Executive Summary
Little Hoover Commission Testimony
of Girard Miller
Public-sector consultant and commentator

My remarks today are submitted as an individual and not as a representative of any organization with which I am or was previously affiliated, including my current or prior employers. I would ask that the media follow my written instructions on proper attribution as a consultant and commentator without organizational affiliation.

Nature and Size of the Problem:

Although most people think of pensions, you need to look at all public employee retiree benefits including retiree medical benefits. Almost half of the total deficit is from retiree health care deficits.

In California, our pension plans statewide are approximately 30% underfunded today, and retiree medical benefits plans are more than 90% underfunded.

For California, I estimate the 2010 combined actuarial deficit for all state and local retirement plans to exceed $325 billion, using mainstream methodologies and current market levels.

$325 billion in retirement system obligations is almost equal to the total outstanding bonded debt of the state and all political subdivisions combined. Unlike the bond issues, however, this debt was never approved by the voters.

That's roughly $8,000 for every man, woman and child, and $22,000 for every working adult. The *additional* financial burden for inadequately funded public retirement plans from this day forward will be roughly $1,300 annually per household.

California's average pubic-retiree medical benefits plan has never saved a penny to pay for vested obligations, and is in worse financial shape today than the federal Medicare program (which is projected to become insolvent in 2016).

Given the state constitution's tax-limitation provisions and the extraordinary 2/3 majority voting requirements for taxing increases, there is presently no practical alternative to more layoffs and furloughs, hiring freezes for the next decade, and further shrinkage of public services as a result of retirement plan deficits.

<u>How did we get here?</u> Most objective observers would point to a combination of the following structural trends and problems:

- **Unsustainable, irreversible, unfunded and constitutionally protected benefits increases often were awarded retroactively, resulting in chronic deficits.**
    - **For example, irrational and irrevocable benefits increases were awarded in California during the 1998-2000 internet bubble period. To pay for them, pension trustees and elected officials deluded themselves to believe that the Dow Jones Industrials Average would now stand at 28,000 instead of the 11,000 level we just reached last week. After intense lobbying by labor interests, policymakers bet the ranch on that pipedream.**
- **Over the last 50 years, American longevity increased by 5 years for people who reached the age of 65, yet we actually reduced the average retirement age for public employees. The Social Security retirement age has been raised from 65 to 67 but public pension plans have not followed suit. Shorter working career periods and longer retirement periods are a toxic combination in a retirement system.**
- **Employee pension contributions have been insufficient, leaving the employers to pick up the tab.**
- **Salaries consistently grew at a faster rate than actuaries had assumed, which created unfunded liabilities. In many cases, government salaries grew faster than those of most taxpayers, while pension benefits were increased as well.**
- **Cost of living allowances or pension enhancements were granted to retirees without proper actuarial funding.**
- **Retiree medical benefits that once cost employers a few hundred dollars monthly for a handful of retirees now cost more than $10-12,000 a year while the number of retirees receiving these benefits has exploded.**
- **Many employers have failed to make their annually required contributions.**
- **Structural abuses such as pension-spiking have been tolerated.**
- **Labor arbitrators have ignored the evolution of retirement benefits in the private sector.**
- **Governmental accounting standards have lagged the corporate sector.**

California must provide a legal framework to enable dysfunctional benefits plans to be modified, terminated, frozen or converted to a viable structural form that enables the employer to resolve a financial crisis without resorting to bankruptcy or defaults on other obligations. I would also suggest that every new public employee should have a legal right to elect into a defined contribution plan, which will change the playing field over time.

Taken together, my recommendations would reduce our state's retirement funding problems by 30 to 40 percent, and produce positive results for our state and local governments in the credit markets that will save even more jobs.

Governance

The reported shortcomings in governance at CalPERS have coincided with dismal results in the capital markets, which further undermines confidence in the entire system.

I strongly encourage the Commissioners to review the work of the widely respected Government Finance Officers Association which has published a Recommended Practice concerning retirement plan governance.

Among GFOA's recommendations:

a. ***Balanced board composition.*** **The governing boards must have independent trustees -- just like the mutual fund industry.**

b. ***Codification of fiduciary duties.*** **Trustees of retirement plans in California should be held to the highest standards of behavior and accountability, with personal liability for violations.**

c. ***Require a code of conduct.*** **Behaviors and activities of pension marketeers should be controlled by state laws that subject violators to civil and criminal penalties. Conduct violations should disqualify a trustee from voting on any matter related to the infraction.**

The appendix to my written testimony contains specific statutory language.

Constitutional Amendment

I'd now like to explain why we need to amend California's constitution. There are two reasons:

> **(1) The current constitution has been interpreted by the courts to entitle incumbent employees to receive benefits for** ***future*** **service based on current plan designs. There is unfortunately no other way for California to assure sustainable funding without amending the constitution to restore the right of the people's elected representatives to change future benefits for incumbent employees if they have become unaffordable.**
>
> **(2) The tax limitations imposed by Proposition 13 have hamstrung the ability of the state and its local agencies to raise revenues to properly fund both pension and retiree medical obligations for prior service -- even if they are successful in bargaining with employee associations for a fair cost-sharing arrangement to remedy the crushing unfunded liabilities that have accrued in their retirement systems.**

Accordingly, I urge this Commission to design a referendum amendment of the California constitution to provide the following:

- **Public employees must pay half of the cost of their retirement benefits.**

- **Public employers must make their actuarially required contributions on a timely basis.**

- **Younger public employees must wait to retire when they reach the retirement age under Social Security, with the exception of qualified public safety officers. For older workers, the legislature should gradually increase retirement eligibility ages.**

- **Public employers must be allowed to bargain with employees to reduce or modify benefits of incumbent employees for services they provide thereafter. They must also be empowered to freeze the current benefits plan or transfer it to an employee beneficiary association. Payments to retirees cannot be reduced through such actions, of course.**

- **No retirement benefits increase may be awarded for prior service unless fully funded or approved by a majority of voters.**

- **Guaranteed retirement medical benefits for younger employees must begin no sooner than the minimum age for Medicare and must apply to the retiree only, and not for dependents or survivors. Public employers can still provide a supplemental defined contribution plan for dependent benefits, and for retiree medical benefits commencing at an earlier age.**

- **A public employer should be empowered to levy additional taxes to fund its liabilities, after approval by a qualified majority of voters. Specific details are provided in my written testimony.**

- **A majority of the members of a retirement plan's governing board must be independent trustees.**

Statutory Reforms

In addition to the foregoing language for a constitutional amendment, several additional reforms should be enacted by statute.

- **Labor arbitrators must consider total compensation and prevailing retirement benefits levels offered in the private sector.**

- **For new employees, the pension formula should be reduced to sustainable and sufficient levels. Employers with the financial capacity to provide additional retirement benefits can add-on a supplemental defined contribution plan without having to fear that they can never turn back.**

- **No cost-of-living or inflationary increase may be awarded to retirees unless the retirement plan is properly funded or approved by a majority of voters. Pension plans must retain a reserve for adverse markets before they increase benefits in the future.**

- **CalPERS must offer participating agencies greater flexibility in plan designs.**

- **Before it increases retirement benefits, the governing body of a public employer must review in public a multi-year fiscal sustainability analysis**.

