To: MCCMC Members

From: Larry Chu
Vice Mayor, City of Larkspur
MCCMC President (2007-08); Executive Committee (2006-10)

Date: September 17, 2010

RE: California's Unfunded Pension Liability

Background:

The current public employee pension system is the result of legislation sponsored by the California Public Employees Retirement System in 1999 under Senate Bill 400 (SB400). CalPERS argued that its members and retirees were not benefiting from the high returns that had been generated throughout the decade[1].

The California Legislature overwhelmingly (109-7) granted public employees (which also includes the California State Teachers Retirement System and the University of California Retirement System) a new formula which increased the percentage applied to each year of service to the last year of compensable earnings and allowed for retiring as young 50 years old (as in the case of some of the public safety plans).

SB400 was pushed through quickly and without much debate. It was also done without the benefit of a detailed and independent financial analysis by the Legislative Analyst's Office (LAO). The report, identifying $400 million in additional cost just in 2001-02 alone, was not released until almost three months after SB400 was passed[2].

The LAO issued another report in 2004 recognizing an unfunded liability and recommending a restructuring of retirement benefits. Light was cast on two issues: (1) lower than expected stock market returns and (2) enhanced retirement benefits as a result of SB400[3].

This issue of unfunded liabilities had remained virtually ignored until the economy started to unravel in September 2008. Financial publications started to question the continued use of Defined Benefit Plans and it has caught on in the mainstream media.

In April 2010, the Stanford Institute for Economic Policy Research (SIEPR) released a report on the State's unfunded pension obligations using a methodology whereby

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[1] SB400 Senate Floor Analysis (9-28-99)
[2] State Employee Compensation: The Recently Approved Package (Legislative Analyst's Office – 12/6/99)
[3] Alternative Retirement Benefit Programs (Legislative Analyst's Office – 2/18/04)

random market occurrences are simulated[4]. The analysis shows a 71% probability that in 16 years, the CalPERS will be underfunded. There is a 12% probability that this liability will exceed $500 billion. The report also provides the underfunding probabilities for CalSTRS and UCRS.

CalPERS issued a 13-point defensive response to the report[5] (which has subsequently been refuted by SIEPR). Nothing was stated in the CalPERS response to recognize and address what is a systemic problem and condition.

Sustainability:

In the 1990's, the stock market was primarily fueled by speculation. Price appreciation was not the result of sound investment fundamentals. In doing the simple math on an 8.25% discount rate[6] used by CalPERS, the market would need to increase by 221% every decade.

To make up for what is now a "lost decade" of returns, the market will have to appreciate 529% by 2020 for CalPERS catch up to where it should be[7]. For perspective, the Dow Jones Industrial Index would have to be at 56,124 and the S&P 500 Index would have to top 7,172.

This was never a sustainable model in perpetuity. Even the CalPERS Chief Actuary has now acknowledged there is a problem[8]. There are opposing viewpoints that continue to place the blame on a bad economy for the unfunded liability. However, this was not the cause. A bad economy unveiled and exposed the true vulnerabilities in the system.

To cite past performance, especially in a period of abnormally high returns, is also not a valid argument. Any financial prospectus will state past performance is not an indication of future returns.

The discount rate used by CalPERS, which was adjusted from 8.25% to 7.75% in 2003, is still too high. This understates the unfunded liability. SIEPR may have used a discount rate in their analysis that is too low. Ignoring a debate on which is correct (and it's probably somewhere in between), the fact remains that both calculations will still show that California's pension obligations are underfunded by hundreds of millions of dollars.

Investment Returns:

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[4] Going For Broke: Reforming California's Public Employee Pension (www.stanford.edu/group/siepr/cgi-bin/siepr/?q=/system/files/shared/GoingforBroke_pb.pdf)

[5] www.calpersresponds.com/issues.php/response-stanford-policy-brief

[6] In this context, the rate used in determining the present value of future cash flows.

[7] Based on pricing as of 9/17/10.

[8] Ron Seeling quoted as saying "We are facing decades without significant turnarounds in assets, decades of – what I myself, my personal words, nobody else's – unsustainable pension costs." (Sacramento Bee – 8/19/09)

Traditionally, pension funds have looked for safe, steady returns. Investing in investment grade municipal and corporate bonds provides for a regular or fixed return. In the past decade, CalPERS has done very well in this asset class and have been ranked in the top percentile among its peers in domestic fixed income returns[9].

