

California Public Pension Reform; The Aftermath of Perfect Storms

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Introduction

The defined benefit retirement system in California is currently under scrutiny by many and under attack by others. This paper is written in the context and perspective of those local governments that are currently in CalPERS and from the point of view of my position as a county supervisor of the County of Kings, the president of CSAC, and a current board member of CalPERS since 2005.

The title of the paper purposely infers to more than one perfect storm as it is my belief that there has been at least two since 1999 that have made reform of the current system not just necessary but inevitable. The whole discussion of reform seems to be in itself an array of possibilities by many from trying to dump the system and replace it with a defined contribution system to those that think a wait and see position may cure the challenges.

As of most recent it would seem that those that were trying to radically change the fundamentals of the system have refocused and are addressing the laws that control it, investigating the loop holes, and studying the fundamental assumption of asset classes and rates of return. The recent Stanford report (Bornstein, Markuze, Percy, Wang and Zand 2010) is a good example of a refocus of effort. Even though many may disagree with many of the assumptions, it will in itself begin a dialogue of a more in depth discussion on intellectual assumptions and actuarial studies.

For this discussion a four legged stool may be the best way of describing the thrust of where I believe the reform movement has been coming from. As above mentioned the group that, for their own philosophical reasons, were in the camp of the most aggressive from throwing the system out, major referendum change, or promoting massive media attacks on the whole concept of defined benefits it seems to have morphed to a different approach and place in time.

This group seems to have included political interest, consumer advocates, some legislatures, and some with their own vested interest from the private sector. If one truly believes in the American system of democracy one should be no more critical of this group than one should be of those, at least in the early stages, that said there was no problem and or reason for reform.

A second part of the reform movement is from labor and in this case it covers such a wide variety of types of organized labor that nothing in these words should be considered directed at any particular group. The only real distinction however is the difference of how the organized labor leadership at the state level has handled the reform movement versus how many of the smaller bargaining units of local governments have addressed the issue. Since this paper is meant to address more from the local perspective the remarks will be more focused in that arena. It would however be note worthy that for the last two years that I have been working on reform research, the state labor organizations have been very forthright and open in conversations of what should and might be done in the reform arena.

Over the last two years as the PERS board member who represents local governments I have visited many cities, special districts, and counties and have spoken to hundreds of local elected and appointed on the reform issues. In most visits to these local agencies the local labor organizations were there and were part of the discussion and from those meetings several direct discussions were entered into with those that represented the labor force in many of those same agencies. There was not one occasion where those labor units did not acknowledge the willingness to study the pension situation and in almost every case they agreed that some sort of reform movement may be necessary. It is important at this junction however to emphasize that the kind of reform we were discussing was one of a tune up not an overhaul.

A third group that has been and will be some of the real leaders of reform are local government itself. As many were talking about reform, local governments were taking action to study their financial conditions and many began the process of real consideration in modifying to second tiers under current law. One of the most revealing aspects in working with these local agency groups was how interconnected the discussion was between management and labor. Many agencies, especially the smaller ones tend to have a more day to day opportunity to vent concerns or ideas about the whole pension matter. In my own county, several times a week I can get asked by maintenance persons, police officers and most other positions on how things are going at PERS and what do I think will happen in reform. Local agencies are dealing with reform on a day to day basis because the economic downturn has affected all governments and real choices are being made every day about services, productivity, and yes, employee morale.

The forth group that is and will have a major influence on reform is the media. There are always of course those quick stories that pop up each day in reaction to a news breaking story about PERS or related stories on pension or reform. As a researcher I cherish in depth written scholarly white papers that have been peer review and cite the many works that were scrutinized for validity but it would be a huge error to minimize the tremendous impact that journalism is and will have on the eventual reform of the defined benefit system as we know it today. Some of the most valuable public policy changes in this country have come from investigative work by our journalists.

The Perfect Storms

As we enter this section of discussing the perfect storms I believe a disclaimer is necessary. I am, as an elected and as public policy leader in California, a strong proponent of

defined benefits, but my comments going forward from this point, will at times be considered harsh about the many misjudgments in public policy that have taken place.

The first perfect storm began in 1999 when AB 400 was passed into law. This law in a historical perspective and from a local agency point of view may go down as one of the worst public policy decisions in the history of California. During the period preceding the passing of the bill pension funds had done fairly well and many, especially in the local agencies, were fully funded and some were even super funded. The bill which is well known and need not an in depth dissertation in this paper, however had unintended consequences that would eventually be devastating to some local government budgets and their pension fund liabilities. The bill allowed formulas to be enriched for public safety officers to a formula of 3% at 50 at the state level and also allowed local agencies to do the same if local bargaining agreed to do so. It is important at least from a local perspective to point out that this was a state law fought for by those at the state level by both organized labor and the legislature but it set in motion an undeniable competitive bidding war for safety officers both at the state and local agencies. As the program was adopted by the state it moved across agencies like a grass fire as organized labor doing their rightful job, began the process of trying to get the same benefits for local members. In many interviews that I had with local elected who were in office at the time the same message resonated. They were told that they were fully funded and it would not cost them anything and if they did not make the enhancement their officers possibly would take employment with the state or another local agency.