- **Newly hired public employees should have the option to participate instead in a defined contribution retirement program.**

- **Finally, the Commission should take a close look into disability pensions, which have been persistently abused in some jurisdictions.**

Testimony of

Girard Miller CFA

Public-finance consultant and commentator

Regarding California Public Pension and Retirement Plan Reforms

April 22, 2010

"The current constitutional requirement to pay unsustainable public pension obligations is a promise without a plan"

Thank you for this opportunity to testify -- and to contribute constructively to the dialogue concerning today's public employee retirement system financial crisis. I will discuss both pensions and related retirement plans.

Before I begin, I should establish that my remarks today are submitted to you as an individual and not as a representative of any organization with which I am or was previously affiliated, including my employer PFM Advisors, my prior employer (the Janus Capital Group and the affiliated Janus Mutual Funds), the Governmental Accounting Standards Board, *Governing* magazine, the Government Finance Officers Association or the CFA Institute. I am solely responsible for my comments at this hearing and my views do not necessarily represent those of these organizations. Media attribution of my testimony and remarks today should reference only "a public-finance consultant and commentator."

As you have probably learned elsewhere, the unfunded liabilities for state and local retirement benefits are estimated to range between $2 trillion and $5 trillion nationally depending on the calculation methodology. Using conservative estimates, that's roughly $8,000 for every man, woman and child in America, and $22,000 for every working adult. The *additional* financial burden for inadequately funded public retirement plans from this day forward will be roughly $1,300 annually per household. That is the magnitude of future service reductions and tax increases that citizens in California and many other states now face, unless action is taken to reform our retirement systems.

For California, I estimate the 2010 combined actuarial deficit for all state and local retirement plans to be approximately $325 billion using mainstream methodologies and current market levels. That down-to-earth, real-time number incorporates the most recent data published on CalPERS, CalSTRS and county pension fund portfolio levels vs. liabilities, the state's 2009 financial report disclosing its $50 billion unfunded OPEB liability, and extrapolation from the 2007 survey by the Public Employee Post-Employment Benefits Commission. *(We often refer to retiree medical benefits as OPEB, which stands for "other post-employment benefits" in the jargon of governmental finance.)* **California's numbers per-capita and per-household are therefore comparable to the national statistics provided above.**

$325 billion in retirement system deficits is almost equal to the total outstanding bonded debt of the state and all political subdivisions ($330 billion, per U.S. census

bureau online database). Unlike the bond issues, however, this debt was never approved by the voters.

In California, our pension plans statewide are approximately 30% underfunded today and retiree medical benefits plans are more than 90% underfunded.

To put this into perspective, California's average pubic-retiree medical benefits plan is in worse financial shape today than the federal Medicare program (which is projected to become insolvent in 2016).

Failure to address these deficits will burden our children with future costs. Many California school districts that now guarantee lifetime retiree medical benefits prior to Medicare will be forced to freeze hiring, eliminate electives and increase classroom sizes by 10-25 percent in the coming decade. To pay for pensions and OPEB, and sustain their essential police and fire services, some cities will have to close or sell libraries and privatize parks and recreational facilities unless something is done soon. Dwindling public funding of cultural and artistic programs will evaporate entirely in most jurisdictions. At the state and county level, it is inevitable that social services for the elderly and the disadvantaged will suffer disproportionately as more scarce revenues are diverted to pay off escalating, uncontrolled retirement benefits obligations for work done by public employees *in years already gone by*.

Given the tax-limitation provisions and the extraordinary 2/3 majority voting requirements for taxing authority in the state's constitution, there is presently no practical alternative to service reductions, more layoffs and furloughs, and further shrinkage of the social-welfare safety net that California now provides to needy residents. For the next 25 years, the poorest people in California will suffer the most for retirement benefits granted unwisely to public employees in transient times when financial markets were exuberant.

I have attached to my comments an article I co-authored for the *Government Finance Review* last year which summarizes the problems facing the state and its public agencies, the symptoms of unsustainable retirement plans, and some of the remedies that will be necessary nationwide. Even when the national and California economies recover from the Great Recession, the so-called "new normal" level of economic activity and governmental revenues across the country will most often be insufficient to defray the escalating costs of public employees' retirement benefits. Simply stated, the revenue will not be there to absorb these totally predictable cost increases.

What <u>is</u> unique about California is that the state's constitution and the courts' interpretations thereof have made our state and municipal retirement plans' financial deficiencies much more intractable under current law. Remedies that could be achieved through legislation or by majority vote in other states are not available to California's public employers, as I will explain below. This legal

straightjacket is exacerbated by extraordinarily powerful public employee union influence in both the state legislature and on the pension boards themselves. Finally, the governmental labor arbitration environment in California relies almost exclusively on public-sector comparables for specific job titles that systematically ignore the prevailing local labor market for new recruits. This results in an ever-upward spiral of retirement benefits as public employers are played off against each other in the interest-arbitration game.

<u>Intergenerational equity considerations.</u> Without timely action to defray these unfunded liabilities while the employees associated with them are still working and the retirees are still alive, today's leadership generation will saddle our children and grandchildren with costs for which they will derive absolutely no public services. In fact, the likely outcome will be a curtailment of future public services -- to pay for benefits received by retirees and workers already deceased. Californians born after 1980 will have to pay for the retirement of <u>four</u> generations of public employees – today's retirees, today's incumbent workers, the employees who replace them, and then their survivors. In the financial world, this is known as Ponzi scheme or a pyramid scheme.

By failing to require actuarial funding of all governmental retirement plans (especially retiree medical benefits, or OPEB) the legislature has unwittingly allowed the ultimate costs of those benefits to increase 50% more than necessary, and to doom those born after 1970 with costs and service reductions that will ultimately be double or triple what they would have been if properly funded.

Another troubling consequence of doing nothing to reform public retirement plans is the fate of the thousands of young California collegians now studying in the fields of criminal justice, education/teaching, library science, public health, city planning, social work and other public-service professions. Because of the chronic hiring freezes that these retirement deficits will compel for the rest of this decade, most of those students will never find work in this state. We are wasting taxpayer money (and theirs) to train them for jobs that won't exist. Somebody in Sacramento should warn them to change majors now and pursue careers somewhere else -- or we face the prospect of thousands of disillusioned college graduates every year for a decade.

<u>How did we get here?</u> Most objective observers would point to a combination of the following structural trends and problems:

- **Retirement eligibility ages often were reduced over the past 50 years -- while longevity at age 65 increased by 5 years. Shorter working career periods and longer retirement periods are a toxic combination in a retirement system.**
- **Unsustainable and unfunded benefits increases often were awarded retroactively, resulting in chronic unfunded liabilities. Pension formulas now provide many employees with retirement income well above the amount necessary to replace their take-home pay in the working years. Pensions have often become a form of deferred compensation and not just a**

reasonable source of replacement income to assure a dignified and secure retirement. Paradoxically, there are a growing number of public employees who will find themselves in a higher tax bracket in retirement than while they were working.