However, public pension funds, including CalPERS, have been adding more risk and volatility in their asset mix. While they may claim it is for diversification, the motivation is to get higher returns to make up for the losses or to close the gap on the underfunding[10].

CalPERS' investment policies prohibit highly speculative investments, yet the board allowed for investing in Credit Default Swaps (CDS)[11] in May 2007[12]. These are highly leveraged instruments used for arbitrage[13], hedging, and speculation.

In addition, 21.2% of the current value of assets under management[14] is in real estate or private equity[15]. The ratio would be much higher on a cost basis leading one to ask if there was unacceptably high risk at the time of these purchases.

The losses on riskier and more volatile investments have placed CalPERS at the bottom 7% of their peer group last year and in the bottom 10% in the past five years[16]. CalPERS is also in the bottom 1% of their peers in Private Equity[17].

Governance:

The governing boards of private sector investment management firms consist of investment professionals and legal or regulatory professionals in the industry. In contrast, the President of CalPERS is a Glazing Specialist for a school district and the Chair of CalSTRS is a retired science teacher. The board of CalPERS has one investment professional and CalSTRS has none.

Are they as individuals and as a group capable of making an independent and autonomous decision without the opinions and influences of their staff and the fund managers that solicit the business to sub-manage the pension assets? The anecdotal evidence would suggest not given the consistently bad timing associated with their investment decisions.

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[9] CalPERS, the Great and the Not-So (Wall Street Journal – 12/9/09)

[10] California Pension Fund Hopes Riskier Bets Will Restore Its Health (New York Times, 6/24/09)

[11] Unregulated financial instruments providing credit protection from default, but not to be equated with insurance. A small investment can buy coverage on bonds worth much more. A buyer also does not own the debt obligation. The risk comes when the defaults start to rise and the seller of the swaps, who is not required to maintain capital reserves to pay off the buyers, can no longer cover all the loans.

[12] CalPERS Derivative Investment Policy (5-14-07)

[13] Price differential of the same instrument in two or more markets.

[14] As of 9/15/10.

[15] Equity investments in firms through venture capital or leveraged buyouts and not through publically traded exchanges.

[16] 2009 Difficult Year for CalPERS (Capitol Weekly – 1/7/10)

[17] CalPERS, the Great and the Not-So (Wall Street Journal – 12/9/09)

SB400 was passed just after the dot-com bubble put pushed stock market at its all-time high. A year after allowing the use of CDSs, sellers like AIG, Lehman Brothers, Bear Sterns had defaulted on their obligations and went bankrupt. A vast majority of CalPERS real estate holdings were acquired at the market high[18] and the price tumbled. Private equity deals done in the same timeframe have been equally impacted by the recession and their situations are exacerbated by a tightening of credit.

In addition, CalPERS is now having to answer to ethics violations. Former CalPERS board members are being investigated by federal and state authorities for accepting payments from CalPERS investments into private equity firms that they represented[19].

There are other conflicts. Typically, the majority of the board (in CalPERS' case, a plurality) is elected by the members who receive the benefits. As in the case of SB400, from a fiduciary standpoint, how can the CalPERS board be representing its members to the detriment of the public who pays for these benefits?

Is CalPERS getting the best risk adjusted rate of return? A combined study of 20 public pension plans (which included CalPERS) by the University of Illinois and Michigan State University made the observation that they have a bias towards investing in companies within their own state. This bias is three times higher than other institutional investors[20].

Whether this is due to having more knowledge about companies in their own state or whether there are political reasons to support in-state companies, the lack of diversification and overweighting of the portfolio can be detrimental when the State and companies within the state are experiencing the same economic and fiscal pressures.

Is CalPERS sacrificing returns for social causes? The Principles of Responsible Investment[21] does not necessarily equate to lower returns. However as an example, the $100 million loss in affordable multi-family units in East Palo Alto has been questioned. This is now back in news as a judge has ordered CalPERS to disclose the documents associated with the decision making process on this deal[22].

Regulatory:

Finance Directors will say there are in compliance with respect to the reporting of unfunded liabilities. And they are. However, the inference is that compliance and adequate funding are synonymous and therein contributes to promoting the fallacy that the system is not broken.

