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Testimony before the Little Hoover Commission

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Good morning commissioners. Thank you for having me here to discuss CalPERS and our role and response to pension reform.

Much has changed since we last met. Through it all, CalPERS remains committed to being transparent and honest and to being responsive to our many stakeholders. We continue to welcome all opportunities to provide forthright and useful information to our partners in all branches of government, including this Commission.

First, I will discuss the Public Employees' Pension Reform Act that goes into effect January 1 and its impact on CalPERS and our contracted public agencies. Then, I will provide you with an overview of several other significant changes that have occurred since I last addressed this commission. Finally, I will address some of your questions concerning municipal bankruptcy and retiree health care.

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On August 31, 2012, the legislature passed legislation that will transform public pensions. This milestone was achieved after several months of public hearings, a final report by this Commission and an entire year of public testimony and deliberation by the Conference Committee on Public Employee Pensions. As you know, the framers of the legislation included many of your recommendations in this final bill.

In today's uncertain economic environment, employees are understandably concerned about retirement security. Defined benefit plans remain essential for recruiting and retaining talented individuals for public service. That makes sustaining and strengthening the fiscal soundness of public pension plans all the more important.

A June 2012 CalPERS white paper concluded that public employers can mitigate the risks of meeting pension obligations by instituting the following policies:

- Continual contributions at least equal to normal cost
- Employee contributions that help share in the cost of the plan
- Properly funded benefit improvements
- Responsible (ad hoc) COLAs
- Appropriate anti-spiking measures
- Achievable economic actuarial assumptions

The Pension Reform Act touches upon almost all of these policies and implements positive changes.

CalPERS applauds this significant and comprehensive legislation. This reform will reduce public employee retirement costs while preserving traditional pensions as a proven and cost-effective form of retirement security for California's public servants.

A preliminary cost analysis by our actuarial staff estimates that the reforms will save California taxpayers $42 to $55 billion over 30 years for CalPERS plans. Other California public pension plans will save tens of billions of dollars more.

To sum up CalPERS views, CEO, Anne Stausboll, issued the following statement:

"Legislative leaders and stakeholders involved in the pension reform process have done extraordinary work. They have produced a comprehensive set of reforms that moves us forward to having a stronger and more affordable retirement system.

"While the reforms may not satisfy everyone, they are a positive and significant step in ensuring public pensions are sustainable, secure, and cost-effective."

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It is important to note that many public employees have already made significant concessions over the last few years. Through collective bargaining agreements, most State employees are now paying 2 to 4 percent more from their paychecks toward pensions for a total of 8 to 11 percent of their compensation.

The State reforms alone saved taxpayers $400 million in the current fiscal year.

At the local government level, more than 300 CalPERS' public agencies have agreed to significant pension reforms over the past few years that have resulted in 475 plans decreasing benefits. Most of these changes were for a lower benefit formula and about half of them also included a change to 3 year final compensation.

CalPERS will continue to serve as a partner with public agencies to provide the resources necessary to support prudent and responsible pension reforms.

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At the administrative level, CalPERS continues to take significant steps to ensure the sustainability of the fund.

Our Board regularly reviews the fund's investment policy and actuarial assumptions. Changes to these assumptions impact the level of CalPERS unfunded liability. The Board recently reduced the annual investment return assumption from 7.75 percent to 7.5 percent.

Ultimately, the assumption change increased CalPERS unfunded liability. Our policy is that changes in unfunded liability resulting from changes to the actuarial assumptions are amortized over 20 years. The change to 7.5 percent will increase the employer contribution rate for public agencies by about 1 percent to 2 percent of payroll for most miscellaneous plans and 2 percent to 3 percent increase for most safety plans.

These increases will be effective for the 2013-2014 fiscal year. Recognizing that these changes impact employer's budgets, the Board voted to allow employers to phase in the increase in contributions over 2 years, with smaller payments in the first year and slightly higher payments in later years.

The change will similarly increase the State's contribution for miscellaneous employees by 1.6 percent, State peace officers and firefighters by 2.2 percent, CHP by 2.4 percent and school employers' contributions for school employees by 1.2 percent. Increases for these groups are effective one year earlier, in 2012-2013.

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As an organization, CalPERS continues to take significant actions to manage risk, promote ethics and accountability and increase transparency and education.

We have also turned our focus inward and have taken important steps to enhance our internal strength, leadership team, culture and organizational structure.

Managing Risk

We have recently increased the benefit security for members in our terminated agency pool by adopting a low risk investment policy and asset allocation strategy that more closely reflects expected benefit payments.

The discount rate for the terminated pool is now 3.8 percent due to an investment strategy that is designed to protect the principal by investing in a combination of 10 year and 30 year U.S. Treasury securities. In this case, there are no more employee or employer contributions coming into the account, so it is incumbent upon us to exercise extreme caution with these investments.

