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# **PERS FAQ's**

*December 2005*

**city of san luis obispo**

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## INTRODUCTION

The purpose of this booklet is pull together in one place the following six key documents that have been prepared over the last four years on retirement cost trends and their impact on the City's long-term fiscal health.

### RETIREMENT COST FAQ'S

This summary report provides answers to "frequently asked questions" about the City's retirement costs under our defined benefit program, which we contract for through the California Public Employees Retirement System (PERS).

### BACKGROUND MATERIALS: BUDGET REPORTS

The fiscal challenges facing the City because of rising retirement costs are not "new" news: they have been on the City's financial radar since the aftermath of "9/11." The following are documents that were prepared as part of the 2003-05 and 2005-07 Financial Plan process that discuss this issue in-depth.

#### **General Fiscal Outlook: December 2002**

Prepared in December 2002 in conjunction with the 2003-05 Financial Plan process, pages 1 through 6 of this report provide a detailed analysis of the fiscal difficulties facing the City due to increasing PERS costs.

#### **Excerpt from the 2003-08 General Fund Fiscal Forecast**

As foreshadowed in the *General Fiscal Outlook*, the 2003-08 forecast provides a detailed discussion of PERS costs and their impact on the City's long-term fiscal situation.

#### **Excerpt from the 2005-10 General Fund Fiscal Forecast**

The 2005-10 forecast again discusses the retirement cost impacts on the City's long-term fiscal situation.

### NEED FOR REFORM: CITY RESOLUTION 9667

There is no doubt that retirement costs are a major part of the City's fiscal story. However, as discussed in *Retirement Cost FAQ's*, we believe that the retirement plans in place today are appropriate, given the circumstances under which they came about and our need to attract and retain qualified employees – who are the foundation for the services that our community tells us that they highly valued.

Nonetheless, we also recognize that some reforms are needed, and for this reason, we are working closely with the League of California Cities and others for "course corrections" in the PERS system. In April 2005, the Council was presented with a comprehensive report on these efforts, and adopted Resolution No. 9667 supporting reform efforts.

### RESEARCH BRIEF: DEFINED BENEFIT VERSUS CONTRIBUTION PLANS

This "research brief" prepared by PERS in January 2005 discusses the "myths and realities" of defined benefit versus contribution plans.

# Retirement Cost FAQ's

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## Retirement Cost FAQ's

The following provides answers to “frequently asked questions” about the City’s retirement costs under our defined benefit program, which we contract for through the California Public Employees Retirement System (PERS). The City is one of 2,500 public agencies statewide that contract with PERS, which manages \$200 billion in pension assets on behalf of these agencies.

### Overview

There is no doubt that retirement costs are a major part of the City’s fiscal story. However, we believe that the retirement plans in place today are appropriate, given the circumstances under which they came about and our need to attract and retain qualified employees – who are the foundation for the services that our community tells us that they highly valued.

However, we also recognize that some reforms are needed, and for this reason, we are working closely with the League of California Cities and others for “course corrections” in the PERS system.

### Some Facts

1. PERS investment losses have had the greatest impact on higher retirement costs, not enhanced benefits.
2. Public employees should have a stable defined benefit plan as a trade-off for the lack of ability to participate in stock options, profit sharing or bonuses as many private sector employees do. Such a benefit helps us compete with the private sector for qualified employees. At the end of the day, it is through our employees that we deliver the City’s essential services of catching bad guys, putting out fires, responding to medical emergencies and paving streets.
3. When the City entered into contracts with our public safety unions to enhance retirement benefits, three factors were in place:
  - Due to high investment returns, there were significant excess assets in our retirement program, and because of this, PERS told us that future employer contributions were unlikely as far as the eye could see.

Of course, PERS could not reasonably be expected to have anticipated the “trifecta” impact on the stock market of “9-11,” the dot.com meltdown and corporate scandals like Enron and WorldCom. And while PERS experienced several years of losses, they were far lower than those experienced by comparable investors.

- Many cities also received this same message of no or low costs in the future, and with the change in the law at the State level creating optional enhancements to the PERS system, the new retirement levels quickly became the statewide public safety standard for cities.

- Binding arbitration for sworn police and fire employees – which was solidly approved by the voters of San Luis Obispo in November 2000 – created a bargaining environment that made it difficult not to meet that statewide standard. This was especially true since every shred of documentation from PERS told us that it wouldn't cost us anything. And once the enhanced public safety benefits were agreed upon, it was hard to keep non-safety employees – who were willing to absorb the full added cost – from pursuing enhanced benefits, especially since they were willing to give up already agreed upon salary increases in order to do so.
4. Because our public safety retirement plan is in the mainstream of plans in most other cities throughout the State, the fact is that without this plan, we would not be able to attract and retain qualified police officers and firefighters. For this reason, many of the few remaining agencies that have not already adopted these “mainstream” plans for their sworn police and fire employees are in the process of doing so.

### **Increased Retirement Costs Is Not “New” News**

In the aftermath of “9/11” and other impacts on stock market performance such as the “dot.com” blow-up, we knew that large increases in retirement costs were in our future, and we contracted with an independent actuarial back in 2002 in order to get a handle on these. The estimates made then have been astonishingly close to actual results; and these impacts were included in our five-year fiscal forecast prepared back in 2002 (and updated again as part of the 2005-07 Financial Plan in December 2004).

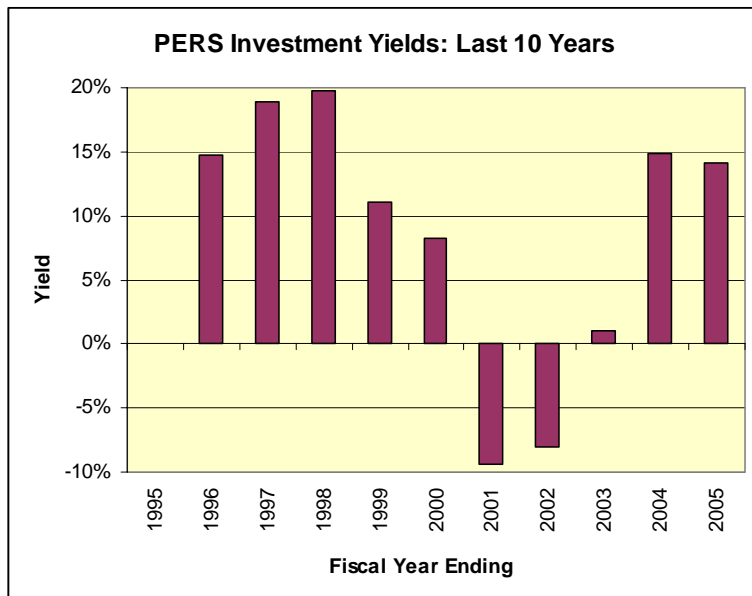
#### ***If higher PERS costs are largely due to investment losses, will costs go down if their investment performance picks-up?***

Maybe. For example, when PERS investments were performing well in the late 1990's, the City had no employer contributions. The impact of investment performance cuts both ways: we enjoyed the upside benefits of the PERS superior performance for a number of years; and now we are experiencing the downside of its losses. Because PERS has a number of “smoothing” strategies for moderating rates, even if investment performance in the future is strong, we will not see an immediate reduction in rates.

For now, we believe that the best assumption for future fiscal planning is that rates have now stabilized; but we shouldn't plan on significant rate decreases any time soon.

#### ***How have PERS investments performed?***

As reflected below, PERS' yields on their investments have swung widely over the last ten years, with gains close to 20% in fiscal year 1997-98, and losses of close to 10% in 2000-01. Over the long term, they have exceeded their target growth of 8.25% (recently revised to 7.75%); but averaged over the last five years, they are significantly below their target return.



**Key Facts**

*Target Yield for Actuarial Purposes*

- 7.75%

*Actual Yields*

- Last Year 14.1%
- Last 3 Years 10.0%
- Last 5 Years 2.5%
- Last 10 Years 8.5%

*According to Ron Seeling, PERS Chief Actuary, the statistical probability of this level of deviation occurring within a five-year span is one in ten-thousand.*

***How much does this cost?***

For 2005-06, our estimated PERS cost for employer contributions is \$5.6 million. To place this in perspective, this represents about 7% of our total City budget of \$74.3 million. So, while it's certainly a significant cost, it is not an undue portion of total City costs.

***What are the City's employer contribution rates?***

For 2005-06, employer contribution rates as a percent of payroll are as follows. (Note: These rates are only paid for "regular" compensation; unlike Social Security, they do not apply to overtime or "non-regular" pay):

	<b>Normal Rate</b>	<b>Unfunded Liability Rate</b>	<b>Total Rate</b>
Non-Sworn	9.8%	7.3%	17.1%
Public Safety Sworn *	16.4%	14.9%	31.3%

\* For example, police officers and firefighters

As reflected, our current rate is comprised of two components:

1. The **normal** rate is what's required to actuarially ensure that current contributions will meet future benefit requirements, assuming that there are currently no excess assets or unfunded liabilities.
2. The **unfunded liability rate** is what's required to amortize past unfunded liability costs over time. As noted above, due to investment losses, the PERS balance sheet went from excess assets to significant unfunded liabilities.

***Do employees contribute to the PERS system?***

Yes. While the method of doing so varies between employee groups, employees are responsible for making contributions to PERS along with employer contribution rates as follows.

**Employee Contribution Rates**

Non-Sworn	8%
Public Safety Sworn	9%

***How does this compare with private sector costs?***

Very favorably, since City employees are not covered by Social Security.

For comparison purposes, private sector employer costs for Social Security are 5.7% of payroll (excluding the portion for Medicare of 1.45%, which the City does participate in). As such, if employers in a defined contribution plan contribute a modest 4% of compensation to their plans, then the two programs would be very similar: 9.7% in the private sector compared with the normal contribution rate of 9.8% for non-sworn employees.