- **Investment assumptions proved to be too optimistic. Even with the recent massive stock-market rally of 70+% from the trough in March 2009, the investment losses in the past three years have *doubled* the unfunded liabilities of our pension funds. Although long-term investment performance over periods of 30 years were consistent with their accompanying actuarial assumptions, the irrevocable benefits increases of the past 10-12 years coincided with periods of dismally weak investment performance. Unfortunately, there is no reason to assume that future market performance will exceed current assumptions enough to magically eliminate today's unfunded liabilities.**
- **Unsustainable major benefits increases were awarded in California during the 1998-2000 internet bubble period. To pay for them, pension trustees and elected officials deluded themselves to believe that the Dow Jones Industrial Average would now trade at 28,000 instead of the 11,000 level we just reached last week. Decision-makers bet the ranch on that pipedream after intensive lobbying by labor groups who claimed it would cost nothing.**
    - **This commonplace pension policy error resulted a hundred billion dollars of avoidable (but now constitutionally irreversible) costs that must now be borne by California taxpayers who were excluded from the decision-making process, especially those too young to even vote at the time.**
- **Employee pension contributions have remained flat while employer contribution rates have increased significantly, and many employers have agreed through collective bargaining to waive some or all of their employees' pension contributions. The absence of a significant employee contribution rate has incentivized employee organizations to pursue ever-increasing retirement benefits at no real cost to employees, apparently in the belief that taxpayer's money grows on trees – and sometimes with the cynical knowledge that true costs are hidden from the public by opaque governmental accounting and budgeting procedures and a lack of fiscal discipline among elected officials who have no incentive to pay today for today's costs of services.**
- **Governmental salaries consistently grew at a faster rate than actuaries had assumed, which created unfunded liabilities. Many Baby-Boom employees have experienced five-fold to ten-fold increases in their annual compensation during their careers, in comparison with the threefold increases that actuaries had projected over the past 30 years. The result is a pension system that pays out benefits far greater than the plan could realistically afford without increasing member contribution rates. The actuarial models failed to match the underlying realities of employee compensation practices and career paths. Extraordinary stock market appreciation wallpapered over this problem from 1983 through 1999.**

    - **To the best of my professional knowledge, no actuary, no public official, no pension trustee, no consultant and no public employee association ever mentioned or disclosed this phenomenon when pension benefits were increased retroactively in the 1998-2000 bubble era, even though the demographics and the data were evident prior to that tipping point. The fiduciary Duty of Care was completely ignored by virtually every participant in the process. Pension governance simply failed.**
- **Cost of living allowances or pension enhancements were granted to retirees without proper actuarial funding.**
- **The costs of retiree medical benefits have escalated dramatically with medical inflation over the past 25 years. Benefits that once cost employers a few hundred dollars monthly for a handful of retirees now cost more than $10-12,000 a year for a rapidly growing legion of Baby Boomer retirees in California. Granting these benefits before retirees achieve Medicare age, and to dependents and survivors, has escalated the costs even further.**
- **Many employers have failed to make their actuarially required contributions. For pensions, there have been funding holidays when markets were rosy, and when budgets were tight. For retiree medical benefits, most employers have simply paid the bills for actual retirees after they retired, without ever putting money aside during their employment, as would be prudent and fiscally sustainable. As noted before, the result is an actuarial status for OPEB that is actually worse than the federal Medicare system.**
- **Structural abuses such as pension-spiking and pension-pyramiding, which artificially inflate some retirees' pensions to exceed their actual salaries, at the expense of general taxpayers.** *(Spiking is accomplished by collecting overtime and sick leave accruals in the final year of work, and pension pyramiding gives duplicate service credit for jobs with multiple employers.)* **Although the impact of spiking is less significant financially than many of the other factors cited above, it remains one of the most highly visible policy failures and erodes citizen support of public servants.**
- **Labor arbitrators have focused on public-sector comparables in making awards regarding retirement benefits, rarely taking into consideration actual private-sector compensation practices and local labor market conditions, so there is little consideration of what the employer's relevant job market actually demands for retirement benefits in order for public agencies to attract workers and remain competitive. This artificial legal environment contributes to the growing gap between public and private sector retirement benefit levels and exacerbates "pension envy."**
- **Governmental accounting standards have lagged the corporate sector. The Governmental Accounting Standards Board (GASB) historically has arbitrarily allowed public agencies to amortize their unfunded liabilities over 30 years, even if most employees who receive those benefits will have already retired and many retirees will have died, before the taxpayers finish paying for their costs. As reported in the *Wall Street Journal* on March 29, GASB is now reviewing its pension accounting standards. If they adopt the FASB**

standards for corporate pension accounting, which uses the average remaining service life of employees, the annual required contributions for past service liabilities could double. GASB is also considering a more-conservative method for calculating unfunded liabilities which would raise my previous estimate for California from $325 billion to approximately $400 billion.

- **Combined with the aftershock from recent investment losses, this will be the "triple-whammy" that mortally wounds California and its political subdivisions. You should ask CalPERS officials what a 6 percent actuarial discount rate and a mandatory doubling of the annual amortization of today's unfunded liabilities would mean to its member agencies once their contribution grace-period from "actuarial smoothing" ends in 2013. It is this underwater side of the iceberg immediately ahead that convinces me that legislative and constitutional action is unavoidable and necessary.**

I would like to carefully note that my observations here are generalizations, and that there are a number of retirement systems in California which are soundly designed and financed and thus do not require reforms to operate effectively. However, the general trends I have cited are much more frequently the norm than the exception. Legislative action will be needed to provide a framework for sustainable benefits for most employers and their employees. A chain is only as strong as its weakest link.

The Commission may want to review the various county grand jury studies of retirement finances which have been conducted and published in recent years. Those reports provide documentation to substantiate many of the problems I will be highlighting today.

Just like our nation's Social Security and Medicare retirement systems, the state's public employee retirement systems' financial deficits will have to be resolved through serious measures with shared sacrifices that include benefits plan reforms and reductions, higher retirement ages, service level reductions, layoffs, and in some cases, additional revenues from taxpayers.

As I will explain, these remedies can best be provided through a constitutional solution that requires shared sacrifices and lays a foundation for sustainable, affordable and sufficient benefits that assure the retirement security of our state's dedicated public servants and the respectful support of taxpayers. In some cases, legislation or administrative reforms alone can help improve the retirement systems' operational efficiency and long-term financial sustainability. But it is my professional conclusion after studying this issue in depth that today's problems in California are so fundamentally deep and widespread that only a constitutional reform can fix the deficits that have accumulated over the past thirty years.

My suggestions are intended to provide reforms that will strengthen and preserve the public employee retirement systems in California. Unlike the critics who would

throw out the baby with the bathwater, and replace the entire public pension system with the defined-contribution structure now commonly used in the private sector, I strongly believe that retirement security for public employees can be most effectively and efficiently provided by retaining and reforming the defined benefit structure as the core feature in the overall retirement system for public employees -- using defined contribution plans more extensively to supplement the base benefits and to share risks and costs equitably between public employers and employees.

Without significant structural reforms to the defined benefit system, however, it will inevitably collapse under its own weight, and the disparity between public pensioners and the taxpayers who support them will worsen to the point that a severe backlash could ensue. California must provide a legal framework to enable dysfunctional and unsustainable benefits plans to be modified, frozen or converted to a viable structural form that enables the employer to resolve a financial crisis without resorting to bankruptcy or defaults on other obligations. Otherwise bond ratings throughout the state will suffer, and financing costs for vital facilities will rise even higher, if California's legislature allows one or more public employers to drag down the entire state because of mismanaged retirement plans. Hybrid systems and plan termination features as I propose below will assure taxpayers and voters that public employees and employers share equitably in the costs and the risks inherent in their retirement plans, and bear the consequences of greed and ineptitude equitably as well. I would also suggest that every new public employee should have a legal right to elect into a defined contribution plan, as explained below.

