TO: Alameda County City Managers Association
Contra Costa County Public Managers Association

FROM: Pension Reform Task Force of the Alameda County City Managers Association and the Contra Costa County Public Managers Association

DATE: January 21, 2010

SUBJECT: Proposal for Regional City Pension Standard

Introduction

After reviewing the work of several other California City Management associations on pension reform, the Alameda County City Managers Association and the Contra Costa County Public Managers Association established a joint working group on pension reform to make recommendations to our respective organizations regarding regional public pension reform.

The need for such a working group stems from the following tenets:

1. The general state of the economy has sparked a public outcry over public pensions that may lead to overreaching and inappropriate pension reform by statewide initiative.
2. The majority of current public pension programs under the California Public Employee Retirement System (CalPERS) and most other public retirement systems in California are not financially sustainable.
3. It is important for cities in the same geographic region to work toward a uniformity of action on pension reform so as to avoid an inherent competitive disadvantage in hiring qualified staff.

The working group has concluded that the existing pension programs have worked well to support career local government employees for decades; however, there is a growing recognition that they are not financially sustainable. To that end, the working group is recommending a new tier pension offering that could be implemented by the great majority of cities in Alameda and Contra Costa Counties. Those pension offerings would not affect existing employees who have vested rights to the current pension program, but would affect new employees after a date certain and be both sustainable and defensible.

As to existing employees, the working group is recommending that public employers require employees through labor negotiations to fund a portion of their pensions through direct payroll contributions. In these difficult economic times, this will create an immediate annual operating savings for public agencies as well as create more parity within the workplace as it relates to future new tier pension offerings.

Background

For more than 70 years, the State of California and local governments have offered a "defined benefit" retirement plan to employees. This system provides a guaranteed annual pension based upon retirement age, salary, years of service and the appropriate benefit factor multiplier. Most, but not all, municipalities in California are part of the California Public Employees' Retirement System (CalPERS). All cities in Alameda/Contra Costa County, with the exception of the Cities/Towns of Danville, Lafayette and Orinda and the Counties of Alameda and Contra Costa, are CalPERS members.

The goal of this study is to provide current and future employees with an appropriate pension. The benefit level should be set to be fair and adequate, but fiscally sustainable for employers and taxpayers. Any proposal for such a regional pension standard must be based on sound actuarial work. Many financial planners and actuaries suggest that a replacement of 65% to 75% of salary is needed to provide a reasonable retirement income. Financial Planners take into account lower expenses in retirement and public workers saving for their own retirement; e.g. contribution to a 457 Plan rather than relying on CalPERS for a 100% replacement of pre-retirement income.

While we recognize that the defined benefit plan has worked for decades and should be retained at some level, it is clear that defined benefit pensions are increasingly rare in the private sector. The great majority of private employers offer “defined contribution” plans where the employer contribution is a fixed amount and the benefits are based on contributions and investment earnings. These plans put the risk largely on the employee to amass and manage assets to ensure an adequate pension after retirement. Such 457 and 401(k) plans have not performed well in recent years due to turmoil in the markets. Yet, there is a growing sentiment amongst the public and opinion leaders that State and local government workers should be forced to defined contribution plans.

We believe this would be a mistake, for the following reasons. Defined benefit plans have proven to be more efficient than defined contribution plans for delivering pension benefits. Defined benefit plans generally earn far more than defined contribution plans, because they are professionally managed. Defined benefit plans offer lower fees and cover disability retirements and death benefits that are not included in defined contribution plans. Further, defined benefit plans offer a protection for inflation and manage longevity risk better than defined contribution plans by pooling larger numbers of people. Moving from a defined benefit plan to a defined contribution plan entails large start-up costs and forces changes in asset allocations that will produce lower investment results in the defined benefit plan that remains for existing employees. In other words, a forced conversion to a defined contribution plan would cost the taxpayers more for many years.

However, defined benefit plans have become more expensive in recent years. In the late 1990s, when CalPERS was earning extraordinary returns on its portfolio, the California Legislature enacted significant benefit enhancements for public employees in the CalPERS systems that were optional for participating local governments. Market conditions at that time led to “super funding” of local government pensions causing management and labor to seek increased benefits to stay competitive. It is now common for public safety officers to retire close to age 50 with almost a full salary under the 3% at 50 Plan. These increased benefits have proven to be unsustainable and need to be rolled back to more appropriate pre-1999 levels.

The costs for these defined benefit plans vary based on two factors: the benefit paid to retirees, and returns earned by investment managers. The pension funds are not immune to stock market declines, and CalPERS has suffered staggering losses in its portfolio since mid 2008. While the market is showing some resiliency, member agencies will be called upon to pay significantly increased contributions to fund pensions for current employees and make up huge losses over the next 30 years.