Currently, the terminated pool is funded at 240 percent, meaning there is very little risk to future beneficiary payments. If one large agency chooses to terminate its contract, it could bring the funding level closer to 100 percent, which would place member benefits at risk. While the funding ratio will decrease as a result of this change, by investing these funds more conservatively, the benefits are protected.

Promoting Ethics and Accountability

We successfully advocated for financial market reforms that give a greater voice to investors, bring accountability to corporate board rooms and give investors access to the proxy.

We initiated an independent review of the use of placement agents by outside firms managing investments and completed preliminary governance and operational change recommendations.

We also advanced strong new laws around placement agents which include requiring them to register as lobbyists. As a lobbyist, placement agents can no longer accept fees that are contingent upon an administrative decision by CalPERS to invest with their client.

We implemented an ongoing program to reduce money manager fees achieving a $300 million reduction through 2016.

We launched a Web-based system that lets money managers submit proposals directly to CalPERS without the need of placement agents.

We adopted regulations to enhance disclosure and transparency of public employee compensation.

We launched a comprehensive and integrated pension database that allows staff to analyze MOUs, salary schedules, employment contracts and other related documents at the employer level rather than focus only on individual accounts.

Staff will also be able to review the compensation for active members in addition to retirees by obtaining reports of high wage earners who are nearing retirement age.

We completed an audit of the City of Bell and dramatically reduced the pensions of city officials.

We also launched a new 24-7 Ethics Helpline to allow the public to report suspected fraud and waste.

Increasing Transparency and Education

All of our actuarial valuations are now available on our website.

We provide investment return sensitivity analyses in all of our actuarial valuations for employers to appropriately gauge the impact varying levels of future returns will have on the cost of their plans.

And, beginning this year, we will also include sensitivity analyses of the impact of changes to the assumed discount rate on current valuation results.

All of these new valuation elements are consistent with the enhanced risk disclosures recommended by the California Actuarial Advisory Panel.

Actuarial valuations will also disclose the hypothetical termination liability using the reduced discount rate of the terminated agency pool. The hypothetical termination liability is the amount that would be immediately due to CalPERS to fulfill all their current obligations if an agency elected to terminate their contract with us.

We developed a pension tool kit for local elected officials to promote greater education of pensions and assist in policy and decision making.

We've also increased transparency through new policies to post travel costs and financial disclosure statements on our Web site, prohibit staff from accepting gifts and requiring contractors to disclose business connections and gifts.

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You asked how we've responded to efforts by pension obligation bond holders and insurers to establish priority over pension contributions during recent bankruptcy proceedings.

CalPERS pension benefits are constitutionally protected and the Board is constitutionally required to administer the plan solely in the interest of and for the exclusive benefit of plan participants and beneficiaries.

My colleague, CalPERS General Counsel, Peter Mixon recently issued a statement describing CalPERS legal position in bankruptcy proceedings. In that statement, he concludes that in drafting Chapter 9 bankruptcy law, Congress preserved the constitutional sovereignty of the States in municipal bankruptcy proceedings. As a result, Chapter 9 does not preempt the State of California's control over the system of benefits provided to its employees and the employees of participating municipalities.

The statement goes on to set forth that as a trustee, CalPERS is a fiduciary and must ensure the integrity of the State of California's benefits system. CalPERS does not have the right to "forgive" or reduce employer contributions which are necessary to sustain the soundness of the system and ensure the payment of promised benefits.

In a separate statement, Mr. Mixon concluded that the obligations that public agencies owe to their workers have priority over those of general unsecured creditors including bondholders. He went on to observe that "unlike insurance companies, policemen, firefighters and other public employees are not in a position to evaluate the credit risk of their employers."

We believe that, while the fiscal challenges facing cities and counties are difficult for all those involved, pensions are not the cause of, nor a significant contributor toward, bankruptcies. Ambitious borrowing during boom times, and low revenues that came with the bust, are actually the biggest factors behind recent bankruptcy filings.

CalPERS remains committed to working with cities and other public agencies in these turbulent economic times. We continue to provide information and other forms of assistance to local agency leaders as they make very difficult financial decisions.

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Finally, you’ve also asked about CalPERS position regarding the vested rights of retiree health benefits.

CalPERS administers promised health benefits according to State law and takes this responsibility seriously. We are committed to providing comprehensive and cost-effective health benefits for our members.

While CalPERS considers that earned health benefits may be a “vested right” under current statutes, we do not, at this time, have an opinion regarding the constitutional protections of promised retiree health care.

We are watching intently as several cases regarding these protections wind their way through the courts. Most recently, in a closely-followed Orange County case, the Supreme Court of California unanimously ruled that when health care benefits have been approved for retirees, a lifetime right to those benefits can be implied. The Court further concluded that health benefits can be considered a vested right, fully protected by both contract law and the Constitution if it can be proven that health benefits were promised to workers.

It is clear to us that this issue will be further litigated.

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That concludes my testimony. It was my pleasure to speak with you. I'm available to answer any questions you may have.