

**Little Hoover Commission
Written Testimony
Marcia Fritz, CPA and President
California Foundation for Fiscal Responsibility**

Current status of ballot initiative and status of the effort

We suspended our efforts to qualify an initiative for the November ballot which would have required that pension benefits for all new state and local agency workers be uniformly capped, and that benefit increases thereafter be allowed only with voter approval.

We could not raise funds to pay for professional signature gatherers. Pension reform would have (1) saved California's state and local governments over \$500 billion over 30 years in reduced pension costs, (2) increased tax revenues on monies pumped into the economy that otherwise would have funded pensions, (3) lowered retiree health costs, and (4) provided attractive, secure benefits for future workers. No single individual, group, or bond investor directly benefits from pension reform.

Powerful special interests and others prefer the status quo: Wall Street, municipal bond companies, organized labor, rank-and-file workers, city managers, police and fire chiefs, politicians supported by labor, politicians who accrue pension benefits, PERS staff, PERS governing board members, hedge funds, real estate developers, private equity investment firms, and even out of state retirement communities (who attract approximately one fifth of the retirees). There is money to be made on funds going into pension systems, and money to be made on funds going out. The higher the benefits, the better!

We also did not get endorsements from top leaders: the Governor, candidates for governor, constitutional officers such as the Treasurer and Controller, and city leaders such as mayors of San Francisco and Los Angeles. Some support pension reform privately, but they prefer local efforts—primarily collective bargaining—to a statewide ballot measure. So far collective bargaining has not materially reformed pensions.

Taxpayer frustration

I have seen polls that show 2/3rd of voters would support 401(K) benefits for future workers.

Defined benefit plans provide more value to workers at the lowest cost to taxpayers compared to defined contribution plans. HOWEVER, benefit formulas must be sensible, pension funds are administered fairly and efficiently, and pension systems are governed by qualified individuals without conflicts of interest.

Following was a notice read into the official record during a special session of the Board of Retirement, Contra Costa County Employees' Retirement Association, on January 11, 2010:

"NOTICE OF PERSONAL FINANCIAL INTEREST"

"The following members of the Board of Retirement have personal financial interest in the matters before the Board at this meeting, by reason of their being active or retired members of CCCERA: Terry Buck, Richard Cabral, John Gioia, Brian Hast, Sharon Naramore, William J. Pollacek, James Remick and Jerry Telles. The following senior staff members of CCCERA have personal financial interests in the matters before the Board at this meeting by reason of their being active members of CCCERA: Marilyn Leedom, CEO; Silvina Leroux, Deputy CEO; Cary Hally, CIO; Rick Koehler, Accounting Manager; Kathy Somsen, Benefits Manager; and Karen Levy, Counsel. All of these individuals' interests are indistinguishable from the interests of the other active and retired members of the system and they need not recuse themselves from these deliberations.

Their attorney advised the board during the hearing that pension payments were illegally spiked. The board voted to do nothing to stop illegal payments to current retirees and to continue the practice for current workers. They modified their policy only for future workers. **Board members and their staff's personal financial interests in the outcome of this decision compromised their objectivity.**

California public employees' pension benefits are administered by 6 state retirement systems, 21 county systems, 11 city systems, and 15 special district systems. Each system's retirement board contains a majority who have personal financial interests—and rely on interpretations and recommendations from staff who also have personal financial interests—in most matters brought before the them.

Conflicts of interest also arise during collective bargaining. Senior managers negotiate with labor and directly benefit in contract terms they negotiate, such as pension formulas and elements of final compensation to include in pension calculations. Staff advises their governing board. Many who serve on city councils and county boards of supervisors also have personal financial interests in pension decisions. Politicians routinely accept political contributions from labor. Finally, outside contractors, such as labor consultants who perform pay and benefit surveys, are hired by staff who have a financial stake in their findings. MOU's typically stipulate the Union must agree on the selection of the contractor and the agencies used in surveys for comparisons.

As Girard Miller testified in April, "California's crisis of confidence in its retirement systems is largely attributable to poor judgments, faulty decisions, and **terrible governance practices**".