This is not just a "doom and gloom" story, however. *There is also a positive side of retirement plan reform.* If California takes positive and pro-active actions to correct its massive retirement funding deficits, it will immediately enjoy the benefits of higher bond ratings and lower financing costs at all levels of government statewide. Investors who now avoid the mounting credit risks of California state and municipal bonds in today's malaise would quickly realize that the people and the politicians here are again committed to the kind of fiscal discipline that would make our state a worthy investment. The result would be an immediate and ongoing reduction in financing costs throughout the entire state that would further improve the ability of our public agencies to perform their vital social mission -- and make it easier to compensate public servants for their work, through enhanced cash compensation in the future where market conditions permit. Instead of a vicious cycle as I have described above, a virtuous cycle would begin. The long-term cost savings statewide from improved creditworthiness over time would be roughly $750 million annually if state and local agency interest costs are reduced by five percent (or 0.25% of principal outstanding), which would translate into 10,000 jobs saved along with the public services those workers now provide. Voters looking for a positive message would understand this as a genuine opportunity to put California on a new course.

As baseball's legendary Yogi Berra once said: When you come to a fork in the road, take it.

My comments and suggestions today will cover three dimensions of the state's dysfunctional public retirement systems:

1. **Pension plan governance**

2. **Problems soluble only by constitutional amendment and suggested provisions**

3. **Problems soluble by legislation and suggested provision**

Taken together, my recommendations would reduce our state's retirement funding problems by 30 to 40 percent, ensure that this mess never happens again, and improve the credit ratings of the state and most of its political subdivisions as well.

<u>Terminology:</u> In making these comments, I will try to use the term "pensions" to refer only to defined-benefit pension plans that pay a finite benefit for life, based on a formula and regardless of employee and employer contribution levels. When I use the terms "retirement systems" or "retirement plans" I am including both pension plans and OPEB plans (retiree medical benefit plans that pay a defined benefit such as an annual stipend, a Medicare supplement or a percentage of the retiree's insurance premium). When I refer to a defined contribution (DC) plan, I am referring to 401(k)-type plans that provide for an employer and/or employee contribution that is invested in an individual or group account for the individual's benefit without any specific guarantee of its future value upon retirement; thus the employee bears the investment and longevity risk of a DC plan. In the governmental sector, DC plans are usually organized under federal tax law as 401(a) mandatory contribution plans, 457 voluntary retirement savings plans, 403(b) plans for teachers and hospitals, VEBAs (voluntary employee beneficiary associations), and Section 115 retirement health savings accounts.

For those unfamiliar with actuarial terms, the *normal cost* is the cost to pay for the current year's value of retirement benefits as earned, the *unfunded liability* is the accrued liability for past services which were not funded by prior contributions and investments, and the *annual required contribution* is the normal cost plus the amount needed annually to amortize the unfunded liability.

<u>Governance</u>

California's crisis of confidence in its retirement systems is largely attributable to poor judgments, faulty decisions, and terrible governance practices. As we all know, it is impossible to legislate good judgment and smart decisions, but it *is* possible to establish and require sound governance procedures and practices. Especially when billions of dollars are at stake.

For decades, the California pension system was widely regarded as the pinnacle of the public-sector pension world. The smartest people consistently made the best

decisions with the biggest money. CalPERS was widely respected for its good judgment, high integrity, smart investment strategies, superior money managers and market leadership. Sadly, that is no longer the case, as federal investigators are now studying CalPERS governance and business practices with negative implications. The media has enjoyed a field day reporting on "pay to play" vendor contributions to a board member's election campaign, undue influence in some quarters, and deficiencies in disclosure practices. In the eyes of many, the fiduciary Duty of Loyalty and the Duty of Care -- hallmarks of a trustee's responsibilities -- have been betrayed.

This failure in governance has coincided with dismal results in the capital markets, which further undermines confidence in the entire system. Last year, CalPERS reportedly underperformed its own investment benchmark by 940 basis points (9.4% of principal). From my 25-year experience in the money-management profession including the presidency of a large $170 billion mutual fund complex, I can tell you investors would have yanked their money out of any private-sector investment firm with that track record. Although I have publicly applauded the new CIO of CalPERS for his recent efforts to add transparency in investment policy-making and to "come clean" with real-estate portfolio valuations (in a March 18 column at Governing.com), many critics believe there is a relationship between poor performance and poor governance.

I do not come today to pick on CalPERS, or to exaggerate its shortcomings. Other pension funds have their problems, too, albeit less visibly. To their credit, CalPERS leaders have begun the hard work to reform the practices of "placement agents," an effort I support. Rather, my concern is a statewide spottiness of sound governance, and an inadequate legal structure that has allowed special interests to operate in the shadows. My focus today is to help strengthen the system statewide, eradicate the influence-peddling, restore CalPERS to the national leadership stature it once enjoyed, and elevate the other systems to higher levels of performance.

Fortunately, the Commission now has a reliable, independent and objective source of information that can help guide legislative reform in this vital realm. The widely respected Government Finance Officers Association of the U.S. and Canada has promulgated a Recommended Practice concerning retirement plan governance which can provide important guidance in crafting legislative requirements that should apply to all California retirement systems.

I have attached a copy of the GFOA best-practice statement to this testimony, and the appendix herein contains specific statutory language I would suggest you consider.

Among GFOA's recommendations:

a. ***Balanced board composition.* In California, the control of many public pension and retirement boards of trustees has become dominated by the interests of the beneficiaries, to the detriment of the general public. The GFOA recommended practice on board composition should encourage the Commission to draft legislation to restore and assure balance in board membership so that no single interest or group is dominant. This requires independent trustees -- just like the mutual fund industry requires.**
    - **Congress figured this out 70 years ago with the Investment Company Act of 1940 (mutual fund law), and I remain amazed that the public sector has not awakened to its parallel problem. A majority of pension trustees should be disinterested parties. Important board actions involving potential conflicts of interest by trustees as beneficiaries should require a separate confirming vote of the disinterested trustees -- as is the standard fiduciary practice in the trillion-dollar mutual fund industry. Independent trustees should bring expertise from relevant professional fields including finance, accounting, investments, law and human resources. California's citizens deserve to have experts on their boards, in the majority. For proposals involving a systemic increase in benefits or a relaxation of actuarial or participant eligibility standards, state law should require that independent trustees must approve that decision in the absence of interested directors who might gain financially from their decisions, just as independent mutual fund directors in the private sector must separately approve any proposal that could benefit interested trustees or the advisor.**

b. ***Codification of the Duty of Loyalty, the Duty of Care and the Duty of Prudence.* Trustees of retirement plans in California should be held to the highest standards of behavior and accountability, with personal liability for violations. Those who seek to advance special interests to the detriment of a plan and any of its stakeholders should be liable for damages and losses suffered by taxpayers or beneficiaries as the result of inappropriate behaviors. Trustees must be required by law to hang up their hat as representatives of specific constituencies when they enter the boardroom.**

    GFOA's amplification and modernization of the traditional Duty of Care includes an obligation to monitor the sustainability of a retirement plan's finances, so that trustees cannot shrug their shoulders as they watch their plan's financial condition crumble before their very eyes through benign neglect. As with the mutual fund industry by order of its regulators, this fiduciary accountability for misbehaving, wrongdoing and inattention by trustees should be excluded from indemnification by the fund and D&O insurance policies.

c. ***Requiring a code of conduct.* In New York, the attorney general has drafted a proposed Code which I commend to you for its thoroughness. Aggressive**

enforcement of state law in New York has brought about several noteworthy settlements with private-sector third-party marketers that could easily have been replicated here in California if there were a comparable legislative framework. Behaviors and activities of pension marketeers as well as trustees and administrators should be controlled by state laws that make violations a matter of civil and criminal action. Conduct violations should disqualify a trustee from voting on any matter related to the infraction, such as investment authorizations, money manager selections or class-action representation by private counsel. Verbal reprimands are insufficient.