The perfect storm part is a little more complicated than a bad piece of legislation. Many of those in leadership at the time in the state and local agencies were boomers in their early and mid fifties who by human nature had a built in inclination for self preservation. Most of the

elected at the time, including myself, were not trained in or familiar about the whole concept of the volatility index or the risks associated with it. This radical shift of retroactive enhancements came with a silent but potentially devastating volatility risk not previously understood or considered by most.

SB 400 allowed enhancements in local agencies that in many cases could change formulas from 2% at 50 to 3% at 50 which in simplistic numbers changed a retirement formula from 60% to 90 % (50 % increase) of pay and with the stroke of a pen it was retroactive for the years served. The storm was even darker at this point because with only a few exceptions by law and policy it was done behind closed doors without public scrutiny. It is important to understand that it was not intentional of local representatives to keep this from public view but labor negotiations were done in a true bargaining fashion as prescribed by law and policy. The announcement in open session was passed as any other everyday occurrence even though it was a vested and long term obligation to the citizens of that jurisdiction.

The second storm was in many ways potentially equally as devastating but one that set in motion great opportunities of conflict of interest that is seldom reflected on. In 2001 AB 616 was passed which allowed the enhancement of miscellaneous employees to as high as 3% at 60. Senior managers throughout local agencies many of which were boomers in their mid fifties were put into a precarious position of negotiating with labor and advising elected on formulas that would retroactively change all the miscellaneous employees including themselves and the elected if they were qualified. Again, the percentage simplistic calculation changed a 60 % formula to a 90 % (50 % increase) retroactively without public comment and it was vested for life. A manager could have worked for 29 years at 2% at 55, was part of the negotiating team to enhance the benefits of the entire agency to 3% at 60, worked for one year more and retired with

90 % of pay. This is not intended to in any way imply anything illegal but it indicates the lack of public transparency, potential conflict of interest and bad public policy. This action theoretically could now put some agencies with both safety and miscellaneous employees at 90% formulas.

Conclusion

As an elected official and a board member of CalPERS I strongly believe reform of the California defined benefit system must be done in an open and equitable manner. The work force of California government employees including our local agencies is one of the great assets of the California way of life. It is my own beliefs that CalPERS becomes the target of many of our pension liabilities issues when who really is responsible are we the elected. We passed the laws that in some cases allowed unsustainable formulas to come into state and local agencies. We passed laws that permitted the obligation to tax payers without their ability to vent and question in open public forum. We passed laws and established polices that allowed loop holes which encouraged or at least permitted spiking even at the management level. We put elected and managers in untenable positions where they had to make decisions that by most other standards would be considered in conflict of interest.

The employees that have worked hard to fulfill the services that we have grown to expect and need in our modern society are not the cause of our current pension unfunded liabilities but bad public policy is. We should seek public policy that grants the tools to public agencies to modify new employee contracts in a fair and sustainable manner and the process must be accomplished in a public forum. It is also imperative to point out that some agencies did not obligate beyond their means.

We should and will continue to expect CalPERS to invest in a fiduciary responsible way that has for many years invested in the best interest of members and employers. The major downturn of the global economy did affect the fund, as it did across the world, but the track record of PERS has demonstrated their ability to adapt and we should expect in the future they will do the same.

When taking the Stanford report into account one must consider the impact of following their recommendations to local agencies. Within the report several options are mentioned for going forward with reform and in that aspect one would have to agree that a new tier approach is reasonable and will in fact require some agencies to do so to balance some of the formulas that are unsustainable as they were created under SB 400 and AB 616. To accept the notion that an ultra conservative rate of return through fixed instruments is the way to proceed could have a damaging affect to local agencies that are already cash strapped. This type of employer contribution should not change because of political pressure but rather because of reasonable asset class and return strategies that have been studied and validated.

The CalPERS response to the Stanford report (CalPERS 2010) points out that over the last 20 years the portfolio returned an investment rate of 7.9 %, even taking in consideration the great recession. The data within the Stanford report has somewhat been selective of time when considering the returns that bonds might yield. It is important not to lose focus on the primary fiduciary goal of the retirement fund of PERS and that is to insure the funding and paying of retirements promised by the state and local agencies. It is however a grave error to discount the substantial benefit the investment strategies and returns contribute to the California economy. During the scheduled asset allocation process and the assumed rate of return strategy session that

will take place this year, interested parties should take an active role in contributing comments and data that will support the ultimate decision by the CalPERS board.

Local agencies, their elected, and managers have advanced their working knowledge of pensions to a level significantly higher than any time in history and one can count on that they will take a very active role in public policy and strategies that will affect their pension plans and contributions.

I have nothing but the deepest admiration and respect for the people at PERS. They are a highly committed and qualified group of board members and staff who commit all of their effort to the members and the employers. I personally agree with and support the current asset allocations and assumed rate of return and will actively participate in the upcoming asset work planning session and the ultimate board decision that will come from the study.

Reform will come in a variety of needed steps including formulas that allow second tiers for new hires but it must go much further. Transparency, public forum debates, conflict of interest rules, and third party validation, are but a few of the steps that ultimately reform must adopt.

References

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