The website: www.pensionsunami.com posts hundreds of stories of undue political influence, disability abuse, pension spiking caused by adding elements to final pay before retiring, "double dipping" (retire with the intention of continuing to work in the same position), pensions for rank and file employees that exceed final wages, an explosion of retirees receiving pensions that exceed \$100,000 annually, and cuts in services and tax increases required to fund pensions.

Fraud or negligence?

A former board member and former CEO of the state's largest pension system are under investigation by the Attorney General for bribery and corruption related to investments that lost millions of dollars (Sacramento Bee, June 3, 2010). One of the investment firms involved in the scandal (Aurora) is headed by an individual who chaired the Governor's Post Employment Benefits Commission in 2007. The Commission was formed to propose a plan to address the state's unfunded retirement liabilities. A short time after releasing their report Aurora secured a \$400 million deal from CalPERS. The Commission chairman's financial interests during the draft phase of the Commission's report seriously compromised the report's objectivity. The report did not contain a single recommendation to reduce benefits—only how to pay for them, increasing funds for Wall Street.

Fraud is deceit, and the essence of deceit is to create trust and then betray that trust. California's public pension systems are not regulated—by ANYONE. Proposition 162, passed in 1992, states:

The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system.

Systems follow Government Accounting Standards Board rules for reporting, and, except for STRS, fund their pensions the same way they report costs. GASB does NOT regulate! It only provides rules for REPORTING, and their rules contain a broad range of options. CalPERS' uses a 30 year amortization policy to fund actuarial losses--the most liberal "easy payment plan" available under current GASB rules. Just like bad mortgages, the payments are low at first, but increase relentlessly as time goes on.

Consider the following:

SB 400 pamphlet provided to legislators did not reveal that, unlike other state pension funds (miscellaneous, industrial, safety, peace officer/firefighter) the CHP's pension fund did not contain a surplus. The combined total gave the illusion that all funds contained a surplus. WAS THIS DECEPTION WAS FRAUD OR NEGLIGENCE?

SB 400 analyses did not warn that pending litigation would likely award additional pension benefits to retirees, increase future costs, and reduce surpluses. WAS THIS OMISSION WAS FRAUD OR NEGLIGENCE?

SB 400 required a change in the funding policy and reduced pension costs even though benefits were increased. WAS THIS A BRIBE?

Local agencies were permitted to grant 2.7% @ 55 formulas to miscellaneous workers and 3% @ 50 formulas to safety workers who were also covered by social security. PENSION SYSTEMS DID NOTHING TO DISCOURAGE EXCESSIVE BENEFITS, AND PROMOTED BENEFIT INCREASES AT GOVERNMENT CONFERENCES. WAS THIS PRUDENT BEHAVIOR?

Hundreds of agencies increased benefits retroactively when their pension funds contained deficits. PENSION SYSTEMS DID NOTHING TO SUGGEST PROHIBITING RETROACTIVE INCREASES TO PENSION FORMULAS WHEN PLANS WERE UNDERFUNDED. WAS THIS NEGLIGENCE?

Current rules allow unreasonable pension spiking, underpriced “air time” purchases, blatant double dipping, expensive extra service credit giveaways, and disability abuse. PENSION SYSTEMS DID NOT SUGGEST LEGISLATION TO ELIMINATE EXPENSIVE LOOPHOLES THEY KNEW WERE BEING ABUSED. WAS THIS NEGLIGENCE?

CalPERS’ Facts at a Glance retirement webpage shows average pensions, but does not show average pension for NEW retiree since benefits were increased. IS THIS DECEPTION?

CalPERS and unions successfully lobbied against AB 1961 (Richman--ATTACHED) which would require a triennial performance audit of CalPERS’ administration and ethics compliance. Due to its findings the Governor’s Post-Employment Benefit Commission’s also recommended “all public pension plans should have periodic performance audits conducted by an independent auditor.”