***How does this compare with other agencies?***

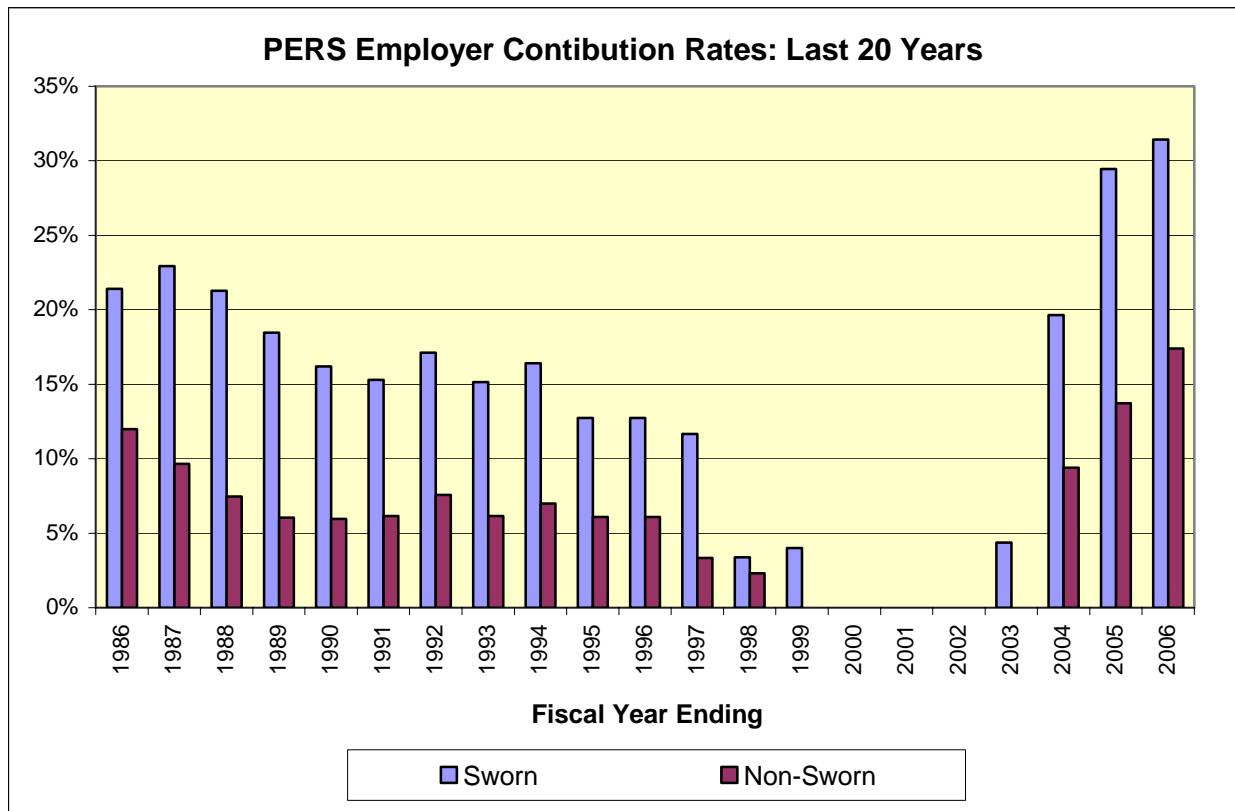
These are comparable to rates paid by other cities throughout the State.

***How have PERS employer contribution rates changed over time?***

As discussed above, PERS rates are driven by investment returns, along with a number of other actuarial factors, including:

1. System participation levels (how many employees will actually retire under the system and receive retirement benefits?)
2. Age of current participants (how close to retirement age are current employees?)
3. Mortality (how long will they live after retirement?)
4. Salary costs and inflation (how will these rise over time from today's levels?)
5. Contractual benefit levels.
6. Status of current funding (are current assets greater or less than accrued liabilities?)

The impact of changing assumptions (and actual outcomes) in any of these factors can result in significant ranges from year-to-year, as reflected in the following chart of sworn and non-sworn employer contribution rates over the last 20 years.



As reflected in this chart, while rates are higher than in the past, the very low rates in the late 1990's and early 2000's were an exception – not the rule – to employer contribution rates.

Based on the “roller coaster” swings in the past, it is possible that rates will move back to the “normal” levels of the 1980's if PERS investments continue to do well. However, as noted above, we believe that the best assumption at this time for future fiscal planning is that rates have now stabilized, and we shouldn't plan on significant rate decreases any time soon.

This assumption is underscored by the rates recently provided to us by PERS for 2006-07 and estimated for 2007-08, which are virtually the same as our current rates. In short, continued increases in rates are unlikely, but so are any significant decreases.

### ***What's the long-term organizational outlook for PERS?***

PERS is among the most respected pension plan managers and investors in the country (if not the world). In short, while there is legitimate concern about the future prospects of many other pension institutions, in both the private and public sector, this is not the case for PERS. For more information about their management capabilities and fiduciary responsibilities for more than 2,500 employers, and 1.4 million employees and retirees, visit their web site at [www.calpers.ca.gov](http://www.calpers.ca.gov).

# Budget Reports

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**2003-05 Financial Plan**

**GENERAL FISCAL OUTLOOK**

*Toughest Fiscal Outlook in Many Years*

**November 2002**



**city of san luis obispo**

## 2003-05 Financial Plan

# GENERAL FISCAL OUTLOOK

## OVERVIEW

### *Toughest Fiscal Outlook in Many Years*

Stated simply, we are facing our toughest fiscal situation in over ten years. From 1992 to 1994, along with other communities throughout California, the City was experiencing the largest economic downturn since the Great Depression; and the State was on the brink of taking away from us what would end-up being over \$1.5 million *annually*. This left us with a continuing, “systemic” budget gap of over \$4 million annually, which we successfully closed through a combination of new revenues, strategic use of reserves in reducing future year costs, and deep cuts in both operating and capital programs. These expenditure cuts included reducing regular staffing over a two-year period by 39 regular positions and reducing our capital improvement plan expenditures by 50%.

The challenges facing us today can be attributed to three key factors:

1. Unprecedented increases in retirement costs due to investment losses by the Public Employee Retirement System (PERS), which the City contracts with for retirement benefits for our regular employees.
2. The threat of more State budget cuts as it deals with its own very serious budget issues.
3. Adverse trends in several of our key General Fund revenues.

### ❶ PERS COST INCREASES

The large increase in PERS costs is by far the greatest fiscal challenge facing us at this time. While the reasons for this are discussed in more detail below, the short story is this: largely due to portfolio investment losses, we are looking at retirement cost increases in the General Fund from 2002-03 levels of **\$1.4 million in 2003-04**; and **\$3.2 million** in 2004-05. Placed in context, for 2004-05 this represents about 10% of our General Fund revenues.

And because of the “smoothing” methodology used by PERS in setting rates, and the likelihood that PERS investment yields will continue to be less than their actuarial assumptions for the foreseeable future, ***these rates are likely to continue to increase beyond 2004-05***. This impact will be compounded in 2005-06, after agreed-upon retirement benefit enhancements for sworn fire staff go into effect.

We are currently working with an independent actuary to help us better assess these long-term costs. However, the information we already have clearly shows that this is a major cost issue for us.

***What Is Driving These Cost Increases?*** There are two key factors driving these increased costs

1. Increased retirement benefits for sworn safety staff.
2. PERS investment losses.

## 2003-05 Financial Plan

### GENERAL FISCAL OUTLOOK

As discussed below, PERS investment losses are by far the biggest factor. Increased safety retirement benefits contribute to the problem, but they are not the primary cost driver.

#### PERS Investment Losses

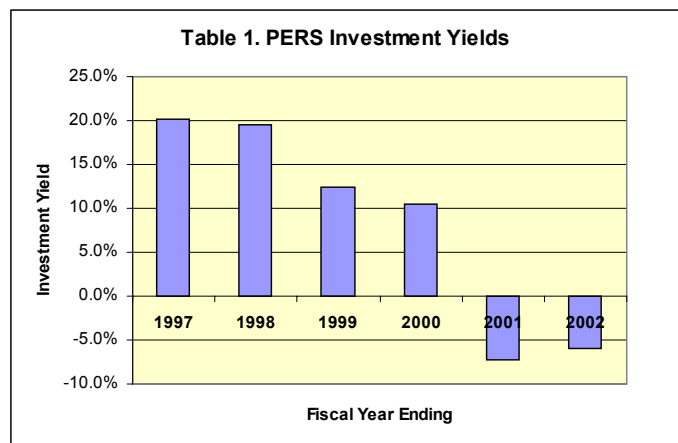
In addition to benefit levels, there are a number of actuarial assumptions that determine employer contribution rates and related costs, including projections for:

- System participation levels (how many employees will actually retire under the system and receive retirement benefits?)
- Age of current participants (how close to retirement age are current employees?)
- Mortality (how long will they live after retirement?)
- Salary costs (how will these rise over time from today's levels?)
- Status of current funding (are current assets greater or less than accrued liabilities?)
- Estimated investment returns on interest earning.

While all of these assumptions affect the City's PERS costs, it is these last two items that are driving these unprecedented cost increases.

Under their actuarial model, PERS assumes an investment return of 8.25% annually. Until the last two years, their actual yield was much greater than this (see Table 1); and over the last ten years, PERS investment yields have averaged 9.4% (including the negative returns in the last two years). As such, the underlying assumption of an 8.25% return over the long run is a reasonable one.

However, in the last two years, PERS has experienced significant portfolio losses (as has every other major institutional investor): in 2001-02; this loss was 7.2%; and most recently, the loss was 5.9% for 2001-02.



This results in a combined, compounded loss of 13.5% over the last two years. However, under the PERS actuarial model, investment yields over this same period should have been 17.2% (8.25% annually compounded). This means that overall, actuarial assets are 33% lower than otherwise assumed under the model.

This has two major impacts on City PERS costs:

## 2003-05 Financial Plan

### GENERAL FISCAL OUTLOOK

**Changes in Actuarial Funding Status: Making Up for the Impact on the Past.** Because of the superior performance of PERS investments in the past, we have had a significant surplus of actuarial assets over liabilities. As summarized in Table 2, even with the negative results from two years ago, there were *surplus* assets of \$8.1 million for sworn police and fire staff (Safety Plan) and \$12.3 million for all other employees (Miscellaneous Plan).

	Plans**	
	Safety	Miscellaneous
Actuarial Value of Assets	62,387,439	55,308,148
Accrued Liabilities	54,256,329	43,017,170
<b>Surplus</b>	<b>\$ 8,131,110</b>	<b>\$ 12,290,978</b>

\* This is the basis for our rates in 2002-03.

\*\* Separate plans are maintained for each of these groups.

Because of these surplus assets, we have not been required to make our “normal” employer contributions for several years: the surplus assets were amortized and credited against this cost. As reflected in Table 3, this meant our General Fund costs in 2002-03 were **\$1.4 million less** than they otherwise would have been because of this surplus. (As noted in this table, we incurred no costs at all for our non-sworn employees.)

