Do pension boards need restructuring?

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by Ed Mendel
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SAN JOSE — A proposal to give independent financial experts, with no connection to the city, a majority of the seats on two San Jose public employee pension boards was opposed by union leaders at a hearing last week.

A consulting firm hired by the city argues that pension boards dominated by "stakeholders" representing management and labor are an outdated model, resulting in two big problems in the modern world.

— An amateur board lacks the expertise to properly oversee complicated new ways to manage pension funds such as "liability-driven investing" and "immunization," which can help manage the level and volatility of pension contributions.

— A stakeholder board also has conflicts of interest. For example, managers might skew investment decisions to reduce contributions. Employees might pursue risky high-yield investments that could produce supplemental retirement payments.

San Jose has struggled with a budget deficit for nearly a decade, resorting to layoffs and service cuts. Now big pension fund losses in the stock market crash may require *a $50 million increase* in the city's annual $131 million pension contribution.

The city forecasts that the contribution for the police and fire pension fund, currently about 27 percent of pay, will jump in five years to 50 percent of payroll under "optimistic assumptions" and to 60.9 percent under "baseline assumptions."

Rather than plunging right in with something like a "two-tier" plan to cut retirement benefits for new hires, city officials may have thought that reforming "governance" might be a less controversial first step toward pension reform.

But the *proposal to restructure* the board, called a "power grab" by some, was sharply criticized by leaders of the city's two biggest public employee unions Thursday (Aug. 27) during the second of two hearings last week.

San Jose pension governance hearing

Yolanda Cruz, president of the Municipal Employees Federation, AFSCME Local 101, said the city is trying to use the national financial crisis to take control of pension boards that are not in need of reform.

“We all know, as city employees, the city is looking to take away things from us,” said Cruz. “They want to implement two-tier plans. They want to do a lot of stuff.”

Bobby Lopez, president of the San Jose Police Officers Association, said his union opposes the proposal to let the city council appoint four independent experts to the seven-member boards because of “systemic distrust” of the city manager, Debra Figone,

“The problem with giving the city the four votes is that we don’t trust them,” said Lopez. “They have lied to us in the past … If you give them four votes, unfortunately our three votes don’t count.”

The consultant, Cortex Applied Research of Toronto, contends that the city should have majority representation on the board because it bears the risk. The city, not the employees, has to come up with the money when pension funds fall short.

One of the “best practices” examples of pension board restructuring in the Cortex report is the San Diego City Employees Retirement Association.

In a worst-case example of how conflicts of interest can play out on a board dominated by stakeholders, San Diego officials made two deals with union officials over the years that increased benefits while cutting contributions to the pension fund.

For city officials, the lower contributions made more revenue available for other programs, without raising taxes or cuts elsewhere in the budget. Union officials got more retirement benefits for members and themselves.

But the short-term gains for the city hurt the long-term health of the retirement system, whose unfunded liability ballooned to $1.7 billion. To begin closing the gap, the city eventually laid off employees, cut services and could not sell bonds for several years.

State and federal charges brought against eight former pension officials in 2005 and 2006 are still pending. Meanwhile, the city has restructured its pension board, following recommendations made by a blue-ribbon panel and an audit committee.

Now the 13-member board has seven independent financial experts appointed by the mayor and confirmed by the city council, five members representing active and retired employees, and one member representing city management.

An overhaul of the Oregon Public Employees Retirement System in 2003 included a similar restructuring of the board, giving three of the five seats to persons with some financial management experience and no connection to the retirement system.

“You have to make sure that you have people with an independent view of the program,” Oregon Gov. Ted Kulongoski told *Plansponsor magazine*.

The structure of pension boards, their “governance,” may be a growing issue as public employee retirement systems appear to be on their way to requiring a larger share of state and local government budgets.

Pension boards have power over the public purse.

The boards can agree to generous retirement benefits, expecting most of the cost to be covered by investment earnings. That was the rationale in San Diego, when they made the two agreements to cut contributions and increase benefits.

In the past, investments have produced 75 percent of the revenue of some retirement systems, dwarfing employer and employee contributions. Many pension funds now assume they will earn around 8 percent a year in the future.

But if earnings fall short, as critics predict, the annual pension payments made by state and local government will be increased. As the San Jose consultant noted, employees do not share the risk of having to cover pension fund shortfalls.

Most pension boards, with the notable exception of the California State Teachers Retirement System, also have the power to set increased contribution rates that must be paid by state and local governments.

The stock market crash last fall wiped out a quarter or more of the value of many pension funds. Now like the two San Jose pension funds, public retirement systems throughout the state plan to get larger payments from state and local government.

Pension boards have another kind of power, particularly if they have large investment portfolios like the California Public Employees Retirement System, $195 billion, and CalSTRS, $125 billion.

The pension boards can pursue social policy by directing part of their investments into environmental projects, low-income areas, minority-owned businesses and other things. Some call it "socially responsible investing."

Among the pension governance stirrings this year have been two calls not for the independent experts proposed in San Jose, but for improvements in the old stakeholder model of pension boards.

—Pension *reforms proposed* by 17 city managers in San Diego County included stronger employer representation on the 13-member CalPERS board currently dominated by representatives and allies of labor.

—A labor union *talked about an initiative* drive to shift control of the University of California retirement system, the third largest public pension system in the state, from the UC regents to a new 13-member board with a majority of employee representatives.

Reporter Ed Mendel covered the Capitol in Sacramento for nearly three decades, most recently for the San Diego Union-Tribune. More stories are at http://calpensions.com/ Posted 31 Aug 09