, while maintaining an overall compensation structure that will allow them to attract and retain a quality workforce.
  - The employees appear to be largely motivated by a desire to preserve a reasonable defined benefit plan for future generations of workers, taking into account how the costs for such a plan could impact current and future workforce and compensation levels.

- The employers appear to remain committed to providing a defined benefit pension plan, albeit with lower benefit formulas and reduced costs relative to the current plan.

  - Employers see defined contribution plans as an 'add-on' rather than a replacement for defined benefit plans. Employers note that defined benefit plans out-perform defined contribution plans and offer greater

retirement security, and are thus more successful for attracting and retaining full-career public employees.

- Because of the difficulty in changing plan features for current employees, employers are focused on new, lower formulas and different cost-sharing methodology for new hires.

- Employers are seeking immediate cost relief as well as future cost reductions. Again, because of legal constraints on changing plan elements for current employees, employers see immediate cost reductions possibly coming from changing the current cost-sharing approach when and if possible (e.g., ending employer subsidies of the employee part of contributions).

- Longer term, employers desire a more equitable sharing of pension costs and risks between employer and employee. They believe that a greater alignment of interests in the financial health of the retirement system will reduce the incentives for either side to advocate changes that will result in disproportionate impact to the other party. Among other things, employers believe there should be some type of cost-sharing with respect to unfunded liability, which currently falls solely on the employer.

- Employees recognize that there are important cost considerations surrounding plan design and different approaches to cost-sharing. Employees further recognize that these cost considerations will have an impact on current and future workforce and compensation levels. However, employees have questions regarding whether the current and projected increase in costs is a permanent, ongoing problem or whether it is a short term, aberrational experience.

- Employees appear to be willing to consider 'stepping down' to a lower benefit formula for new hires, but thus far do not appear to be willing to lower the formula to the levels suggested by the employers.

- Employees appear to be willing to consider different approaches to cost-sharing, but believe that cost-sharing needs to take into account the ability to pay and the capacity for bearing risk. To that end, employees believe that if they are going to be asked to take responsibility for some element of unfunded liability, then employees should also share in the cost reductions that come when the plan is more than 100% funded.

- Employees appear to be willing to consider possible changes to the plan design for current employees, but are unsure what would qualify as a sufficient benefit that is 'equal or better' (the legal requirement) than what they would be giving up.

- There appears to be an interesting dichotomy forming on the employer side.

    - On the one hand, employers continue to believe in local control and would like to see more options in the 1937 Act regarding benefit formulas, cost-sharing and the ability to develop hybrid plans (i.e., featuring both defined benefit and defined contribution components) in order to allow employers to tailor the benefits to their particular circumstances and need.
    - On the other hand, employers appear to be forming working coalitions across local government boundaries in an effort to reach agreement on appropriate benefit levels for new tiers and other plan design components. This effort appears to be intended to help prevent a 'bidding war' between employers in a regional labor market.

Possible Changes to the 1937 Act to Facilitate Pension Reform:

As previously noted, the 1937 Act contains the options available to the employer and employee in developing the design for the retirement plan. If the 1937 Act does not authorize a given benefit formula or approach to cost-sharing, then it is generally not permissible unless and until the 1937 Act is amended. The discussion that follows reflects comments and observations that have been made by various parties regarding how the 1937 Act might be improved.

- Expand the 'tool box' of options available in the 1937 Act to give parties more flexibility in fashioning a plan design that fits their objectives and circumstances. This would include additional benefit formulas and cost-sharing options.

- Prohibit 'contribution holidays' by which an employer is allowed to forego making the normal, ongoing retirement contribution because the retirement system is more than 100% funded. The lesson from the market volatility of the last decade is that a reasonable stream of funding needs to maintained even if markets are booming and funding is strong. Dollars not contributed today are dollars not available in future years to mitigate a potential market downturn.

- Eliminate or clarify the term ‘excess earnings’ as used in the 1937 Act. Again, the last decade has shown that investment earnings in excess of the actuarial target in a given year do not represent permanent ‘excess earnings’ and thus should not be viewed as available to be applied toward ad hoc or non-vested benefits. Rather, the excess in a given year should remain available to offset earnings shortfalls in future years.

- Encourage establishment of meaningful contingency reserve funds at the retirement systems. While moneys set aside to fund the contingency reserve will not be available to push downward on costs today, a meaningful contingency reserve can help mitigate the upward pressure on costs due to market downturns in the future. This will help reduce volatility in the employer contribution costs.

- Prohibit retroactive benefit enhancements unless the past service upgrade is paid for by the employee or the additional unfunded liability is immediately covered by the employer.

- Modify the provisions of disability retirement to ‘correct’ court decisions that have arguably expanded the meaning of certain terms beyond what was intended by the legislature.

Observations re Sensible Pension Reform:

The global market meltdown and the broad-based economic recession have put a spotlight on the greatest strengths of and the greatest challenges facing public pension plans.