Attached is a letter of support for AB 1961 from William Holder, Professor of Accounting, University of Southern California, and member of the Governmental Accounting Standards Board. To date we are not aware of any performance audits conducted on pension systems.

Pension benefit levels and negotiations

Pension benefit levels should never provide any possibility that it becomes financial folly for someone to keep working instead of retiring. Examples of unreasonable benefits among dozens of formulas and optional benefits that make it possible to game the system and earn more in retirement than while working:

- (1) Some of the highest formulas are for workers also covered by social security.
- (2) The state pays 2% of prison guards’ wages to a defined contribution plan even though they are covered by 3% @ 50 defined benefit formulas.
- (3) Employers pick up employees’ pension contributions, and the pick-up is added to final pay for pension calculations.
- (4) Cash-outs at retirement, such as vacation, sick-leave (for some), and unused in-lieu compensation are added to final pay for pension calculations.
- (5) Employees can purchase five years of “air-time” at bargain prices to add to retirement income.
- (6) Employees close to retirement are given two FREE service years to encourage early retirement in lieu of layoffs or salary cuts.

Serious problems remain with the negotiation process:

- UNIONS HAVE USED THEIR MONEY, POWER AND INFLUENCE TO CONTROL DEMOCRATS IN SACRAMENTO AND AT THE LOCAL LEVEL;
- ELECTED OFFICIALS LACK PENSION KNOWLEDGE AND POLITICAL WILL;
- VOTERS ARE NOT ENGAGED IN NEGOTIATION PROCESSES.
- CURRENT RULES ALLOW UNIONS TO STACK THEIR BOARDS WITH CRONIES WHO BECOME INSENSITIVE TO TAXPAYER INTERESTS.

California is one of just a handful of states that allow pension benefits to be negotiated at the bargaining table (selecting among a variety of formulas and a list of dozens of optional benefits).

Defined benefits are guaranteed, risky, impact finances for decades, and once granted cannot be adjusted or easily renegotiated. Collective bargaining and contract negotiations are in private, away from public view, among parties, including contractors and actuaries, with serious conflicts of interest. During the process all parties are prohibited from discussing anything that occurs with anyone else or risk serious sanctions. The bargaining table is perhaps the last place that pension benefits should be determined. Even elements of compensation impact long term pension costs. A seemingly small change in how auto expenses are reimbursed, for example, can materially increase long-term pension costs. Elected officials are simply not adequately equipped.

Education is essential

There are five ways to handle a financial crisis:

Succumb—An apathetic response among weary voters

Neglect—Ignore the problem, be dim witted about it

Avoid—This tactic is used by politicians who are sly, cunning, and pandering

Flee—Leave, quit, step down from office

Attack—A direct action on a valid threat is the most sane action

Attacking the problem requires thorough understanding, and education is essential if it is to be solved by local officials through collective bargaining.

Every elected official who negotiates MOUs should be trained on the fundamentals of pension benefits, what is possible to minimize the costs and maximize the benefits, and how to avoid pension traps. And the training should be done by highly qualified professionals who do not in any way have personal financial interest in decisions that may emanate from such training. Education is, perhaps, the most cost effective tool for reducing benefit costs in a very short time.

Transparency and elements of fairness

Collectively bargaining benefits are not transparent. Fairness for taxpayers has not been a consideration. The main focus has been, “can we afford this?” Agencies rarely benchmark their compensation packages to comparable positions in the private sector. Salary surveys benchmark to jobs in other public sector agencies and labor unions have a say in who conducts the surveys and which agencies are included in the study.

Employee compensation is government’s biggest cost. Salary and benefit surveys should be conducted only by individuals hired directly by the governing board. Aptitude, objectivity, and independence are essential qualities, and there should be a rotation of professionals to better ensure their judgment is not clouded by personal financial interests. Surveyors should also be highly trained in the fundamentals of pension benefits and costs. And surveys should always include comparisons of compensation and benefits earned by those performing similar jobs in the private sector. Public safety jobs that do not have equivalent private sector jobs can be benchmarked to compensation for jobs that are similarly hazardous according to the Department of Labor statistics.