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[18] "The vast majority of the real estate commitments that figure in these declines in our portfolio were made during the 2005 and 2006 market peak." as stated by Clark McKinley, investment officer for CalPERS' Office of Public Affairs, in an email response to The Registry (11/10/09)

[19] CalPERS, contingency fees on Assembly agenda (San Francisco Chronicle – 4/4/10)

[20] Investment Behavior of State Pension Plans (Jeffrey Brown, Joshua Pollet, Scott Weisbenner – September 2009)

[21] United Nations Environment Programme Finance Initiative

[22] CalPERS Ordered to Release Page Mill Documents (Palo Alto Online – 9/15/10)

The Government Accounting Standards Board (GASB) Statement 25 deals with the financial reporting requirements for Defined Benefit Plans. One requirement is to provide information on the changes in plan assets. Six years of historical trend and actuarial data is the minimum requirement[23].

Two problems arise from using only the minimum requirement. First, retired employees are in the system a lot longer than six years. Retirement age is as low as 50 years for public safety and 55 years for miscellaneous employees or teachers. Projections for the average life expectancy in 2010 for an American male are 75.7 years and 80.8 for a female[24].

Second, the GASB states that they set the standards for accounting and financial reporting, but not for how governments provide the resources to fund their pension benefits[25]. With no regulatory guidelines to provide guidance for public policy and term limits at the state level, the California Legislature will continue to defer any solutions.

Impact On Cities:

CalPERS knows it needs to close the funding gap. Their Chief Investment Officer wants to get higher returns through a strategy of increasing the level of investments into riskier and more volatile instruments such as derivatives[26] and Exchange Traded Funds[27].

There are no direct consequences to public pension funds when they lose money or the level of funding is inadequate. The cities are told their contributions have been adjusted to make up for the difference. Even if high-risk investments are able to produce the expected returns over the long-term, the high volatility associated with these instruments will result in cities being vulnerable to large variation in cash payments.

The only options left for cities would be to reduce services, to increase debt (e.g. pension obligation bonds), or to use reserves set aside for disaster response.

For the State, CalPERS has been willing to assume this year’s funding increase, but it must be paid back at the end of the next fiscal year with 7.75% interest, i.e. equivalent to the actuarial requirements of the fund. CalPERS may be helping with a cash flow problem for this year. However, the net effect is that the State’s General Fund is

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[23] Summary of Statement 25 (GASB – November 1994)
[24] National Vital Statistics Reports (US National Center for Health Statistics –4/17/09)
[25] Fact Sheet about Preliminary Views, Pension Accounting and Financial Reporting for Employers (GASB – June 2010)
[26] Instruments whereby the price and value are derived from some underlying commodity or security. Most often, these are in the form of options, futures, forwards, and swaps.
[27] CalPERS After Scandal Embraces Risk Facing $240 Billion Gap (Bloomberg – 9/8/10)

generating a 7.75% return for CalPERS. This is less money returned to the cities and investment income that CalPERS surely would not be able to achieve on their own.

Next Steps:

The natural expectation is to think the solution will come from the State level. However, both sides of the partisan divide seem to be looking at each other to fix the problem. Democrats are beholden to the public employee unions, but recognize that each dollar spent on escalating pension benefits is another dollar lost on social services. Republicans don't want to be seen as being soft on crime by not supporting law enforcement and prison guards, but they also know that the amount of money needed cannot be achieved without increasing taxes.

Most elements of this dysfunctional system are out of the control of cities even though they are a primary stakeholder. What the cities can do is to start lowering the cost and begin eliminating the risks associated with pensions. Note that this does not address other post-retirement benefits and associated liabilities.

The State and some Marin jurisdictions have made some small initial efforts to lower the costs. But nothing has been done to lower the risk and uncertainty.

After my report on the unfunded pension liability issue at the April 23rd MCCMC meeting, I informally assembled over a dozen elected officials from different jurisdictions in Marin to exchange thoughts and ideas online. While I have developed my own clarity of thought in what I believe the solution is and how to get there, it needs a broader discussion at a policy level and the feedback from our managers.

On August 23rd, the MCCMC Executive Committee had a conference call to plan the agenda and program for 2010-11. One item on the agenda was for me to provide an update on the pension issues. It was suggested that the Mayors Select Committee be assembled on October 27th to discuss the formation of an ad-hoc committee to study this problem and to have this committee come back with recommendations to our members.

This discussion could eventually evolve to the regional level where it would include our colleagues in the North Bay Division. However, do not expect the support from the League of California Cities until after the end of the year at the earliest. In a dialogue with Chuck Dalldorf[28] in April, he stated this is an important issue for the League, but it

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[28] Regional Public Affairs Manager, League of California Cities in the North Bay and Redwood Empire divisions (April 2009-June 2010).

is not their fight right now since they need the support of labor unions for other proposed ballot initiatives in November.