The Commission and the attendees should be reassured that the vast majority of public pension plan trustees are honest, diligent and well-intended. I do not want to tar these conscientious fiduciaries with the brush that has been soiled by the misbehavior of a few. But in this realm, the old adage about one rotten apple spoiling the entire basket is especially apt. All trustees are responsible for good governance and fiduciary vigilance. Every board must discipline its members. Zero tolerance must be the law of the land.

Constitutional Amendment

I am not a great fan of constitutional micro-management through complex proposals to be submitted to an electorate that seldom reads them in their entirety and is subjected to media blitzes that distort the content of the proposals, making a mockery of intelligent democracy.

However, the unfortunate and inescapable fact is that this state's current "pension funding mess" cannot be resolved without an amendment to the California state constitution. There are two reasons for this:

(1) The current constitution has been interpreted by the courts to entitle incumbent employees to receive benefits for *future* service based on current plan designs, so there is evidently no other way for this state to assure sustainable finances for retirement plans without amending the constitution to restore the right of the people's elected representatives to change future benefits for incumbent employees if they have become unaffordable.

For a comprehensive and thoughtful discussion of this dilemma, see the excellent article by A. Monahan at the University of Minnesota School of Law: *Monahan, Amy, Public Pension Plan Reform: The Legal Framework (March 17, 2010). Education, Finance & Policy, Vol. 5, 2010; Minnesota Legal Studies Research No. 10-13*. http://ssrn.com/abstract=1573864

(2) The tax limitations imposed by Proposition 13 (now sections of Article 13 of the state constitution) have hamstrung the ability of the state and its local agencies to properly fund both pension and retiree medical obligations for prior service, even if they are successful in bargaining with employee

associations for a fair cost-sharing and burden-sharing arrangement to remedy the billions of dollars of unfunded liabilities that have accrued in the state's retirement systems.

Thus, a constitutional amendment is necessary and timely. This provides an opportunity to lay out several additional ground rules for sustainable retirement plan finances that the legislature cannot subsequently overturn in a moment of irrational exuberance when investment markets are giddy, or bowing to political pressure from union groups or special interests. To succeed in the legislature and the voting booth, a constitutional solution to problems this complex must be balanced and bipartisan. Sacrifices and burdens must be shared and all parties must recognize that failure to work together will bring increasing harm to the citizens of California. We cannot allow current dysfunctional practices to continue, and we cannot require today's public employees and future public servants to bear the entire cost of the necessary reforms by just shrinking the payroll.

Accordingly, I suggest that this Commission consider the development of a legislative package that includes a referendum amendment of the California constitution to provide the following:

- **[C-1] Public employees shall pay one-half of the normal actuarial cost of their retirement benefits. This requirement does not apply to defined contribution plans.**
    - *When the cost of a benefit to employees is zero, the demand is infinite. A genuine partnership between employers and employees requires equal cost-sharing. Pragmatic experience has shown that demands for additional benefits become more realistic when employees bear half the cost. Several California cities have adopted this principle, but most have strayed in the opposite direction, and many are even paying a portion of the employee's normal contributions as a result of collective bargaining. Where public employers have succumbed to the practice of "employer-paid member contributions," the budgetary results have most frequently proven to be unsustainable and must now be reversed. The fastest way to materially mitigate public employers' retirement plan costs is to require equal cost-sharing as a matter of fundamental law. Where retirement benefits have been used to compensate for inadequate salaries, the public will benefit from better transparency through appropriate adjustments to cash compensation if the employer's budget permits.*
    - *A constitutional requirement for employees to pay half is far more simple, enduring and flexible than any benefits formula that could ever be etched into permanent law. Specific benefits formulas and ceilings are better suited to statutes (See [S-2] below)*
    - *Constitutional mandates need not apply to defined contribution plans, because those are modifiable prospectively at any time with no risk of unfunded liabilities.*

    - *This single provision would ultimately save about 40,000 jobs in the public sector statewide, and preserve the services they provide the public.*

- **[C-2] Public employers must make actuarially required contributions to their retirement plans on a timely basis unless the Governor and the Legislature declare a financial emergency based upon a precipitous decline in revenues that would otherwise impair the public safety and the repayment of public debt.**
    - *The current constitutional requirement to pay pension obligations is a promise without a plan. The security of benefits promised can be assured only if employers make their required actuarial contributions. This provision would apply also to retiree medical plans, which are woefully underfunded and most commonly are entirely unfunded. Almost every problematic pension fund in the nation has a history of pension contribution holidays. If employees are expected to make sacrifices through additional contributions and longer service periods, they should be given the peace of mind that their employers are paying their bills on time to assure that the funds will be available when members retire.*
    - *Younger taxpayers cannot be left holding the bag in an intergenerational Ponzi scheme. Given the state's median age of 34 years, thoughtful citizens and voters now under the age of 40 should be able to expect that unfunded liabilities (for public services provided to the previous generation) should be paid for during the lives of their elders and not left behind to them. In five short years, that demographic will represent a majority of California's adult population. Why should that new voting majority accept a financial burden left to them in the form of "taxation without representation" because they were minors when the costs were incurred? If conditions worsen, it is conceivable that a future generation would vote to revoke and repeal the unfunded promises made to retirees, leaving them with pennies on the dollar. Intergenerational conflict will only increase if remedial action is not taken before it is too late.*
    - *An additional and compelling benefit of actuarial funding for all retirement plans is the power of compound investment income that is realized by properly funded retirement trust portfolios. Investment income can defray as much as 70% of a fully funded retirement plan's liabilities, reducing employers' and employees' costs dramatically. The long-term costs of today's unfunded OPEB plans can be reduced by 30% to 40% through actuarial funding. For this requirement to work, however, public employers must be provided the comprehensive legal framework to achieve the savings, split the costs and secure the revenues to meet this additional obligation.*

- **[C-3] Public employees born after 1970 with less than 35 years of service at the time of retirement may not receive an unreduced pension until they reach the age of 67 or the normal retirement age under Social Security if greater, except that public safety first-responders with 25 years of service may retire**

ten years prior to that age with unreduced benefits if their plan allows. The legislature shall enact transition requirements that incrementally increase retirement eligibility ages for incumbent employees born earlier, by no more than four months for each remaining service year prior to their current eligibility age.