	Normal	Actual	Savings
<b>Safety</b>			
Employer Contribution Rate	13.6%	4.4%	9.2%
Payroll	8,407,000	8,407,000	0
<b>Safety Cost</b>	<b>1,143,400</b>	<b>369,900</b>	<b>773,500</b>
<b>Miscellaneous</b>			
Employer Contribution Rate	7.1%	0.0%	7.1%
Payroll	9,090,700	9,090,700	0
<b>Miscellaneous Cost</b>	<b>645,400</b>	<b>0</b>	<b>645,400</b>
<b>Total Employer Cost</b>	<b>\$ 1,788,800</b>	<b>\$ 369,900</b>	<b>\$ 1,418,900</b>

before benefit increases that will go into effect in 2003.

However, with this latest year of investment losses, the surplus is significantly reduced in both plans. As such, although we will continue to receive some offsetting credits in 2003-04, most of the increase we will see next year is because we will no longer receive a significant reduction in our “normal” costs.

In short, we will no longer receive this “windfall” in our PERS retirement rates. We enjoyed the upside benefits of the PERS superior performance for a number of years; and now we are experiencing the downside of its losses.

**Changes in Future Costs.** Along with the devaluation of the market value of our assets, we now have to begin making “normal” cost contributions. In taking this into consideration (both when actual investment performance is better than actuarial assumptions as well as when it is worse), PERS has two techniques for trying to stabilize costs. The first is allowing a range of actuarial asset values compared with the market value of the portfolio of 90% to 115%. With this approach, if the market value versus the actuarial value falls within this range, PERS does not make any contribution rate adjustments. The second one is smoothing: gains or losses are averaged over three years, thus mitigating in any one year the affects of major swings in investment earnings.

## 2003-05 Financial Plan

### GENERAL FISCAL OUTLOOK

Together, in “normal times,” these strategies would go a long ways towards stabilizing rates. But PERS investment results over the last five years have been anything but normal, with yields within this timeframe ranging from annual gains of 20% in 1998 to a loss of 6% in 2002. According to Ron Seeling, PERS Chief Actuary, the statistical probability of this level of deviation occurring within a five-year span is one in ten-thousand.

#### Sworn Safety Employee Benefit Increases

Retirement benefit increases for safety employees have also had an impact on our retirement rates, although it much less than the impact of investment losses. For *fire sworn* employees, beginning in 2002, we moved from a “2% at 50” retirement benefit (2% of pay for each year of service; for example, under this benefit plan, a firefighter with 25 years of service who retires at age 50 would receive 50% of her salary) to the “3% at 55” formula (3% of pay for each year of service, or 75% of pay at age 55 with 25 years of service). And beginning in 2003, benefit levels for our *police sworn* employees will increase from “2% at 50” to “3% at 50” (or 75% of pay after 25 years at age 50.) Lastly, in December 2005, the benefit level for *fire sworn* employees will increase from “3% at 55” to “3% at 50.” However, as summarized below, this has had only a modest impact on rates, compared with the impact of investment losses.

#### PERS Stewardship of Plan Assets

In light of recent investment losses, it should be noted that PERS has done an outstanding job of managing its portfolio. As noted above, even after factoring in the losses over the last two years, PERS investment yield over the last ten years has averaged 9.4%. And while a 13% loss in market value over the two years is certainly not good news, it may be the best news possible: there are many folks who would be delighted if their personal retirement accounts had only lost 13% of their value during this same period.

In short, PERS investment track record can only be evaluated in the context of overall market conditions; and by this measure, it has been an excellent steward of our assets.

It should be noted that retirement benefit enhancements have also recently implemented for non-sworn employees. However these costs were fully offset by salary reductions and future year salary caps. As such, these play no role at all in the PERS cost increases facing us.

#### Contribution Rates: Next Five Years

Based on the combined impact of investment losses and benefit increases for sworn safety employees, Table 4 summarizes estimated employer contribution rates and related costs over the next five years, based on the preliminary information available to us at this time.

This table shows two key things:

1. ***Unprecedented Cost Increases Are Ahead.*** We will see significant increases in PERS costs over the next four years. Compared with 2002-03 baseline salary levels and PERS rates (and without adjusting for salary increases in the future due to negotiated “MOA’s,” some of which are already in place through 2005-06), PERS costs will increase by ***\$1.4 million in 2003-04***. They will increase from 2002-03 levels by ***\$3.1 million in 2004-05*** and by ***\$3.6 million in 2006-07***, continuing indefinitely thereafter.

## 2003-05 Financial Plan

### GENERAL FISCAL OUTLOOK

2. *Investment Losses Are the Main Driver.* While sworn safety benefit increases play a role, the main reason for these increases are investment losses. For example, of the \$3.6 million increase by 2006-07, increased sworn benefits only account for about 17% of this change (\$613,000); the remaining 83% (roughly \$3 million) is due to investment losses. As noted above, these losses drive cost increases in two ways: first, there is no longer a surplus asset credit to offset "normal" costs; and secondly, rates must increase to cover the future unfunded liabilities that have emerged.

The simple fact is that if we were just dealing with increases due to sworn retirement benefit enhancements, this would be a manageable cost: at \$600,000, this is about 1.5% of General Fund revenues.

Table 4. Projected Employer Contribution Rates and Costs						
	Current	Projected				
	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
<b>Safety</b>						
"Normal" Rate	13.6%	14.8%	14.8%	14.8%	14.8%	14.8%
Credit for Surplus Assets	-9.2%	-1.0%				
Enhanced Benefits (See Notes)		2.5%	2.5%	4.9%	7.3%	7.3%
Investment Loss			12.6%	12.6%	12.6%	12.6%
Net Rate	4.4%	16.3%	29.9%	32.3%	34.7%	34.7%
PERS Payroll (See Notes)	8,407,000	8,407,000	8,407,000	8,407,000	8,407,000	8,407,000
Employer PERS Cost	369,900	1,370,300	2,513,700	2,715,500	2,917,200	2,917,200
<b>Increase from 2002-03</b>		<b>1,000,400</b>	<b>2,143,800</b>	<b>2,345,600</b>	<b>2,547,300</b>	<b>2,547,300</b>
<b>Miscellaneous</b>						
"Normal" Rate	7.1%	7.1%	7.1%	7.1%	7.1%	7.1%
Credit for Surplus Assets	-7.1%	-0.1%				
Enhanced Benefits (See Notes)		2.4%	2.4%	2.4%	2.4%	2.4%
Investment Loss			6.6%	6.6%	6.6%	6.6%
Net Effective Rate	0.0%	9.4%	16.1%	16.1%	16.1%	16.1%
PERS Payroll (See Notes)	9,090,700	9,090,700	9,090,700	9,090,700	9,090,700	9,090,700
Employer PERS Cost	0	854,500	1,463,600	1,463,600	1,463,600	1,463,600
Salary Reduction (See Notes)		(454,500)	(454,500)	(454,500)	(454,500)	(454,500)
<b>Increase from 2002-03</b>		<b>400,000</b>	<b>1,009,100</b>	<b>1,009,100</b>	<b>1,009,100</b>	<b>1,009,100</b>
<b>Both Plans Combined</b>						
<b>Increase from 2002-03</b>		<b>\$1,400,400</b>	<b>\$3,152,900</b>	<b>\$3,354,700</b>	<b>\$3,556,400</b>	<b>\$3,556,400</b>

- Notes**
1. As a practical matter, base payroll costs will increase over time due to MOA increases, which in many cases are already set through 2005-06. However, payroll costs are held constant in this example in order to show the sole impact of rate increases on PERS costs.
  2. The cost of "single highest year" for all safety employees and "3% at 55%" for fire sworn employees is already reflected in the "normal" safety rate in 2002-03.
  3. Enhanced benefits for 2003-04 reflect "3% at 50" for police sworn employees.
  4. Enhanced benefits for 2005-06 reflect "3% at 50" for fire sworn employees at an estimated increased rate of 4.8%, pro-rated for half of the year, since it is effective December 31, 2005.
  5. Enhanced benefits for 2006-07 reflect a full year of "3% at 50" for fire sworn employees at the estimated 4.8% rate.
  6. Miscellaneous employees also negotiated for increased retirement benefits; however, this cost is fully offset by agreed upon salary reductions and caps.

## 2003-05 Financial Plan

### GENERAL FISCAL OUTLOOK

***And It's Likely to Be Worse Than This.*** Lastly, this table understates likely future costs. As noted above, PERS “smooths” actuarial losses by averaging them over the next three years. As such, the projections we have received from PERS through 2004-05 do not fully show the impact of investment losses to-date. Moreover, these rates are based on investment losses in 2000-01 and 2001-02; they assume that from 2002-03 forward, PERS will return to earning its actuarial assumption of 8.25%. And based on year-to-date investment results, this is highly unlikely for 2002-03.

In order to get a better grasp of likely rates and costs in the “out years,” we have contracted with a highly respected independent actuarial firm (Aon Consulting) to provide us with a better idea of future costs. We hope to include these updated costs in the five-year fiscal forecast scheduled for presentation to the Council on December 10, 2002.

***Can It Get Better?*** There is always the possibility that PERS investment gains will again exceed the actuarial assumption of 8.25%. In this case, the substantial rate and cost increases presented in this report could be mitigated. And the fact is that PERS rate have fluctuated wildly over the past ten years. However, given the magnitude of the current loss in actuarial assets (33%) that would have to be made-up, and the small likelihood, based on current trends, that PERS will earn substantially more than 8.25% in the near future, such a turn-around is unlikely in the next five years. As noted above, if the rates change significantly over the next five from those presented in this report, they are more likely to get worse, not better.

***Future Prospects.*** Obviously, facing increased PERS costs that are the equivalent of 10% of our General Fund revenues is a daunting prospect, to say the least. However, every city in the State that contracts with PERS (and this is virtually all of them) is facing the exact same challenge. (In fact, so is the State itself.) For this reason, there is some basis for hoping that some kind of statewide mitigation plan will emerge.

## ② THREAT OF MORE STATE BUDGET GRABS

When the State last experienced a major budget crisis, the end result was budget grabs from cities that now cost us \$1.5 million annually.

For 2002-03, the State faced a budget deficit of \$24 billion (which made prior budget gaps pale in comparison). On paper, this gap has now been balanced. However, the fact is that many of the steps taken to balance the 2002-03 budget were one-time fixes that will not help balance the budget next year. As such, the “conventional wisdom” is that the State is facing another budget gap of \$10 to \$20 billion in 2003-04.

From the State’s perspective, \$4 billion of this gap is due to the “VLF backfill.” Just a few short years ago, the State had a significant

### Incoming governor facing budget crisis

LOS ANGELES TIMES  
During Gray Davis' term as governor, California's state budget has gone from a record surplus to a record deficit.

When the state treasury was flush with cash, the governor and lawmakers from both political parties pushed state spending to new heights. In part, that money was spent to expand programs — especially in education — that locked the state into future spending.