The public has a right to know what is being paid to civil servants, and surveys should be published, along with MOUs and management contracts, weeks in advance of final decisions. MOU’s should never be considered a “done deal” by the time it comes up for vote.

Who is responsible for funding retirement benefits, and at what levels

Some city charters require employees and employers each pay ½ of retirement costs, but few do. Employee contributions should be increased for higher costs due to (1) additional elements required to be included in final compensation in addition to base pay, (2) reductions in retirement ages, and (3) longer life spans. Employee contributions should be adjusted routinely when demographic and other changes occur (except for market gains and

losses). Older workers should pay a higher % of their wages toward their pension. Just like health insurance, pension costs increase as workers get older.

Increase Full Retirement Ages

Public pension benefits are too high compared to time worked vs. time in retirement. Last year the average worker retired before 60 after working less than 20 years, and will collect benefits for 22 to 25 years, even longer with survivor benefits. According to CalPERS, the average pension for new retirees was \$37,000 in FYE 2009—plus most receive social security. If the average worker retired at 65, his pension would be \$57,000.¹ Delayed retirement gives the employer five more years to contribute, requires the employee to contribute five more years, provides five more years of investment income, and cuts five years off retirement.

INCREASING THE AVERAGE RETIREMENT AGE FIVE YEARS WILL CUT NORMAL PENSION COSTS BY ALMOST HALF, PRACTICALLY ELIMINATE RETIREE HEALTH COSTS, AND REDUCE MARKET RISKS—AND BY DELAYING RETIREMENTS, PENSIONS WILL BE HIGHER!

Expand the Opt-Out Election Period

The state currently provides an Alternate Retirement Program whereby an employee can opt-out of the defined benefit plan for the first two years of service and, instead, direct his or her contribution to a 401(k)-style plan. A CalPERS study recently found that 44% of the new employees withdraw with no pension obligation remaining for the state to fund. This demonstrates that many employees see no value in their defined benefit plans. If you provide a mechanism for both state and local agency workers to opt out entirely, at any time--they will do so!!!! And when they do, the employer-employee contribution will go up even further for those who remain in the defined benefit plan (absolute pension costs go up as workers age); split 50-50 and even more public employees will opt out. A permanent opt-out provision would save pension costs immediately.

A minimum benefit equivalent to social security must be provided to those not otherwise covered, such as teachers, without an opt-out option.

End Reciprocity

Employees move from agency to agency without impacting their pension benefit. This option serves no purpose other than to increase pension costs and encourage employee turnover. Private sector defined benefit plans don't provide reciprocity with each other's defined benefit, neither should public agencies. We should be making it less attractive for employees to leave, not easier and more costly!

Litigation Costs are Likely, But Necessary

California is overdue for a legal challenge to the commonly held notion that once pension formulas have been enhanced, and/or retirement ages reduced, the promises are rigid. Our state's pension, civil service, and collective bargaining laws are very lopsided in favor of workers and against the common good. We have uncovered ample evidence of severe conflicts of interest, potential fraud, and even illegal activities which can occur in every facet of these "promises". Unless this notion of rigidity is challenged and serious attempts made to bring justice to those not engaged in the process, to those who are hurt the most, there is a very real threat of social unrest.

¹ Average final wage at retirement today is \$80,000; in 2015 the average pension benefit formula provides 2.5% per year of service (25 years) at age 65 on average final pay of \$92,000 (wages increase an average 3.25% per year).

APPENDIX

BILL NUMBER: AB 1961 INTRODUCED
BILL TEXT

INTRODUCED BY Assembly Member Richman

FEBRUARY 6, 2006

An act to add Section 20005 to the Government Code, relating to public employees' retirement.

LEGISLATIVE COUNSEL'S DIGEST

AB 1961, as introduced, Richman Public Employees' retirement system: performance audit.

Existing law creates the Public Employees' Retirement System to provide specified pension and health benefits for public employees, retirees, and their beneficiaries. Existing law creates the Bureau of State Audits, which is headed by the State Auditor, who is required to conduct financial and performance audits as directed by statute.

