TO: San Diego Division, League of California Cities

FROM: City/County Management Association

DATE: June 29, 2009

SUBJECT: Proposal for Regional City Pension Standard

Introduction

In January 2009, the city managers in the San Diego City/County Managers Association (CCMA) began a study of the pension programs offered local government employees in California and the San Diego region. While all are in agreement that these pension programs have worked well to support career local government employees for decades, there is growing recognition that they are not financially sustainable and are increasingly politically controversial.

To that end, the CCMA has committed to providing recommendations for a second tier pension offering that could be implemented by the great majority of cities in San Diego County. This pension offering would not affect existing city 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.

Background

For 70 years the State of California and local governments have offered a “defined benefit” retirement plan for employees. This system guarantees annual pension payments based on retirement age, years of service, and salary. Most cities in California are members of the Public Employees Retirement System (PERS). All cities in San Diego County, with the exception of the City of San Diego, are PERS members.

The goal of the study is to provide full career employees with pension benefits that maintain their standard of living into retirement. 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.

While we recognize that the defined benefit plan has worked for decades and should be retained, 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 dollar 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

growing sentiment amongst the public and opinion leaders that State and local government workers should be forced into defined contribution plans.

We feel this would be mistaken for several reasons. First and foremost, 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. Hence, it would likely cost the taxpayers more for many years to force future local government employees into a defined contribution plan.

However, the defined benefits plans have become more expensive in recent years. In the late 1990's, when PERS was earning extraordinary returns on its portfolio, the California legislature enacted significant benefit enhancements for public employees in the PERS 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 PERS 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 for the huge losses in '08-'09 over the next 30 years. This will put added pressure on cities at a time when municipal services are stressed to the limit.

Local revenues are depressed at a time when PERS rates will be increasing. HdL, which audits sales tax for the majority of cities and counties in California, does not anticipate a return to 2005 sales tax levels until 2013 or later due to changes in consumer behavior and access to credit. Property tax revenues, long considered the most reliable for steady growth of all municipal revenues, are down in San Diego County this year and only meager improvement is expected in the coming years. The PERS policy adopted June 16, 2009, spreads the deep losses from FY 2008-09 over the next thirty years, beginning in 2010 and rising through 2013. The increased rates will catch cities just as they are beginning to crawl out of this tenacious global 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.

The CCMA working group has met on the subject seven times since January and involved public pension actuary John Bartel to assess the financial impacts of the proposal. Further, we held meetings with local labor representatives, the San Diego County Taxpayers Association and California Foundation for Fiscal Responsibility.

Findings

Ideally, responsible and effective pension reform would be addressed at a Statewide level with consistent pension standards for all. Yet, we cannot wait for a Statewide solution due to the stalemate in Sacramento. 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 CCMA supports a modified level of retirement benefits for all new city employees in the San Diego region.

The CCMA recommends that current employees pay for a portion of their pensions and that a new pension tier for those city employees hired after January 2010, 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 range from 1 – 9% of payroll annually.

2) Second Tier Retirement Proposal

- Safety employees – 2% at 50;
- Miscellaneous employees – 2% at 60; and
- Average of highest three years.

The second tier proposal will deliver savings over a much longer time period as it only affects new hires after January 2010. When the majority of employees are under the second tier, cities can expect to save approximately 2% of payroll per year. Within 30 years, annual savings of 5% of payroll can be expected. The second 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 then legislated at the local level. Each city has a responsibility to meet and confer in good faith to reach agreement with its bargaining units.

The committee also recommends that San Diego cities seek legislative pension reform at the State level. These would include:

- Establishing a 90% benefit cap for miscellaneous employees and safety employees;
- Employer Paid Member Contribution (EPMC) prohibited as PERSable wages;
- Give employers flexibility to determine when part-time employees are entitled to pension benefits;
- Obtain flexibility from PERS to allow employees to move into a lower level tier in the case of two-tier plans if there is some advantage to the individual employee in doing so;
- Provide for reciprocal access to tier 1 benefits for employees who change jobs after January 2010;
- Establish additional reserve funding to reduce volatility;
- Retain full disability benefits for those who are injured and cannot work in any capacity, but restrict disability benefits for those who are able to work (in same or similar job) after work-related injury; and
- Change CalPERS Board membership to achieve better employee/employer balance and greater public agency representation.

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

These reforms would provide adequate and sustainable pensions for long-term employees in San Diego County cities.

Next Steps

CCMA recommends communicating these ideas to other regional manager groups in the hopes of obtaining wider support for pension reform. Los Angeles, Contra Costa, San Mateo, Sacramento, Marin, and Santa Clara area cities have indicated interest. The Orange County Area Managers Group received a presentation of these ideas on June 3 and immediately formed a committee to begin its own work. Also, several local water districts have met to discuss our thinking for pension reform.

The City Managers Department of the League of California Cities has asked the regional approaches to pension reform be a topic of a panel discussion at the annual meeting next February.

City Managers will 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 San Diego County cities.

The City/County Managers Association includes Carlsbad, Chula Vista, Coronado, County of San Diego*, Del Mar, El Cajon, Encinitas, Escondido, Imperial Beach, La Mesa, Lemon Grove, National City, Oceanside, Poway, San Diego*, San Marcos, Santee, Solana Beach, and Vista.

*Note: The City of San Diego and County of San Diego have their own pension systems and have implemented second tiers.