#### FISCAL PROBLEMS WILL LEAP TO FRONT BURNER NEXT YEAR

near the levels they established early in Davis' term. So now, instead of having billions in the bank, the state is borrowing billions from the future to pay today's bills.  
Republican Bill Simon Jr. has criti-

state that has seen its fortunes reverse in recent years. Indeed, California's deep fiscal problems will be a front-burner problem for the next governor — no matter who wins Nov. 5.

The seeds of the state's budget difficulties were sown in Sacramento and on Wall Street.

When Davis took office in January 1999, the stock market was climbing

Please see GOVERNOR, A4

## 2003-05 Financial Plan

### GENERAL FISCAL OUTLOOK

budget surplus, and it flirted briefly with the notion of a State tax cut. Instead, it decided to reduce city and county revenues by reducing vehicle license fees (VLF) by 65%. However, the State agreed to “backfill” these lost revenues, thus keeping cities and counties “whole.” The cost to the State in meeting this commitment, which it can undo tomorrow, is \$4 billion.

For the City, the VLF backfill is worth about \$1.7 million annually. And while the State could help resolve its budget problems through any number of takeaways from cities (such as further property tax takeaways and transfers to school districts, or “Son of ERAF”), the VLF backfill is a likely candidate.

### ③ ADVERSE REVENUE TRENDS

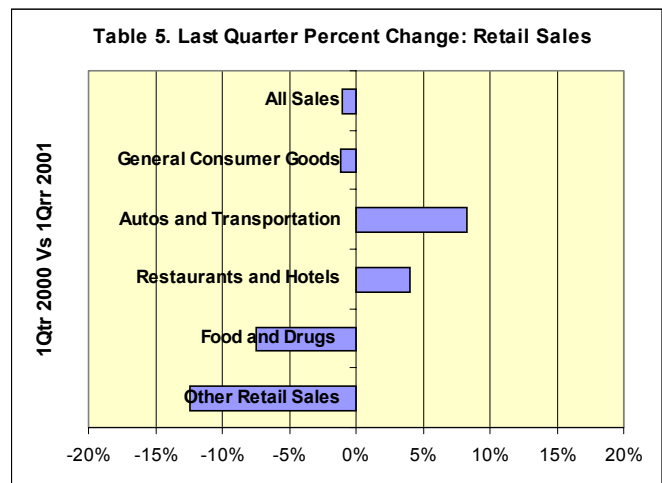
At best, we are facing mixed results in two of our top revenues: sales tax and transient occupancy tax (TOT).

**Sales Tax Revenues.** While revenues in 2001-02 performed better than we expected, the fact is that this was largely due to new car sales. In the last quarter of the fiscal year, even though new car sales were up by 8%, overall sales tax revenues were down by 1%. This was driven by a similar 1% decrease in general consumer goods, which is our second most important category after new car sales.

However, there are opportunities on the horizon in terms of new retail outlets that *might* come on-line within the next two to five years, which have the potential to generate significant new, “net” revenues for the City. Based on past fiscal studies, the following is “short list” of these, along with estimated annual “net” revenues from them:

Home Depot	\$150,000 to \$300,000
Costco	\$300,000 to \$600,000
Court Street/Copeland	\$200,000 to \$300,000
San Luis Marketplace	\$1,400,000 to \$1,500,000

The revenue ranges above are “net” of transfer affects and service costs. In general, while there will be some redistribution of existing sales, detailed studies have concluded that in most cases these will not be significant, as many of the proposed new retail uses will fill major gaps in our current market “capture.”



## 2003-05 Financial Plan

### GENERAL FISCAL OUTLOOK

In addition to these specific projects, our 1998 fiscal impact analysis of annexing the Airport Area showed “net” revenues (after new service costs) of \$450,000 immediately upon annexation; and \$750,000 by build-out.

Overall, this means there is the *potential* over the next two to five years for about \$3 million in new “net” revenues to come on-line.

**TOT Revenues.** Last year, TOT revenues were down from the prior year by 3%. While this was better than many other areas in the State, it represented an 11% swing from our initial projection of 8% growth. While it is still too soon to reach any conclusions based on year-to-date results so far, we appear to be on track with our current projection for a 5% increase in 2002-03. However, this will be on a significantly reduced base from the prior year.

**UCSB Forecast.** This is one of most credible, independent sources available to us in assessing our economic climate, and how this is likely to affect our key General Fund revenues. The results of the UCSB Forecast will be presented on November 8, 2002, and they will play a major role in preparing our five-year revenue projections.

#### SUMMARY

The purpose of this “general fiscal outlook” is to highlight the key factors that are likely to affect us financially over the next two to five years. As reflected in this high-level look, we are facing significant fiscal challenges in the near future, with unprecedented PERS costs as our greatest concern. We will be better able to place these in a more “empirical” context, along with other key factors, after we have finalized the five-year General Fund forecast, which we plan to present to the Council on December 10, 2002.

As we begin the goal-setting process for 2003-05, it is important to keep in mind that just because we are facing very challenging fiscal circumstances doesn’t mean that we can’t fund new initiatives in 2003-05—but it does mean that doing so will be extraordinarily difficult. On one hand, it will be a major challenge to simply continue current “core” service levels and adequately maintain our existing facilities and infrastructure. On the other hand, the option of changing our current priorities and reallocating resources to accommodate new ones always exists—although it is important to stress that this is easier said than done.

In comparison with a similar fiscal outlook facing us ten years ago, there are aspects of the current situation that are even tougher. For example:

1. We were able to reduce development review costs without impacting related service levels in 1992-93, because development applications were down. This simply isn’t the case today: we continue to have a very high case workload.
2. We have been very successful over the past years in achieving better cost recovery for a wide range of services. However, this means that the “net” savings from any reductions will be even less.

## 2003-05 Financial Plan

### GENERAL FISCAL OUTLOOK

3. We have become accustomed to a very high level of capital improvements, such as a significantly expanded paving program and open space acquisition. These will be difficult to reduce.
4. While proportionately less than other services, public safety reductions played an important role in our overall budget-balancing strategy in 1993. With increases in fire minimum staffing requirements since then along with binding arbitration, this will be much harder to do in 2003. And since public safety accounts for about 50% of our operating costs, any reductions we don't make in this area will mean even steeper ones in others.
5. Lastly, the post-Proposition 218 era has fully arrived. Virtually all of the revenue options that the Council considered in 1993 are no longer even on the table as possibilities for Council action today. For example, one of the budget balancers the Council approved in 1993 was an increase in the TOT rate from 9% to 10%. This would now require voter approval; and as a General Fund revenue source, the soonest it could be placed on the ballot for consideration is two years from now in November 2004. This means that any new significant revenue sources will not be available as budget-balancers in 2003-05. However, they could be a factor after this.

In summary, given current revenue trends, the very real threat of large State budget cuts to cities and unprecedented increases in retirement costs, we are facing our toughest outlook in many years. And many of the "tools" that were available to us in the past in responding to similar circumstances simply aren't there today.

of reserves in reducing future year costs, and deep cuts in both operating and capital programs. These expenditure cuts included reducing regular staffing over a two-year period by 39 regular positions and reducing our capital improvement plan expenditures by 50%.

**Our 2003-05 Fiscal Story.** Compared with ten years ago, the challenges facing us today can be attributed to seven key factors:

1. Unprecedented increases in retirement costs due to investment losses by the Public Employee Retirement System (PERS), which the City contracts with for retirement benefits for our regular employees.
2. The threat of more State budget cuts as it deals with its own very serious budget issues.
3. Adverse trends in several of our key General Fund revenues.
4. Increasing insurance costs.
5. Infrastructure maintenance costs.
6. New service responsibilities, most notably maintaining new park facilities currently under construction (DeVaul Park and Damon-Garcia athletic fields) that will come on-line during 2003-05, meeting National Pollution Discharge Elimination System (NPDES) requirements for storm water and debt service on the planned office space at 919 Palm Street.
7. Loss of a dedicated source of funding for creek and flood protection programs and projects.

While each of these is described in more detail below under *Basic Forecast Framework*, the following highlights the three most serious threats to our long-term fiscal health: PERS costs, the threat of more State budget grabs and adverse trends in our two of three top General Fund revenues: sales tax and transient occupancy tax (TOT).

**❶ PERS Cost Increases**

The large increase in PERS costs is by far the greatest fiscal challenge facing us at this time. While the reasons for this are discussed in more detail below, the short story is this: largely due to portfolio investment losses, we are looking at retirement cost increases in the General Fund from 2002-03 levels of **\$2.4 million in 2003-04**; and **\$4.3 million in 2004-05**. Placed in context, for 2004-05 this represents 11% of our General Fund revenues.

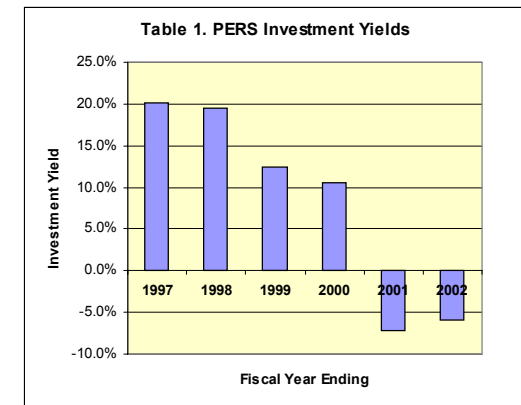
**What Is Driving These Cost Increases?** There are two key factors driving these increased costs

1. PERS investment losses.
2. Increased retirement benefits for sworn safety staff.

As discussed below, PERS investment losses are by far the biggest factor. Increased safety retirement benefits contribute to the problem, but they are not the primary cost driver.

**PERS Investment Losses.** In addition to benefit levels, there are a number of actuarial assumptions that determine employer contribution rates and related costs. Of these, the status of current funding (are current assets greater or less than accrued liabilities?) and estimated investment returns on interest earning are the main ones driving these unprecedented cost increases.

Under their actuarial model, PERS assumes an investment return of 8.25% annually. Until the last two years, their actual yield was much greater than this (Table 1); and over the last ten years, PERS investment yields have averaged 9.4% (including the negative returns in the last two years). As such, the



underlying assumption of an 8.25% return over the long run seems a reasonable one.

However, in the last two years, PERS has experienced significant portfolio losses (as has every other major institutional investor): in 2001-02; this loss was 7.2%; and most recently, the loss was 5.9% for 2001-02.

This results in a combined, compounded loss of 13.5% over the last two years. However, under the PERS actuarial model, investment yields over this same period should have been 17.2% (8.25% annually compounded). This means that overall, actuarial assets are 33% lower than otherwise assumed under the model.

