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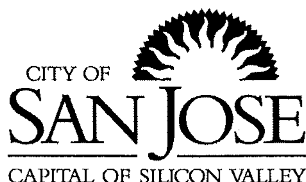


Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: **Pension Reform**

DATE: October 23, 2009

INFORMATION

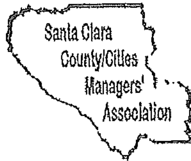
As you may be aware, I am a member of the Santa Clara County/Cities Managers' Association. The Santa Clara County/Cities Managers' Association has recently spent a significant amount of time discussing the high cost of retirement benefits for our respective cities. Although the retirement benefits of all of the cities in Santa Clara County are managed by the California Public Employees' Retirement System (CalPERS), the issues facing the City of San Jose are similar. The costs of retirement benefits are escalating significantly and consequently divert limited resources from direct service delivery to our communities.

Because the high cost of retirement benefits is a concern shared amongst City Managers in our area, the Santa Clara County/Cities Managers' Association joined with the San Mateo County City Managers' Association in preparing the attached policy statement on local government retirement benefits, the corresponding fact sheet, and a list of frequently asked questions. This policy statement endorses a number of principles for a revised pension system and was presented to the Santa Clara County Cities' Association during its September 2009 meeting. The Santa Clara County Cities' Association Board unanimously adopted the policy statement. This policy statement was also presented to the Peninsula Division of the League of California Cities during a special division meeting on October 15, 2009. During this meeting, the elected officials in attendance unanimously voted to support this paper.

Because the City of San Jose shares the problem of escalating retirement benefit costs with our neighboring cities, I wanted to provide you with a copy of the documents prepared by the Santa Clara County/Cities Managers' Association and San Mateo County City Managers' Association. I will also be providing a copy of these documents to our bargaining unit representatives.

DEBRA FIGONE
City Manager

Attachment 1: Policy Statement on Local Government Retirement Benefits
Attachment 2: Fact Sheet: Local Government Retirement Plans
Attachment 3: Local Government Retirement Plans – FAQ's



San Mateo County
City Managers Association

Policy Statement on Local Government Retirement Benefits

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, and years of service. Most, but not all, municipalities in California are part of the Public Employees' Retirement System (PERS).

Over the years, local government retirement costs have risen and fallen based on two key factors: investment returns and the level of benefit payments provided to employees. In the late 1990's the California legislature enacted significant benefit enhancements for public employees in the PERS system that were optional for participating local governments. At that time, some retirement plans were deemed to be "super funded" and many local governments adopted benefit enhancement plans. For example, most public safety personnel are on the "3% @ 50" plan, which provides a pension benefit of up to 90% of salary after 30 years of service as early as age 50.

When the retirement system suffered serious investment losses in the early part of this decade, these losses, combined with newly approved benefit enhancements, caused dramatic increases in employer contribution rates. Cities in our two counties have seen the percentage of their General Fund budget dedicated to PERS costs increase while their retirement liability funding had decreased from over the past decade. For example, in Mountain View, General Fund PERS costs have gone from $2.8 million in FY00 to $7.7 million in FY10; in San Bruno, it has gone from $240,000 to $4 million. Daly City's percent of the General Fund budget spent on retirement benefits has increased from 4.3% to 10.4% between FY00 and FY10; in Belmont, it has gone from .5% to 11.4%. And Campbell has seen its public safety retirement system fall from 122% funded to 70% funded over ten years.

In the past five years, a number of proposals have been introduced to reform or dramatically revise the public pension system in California. In 2004, a task force of the League of California Cities began an extensive study of the defined benefit system and proposed reforms. In 2005, the League board of directors accepted a report on pension reform from the task force as an initial assessment and for consideration in the ongoing debate of this issue. The report included a number of "general principles" and specific reform recommendations. To date, no concrete action has been taken by the legislature.

Recently, the city managers of San Diego County have prepared a white paper on this issue calling for a new and lower second tier retirement benefit for new hires. Other manager groups across the state have begun a similar dialogue in recognition that the costs of the current system are not sustainable. Additionally, Governor Schwarzenegger has proposed returning pension formulas to 1999 levels for new hires – a move he says will save the state $74 billion through 2040. The City of Sunnyvale has done a preliminary analysis of a lower tier and has estimated it could save a total of $44 million over 20 years. The cities of San Carlos and Brisbane have already initiated a lower, second tier for new hires (among other cities statewide).