Because of the global recession, local revenues are significantly depressed. The two major city revenue sources, property taxes and sales taxes are not expected to recover to their previous levels for some time – perhaps years.   The CalPERS policy adopted June 16, 2009, spreads the deep losses over the next thirty years, beginning in 2010 and rising through 2013. The increased rates may well hit cities just as they are finally beginning to escape from the effects of the recession. As such, pension costs will soon escalate beyond our ability to manage them while the benefits exceed what taxpayers themselves can receive and what is needed to attract qualified employees. The local government pension situation will become untenable.

In the past five years, a number of proposals have been introduced to reform the public pension system in California. To date, no concrete action has been taken by CalPERS, the Governor or State Legislature. Several organizations are now consideration ballot initiatives which would reform the pension system in response to the inaction of State Government. It is for this reason the working group has met on the subject five times since August and involved experts to assess the financial impacts of a systematic and regional reform effort. Our findings are as follows:

Findings

The working group recognizes that the most effective reform would be addressed at a statewide level with consistent pension standards for all. Ideally this would be accomplished through the state legislature, but could occur through the initiative process. However, poorly conceived pension reform by initiative could lead to greater costs for taxpayers and harm local government's ability to attract and retain qualified employees. By acting as a region, no one city will be disadvantaged by pension reform. Therefore, the working group supports a modified level of retirement benefits for all new city employees in the Alameda/Contra Costa region.

The working committee also recommends that current employees pay for a portion of their pensions and that a new pension tier be created for city employees hired after these reforms are enacted by the respective city councils, with the following features:

1) Current employees shall participate in the funding of their pensions in all cities. This reform will generate immediate budgetary savings to cities to the extent that existing employees participate in paying for their own retirement. Savings could initially range from 1 – 9% of CalPERS-able payroll annually.

2) New Tier Retirement Proposal

- Safety employees – 2% at 50 (which rises to 2.7% at age 55 or older);
- Miscellaneous employees – 2% at 60 (which rises to 2.418% at age 63 or older); and
- Average of highest three years.

The new tier proposal will deliver savings over a much longer time period as it only affects new hires after they become effective in 2010. When the majority of employees are under the new tier, cities can expect to save approximately 2% of payroll per year. Within 30 years, annual savings of 5 - 7 % of payroll can be expected through reduction in the normal cost of the PERS contribution. The new tier will also lower each city's volatility index (ratio of assets held for pension payments to payroll), which will help stabilize future rate increases.

These changes can be negotiated and implemented at the local level. Each city has a responsibility to meet and confer in good faith to reach agreement with its bargaining units.

These reforms would provide adequate and sustainable pensions for long-term employees in Alameda/Contra Costa County cities and enhance fiscal sustainability throughout the region.

Next Steps

The working group recommends that our respective organizations adopt these goals.

The City Managers Department of the League of California Cities has asked that regional approaches to pension reform be a topic of a panel discussion at the annual meeting next February. The League Board is also investigating pension reform recommendations on a statewide basis. Ideally, these efforts would result in a consistent policy from the League which can be advocated to legislature and the Governor.

The working group also recommends that Alameda/Contra Costa cities work with the League to seek legislative pension reform at the State level. These reforms should include:

- Establishing a reasonable benefit cap for miscellaneous employees and safety employees, including retaining safeguards against spiking which create pensions of 100% or more of final salary;
- Giving employers flexibility to determine when part-time employees are entitled to pension benefits; and
- Changing CalPERS Board membership to achieve better employee/employer balance and greater public agency representation; and
- Allowing existing employees to be enrolled in negotiated new tier plans.

The East Bay Division of the League of California Cities should advocate these changes to the greater League Board and to our State representatives.

This group identified further potential legislative amendments that could be important in overall pension reform efforts. They are not outlined here, as we focused on highlighting the factors most critical to local agencies. It will be valuable for individual City representatives to articulate other identified possible legislative changes of interest. We suggest that information be provided to the League through the East Bay Division, the City Managers department, the Employee Relations department or the Employee Relations Policy Committee.

Short of comprehensive State action, any significant pension reform will happen on a city-by-city basis. City Managers will need to discuss these recommendations with their city councils and seek direction to begin negotiating pension reform as labor agreements expire. In this way, sustainable and defensible pension plans will become the norm over time among Alameda/Contra Costa County cities. It is clearly understood that not all cities will reach these goals to the same extent within the same timeframes.

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