This has two major impacts on City PERS costs:

**Changes in Actuarial Funding Status: Making Up for the Impact on the Past.** Because of the superior performance of PERS investments in the past, we have had a significant surplus of actuarial assets over liabilities. As shown in Table 2, even with the negative results from two years ago, there were *surplus* assets of \$8.1 million for sworn police and fire staff (Safety Plan) and \$12.3 million for all other employees (Miscellaneous Plan) as of June 30, 2000.

	Plans**	
	Safety	Miscellaneous
Actuarial Value of Assets	62,387,439	55,308,148
Accrued Liabilities	54,256,329	43,017,170
<b>Surplus</b>	<b>\$ 8,131,110</b>	<b>\$ 12,290,978</b>

\* This is the basis for our rates in 2002-03.

\*\* Separate plans are maintained for each of these groups.

Because of these surplus assets, we have not been required to make our “normal” employer contributions for several years: the surplus assets were amortized and credited against this cost. As reflected in Table 3, this meant our General Fund costs in 2002-03 (before the benefit changes in Spring 2003) were **\$1.4 million less** than they otherwise would have been because of this surplus. (As noted in this table, we incurred no costs at all for our non-sworn employees.)

	Normal	Actual	Savings
<b>Safety</b>			
Employer Contribution Rate	13.6%	4.4%	9.2%
Payroll	8,407,000	8,407,000	0
<b>Safety Cost</b>	<b>1,143,400</b>	<b>369,900</b>	<b>773,500</b>
<b>Miscellaneous</b>			
Employer Contribution Rate	7.1%	0.0%	7.1%
Payroll	9,090,700	9,090,700	0
<b>Miscellaneous Cost</b>	<b>645,400</b>	<b>0</b>	<b>645,400</b>
<b>Total Employer Cost</b>	<b>\$ 1,788,800</b>	<b>\$ 369,900</b>	<b>\$ 1,418,900</b>

Before benefit increases that will go into effect in 2003.

However, with this latest year of investment losses, the surplus is significantly reduced in both plans. As such, although we will continue to receive some offsetting credits in 2003-04, most of the increase we will see next year is because we will no longer receive a significant reduction in our “normal” costs.

In short, we will no longer receive this “windfall” in our PERS retirement rates. We enjoyed the upside benefits of the PERS superior performance for a number of years; and now we are experiencing the downside of its losses.

**Changes in Future Costs.** Along with the devaluation of the market value of our assets, we now have to begin making “normal” cost contributions. In taking this into consideration (both when actual investment performance is better than actuarial assumptions as well as when it is worse), PERS has two techniques for trying to stabilize costs. The first is allowing a range of actuarial asset values compared with the market value of the portfolio of 90% to 110%. With this approach, if the market value versus the actuarial value falls within this range, PERS does not make any contribution rate adjustments. The second one is smoothing: gains or losses are averaged over three years, thus mitigating in any one year the affects of major swings in investment earnings.

Together, in “normal times,” these strategies would go a long way towards stabilizing rates. But PERS investment results over the last five years have been anything but normal, with yields within this timeframe ranging from annual gains of 20% in 1998 to a loss of 6% in 2002. According to Ron Seeling, PERS Chief Actuary, the statistical probability of this level of deviation occurring within a five-year span is one in ten thousand.

**PERS Stewardship of Plan Assets.** In light of recent investment losses, it should be noted that PERS has done an outstanding job of managing its portfolio. As noted above, even after factoring in the losses over the last two years, PERS investment yield over the last ten years has averaged 9.4%. And while a 13% loss in market value over the two years is certainly not good news, it may be the best news possible: there are many folks who would be delighted if their personal retirement accounts had only lost 13% of their value during this same period.

In short, PERS investment track record can only be evaluated in the context of overall market conditions; and by this measure, it has been an excellent steward of our assets.

**Employee Benefit Increases.** Retirement benefit increases for safety employees have also had an impact on our retirement rates, although it is much less than the impact of investment losses. It should be noted that retirement benefit enhancements have also been recently implemented for non-sworn employees. However these costs were fully offset by salary reductions and future year salary caps. As such, they play no role at all in the PERS cost increases facing us.

**Impact on Future Rates.** Based on the combined impact of investment losses and benefit increases for sworn safety employees, Table 4 summarizes estimated employer contribution rates and related costs over the next five years. This is based on an analysis prepared for us by Aon Consulting, which is a statewide leader in independently analyzing PERS retirement costs. It assumes that the PERS investment yield will be “zero” for 2002-03, and goes back to 8.25% in 2003-04 and beyond.

Table 4. PERS Employer Contribution Rates		
	Safety	Non-Safety
2000-01	0.0%	0.0%
2001-02	4.4%	0.0%
2002-03 Forward		
2002-03 (Spring 2003)	16.3%	5.0%
2003-04	16.3%	9.4%
2004-05	29.9%	16.1%
2005-06	37.9%	19.2%
2006-07	41.0%	19.9%
2007-08	41.3%	20.2%
PERS Costs (In Millions)		
	Annual Cost	Increase From 2001-02
2001-02	\$0.9	
2002-03	1.6	0.7
2003-04	3.3	2.4
2004-05	5.2	4.3
2005-06	6.4	5.5
2006-07	6.9	6.0
2007-08	7.2	6.3

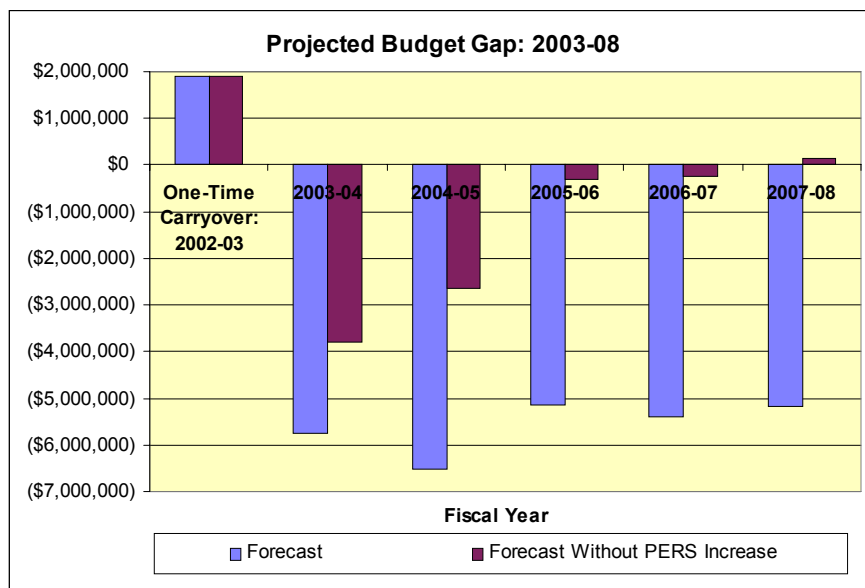
This table shows two key things:

1. **Unprecedented Cost Increases Are Ahead.** We will see significant increases in PERS costs over the next five years. Compared with 2001-02 rates, PERS costs will increase by \$6.3 million by 2007-08.
2. **Investment Losses Are the Main Driver.** While sworn safety benefit increases play a role, the main reason for these increases are investment losses. The simple fact is that if we were just dealing with increases due to sworn retirement benefit enhancements, this would be a manageable cost.

**Can It Get Better?** There is always the possibility that PERS investment gains will again exceed the actuarial assumption of 8.25%. In this case, the substantial rate and cost increases presented in this report could be mitigated. And the fact is that PERS rates have fluctuated wildly over the past ten years. However, given the magnitude of the current loss in actuarial assets (33%) that would have to be made-up, and the small likelihood, based on current trends, that PERS will earn substantially more than 8.25% in the near future, such a turn-around is unlikely in the next

five years. In fact, if the rates change significantly over the next five years from those presented in this report, they are more likely to get worse, not better.

**Impact of PERS Cost Assumptions on the Forecast.** As shown below, projected PERS costs have a significant impact on the forecast: keeping all other assumptions the same, projecting PERS costs based on current rates results in a significantly smaller “budget gap” (and in fact, by 2007-08, there’s a very small “surplus”).



**Future Prospects.** Obviously, facing increased PERS costs that are the equivalent of 11% of our General Fund revenues is a daunting prospect, to say the least. However, every city in the State that contracts with PERS (and this is virtually all of them) is facing the exact same challenge. (In fact, so is the State itself.) For this reason, there is some basis for hoping that some kind of statewide mitigation plan will emerge.

**Threat of More State Budget Grabs**

When the State last experienced a major budget crisis in the early 1990’s, the end result was budget grabs from cities that now cost us \$1.5 million annually. And the problems facing the State today are even more severe.

For 2002-03, the State faced a budget deficit of \$24 billion (which made prior budget gaps pale in comparison). On paper, this gap has now been balanced. However, the fact is that many of the steps taken to balance the 2002-03 budget were one-time fixes that will not help balance the budget next year.

**Incoming governor facing budget crisis**

LOS ANGELES TIMES  
 During Gray Davis' term as governor, California's state budget has gone from a record surplus to a record deficit.  
 When the state treasury was flush with cash, the governor and lawmakers from both political parties pushed state spending to new heights. In part, that money was spent to expand programs — especially in education — that locked the state into future spending.

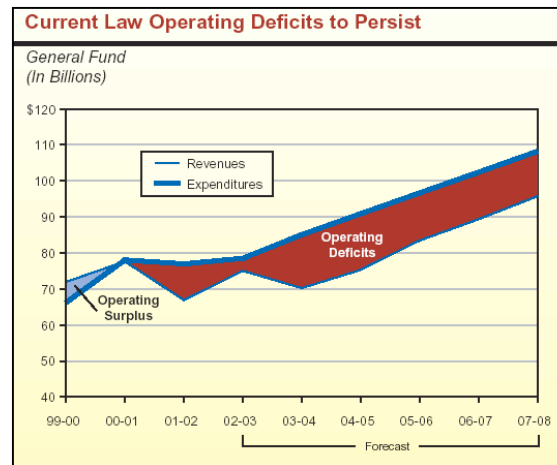
**FISCAL PROBLEMS WILL LEAP TO FRONT BURNER NEXT YEAR**

near the levels they established early in Davis' term. So now, instead of having billions in the bank, the state is borrowing billions from the future to pay today's bills.  
Special to THE TIMES by Robert Simon. He has writ-

state that has seen its fortunes reverse in recent years. Indeed, California's deep fiscal problems will be a front-burner problem for the next governor — no matter who wins Nov. 5.  
 The seeds of the state's budget difficulties were sown in Sacramento and on Wall Street.  
 When Davis took office in January 1999, the stock market was climbing

Please see GOVERNOR, A4

The Legislative Analyst’s Office (LAO) projects that the State faces a \$21 billion budget gap in 2003-04 (\$6 billion carryover deficit from 2002-03 and a “new” gap of \$15 billion in 2003-04). As shown below, the LAO projects that this gap will continue indefinitely unless there is corrective action on either the expenditure or revenue side.