- *As with Social Security, the retirement age for public employees must be raised to reflect increased longevity. Failure to adjust public employee retirement ages will only increase the level of "pension envy" that divides public employees from the populace they serve. Although Americans' life expectancy at age 65 has increased by 5 years since 1960, many California employers actually reduced their normal retirement age requirements during that period. Pension funding has been impaired as workers and employers paid into the system for fewer years and retirees now receive benefits for many more years. Intuitively, benefits cannot be paid out at taxpayer expense for retirement periods that are longer than the employees' service period. Earlier retirements can still be allowed with an actuarial reduction. This section must be included in a constitutional amendment (rather than a statutory measure) as it would apply to incumbent employees.*
- *The selection of a specific birth year (1970) is admittedly an arbitrary trigger point, but most financial planners would agree that 40-year-old workers have ample time to make adjustments in their retirement ages. Most younger workers today already know that they will remain employed longer than previous generations, and age 67 is already the normal eligibility age for Social Security benefits for workers born after 1960.*
- *The final sentence would require the legislature to mandate incrementally longer service careers in proportion to older incumbents' ages: for example, an employee born in 1960 who is now eligible to retire at age 55 might be required to work one additional year beyond current standards but still retire sooner than a comparable worker born in 1965 who would be required to work two or three additional years to receive a full pension. Equal protection considerations would argue that incremental extensions of the retirement age for older workers would be more equitable than a hard demarcation based on a single birth year. Such a transitional provision is too complex to write into a constitution and is better left to the legislative process.*
- *As noted in the final section [C-9], employees covered by collective bargaining agreements who are near retirement would not be affected if they retire during the term of that agreement. Legislative transitional language should also provide for employees to receive an actuarial "make-whole" adjustment to their pension if the present value of previously earned benefits would be reduced by a higher retirement eligibility age.*

- **[C-4] Notwithstanding other provisions of law concerning vested pension rights, a public employer may bargain and agree with employees to reduce or**

modify benefits of incumbent personnel for services they provide thereafter, provided that benefits for previous service shall remain intact or unreduced at the actuarial level earned and vested to that date. An employer may likewise agree with employees to freeze its current benefits plan or transfer it to an employee beneficiary association to fulfill its obligations for past service, and install a successor plan with different or reduced benefits for future service. Rights of retirees cannot be reduced through actions authorized by this section. No contract may be implied with regard to an individual employee's future service.

- *This is one of the most important measures to mitigate current costs and manage unfunded liabilities, and requires a constitutional amendment. The employer's ability to freeze a plan or bargain for reduced benefits on a prospective basis must be affirmed constitutionally by the voters, to over-ride a contrary interpretation in the courts.*
- *Likewise, an underfunded plan could be assigned to a voluntary employee beneficiary organization (VEBA) with benefits pro-rated thereafter on the basis of the plan's funding levels. This collectively bargained arrangement has been used in the private sector to mitigate and resolve employers' unsustainable benefits obligations and could sometimes be a superior alternative to municipal bankruptcy or massive, chronic layoffs and service reductions.*
- *This section would also enable an employer to bargain with employees to change the terms of incumbent benefits, similar to the recent breakthrough contract in Vermont, which changes retirement ages, employee contribution rates and pension formulas with substantial savings to taxpayers.* *http://www.vermonttreasurer.gov/sites/treasurer/files/pdf/retirement-all/OTS-summay-agreeteachers03-10.pdf*
- *Retirees' benefits would remain protected by constitution, and the final sentence provides constitutional clarity regarding implied contractual rights of incumbent employees.*

- **[C-5] No retirement benefits increase may be awarded for prior service unless fully funded with sufficient reserves for market underperformance, or approved by a majority of voters.**
  - *Proponents of retroactive benefits increases for prior service typically assert that they are needed to attract and retain employees – a complete fabrication. Retroactive benefits increases are nothing but a windfall to incumbent employees that have nothing to do with either recruitment (since new hires are unaffected) nor retention (because they actually provide incentives to retire sooner). If granted, they must be funded or else the voters should have a say in the matter. Otherwise, the savings gleaned from new, reduced-benefits tiers for new employees can be reversed and squandered away by a future retroactive increase that infects the next generation with the same deficit disease we now seek to cure. A market reserve for cyclical losses and underperformance must also be provided before a plan can be deemed "fully funded."*

- **[C-6] For employees born after 1960, public employers may provide guaranteed retirement medical benefits for the retiree only, and not for dependents or survivors. Group retirement medical benefits for employees born after 1970 may begin no sooner than the minimum age for eligibility for federal Medicare benefits, unless the plan is fully funded actuarially. Public employers may nonetheless sponsor or contribute toward a defined contribution or savings plan to finance a retiree's dependents' benefits, and retiree medical benefits commencing at an earlier age.**
  - *Retiree medical benefits liabilities now total $1½ to $2 trillion nationally, more than $130 billion statewide, and are clearly unsustainable in many governmental entities throughout California. Private employers rarely provide such benefits as generously as most California public agencies. Limiting retiree medical benefits to a post-Medicare supplement -- for the employee only -- will materially reduce today's unfunded liabilities and the future annual cost of this benefit, while providing incumbent employees born after 1970 ample time to make alternative financial arrangements. The fiscal benefits of this policy are reinforced by the pension cost savings, as more employees work longer until they receive the medical benefits. The language provides explicitly for a defined contribution option or employee-paid retirement health savings plan, to fund benefits for dependents and earlier retirement, which properly mitigates and shares costs.*

- **[C-7] Notwithstanding the prior provisions of Article 13 as amended (colloquially, Proposition 13), a public employer may levy additional taxes to fund retirement plans and maintain services until 2031 after approval by a qualified majority of voters. This tax shall be sufficient to amortize the employer's annual share of the unfunded liabilities of a retirement plan or a subgroup thereof, but not more than one-fifteenth of the unfunded liability outstanding on the effective date of the amendment, provided that:**
  - **At least 55 percent of the voters must approve the measure.**
    - *The Commission could pattern this feature after the detailed provisions of Proposition 39, which provides for a similar supermajority and requires other safeguards such as a citizens' oversight committee, overall debt limits, and controls on the taxing authorization. To enhance the prospects of adoption and "balance" from a labor perspective, a simple majority vote requirement could be considered if taxpayer groups will also support that approach in the context of a comprehensive solution.*
  - **The additional voter-approved tax revenues must be deposited in the retirement trust fund(s) and used for no other purpose. The retirement fund shall thereafter maintain a reserve for investment underperformance based on historical market-cycle experience.**
  - **Incumbent employees must pay at least one-half of their normal cost and at least one-fourth of the actuarial cost to amortize their share of the active employees' unfunded liabilities over the average remaining**

service lives of the incumbent employees from the effective date of this amendment.