Discussion

While the debate is ongoing, no clear consensus has been achieved on addressing the high cost of pension benefits and no action appears imminent. The city managers of Santa Clara and San Mateo counties believe it is important to take a proactive stance on this issue which has long-term implications for the fiscal stability of our cities. This issue is even more important now, given the tremendous losses suffered in the stock market in the past year. At fiscal year end in June 2009, PERS annual returns were down 23.4% from the previous year. This is on top of losses of 5.1% in Fiscal 2008. PERS assumes a 7.75% gain annually to maintain its pension obligations, but clearly there is no guarantee this rate can be achieved. Based on this year's negative returns, employer rates are expected to jump significantly as of July 1, 2011.

Therefore, as a matter of public policy, we endorse the following principles for a revised pension system.

Guiding Principles

- Our residents deserve fiscal policies that preserve local government's ability to meet community needs, while attracting competent and motivated employees to public service.
- Providing adequate retirement benefits is an important part of attracting and retaining public employees; this continues to be an issue as, demographically, there are fewer young people to enter the public sector.
- Current retirement benefit formulas are not fiscally sustainable. The costs are escalating beyond our ability to fund them and diverting limited resources from direct service delivery to our communities. In addition, current pension benefits exceed what private sector employees receive and what is reasonably needed to attract public employees.
- Ideally, this situation would be addressed at a statewide level and there would be consistent standards for all. We cannot, however, afford to wait for a statewide solution. Therefore, the cities of Santa Clara and San Mateo counties support

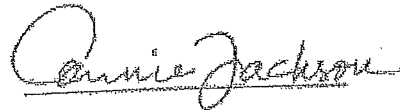
implementation of a reduced and sustainable level of retirement benefits for all new employees of agencies in the region.

- Each city has different histories, perspectives, and fiscal conditions; a "one size fits all" approach may not be realistic, but all cities in the region compete for the same employees and therefore should move in the same direction to a lower-cost benefit.
- Each city has the legal duty to meet and confer in good faith with its recognized bargaining unit representatives concerning changes to existing terms and conditions of employment.
- Every city is committed to moving toward a two tier system for all new contracts.
- Any new system or tier should be fair to employees, sustainable for taxpayers and employers, and based on objective actuarial data.

Action Steps

The city manager associations of Santa Clara County and San Mateo County support the statements in this document and their members pledge to work with their elected officials and labor groups to implement its principles. We further pledge to work with other city managers across the state and the League of California Cities to advocate for changes consistent with this document.

Dave Anderson, SCCCMA



Connie Jackson, SMCCMA

Adopted July, 2009

FACT SHEET: LOCAL GOVERNMENT RETIREMENT PLANS

What type of retirement plan do local governments provide to public employees?

- Public employees who work in most local governments do not qualify for Social Security Retirement Benefits.
- The State of California and most local governments in California have a defined benefit (DB) retirement plan managed by the California Public Employees' Retirement System (CalPERS).
- CalPERS retirement plans are intended to provide employees with retirement benefits and encourage employees to select and maintain a career in public service.
- The CalPERS retirement plan has one plan for public safety employees and a separate plan for miscellaneous (non-safety) employees.

How do CalPERS Defined Benefit (DB) Plans Work?

- A DB plan provides a guaranteed annual retirement pension based on a formula that considers retirement age, years of service, and salary. The annual benefit is distributed in monthly payments. The payment amount is adjusted annually for inflation, subject to a cap on the allowed increase. For most jurisdictions, the cap on the increased payment is 2%.
- The retirement formula for non-safety employees is negotiated between the local government agency and the employee union. The retirement formula can be 2.0, 2.5, or 2.7% of an employee's final annual salary at age 55. For example, a non-safety employee who retires with a final annual salary of $70,000 after working 20 years at the benefit formula of 2.0% would earn an annual retirement benefit of $28,000 (20 years X 2.0% X $70,000). A 2.5% formula would yield an annual retirement of $35,000 and 2.7% would yield $37,800.
- The most common formula for a safety employee is 3% at age 50. For example, a police officer who retires with a final salary of $100,000 after working 20 years at this formula would receive an annual retirement benefit of $60,000.

How are CalPERS Defined Benefit (DB) Plans Funded?

- DB benefit plans are typically financed by employee and employer contributions, and from investment income on those contributions, as managed by CalPERS. Historically, interest earnings have funded about 70%-75% of retirement benefits.
- Most employee contribution amounts are established at a fixed rate, averaging between 7-10% of their annual salary.
- Each city's or county's CalPERS employer rate is adjusted every year based on an actuarial valuation, which takes into account the performance of the CalPERS investment portfolio, and the expected pension obligation for the particular city or county. Employer rates have risen dramatically in the past five years and are expected to continue to rise in the next five years.