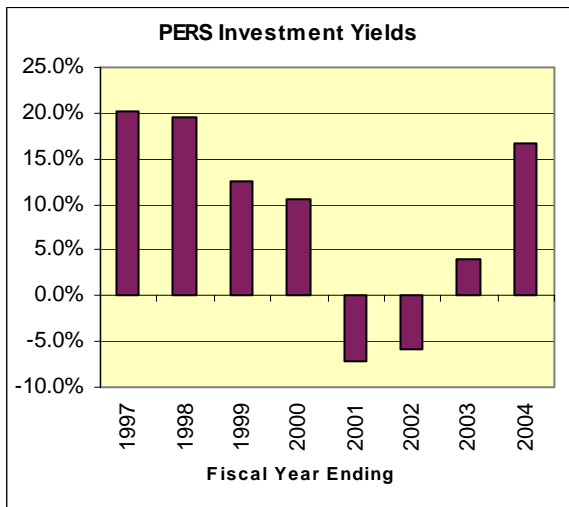


Balancing the State’s budget will be tough. On one hand, the one-time balancers like “tobacco securitization” (\$4.5 billion) and general obligation bond restructuring (\$1.1 billion) in 2002-03 are gone.

On the other hand, the requirement for budget approval by two-thirds of the legislature is still with us. Democrats will resist reductions in education and the health-social services “safety net” while Republicans will equally resist tax increases. And even though the Democrats have a

**Retirement Costs.** Like the sports fields, this is not a new cost concern on our radar. However, it has certainly not gone away. As the Council is aware, our retirement contributions to the California Public Employees Retirement System (PERS) have soared in the last several years. While there are several reasons for this, which we have previously detailed for the Council, the most significant one has been PERS investment returns.

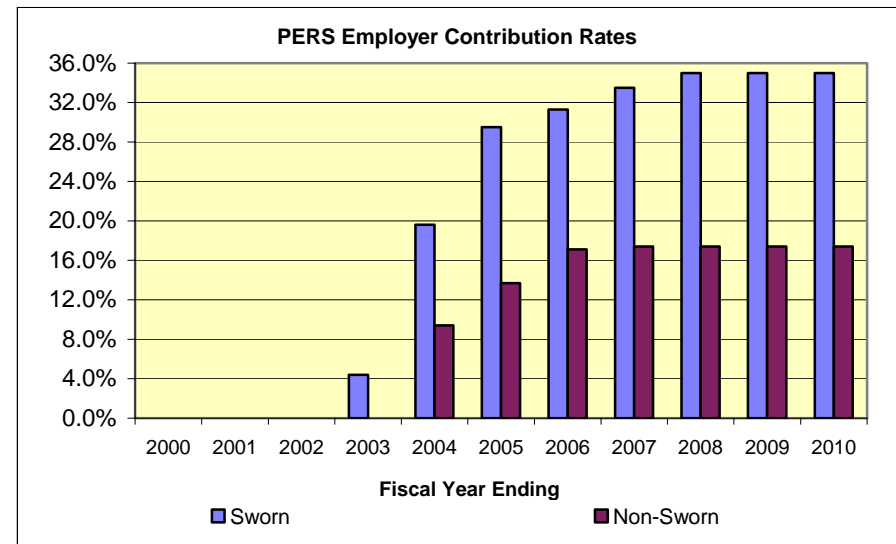
As shown below, these have vacillated widely over the past eight years, ranging from gains of 20% in 1996-97, to losses of 7% in 2000-01, to gains of 16% in 2003-04. These compare with PERS actuarial estimated annual returns of 8.25%



While PERS uses a “smoothing” method that averages returns over a three-year period in setting rates, the high volatility in interest yields has resulted in high volatility in the City’s employer contribution rates.

For example, as recently as 2001-02, the City’s “normal” employer contribution rate (the amount actuarially required to exactly match current contributions with future liabilities) was 14% of salary for sworn public safety employees and 7% for all other employees.

However, because of “excess assets” generated by investment gains in the mid-1990’s, the City’s required contribution rates were actually 0% for both groups. In short, as shown below, the City’s required employer contribution rates have vacillated wide over the past ten years.



**What causes this big swing?** There are two factors. First, investment losses wiped-out the excess assets (and in fact cause unfunded liabilities); as such, there are no longer any credits against the “normal” rate. Second, rates now have to increase above the “normal” level to begin amortizing the unfunded liabilities.

As reflected in the chart above, we recently received our rates from PERS for 2005-06 (and projected rates for 2006-07), which reflect continued increases in contribution rates, albeit at a much lower rate of increase than the past two years. The forecast assumes that rates will stabilize at the 2006-07 level.

**Can it get better?** If PERS most recent yield trends continue, then at some point we can expect that contribution rates will steadily decline to more closely resemble “normal” contribution rates. However, because of PERS “smoothing” methodology, this will take several years. Moreover, under previously negotiated agreements, our sworn fire staff’s retirement benefits will increase from “3% at Age 55” to “3% at Age 50” in January 2006. At that time, we can expect another increase in contribution rates of about 3%. In short, for the next two years, PERS improved investment yields will more likely result in stabilization of rates rather than a significant decline.

# Resolution No. 9667

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**RESOLUTION NO. 9667 (2005 Series)**

**A RESOLUTION OF THE COUNCIL OF THE CITY OF SAN LUIS OBISPO  
SUPPORTING THE LEAGUE OF CALIFORNIA CITIES TASK FORCE IN PURSUING  
APPROPRIATE PENSION REFORMS AND EXPRESSING CONCERNS WITH ACA 5  
AND OTHER SIMILAR INITIATIVES**

**WHEREAS**, the League of California Cities welcomes a comprehensive discussion about pension reform, focused on curbing the increased costs of providing public pensions in the context of the critical role that public pension benefits play in the recruitment and retention of a skilled public workforce; and

**WHEREAS**, the defined benefit model used for public employee pensions has been in place for about sixty years in California, and has ensured that California residents receive high quality services from motivated, highly professional public employees; and

**WHEREAS**, the League recognizes that problems exist and must be addressed in the defined retirement benefit plans in California; such concerns are: a) Increased cost to the public employer and ultimately the taxpayer; 2) volatility of employer pension contributions; 3) some excessive benefit formulas; and, 4) permitted abuses due to the lack of proper restraints in retirement law; and

**WHEREAS**, solutions to problems in the defined benefit retirement plans require a wide variety of options and strategic approaches and should avoid one-size-fits-all solutions, which fail to take into account the complexity of the issues, such as ACA 5 and ACA 1-1x; and

**WHEREAS**, defined contribution plans as the only alternative raise the immediate costs of public pension plans and seriously erode the ability of public employers, such as the City of San Luis Obispo, to retain and recruit skilled public employees.

**NOW, THEREFORE, BE IT RESOLVED** by the Council of the City of San Luis Obispo as follows:

**SECTION 1. League Task Force Recommendations.** The Council hereby supports the League of California Cities' task force in developing recommendations that address the necessary and required reform of the public pension system.

**SECTION 2. Opposition to ACA 5 and ACA 1-1x.** The Council hereby specifically opposes Assembly Constitutional Amendment 5, Special Session Assembly Constitutional Amendment 1, as well as any and all measures proposed for the upcoming special election statewide ballot that would mandate the replacement of the current defined benefit retirement system with a private defined contribution system, whether for new or existing employees.

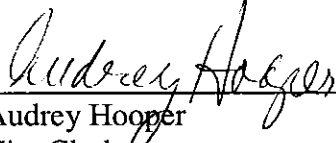
Upon motion of Council Member Settle, seconded by Council Member Mulholland, and on the following roll call vote:

AYES: Council Members Brown, Mulholland and Settle, Vice Mayor Ewan and Mayor Romero  
NOES: None  
ABSENT: None

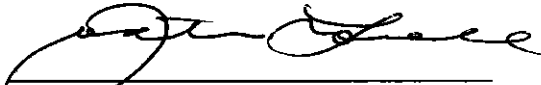
The foregoing resolution was adopted this 5th day of April 2005.

  
Mayor David F. Romero

ATTEST:

  
Audrey Hooper  
City Clerk

APPROVED AS TO FORM:

  
Jonathan P. Lowell  
City Attorney

# Research Brief

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# Research Brief

## Pension Debate: The Myths and Realities of Defined Benefit and Defined Contribution Plans

January 2005

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### ***Moving from a Defined Benefit Plan to a Defined Contribution Plan Won't Help Current Budget Crisis***

The change to a defined contribution (DC) plan would not save the State and local government money for at least 10 years, and in fact, it will add a second pension system that will add start up costs to government budgets. In addition, the State would also have to pay more money to cover disability and death benefits for these employees, as well as Social Security, which State safety personnel and others don't currently receive.

### ***The CalPERS Defined Benefit Plan Works Very Well***

**CalPERS has been a proven great investor for the taxpayers of California.** Over the last 10 years ended June 30, 2004, CalPERS returns averaged 9.7 percent even with two years of negative returns. It has generated positive investment returns 18 of the last 20 years, and costs less than a DC plan. Some 75 percent of income to fund pensions came from good investment earnings during the last 10 years.

**CalPERS investment earnings have made up the lions share of the fund over the last 22 years.** According to its pension consultant Wilshire Associates, wealth created through investments has totaled \$171.9 billion from 1982-2004. During the same period, employer and employee contributions totaled \$29.7 billion and the System paid out \$48.6 billion in retirement benefits.

A report compiled by Cost Effectiveness Measurement Inc. found that CalPERS investment staff added \$7 billion in excess returns over the five-year period ended December 31, 2003, while taking less risk than other public pension funds in the United States, Europe, Canada and Asia.

## ***Excessive Benefits in the Defined Benefit Plan Is a Myth***

**Average pension is small.** No one is getting rich on pensions. Some 25,000 CalPERS members retire each year. The average age at retirement for the largest segment of workers is 60, with 19.5 years of service, and a benefit allowance of \$1,673.82 a month. The average CHP employee retires at age 55, with 27.9 years of service, and receives an allowance of \$3,811.27 a month.