   - *To amortize unfunded liabilities, new employees should not pay for the incumbents' unfunded liabilities, and incumbent employees should not pay for retirees' benefits.*
   - *As written, there would be an incentive for early adoption which works in favor all interested parties.*

- **Except those eligible to retire with full benefits within three years following voter approval, covered employees may not thereafter retire without actuarial reduction before age 57 and the attainment of 25 years of service, or otherwise before age 62. General employees born after 1965 may become eligible for normal retirement benefits no sooner than age 62.**
   - *This clause establishes higher age-and-service requirements (beyond the general statewide requirements of Section C-3) as part of the shared sacrifices required to receive the special taxing authority upon voter approval. These requirements apply only to section C-7 ballot proposals.*
- **The ballot proposal shall provide that pension benefits may not be increased subsequently without voter approval.**
   - *Taxpayers should never be called upon to repeat this exercise without a vote.*
- **The number of employees participating in any of the employer's defined-benefit retirement plans may not increase during years when this additional tax is levied. The employer's total payroll expenses excluding overtime may not increase more than 2 percent annually plus the inflation rate cumulatively in any period during which the tax is collected.**

- *This section is essential to the design of a fiscally sustainable constitutional framework for retirement plan finances. It provides employers and their retirement plans a path to full funding but requires shared sacrifices that cannot be achieved any other way. The language would enable a public employer with deep unfunded liabilities to finance those through an additional tax if necessary, with a supermajority of 55 percent of voters, thereby relieving the operating budget of this fiscal stress.*
- *Taxpayers should not bear the entire burden of bailing out an underfunded retirement plan, however, so the language here would obligate the employer to require or bargain for employee cost-sharing including an incumbent employee contribution toward one-fourth of their share of the unfunded liability, as well as the higher retirement-age provision.*
- *The language also assigns the revenues to the trust fund and prevents employers from indirectly substituting their revenues from additional*

taxing authority to hire more workers or unreasonably increase cash compensation to offset the employees' required contributions.
    - *This provision will not be used widely, but it provides an alternative to municipal bankruptcy, draconian layoffs or severe service reductions, provided that voters and employees accept the rigorous terms of the structured plan. It would provide the only viable alternative to a 2/3 vote to raise taxes for general purposes, which is virtually impossible to achieve. The 2031 sunset date is included to assure younger voters that older taxpayers and workers share in the burden.*

- **[C-8] A majority of the members of a retirement plan's governing board must be disinterested individuals who are not themselves participants in the plan nor representatives, employees or agents of such participants.**
    - *Independent trustees will provide balance to retirement boards. See previous comments on Governance, above.*
    - *Also see Appendix for suggested statutory governance reform language.*

- **[C-9] The legislature shall enact laws to implement this amendment, including a pro-rata four-year phase-in of increased financial obligations for employers and employees, as well as transitional provisions for qualified labor agreements in force when the amendment became qualified for the ballot. Transitional provisions shall include an actuarial supplement to the benefits of any incumbent employee whose total retirement benefit would be reduced below the present value previously earned for services already provided.**
    - *Increased employee and employer contributions should be phased in over a reasonable time period. The word "pro-rata" is used to avoid procrastination in the ramp-up to meet the new legal standards. Policy-makers should also respect pre-existing labor agreements provided they were not undertaken, amended or extended to circumvent the intent and substance of the referendum proposal. Likewise, the final sentence assures that no incumbent employee would receive less in retirement benefits than they had already earned on the date of adoption.*

The foregoing language is complex and extensive in scope. However, it is certainly less complex than the current language of Article 13 as amended, so nobody can argue that this proposal represents a new level of complexity. Some may suggest that it includes several provisions that could be accomplished more quickly through statutory law. However, it is my judgment that a *balanced bipartisan* referendum proposal must include all the features outlined above, in order to compromise opposing interests, garner sufficient citizen support and to establish a new and permanent foundation for fiscally sound retirement systems. Leaving some of these provisions open to statutory revisions would invite erosion of structural discipline over time. Voters and citizens deserve to know that today's retirement-finance crisis will not recur in the future – that is what constitutional amendments are best suited to accomplish. The Commission should also evaluate the public policy risk

that without foundational provisions such as those proposed here, there will be an increasing level of public distrust and resentment of public pension plans that could well invite far more punitive measures through the initiative process.

Statutory Reforms

In addition to the foregoing language for a constitutional amendment, several additional reforms should be enacted by statute. These policies can be refined and adjusted over time, as experience in their application will instruct lawmakers if amendments in the future are appropriate and justified:

- **[S-1] In making decisions and awards involving retirement benefits, labor arbitrators must consider and weight equally the prevailing retirement benefits levels offered all employees statewide and regionally in the private sector as they consider those of comparable public agencies for specific job titles. Total compensation including retirement benefits for public employees may not exceed competitive levels in the most proximate labor market for which comparative statistics are available, again taking into account private sector employment practices generally.**
    - *Labor arbitration often sets the regional pattern for retirement benefits without taking into account total compensation and competitive labor market conditions in the private sector. This language would require the arbitrator to take such factors into consideration, and would assure an equal weighting of public-sector and private-sector comparables and retirement benefits.*

- **[S-2] For new employees, the pension multiplier shall not exceed 1.7% times years of service for civilian employees who shall be eligible to retire with unreduced benefits no sooner than age 67, and 2.3% for public safety employees who shall be eligible to retire with unreduced benefits no sooner than age 57. Employers may provide additional retirement benefits through a defined contribution plan without limitation. Employers outside of Social Security shall supplement their pension benefits with a defined contribution plan requiring equal contributions by the employer and employees.**
    - *The multipliers provided here would assure that retirees can achieve a retirement income replacement ratio of 85% including pension, Social Security and retirement income from their workplace savings accounts (457 or 403b). For those outside of Social Security, the employer should provide a defined contribution option to supplement the pension. A supplemental DC plan with contributions equivalent to Social Security taxes would provide retirement replacement income of 25% for public safety and 35% for general employees.*
    - *Public safety employees retiring at age 57 will still be able to work elsewhere 10 years to qualify for supplemental Social Security benefits, even if their employer does not participate. Many if not most of those*

outside Social Security in their governmental occupation have already also acquired credits toward Social Security through prior or outside employment. Even with federal "windfall" offsets and reductions, these supplemental income sources are material and must be considered in the total benefits plan design. The fact that the federal government now considers the employees' current arrangement (to escape Social Security taxes through a public employer, yet receive benefits through another) a "windfall" should be a red flag for California's policy-makers.

- *This section also assures that a defined contribution plan can be used in any way desired, to supplement the core pension plan. Unlike defined benefits, a defined contribution plan can be modified in the future without creating unfunded liabilities or provoking claims of legal entitlements. The Commission should study the hybrid system in Washington state, where their statewide retirement plan is essentially 50-50% DB/DC. This arrangement shares investment benefits and risks equally between employees and employers.*

- **[S-3] No cost-of-living or inflationary increase may be awarded to retirees unless the retirement plan is (a) fully funded or (b) actuarially funded to provide inflation-based increases or (c) approved by a majority of voters. No plan may be deemed fully funded until it has established a sufficient reserve for market underperformance based on historical market cycle experience.**
  - *Unfunded COLAs create unfunded liabilities and represent magical thinking or an entitlement mentality. Retiree organizations have become quite adept at manipulating politicians without providing a proper funding solution. COLAs can be incorporated into plan design, but at the cost of higher contributions which should be borne equally by employees. If active employees are willing to support increased benefits for retirees through proper plan design and shared costs, then COLAs can be made affordable and sustainable.*
  - *Plans funded at 100% at the transient top of a market cycle are actually not fully funded, as the bubble markets of 1999 taught us all so painfully. A reserve must also be maintained for the next cyclical downturn before assets are used to fund benefits enhancements.*