This bill would require the Bureau of State Audits to conduct and complete a performance audit of the Public Employees' Retirement System on or before December 31, 2007, and every 3 years thereafter, and to report its findings to the Board of Administration of the system and the Legislature. The bill would require the audit to include specified elements. The bill would also require the Board of Administration of the system to report back to the Legislature on the implementation of any recommendations made as a result of the performance audit within one year after receiving the report.

Vote: majority. Appropriation: no. Fiscal committee: yes.
State-mandated local program: no.

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. Section 20005 is added to the Government Code, to read:

20005. (a) The Bureau of State Audits shall conduct and complete a performance audit of the system on or before December 31, 2007, and every three years thereafter, and shall report its findings to the board and the Legislature.

(b) Within one year after receiving a report described in subdivision (a) from the Bureau of State Audits, the board shall report to the Legislature on its implementation of any recommendations made as a result of the report based on the performance audit.

(c) A performance audit conducted pursuant to subdivision (a) shall include, but not limited to, the following elements:

(1) Review the system's code of ethics as it applies to its actuarial operations and review procedures used to monitor compliance

with the code of ethics.

(2) Determine whether the actuary engages in advocacy activities.

(3) Compare actuarial practices to best practices adopted by other pension systems both within California and in other states.

(4) Conduct surveys among system employers to determine satisfaction with actuarial services.

(5) Review quality and consistency of actuarial processes, including complaint processing and investigation.

(6) Determine whether funding policies have been developed with integrity, objectivity, independence, and without undue political influence. Determine whether changes to funding policies are rational, systematic, and preserve equity between periods. Compare policies to industry averages for reasonableness.

(7) Determine whether the actuary considers the reasonableness of each actuarial assumption independently on the basis of its own merits, the degree of uncertainty in assumptions, the potential for fluctuation, and the consequences of any fluctuations. Compare these assumptions to industry averages for reasonableness.

(8) Determine whether systems are in place to ensure that reports generated by the actuary contain information that is relevant, understandable, consistent, comparable, timely, and reliable, and whether the reports are prepared in accordance with generally accepted governmental accounting policies.

(9) Determine whether the actuary adequately considers changes in plan designs or external circumstances that may significantly alter the level and trend of expected future experience when preparing cost analyses of plan amendments.

(10) Determine whether actuarial disclaimers were adequate to ensure that readers understood the risks involved and the sensitivity of assumptions.

(11) Determine whether data is reviewed adequately for reasonableness, and that systematic overstatements or understatements of payroll are likely to be detected.

(12) Determine whether employers are properly trained to ensure that payroll data is reported accurately in compliance with pension laws and regulations.

(13) Determine whether pension actuarial communications disclose all facts that, if not disclosed, might reasonably be expected to lead to an incomplete understanding of the communication.

(14) Determine whether prior actuarial measurements are adjusted, when appropriate, for changes in participant or demographic characteristics, changes in external factors, length of time since prior measurement, and similar changes, when a prior measurement is used in lieu of a new detailed measurement for plan amendment cost analyses. Determine whether the actuary projects assets and actuarial liabilities in a consistent manner when the actuary approximates results based on prior measurements.

(15) Determine whether contracting local agency employers were provided sufficient information to determine long-term costs of retroactive benefit increases and related risks in order to make informed decisions.

(16) Determine whether all reports, including cost analyses of proposed plan amendments, receive peer reviews prior to release to ensure correctness, completeness, and appropriateness of the work product.

(17) Compare estimated costs related to proposed plan amendments

to actual costs for a representative sample of employers and determine whether risks related to factors causing material differences, if any, were clearly disclosed.

(18) Compare the system's actuary department structure to alternative structures and determine whether there are ways to improve the actuary department structure. Review and evaluate methods used to select chief and staff actuaries, methods used to evaluate their performances, and methods used to determine compensation and performance bonuses.

(19) Review any reports prepared by outside consultants related to actuarial operations and determine whether these reports were presented to governing board members.