**The majority of State cost increases are due to market downturn, not to increased benefits.** Nearly 80 percent of increases in employer rates between 2002-04 are due to the two-year downturn in the economy. And as a percent of payroll, the State pays less per employee than it did 25 years ago for school employees, state miscellaneous employees, state industrial workers, state safety workers and state peace officer and firefighters.<sup>1</sup>

### ***Defined Contribution Plans Don't Cost Less, They Cost More***

**Dollar for dollar, DC plans cost more.** Administrative costs of DC plans are higher – often much higher – than a DB plan.<sup>2</sup> The average cost of administering CalPERS defined benefit plan from 1997 to 2003 was 0.18 percent. The annual cost of a DC plan can rise to as much as 2 percent of assets. The expense ratio for a stock mutual fund is 1.1 percent of assets.

**CalPERS investment portfolio is low cost and less risky than other public pension funds.** A Cost Effectiveness Measurement Inc., found that CalPERS saved \$144 million compared to its peers, paying less for consulting, custodial and active management services. Costs to run the pension fund's investment portfolio were \$413.2 million in 2003, compared to a peer benchmark of \$557.1 million.

**In a typical DB plan, 80 cents of each \$1 is spent on members who retire; in a DC plan 50 cents of each \$1 is spent on benefits with the other 50 cents spent prior to retirement.** For retiring members to receive the same amount of benefits, contributions to the fund would need to increase substantially.<sup>3</sup>

**There is no guarantee that tax dollars put into an employee account will be used for retirement.** Research indicates that most employees who leave one job for another, cash out their accounts – including the monies contributed by the employer for the purpose of retirement -- rather than roll them over to the next employer's retirement plan.<sup>4</sup> If DC proceeds fall short of basic retirement income needed, the State will end up paying more in public assistance when employees are old, ill and infirm.

**A comparison of operation expenses favors DB plans.** Employees pay big fees to mutual funds and other investment managers on their investment dollars in

DC plans. On average, mutual funds charge \$1.35 for “load” and/or administrative expenses for every \$100 invested. For each of the last 6 years, CalPERS spent less than two tenths of one percent of the fund’s value – 18 cents on every \$100 invested.<sup>5</sup>

**The State will bear start-up costs of a DC plan, bringing to two the number of plans it will need to budget for.** The State’s contributions to the CalPERS plan do not require direct payment of administrative costs to run the system. If the State were to set up a DC plan, it would have to pay for start-up costs. The DC plan does not cover costs of disability retirements and death benefits, which are embedded in the cost of the DB plan. The State would also have the added expense of starting to pay 6.7 percent of payroll for police, firefighters, and others in safety classes who don’t get social security under the existing DB plan.

**The State throws away an opportunity to use future investment returns to cover retirement costs, relieving taxpayers from some of the burden of funding pensions.** A DC plan does not give the State the ability to use investment returns to pay for a portion of pension costs. For example, investment returns and employee contributions generated enough income in the mid-1990s that the State did not pay any contributions during four years -- Fiscal year 1998-99 through Fiscal Year 2001-02 -- for 350,000 classified school workers. That represented a savings of over \$4 billion alone.

Over the last 10 years, 75 percent of the income to CalPERS has been from investments, not employer or employee contributions. Over the last decade, members’ contributions have actually exceeded the amount of employer contributions by \$1.1 million.

***Replacing a Defined Benefit Plan with a Defined Contribution Model  
Turns Off The Future Spigot of Pension Dollars For Investments in the  
State Of California***

Under the existing CalPERS defined benefit plan, more than \$19.5 billion in pension dollars is set aside for California investments. Replacing CalPERS with a DC plan would mean that future contributions needed for a DC plan could not be re-deployed for California investments. It would turn a blind eye to the opportunity to redeploy capital to strengthen California business, promote job growth, and build communities and infrastructure. These investments – a part of CalPERS diversified portfolio of investments -- help strengthen the State’s economy and tax base.

Currently, CalPERS invests more than \$10.7 billion in companies based in California – from blue chip corporations on the New York Stock Exchange to start-up firms in south central Los Angeles and the Silicon Valley.

CalPERS holds \$2.4 billion in fixed income assets, including corporate bonds in California, that enable corporate expansion. And CalPERS invests \$6.4 billion in California real estate. These include investments in industrial office properties, office buildings, senior housing and retail establishments. CalPERS is also one of the largest real estate developers, financing more than \$2 billion worth of single family homes.

CalPERS pension dollars have financed the building of more than 43,000 homes and developed 33,000 lots for single family homes. This public pension capital has provided \$13.8 billion in mortgages for nearly 100,000 California families.

The private equity portion of the CalPERS portfolio has invested in many start-up companies, including biotechnology which capitalizes on the advent and convergence of new technologies including genomes, bioinformatics and therapeutic agents.

During the recession of the late 1980s, CalPERS was among the only sources of construction capital in the State. After the terrorist attacks on September 11, 2001, CalPERS helped stabilize the New York Stock Exchange by continuing to invest into the stock market in spite of the market uncertainty.

### ***Defined Contribution Plans Threaten Employee Retirement Security***

**DC Plans Make Future Uncertain.** Tax dollars set aside for employees' use to finance their pension under a DC plan may never be used as is intended. That is because under a DC plan, participants will face daunting risks investing on their own. Some may not be able to resist cashing out retirement assets prematurely. These are uncertain factors on which to base a worker's retirement income security. And research suggests that DC plan participants generally earn rates of return on investment far below what DB plan funds typically earn.<sup>6</sup>

**Even if employees in a DC plan do manage to earn the same rate of return as a DB plan fund and resist the urge to cash out prematurely, at the end of a full career they will likely receive a smaller benefit than similar employees in the DB plan.** For example, an employee in a DB plan (with a benefit formula of 2% at age 60 and employer and employee contributions of 10% of pay) hired at age 30 with a starting salary of \$25,000 and 5% pay increases each year will have a retirement benefit with a present value of \$732,100 upon retirement at age 60.

In contrast, the retirement benefit for an employee in a DC plan hired at the same age with the same salary (assuming that the DB plan and DC plan both earn a rate of return of 8%) will have a present value of \$497,529 upon retirement at age 60.<sup>7</sup>

**Employees could outlive their retirement assets in a DC plan.** DC plans do not take into account the risk that the employee will outlive their retirement assets. If public servants didn't earn enough through their DC plan, the question will become who will help them when their retirement nest egg runs out? Will the State's safety net – currently stretched to its limits – be responsible?

**DC plans do not include inflation protection, disability benefits or death benefits.** For retirees in a DC plan, an annual inflation rate of 2.5 percent from age 65 to 93 would cut purchasing power in half. Employees would be without either disability or death benefits in a DC plan. This is an inequitable arrangement when workers with the DB plan work along side of them. (Disability & death benefits are already factored into a DB plan.)

**When offered a DC plan, some employees don't even contribute and most contribute less than the maximum amount allowed.** 26 percent of employees who are eligible for 401(k) plans do not participate. Non participation is concentrated in lower-income employees. Among all employees, less than 10 percent contribute the maximum allowable amount, which further restricts their ability to match DB payout amounts.<sup>8</sup>

**Chances that the DC plan would not provide an adequate benefit are high.** Research suggests employees do not invest well on their own to ensure an adequate benefit through their later years. An annual study conducted by Dalbar, a Boston fund consulting firm, found that the average stock fund investor had a 5 percent annual gain from 1984 to 2000; compared to a 16 percent annual average gain for the Standard & Poors (S&P) 500 stock index for that period.<sup>9</sup> Over the last 10 years ending June 30, 2004 CalPERS returns averaged 9.7 percent.

A John Hancock Financial Services Retirement Survey of defined contribution participants published in May 2002 showed that “many have a cockeyed view of how investments work across the board.” John Hancock researchers said that most defined contribution participants will fall well shy of the estimated 75 percent of pre-retirement income needed to maintain the same lifestyle in retirement.<sup>10</sup>

One half of DC plan investors do not diversify, almost none rebalance portfolios periodically.<sup>11</sup>

**Defined benefit plans outperform 401(k)'s in a down market.**

According to a 2004 analysis by Watson Wyatt Worldwide, defined benefit plan returns tend to do better than those of 401(k) plans during bad market years that follow periods of hot stock market returns. Watson Wyatt Worldwide analyzed

2000 and 2001 Form 5500 data for companies that sponsor both defined benefit and defined contribution plans.

Previous studies by Watson Wyatt showed that from 1995 to 1998, defined benefit plan returns beat those of 401(k) plans. Once the market turned sharply downward in March 2000, defined benefit plan returns began to dominate again, with Watson Wyatt researchers theorizing that better downside protection came from the higher portfolio diversification of the professionally managed defined benefit plans.<sup>12</sup>

***Defined Contribution Plans Will Hamper Recruitment and Retention and Make State Attract Less Capable, Not More Capable Work Force***

**DB benefits help recruit for classifications when the State experiences a labor shortage.** The State competes with the public sector for many specialized workers – especially safety employees. The State has and will continue to have challenges recruiting scientists, researchers, technology workers, nurses, doctors, accountants and other specialized workers. (This occurred when the State had mandatory tier 2 programs in the early 1990s.) Human Resource specialists indicate that it is not the pay that attracts people to work for the State, but rather the retirement benefits. State workers have not kept pace in pay – most of whom went without annual pay raises for many of the last 13 years.<sup>13</sup>

**DB plans promote longevity which gives good return on the investment in training specialized workers such as firefighters and safety personnel.** In contrast, under a DC plan, employee turnover may be higher, causing the State and local government to waste taxpayer dollars training a revolving door of workers.

**DC plans would encourage older, more expensive workers to continue working longer, rather than retire.** The performance of the markets would have a significant influence on when people retire. When the economy is doing poorly and individuals' DC accounts are down, they may decide to work beyond a reasonable retirement date, creating less opportunity to replenish the workforce with younger workers.<sup>14</sup>

People who retire with a defined contribution plan end up retiring later than earlier. The expected retirement age of a DB plan is 63.9 nationwide; the expected retirement age of a DC plan participant is 65.1 years.<sup>15</sup>

**Market timing would determine when people retire.** Retirement trends, not age periods of market growth would spawn large numbers of employees retiring. Down markets would restrict the number of workers retiring.