- **[S-4] CalPERS must offer participating agencies greater flexibility in plan designs. Pension plan design options must include age 62, 65 and 67 for civilian normal retirement (57 and 60 or 62 for public safety) and multipliers of 1%, 1.25%, 1.5% and 1.75%. CalPERS employers must be allowed to determine the levels of retiree medical benefits and age-eligibility at the local level and CalPERS should provide retiree medical plan administration, benefits procurement and investment services on an unbundled basis.**
  - *The Commission should obtain input independently from municipal administrators about the inflexibility of the CalPERS formulas and regulations. Local agency employers are the ones who live with and work around the current system. Clearly CalPERS must have some level of*

uniformity in its multi-employer arrangements to prevent chaos in administering hundreds of disparate plans, but a handful of additional and pragmatic options would give employers far greater flexibility to manage costs downward than their systems now permit.
- *If these reforms can be accomplished through administrative actions without legislation, many employers would rejoice. The simpler the solution, the better.*

- **[S-5] Before retirement benefits are increased, or a labor agreement is approved which includes an increase in the annual employer payments for retirement benefits including those already scheduled, the governing body of a public employer must receive and review in public a multi-year fiscal sustainability analysis which includes:**

  - **A realistic baseline projection of future revenues and expenses necessary to continue current operations and services over the next five and ten years.**
  - **The expected cost of retirement benefits in the next ten years, including both the projected disbursement schedule and the actuarially required contributions.**
  - **The expected cost of proposed retirement benefits increases if investment assumptions prove insufficient by one and two statistical standard deviations during the study period.**
  - **The percentages of retirement plan expenses that will be paid by the employer and the employees in each year of the study.**
  - **The amount of any revenue increases or service and cost reductions that will most likely be required to sustain the current and any proposed retirement benefits**
  - **The level of employee contributions that would be required to equally match the employer's projected actuarial costs for future service, and separately for past service, and the impact such contributions would make on retirement plan sustainability, tax rates and service levels.**
  - **The approximate annual budgetary increase necessary to amortize unfunded liabilities over the remaining service lives of active employees if that period is shorter than the current actuarial assumption.**

  A fiscal sustainability analysis will inform management and elected officials of the consequences of proposed benefits increases, and assure that consideration is given to options that could mitigate costs.

- **[S-6] Where a pension plan is offered, every public employee hired hereafter by an agency with more than 300 full-time employees shall have the option to participate instead in a defined contribution retirement program with both employer and employee contributions of no less than six percent of earnings (or the employer's actuarial normal pension cost if lower). For employers**

without Social Security benefits, the minimum defined contributions shall be ten percent each for the employer and employees. The employer alone shall determine the vesting schedule for its contributions, with full vesting no later than the seventh anniversary of employment. Employee contributions shall be fully vested immediately. Alternatively, public employers may instead offer a hybrid retirement plan with approximately equal components of defined contribution and defined benefits.

- *This feature will increase the attractiveness of public service for mobile and professional employees. Some workers would prefer a portable defined contribution plan if given the choice. By giving employees the right to a DC plan, there will eventually be less pressure on the pension systems. Nobody will be obligated to join such a plan. Small employers would be exempt, to minimize administrative costs.*
- *To provide for sufficient retirement income for a 30-year employee with Social Security benefits and a workplace savings plan, a defined contribution retirement plan generally must require employer and employee contributions totaling 12 percent of pay, thus a 6 percent employer and 6 percent employee contribution minimum is recommended. For employers outside Social Security, equal employer/employee contributions of no less than 10 percent each would be appropriate, sufficient and sustainable.*
- *Following the Washington state model, employers could also elect to offer new employees a 50-50 DB-DC plan as an alternative. Employers should be given broad latitude in designing this option since it includes a "safety net" in the DB component.*
- *CalPERS and CalSTRS should be able to offer both a DC and a hybrid program as alternatives to their traditional pensions, as would private-sector competitors, so there is no bias for or against them if they develop a viable DC option. This is a "level playing field" proposal. In Washington, the state retirement system was mandated to provide the compulsory hybrid system to teachers, public safety officers and general employees.*

- **As noted in the section on Governance, the Appendix immediately below contains suggested statutory language on that topic.**

- **Finally, the Commission should take a close look into disability pensions, which remain a highly controversial and problematic topic in the field of public safety finances. Abnormal percentages of duty disability pensions are claimed by employees in some jurisdictions, often because of favorable federal tax treatment of disability pensions which provide undue incentives for employees to "go out early" with tax-advantaged lifetime benefits. Statutory controls on the decision process, elevating the level of evidence required to substantiate a disability claim, reforming the presumptive criteria for disability, and**

> **other curbs on abuses would be an important way for legislators to "reduce fraud, waste and abuse in government spending."**

I would again like to express my appreciation for this opportunity to provide constructive suggestions for reform. Feel free to contact me at any time for additional information. I will follow your work on this project closely.

(Appendix follows)

Appendix

Pension governance suggestions from Girard Miller

Text has been expanded from a prior article at Governing.com dated November 5, 2009

Independent trustees and fiduciary standards. A majority of a plan's trustees shall be independent of that retirement system and all its participating employers. No independent trustee may be employed by a public agency or be a participant or retiree in the system. No independent trustee may presently be affiliated with a service provider or vendor to the system, or an employee or retiree organization affiliated with the system. At least two-thirds of a board's independent trustees shall be qualified for service as certified or licensed financial, actuarial, accounting, legal, benefits or investment professionals at the time they are selected. All trustees shall be held to the highest reasonable standards of fiduciary law.

All trustees shall be subject to the highest prevailing fiduciary standards of the Duty of Loyalty, the Duty of Care and the Duty of Prudence with respect to investments, plan governance, and selection of staff and service providers. For this purpose, the Duty of Care shall include thoughtful, comprehensive and impartial consideration of the sustainability of retirement benefits and the consequences of investment underperformance and actuarial mis-estimations. The Duty of Care shall include full consideration of intergenerational equity in reviewing or approving actuarial assumptions and techniques. The Duty of Loyalty shall include recusal or disqualification from voting on any matter in which the trustee has a conflict of interest or a beneficial interest. The Duty of Prudence shall include an obligation to establish and maintain an investment portfolio reserve for market underperformance which may not be used to fund benefits increases, taking into account the current portfolio composition and historical market and business cycles. Trustees who are not disinterested trustees or independent trustees may not be insured or indemnified for actions which are found to constitute a conflict of interest or a breach of fiduciary duty.

Code of conduct. Subject to approval by the Governor, the Attorney General shall publish a code of conduct to govern public pension fund governance and commercial transactions and relationships. The legislature shall establish or authorize sanctions and penalties for violations of the public pension code of conduct which may include both civil and criminal penalties.

"Pay to Play" prohibitions. No person or organization may be engaged and compensated as an investment advisor or service provider to a retirement plan board or fund if, within the past five years, that person or organization or any of its employees, officers, partners or agents have made gifts or campaign contributions benefiting or supporting any person presently serving in any capacity related to the system's governance. Campaign contributions by residents eligible to vote for the recipient are exempt from this provision if they do not exceed the candidate's average individual contribution or $500, whichever is less.