What are the Current Issues Facing Public Sector Pensions?

- Many public agencies enhanced their pension benefits during the stock market boom and the strong economy of the late 1990s. Local government agencies enhanced retirement benefits during this time in order to remain competitive after the state authorized enhanced benefits and because many CalPERS plans were not making any employer contributions at the time.
- Costs to public agencies have increased significantly due to enhanced benefits, and the economic recession that resulted in significant losses in investment returns will increase costs even more.

What Can be Done to Control Public Retirement Benefit Costs?

- Many local governments have discussed and are committed to moving toward a modified retirement benefit that is more sustainable.

LOCAL GOVERNMENT RETIREMENT PLANS – FAQ for the Public

Q: ***Why does local government use a defined benefit plan?***

A: A defined-benefit retirement plan has been part of the public sector benefit package for decades. It has assisted public agencies in attracting and retaining employees. Most local government agencies do not participate in Social Security, so cities consider that a modified defined benefit plan will be the primary retirement benefit. Many private sector employers used to have defined benefit plans and also social security. In general, returns are better and fees are lower in defined benefit plans, which benefit from professional investment management.

Q: ***If the current public retirement system is too expensive, why don't municipalities just change to a different plan?***

A: Many cities have been advised that they cannot lawfully change employee benefit plans for current employees since the benefits are considered "vested." In many cases, changes for future employees require renegotiating agreements with the applicable labor organizations.

Additionally, each municipality is concerned that if it is the first to switch to a modified, more affordable retirement plan, then it will be at a disadvantage in recruiting talented new staff. The current joint effort by cities in the counties of San Mateo and Santa Clara encourages regional action to pre-empt that recruitment problem on the Peninsula and South Bay.

Q: ***What types of solutions are cities considering to address the high cost of public retirement plans?***

A: The most common suggestion is that cities renegotiate the benefit formula through collective bargaining with employees. A "two-tiered" retirement plan would be created; newly hired employees would have a reduced and more affordable retirement plan and current employees would retain their current plan. This two tiered retirement plan would reduce retirement costs as the workforce turns over, providing long-term budget savings.

Other suggestions range from developing hybrid retirement plans (a combination plan that blends a defined benefit plan with defined contribution features) to negotiating that employees contribute more of their salaries to pay for the cost of their retirement benefits.

Q: ***How much can be saved with a second tier?***

A: The savings will largely depend on how the new tier is structured and the rate of employee turnover. However, it is estimated that reducing the benefit formula to the levels which existed in the mid-1990's would generally result in savings approximating 5% of total payroll (which is one of the largest General Fund expenditures for public agencies) once all employees are on the new tier. As an example, if a city has a current annual PERS expenditure of $2M and a rate of 30% of payroll for its Safety employees, a new lower tier could reduce the rate to 25% (annual cost savings of $332,000 or 16.6%), excluding any other changes.

Q: ***Why don't public agencies just move to a single, unified retirement system?***

A: CalPERS, in which most public agencies participate, is indeed a single, unified retirement system, with all the attendant economies of scale in administration and investing. In fact, CalPERS is the largest pension fund in the United States, public or private. It offers a menu of retirement options with differing levels of benefits, and costs, among which individual local governments choose in order best to match their own recruitment and retention needs.

Q: ***How do cities go about changing benefits?***

A: Cities have an obligation to "meet and confer" in good faith through the collective bargaining process with employee organizations in order to change the terms and conditions of employment. Councils would provide direction to management to request a new pension benefit and it would be negotiated with employee groups. Employees should understand the financial strains of the current system and how it will impact employment and services if not changed.

LOCAL GOVERNMENT RETIREMENT PLANS – FAQ for Employees

Q: What is the problem?

A: The problem is that the current benefit levels are not sustainable. It is true that for many years the stock market was booming, cities and counties paid very little, if anything, into PERS, and some were deemed "super-funded"; as a result, most agencies significantly enhanced employee benefit formulas. Unfortunately, that has now put a tremendous strain on agency budgets. The increase in employer costs began long before the current economic crisis, but is worse because of it. Cities that once budgeted for an 8-12 % PERS rate are now saddled with rates around 17-33%. For example, in Daly City, in the past decade, the percent of the General Fund spent on retirement benefits has increased from 4% to 10%. Funding these retirement obligations is siphoning away money from services to the community.