We have seen how defined benefit plans provide and maintain retirement security in even the most challenging of environments. In contrast to individuals who retired under a defined contribution plan and who saw the value of their retirement savings halved, our retirees were able to count on their normal flow of retirement income. And unlike those other, unfortunate retirees, our plan members were not forced back into the workforce because their retirement income was no longer sufficient to cover their costs. In addition, because our retirees were able to maintain a near normal lifestyle, they were able to continue to inject money into the local economy, creating a ripple effect of economic activity at a time when the community needed it the most.

At the same time, the substantial investment losses have presented a significant cost management challenge for our plan sponsors. This challenge will continue until such

time as the investment markets can generate sufficient investment returns to negate the earnings shortfall and our systems have returned to a stable cost environment.

Fortunately, our retirement systems are endowed with the features that will allow us to address the challenges that face us. First, we are built to ride out market disruptions and to be well-positioned to capitalize as the market recovers. Second, we have the ability to adjust the manner in which we fund the system and/or invest system assets. Third, our plan designs can be changed to respond to new developments.

With respect to this last comment, the questions become: What should be changed? Why should it be changed? And how should it be changed?

In addressing these questions, I would encourage policy makers to consider the following principles:

- Sustainability – What will help assure that defined benefit plans remain available for future generations of public employees? What is a reasonable cost to provide such a plan?

- Adequacy – What is the reasonable level of replacement income that should come from the employer-provided pension benefit? How does the pension benefit compare to other sources of retirement income?

- Shared Responsibility – What is a reasonable and appropriate way to share the cost and risks associated with a defined benefit plan?

- Protections and Accountability – How do you assure that the plans are funded soundly; that the assets are managed in a reasonable and prudent manner; that benefits are administered fairly and in a timely manner; and that abuses are rectified?

Finally, I would caution policy makers against confusing discussion of sensible reforms with the pursuit of highly visible but relatively rare examples of abuse. A prime example is the current focus on 'pension spiking.'

The recent high profile stories regarding pension spiking have clearly put public employee pensions in a bad light. Maintaining public trust in the integrity of public employee benefit systems is paramount and when that trust is jeopardized, it is incumbent on the stakeholders of our retirement systems to address the problem.

I would respectfully submit, however, that these are isolated incidents and do not reflect the experience of public employees generally. Specifically, I believe that the vast bulk

of public employees retire with a pension that is properly commensurate with their regular, recurring compensation history.

That does not mean that I believe that steps to stop pension spiking are unnecessary. To the contrary, as previously noted, I believe that pension spiking undermines the public's confidence in the operation of our retirement systems and should be addressed. I would respectfully submit, however, that the solution to the pension spiking 'problem' must be: (1) Commensurate with the size of the problem; (2) Take into account the differences among California retirement systems; and (3) Be careful that it does not create more problems than it solves.

In considering the issue of pension spiking it is important to understand that whether something is considered pension spiking is often a function of perspective.

For some, a pension tied to anything more than a base salary is pension spiking. This does not take into account, however, that the base salary is often just that – i.e., the base – and that there are regular, recurring additional compensation elements that are part of the normal compensation for the position. As a pension professional I believe that a pension should take into account the full, regular recurring compensation for a position.

For others, there is no spiking if the pension includes a compensation element that has been agreed to by the employer and employee regardless of how much and when it applies. However, this can result in unusual jumps in compensation late in the person's working career and a pension benefit that is not truly reflective of the compensation history over the whole career.

The divergent views make it very difficult to settle on a definition of pension spiking that properly identifies the true scope of the problem. Nevertheless, I would respectfully submit that there should be two points of focus when considering pension spiking: (1) Compensation elements that are not regular and recurring; and (2) Large compensation elements that are introduced late in the working career, and that have not been a regular compensation component in the past.

Together, these factors can not only result in larger pension benefits, but because the compensation comes so late in the career, the retirement contributions associated with the compensation do not have the normal length of time to be invested and compounded in order to fully cover the benefit cost. The upshot can be the creation of unfunded liability, which then must be paid off by the employer. As the entities responsible for assuring the sound funding of our retirement systems, SACRS members are particularly concerned about this consequence of pension spiking.

In extreme cases, the two factors can also result in a pension benefit that is larger than the normal, regular recurring compensation paid to the employee. While such an outcome may be the product of an agreement between the employer and employee, and may be permissible under the law, such an outcome is detrimental to the integrity of our retirement systems and should be prevented.

In the end, I believe that the problems associated with pension spiking can be addressed in a targeted manner commensurate to the scope of the actual problem and hopefully the focus of the discussion can return to the real questions of pension reform.

Conclusion:

Thank you for your consideration of these comments. I look forward to answering any questions you might have.

Respectfully,

Richard Stensrud

Chief Executive Officer

Sacramento County Employees' Retirement System