***Contrary to Popular Belief,  
DC Plans Get Thumbs Down From Large Employers***

**The decrease in DB plans has been limited nearly exclusively to small, not large employers.** Companies that are electing to discontinue DB coverage have been small employers, not large employers, and they are doing so because of the expense of complying with complex federal regulations, most of which do not apply to the public sector.<sup>16</sup>

**Large employers have generally kept their DB plans rather than convert to DC plans.**

- **Most of the decrease in DB plans has occurred among small and medium size employers** (employers with less than 1000 employees).<sup>17</sup>
- **Eighty percent of professional service firms offer DB plans, with the average contribution rate from companies with over 1,000 employees sitting at \$40 million in 2003.**<sup>18</sup>
- **Due to their size, public employers are more comparable to large private-sector employers, most of which offer DB plans.** In 2003, 68% of large private-sector employers offered DB plans compared to 45% of all private sector employers.<sup>19</sup>
- **Although DB plans are more prevalent in the public sector, it is likely that more private sector employers would adopt or continue DB plans were it not for the cost and administrative burden imposed by ERISA laws and regulations.** Because public pension plans are exempt from most of ERISA, DB plans are even more advantageous for public employers than for private employers.<sup>20</sup>
- Large and medium private companies value DB plans as primary recruitment and retention tool (American Benefits Council).
- Examples of large companies with DB plans:
  - Chevron
  - Unocal
  - Lockheed Martin
  - Boeing
  - Albertson's
  - Boise Cascade
  - Louisiana Pacific
  - Safeco
  - Weyerhaeuser

**Only 17 percent of Fortune 100 companies have a DC plan as their primary benefit, according to Watson Wyatt.** Most large employers continue to offer defined benefit plans as their primary retirement program and its use among large employers with 10,000 or more employees is increasing. The highly regarded Employee Benefits Research Institute (EBRI) found that since 1985, there was an actual increase in the number of large employers that offered a defined benefit plan as their primary retirement plan. This occurred during a period of many corporate mergers of large firms, who had a unique opportunity to select one or the other.<sup>21</sup>

**The majority of U.S. companies with 1,000 or more employees that offer a DB plan believe their plan directly impacts employee retention.** According to a September 2004 study by Diversified Investment Advisors.<sup>22</sup>

### ***Public Sector Experience with DC Conversions Has Not Been Highly Successful***

Since 1997, large numbers of public employers have been given an opportunity to participate in a DC plan as their primary retirement benefit. In Florida and Michigan, an overwhelming majority – more than 90 percent of those eligible to switch to a DC plan – elected to stay with the DB plan.<sup>23</sup>

The state of Nebraska recently converted back to a DB plan from a DC plan. A study showed that over 20 years, the typical worker posted an average annual return of 6 to 7 percent. (Money managers running the state's old-fashioned defined benefit plan ran 11 percent average returns.) Even though the state made much effort to help individuals invest wisely, half of all employees stayed in the default fund, even though they had 11 choices. Nebraska retirement system officials were concerned that the state was wasting taxpayer money via matching contributions to workers accounts.<sup>24</sup>

In Florida, where employees could leave the DB plan for the DC plan, most opted to stay in the DB plan.

When the Illinois Municipal Retirement Fund looked into switching from a DB to DC plan, it found that its total cost – administrative and investment expenses – could rise from 0.44 percent of assets to as much as 2.25 percent of assets, a difference that approached \$315 million a year.<sup>25</sup>

### ***The Value of “Defined Contribution Portability” Is Not What It’s Cracked Up To Be***

**The conventional wisdom is wrong that workers today are more mobile and want more portability of their retirement benefits.**

- **Workers are not necessarily more mobile.** From 1983 to 2000, median job tenure increased or stayed the same for all workers in the U.S. with

the exception of workers in two sectors (manufacturing and transportation/public utilities).<sup>26</sup>

- **Public-sector workers are even less mobile.** From 1983 to 2000, the median tenure for government workers in the U.S. increased from 5.8 years to 7.2 years. In 2000, the median years of tenure for government workers (7.2 years) was more than twice that for workers in the private sector (3.2 years).<sup>27</sup>
- **DC plans are not necessarily the solution to deal with the issue of pension portability.** A significant proportion of workers with DC plans “cash out” their accounts when they change employers rather than leave it in the account or roll it over to their new employer’s plan. For example, a study conducted by the human resources consulting firm Hewitt Associates found that 57% of employees who leave their companies choose cash payments from their retirement savings plans instead of rolling over the balances to their new employer’s plans or into individual accounts.<sup>28</sup>
- **DB plans have been adopting changes to make benefits more portable** (e.g., shorter vesting periods and expanded reciprocity).
- **In cases where public employees have the option of participating in an alternative DC retirement plan, it appears that most opt for the DB plan.** During the first two years of Florida’s optional retirement program, only 3.4% of eligible employees opted for the DC alternative (8% of new hires).<sup>29</sup> In Michigan, state employees hired prior to March 31, 1997 had the option to remain in a DB plan or switch to a DC plan that was mandatory for all new employees. Only 6% of eligible employees switched to the DC plan.<sup>30</sup>

**DC plan would hurt “portability” via reciprocity with public agencies within CalPERS.** One of the recruitment features of the CalPERS DB plan is that there is reciprocity with other public agencies in the State; these employees would not have the same reciprocity benefit as others who work for the State.

**Employees taking money out of CalPERS when they leave State service will drain the fund.** The Sacramento Bee in a 1996 editorial pointed that “Every worker intending to leave public service short of vesting for a pension – political appointees, highly paid managers, and professionals who have private sector skills – would likely choose the new option, draining funds from the system. That would leave taxpayers with the same pension obligations but less money to fulfill them.”

### **Moving to a DC Plan Helps and Hurts the Wrong People**

Higher costs and fees are charged for DC plans. Wall Street money managers will make money on these assets even if investors lose. Many people would

rather have investment managers within public service manage the assets rather than mutual funds whose goal is to make profits for itself. DC plans prevent participation in the full range of investments such as real estate and private equity investments.

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<sup>1</sup> “Employer Contribution Rate History - CalPERS State and Schools Actuarial Valuation, June 30, 2003.

<sup>2</sup> “Myths and Misperceptions of Defined Benefit and Defined Contribution Plans.” A NASRA White Paper. December 2003.

<sup>3</sup> National Conference on Public Employee Retirement Systems White Paper on Defined Benefit and Defined Contribution Plan, 1997

<sup>4</sup> “Myths and Misperceptions of Defined Benefit and Defined Contribution Plans.” A NASRA White Paper. December 2003.

<sup>5</sup> Cost Effectiveness Measurement, Inc. Benefit Administration Benchmarking Analysis. May 2003.

<sup>6</sup> Ian McDonald, “Fundholder’s Lament: All Bear, No Bull,” Wall Street Journal, April, 25, 2002. And “Benefit Review Study of the Nebraska Retirement Systems.” August 2000. Buck Consultants.

<sup>7</sup> “The Search for Cheaper Benefits: Defined Benefit versus Defined Contribution,” Public Pension Professionals, article viewed at [www.pensioncube.com/Stories/DBvDC1\\_1.htm](http://www.pensioncube.com/Stories/DBvDC1_1.htm) Feb. 2004.

<sup>8</sup> Munnell and Sunden, *Coming Up Short*, p.150

<sup>9</sup> Ian McDonald, “Fundholder’s Lament: All Bear, No Bull,” Wall Street Journal, April 25, 2002.

<sup>10</sup> “Myths and Misperceptions of Defined Benefit and Defined Contribution Plans.” A NASRA White Paper. December 2003.

<sup>11</sup> Munnell and Sunden, *Coming Up Short*, p.11

<sup>12</sup> “Diversification is Key: Defined benefit plans outperform 401(k)s in a down market,” Pension & Investments November 29, 2004.

<sup>13</sup> Legislative Analyst Office 2000-01 Analysis.

<sup>14</sup> Kosiba, Louis W., Illinois Municipal Retirement Fund General Counsel. “The Defined Benefit vs. Defined Contribution Debate: The \$250 Million Question.” October 13, 1999.

<sup>15</sup> “Myths and Misperceptions of Defined Benefit and Defined Contribution Plans.” A NASRA White Paper. December 2003.

<sup>16</sup> “How Has the Shift to 401K’s Affected Retirement Age?” by Alicia H. Munnell, et. A., Center for Retirement Research, Boston College.

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<sup>17</sup> W. Michael Carter, Actuary. February 6, 1998. Letter to comment on "Pension Liberation: A Proactive Solution for the Nation's Public Pension Systems" (a report by the American Legislative Exchange Council). Published on the National Council on Teacher Retirement website [www.nctr.org/content/indexpg/carter.htm](http://www.nctr.org/content/indexpg/carter.htm). And, Kosiba, Louis W., Illinois Municipal Retirement Fund General Counsel. "The Defined Benefit vs. Defined Contribution Debate: The \$250 Million Question." October 13, 1999.

<sup>18</sup> Results of a survey by Diversified Investment Advisors. "PLANSPONSOR.com" December 2, 2004

<sup>19</sup> Hewitt Associates Newsletter, Jan. 6, 2004.

<sup>20</sup> "Myths and Misperceptions of Defined Benefit and Defined Contribution Plans." A NASRA White Paper. December 2003.

<sup>21</sup> "Myths and Misperceptions of Defined Benefit and Defined Contribution Plans." A NASRA White Paper. December 2003.

<sup>22</sup> Business Wire, September 7, 2004 "Majority of U.S. Companies That Offer a Pension Plan Say It Impacts Employee Retention, New Survey Shows"

<sup>23</sup> "Pension fund slowly gaining popularity." Tallahassee Democrat, Jan. 12, 2004. And Cypen and Cypen Newsletter. December, 1998. [www.cypen.com/pubs/1998dec.htm](http://www.cypen.com/pubs/1998dec.htm)

<sup>24</sup> "Nebraska Sees Red Over its 401(k) Plans." K.C. Swanson. The Street.com. May 7, 2002. <http://www.thestreet.com/funds/belowradar/10021041.html>

<sup>25</sup> Louis W. Kosiba, "The Defined Benefit vs. Defined Contribution Debate: The \$250 Million Question," Illinois Municipal Retirement Fund, October 13, 1999, as cited in Munnell and Sunden, *Coming Up Short*.

<sup>26</sup> "Employee Tenure in 2000." Bureau of Labor Statistics News Release, August 29, 2000. <http://stats.bls.gov/newsrels.htm>, p. 11.

<sup>27</sup> "Employee Tenure in 2000." Bureau of Labor Statistics News Release, August 29, 2000. <http://stats.bls.gov/newsrels.htm>, p. 11.

<sup>28</sup> From *Business Insurance* Sept. 22, 1999 cited in "Are Your Retirement Benefits Important to You?" Oklahoma Public Employees Association News, April 10, 2003. <http://www.opea.org/News/OPEA/opea-20030410e.htm>

<sup>29</sup> "Pension fund slowly gaining popularity." Tallahassee Democrat, Jan. 12, 2004.

<sup>30</sup> Cypen and Cypen Newsletter. December 1998. [www.cypen.com/pubs/1998dec.htm](http://www.cypen.com/pubs/1998dec.htm)