Q: Benefits are paid primarily from investment returns, which over the long term have been very strong. Won't we be OK once the market recovers?

A: The return on investments had to be 7.75% per year to maintain the sustainability of the system. During the past year, PERS lost 23% of its value (on top of losses the previous year). Because of the way rates are smoothed over many years, PERS has already announced that rates are likely to increase at least 4% of payroll over the next five years.

Q: What types of solutions are cities considering to address the high cost of public retirement plans?

A: The most common suggestion is that cities renegotiate the benefit formula through collective bargaining agreements with employees. A "two-tiered" retirement plan would be created; newly hired employees would have a reduced and more affordable retirement plan and current employees would retain their current plan. This two tiered retirement plan would reduce retirement costs as the workforce turns over, providing long-term budget savings.

Other suggestions range from developing hybrid retirement plans (a combination plan that blends a defined benefit plan with defined contribution features) to negotiating that employees contribute more of their salaries to pay for the cost of their retirement benefits.

Q: How will changing the retirement benefit formula affect current employees?

A: The two-tier approach would affect only new hires into local government. They would receive a reduced, but still guaranteed, retirement benefit. However, their coworkers who were hired under a different retirement benefit formula would continue to earn the higher benefit formula for retirement.

Q: It's not fair to have employees sitting side by side getting different benefits.

A: New employees would come in to the system knowing what their benefit is going to be (which is likely still more generous than the private sector). Besides, the reality is that there already are differences. For example, employees hired after 1986 are paying into Medicare and those that were hired before that date are not. Two employees next to each other doing the same work may also have different take home pay based on their tenure with the organization or the health benefits they utilize.

Q: When all the cities are talking about this together isn't that collusion?

A: No, it is not collusion. Cities regularly engage in discussion on issues of common interest. The issue paper simply outlines an important public policy issue and states guiding principles for dealing with it. The document recognizes that each city has an obligation to meet and confer with its employee groups.

LOCAL GOVERNMENT RETIREMENT PLANS – **FAQ for Employees**

Q: ***If our city goes to a lower benefit and other cities don't, will we be able to recruit and retain good employees?***

A: All agencies in the Peninsula more or less compete for the same labor pool, so it would be best if they all had the same benefit formula; that is why the city managers are urging all cities to address this issue. But the reality is that different cities offer different salary and benefits right now, and employees choose to work for different agencies for a variety of monetary and non-monetary reasons.

Q: ***If you change the benefit for new employees, isn't it only a matter of time before you reduce benefits for current employees.***

A: Most lawyers believe current employees have a vested right to receive the pension formula currently offered. We know of no agency that has reduced their retirement benefit to current employees, and that is not our intention.

Q: ***Employees pay their share of PERS so why should they get a lower benefit?***

A: In many (but not all) cities, employees pay a fixed 8 or 9% of their gross pay as the employee contribution to retirement benefits. However, the employer is required to pay whatever else is needed to fund the program. In many cases, that is now anywhere from 10-40% of payroll, which is a huge strain on budgets. Under a second tier, new employees will be paying into PERS just as current employees do but their benefit formula may be lower, which would make the employer share more manageable.

Q: ***Councils and managers agreed to benefit enhancements, so why are you now trying to take them away?***

A: No current pension benefits would be taken away for current employees under a two tier system. And no one person or agency is to blame for the current status of PERS. When managers made recommendations and City Councils approved enhanced benefits, many cities were not making any employer contributions to PERS and they were told by industry experts (actuaries) that there would not be economic consequences associated with the new benefits in the foreseeable future. Unfortunately, those calculations have proven to be wrong and now we are in a different position. It would be fiscally irresponsible to ignore the dramatic effect these enhanced benefits have had on municipalities. A new tier protects the promises made to current employees yet reduces costs over time to make the system more sustainable.

Q: ***We get paid less in the public sector, so we rely on the benefits more than private sector employees.***

A: Remember, no current employees would be impacted by a second tier. Some positions in the public sector are paid less than the private sector, some are not. In any event, even a new lower tier defined benefit plan is likely to be more generous than most private sector plans. What we are really talking about here is returning to something like the level of benefits that existed a decade ago. Councils and managers want to attract and maintain the best employees possible. We are not looking to get rid of PERS but offer a program that is sustainable so that we can keep our employee and service levels.

Q: ***What happens if there is no agreement locally?***

A: For one thing, rates will continue to rise and services and positions are likely to be cut. In addition, the public mood is very negative toward public pensions right now. A voter initiative by opponents of public pensions is being discussed and is much more dramatic in its impact on pensions.