STATE OF CALIFORNIA

PUBLIC EMPLOYEE
POST-EMPLOYMENT BENEFITS COMMISSION

PUBLIC MEETING

Thursday, July 12, 2007
10:05 a.m.

California Teachers Association Headquarters
1705 Murchison Drive
Burlingame, California

Reported by: DANIEL P. FELDHAUS, CSR #6949, RDR, CRR

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A P P E A R A N C E S

PUBLIC EMPLOYEE POST-EMPLOYMENT BENEFITS COMMISSION

Commissioners Present

GERRY PARSKY, Commission Chair
Aurora Capital Group

MATTHEW BARGER
Hellman & Friedman LLC

PAUL CAPPITELLI
San Bernardino County Sheriff's Department

JOHN COGAN
Stanford University

CONNIE CONWAY
Tulare County Board of Supervisors

RONALD COTTINGHAM
Peace Officers Research Association of California

TERESA GHILARDUCCI, Ph.D.
Trustee
General Motors Retiree Health Pensions

JIM HARD
President
Service Employees International Union Local 1000

LEONARD LEE LIPPS
California Teachers' Association

DAVE LOW
California School Employees Association

ROBERT WALTON
Retired (CalPERS)

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A P P E A R A N C E S

PUBLIC EMPLOYEE POST-RETIREMENT BENEFITS COMMISSION

PEBC Staff Present

ANNE SHEEHAN
Executive Director

JAN BOEL
Staff Director

STEPHANIE DOUGHERTY
Research Director

MARGIE RAMIREZ WALKER
Office Manager

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Public Testimony

MORGAN H. BROWN
California Teachers Association Retirement Committee

ANDY COLTART
Retired Public Employees Association

TED COSTA
People's Advocate

SHAUN DUFOSSE
Sonoma County Law Enforcement Association

PATRICIA FINK
Retired Public Employees Association

MARCIA FRITZ
California Foundation for Fiscal Responsibility

MAYA GLADSTERN
Marin County Employees Retirement Association

A P P E A R A N C E S

Public Testimony
continued

KRISTINE S. HUNT
Contra Costa Taxpayers Association

HENRY JONES

CATHERINE KEKAUOHA

HENE KELLY
California Federation of Teachers

BARBARA LAPLANTE
California State Employees Association Retirees

TED ROSE
Retired Public Employees Association

JAMES P. ROSS
Service Employees International Union, Local 521

KATHY SHADDOX
California School Employees Association

TERRY SUTHERLAND

PAUL TUTINO
Retired Public Employees Association

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Presentations

GRANT BOYKEN
Senior Research Specialist
California Research Bureau

KEITH BRAINARD
Research Director
National Association of State Retirement Administrators

A P P E A R A N C E S

Presentations
continued

DAVID ELDER
Former Chair
Assembly Public Employees, Retirement and
Social Security Committee

DONALD FUERST
FSA, Worldwide Partner
Mercer Human Resource Consulting

DAVID JANSSEN, Ph.D.
Chief Executive Officer
County of Los Angeles

BOB PALMER
Administrator
San Joaquin County Employees' Retirement System

RON SEELING
Chief Actuary
CalPERS

JOHN SHOVEN
Senior Fellow, Hoover Institution
and
Professor of Economics, Stanford University

RICHARD STENSRUD
Administrator
Sacramento County Employees' Retirement System

SHAWN TERRIS
President
State Association of County Retirement Systems

DAVID WESCOE
Administrator
City of San Diego Employees' Retirement System

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Table of Contents

Table of Contents

Table of Contents

BE IT REMEMBERED that on Thursday, July 12, 2007, commencing at the hour of 10:05 a.m., at California Teachers Association Headquarters, 1705 Murchison Drive, Burlingame, California, before me, DANIEL P. FELDHAUS, CSR 6949, RDR, CRR, in the state of California, the following proceedings were held:

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CHAIR PARSKY: Although people often think that commissions don't start on time, don't end on time, we're going to try. We've tried at each place. We've succeeded, to some extent.

On behalf of all of my fellow commissioners, I want to welcome everyone in the audience, as well as our speakers, to our fourth commission meeting relating to public pensions.

However, before we begin today, I'd like to, first of all, express our special thanks to the California Teachers Association and to David Sanchez, who is the new president. He stepped outside of his first board meeting in order to say "hello" to everyone. And on behalf of all of the Commissioners, I want to thank you. And please make whatever remarks you think are appropriate. But we thank you very much. And you can address us right from there.

DAVID SANCHEZ: Thank you.

Well, good morning. On behalf of our 340,000 members of the California Teachers Association and our executive director, Carolyn Doggett, we'd like to welcome you all to the headquarters of the California Teachers Association.

Chairman Parsky, all Members of the Commission, and those of you who have come to address the panel, we are glad to have you here, and so pleased that one of the hearings for this very important commission could be held here at CTA.

You are certainly a distinguished group, and we're pleased that that group includes our very own CTA Lee Lipps.

I don't have to tell you that the task of this commission is very, very critical. And your recommendations to the Governor will have a significant impact on the future of California and its public employees.

Teachers and education-support professionals across the state are watching your work very, very closely. And I hope that you will listen carefully as educators and others come to talk to you. I have met a couple already who said they're going to speak.

Providing a secure retirement and affordable health care is critical to attracting and keeping quality teachers in the classroom, as well as police and firefighters in our communities.

California is facing a severe teacher shortage, needing at least 100,000 new teachers over the next ten years.

We do not want to throw up roadblocks to attracting the educated professionals we need in our public schools.

And as the Governor said when he announced the formation of this Commission, promised pensions and health benefits are vitally important to state workers and their families, and they are obligations that must be paid.

I thank you all for the work that you do. I know you are putting in significant time and travel. And we look forward to your report and are counting on you to make informed recommendations.

Please, make yourself home here at CTA. Our board of directors is also meeting today, so I must head back upstairs. This is my very first board meeting. And you'll notice that I'm very casually dressed. There's a good reason for that. This is our summer board meeting, and we asked our board members to not wear a coat and tie to this particular meeting. So yours truly is wearing his guayabera as a sign of being casual. So I must head back upstairs.

But if there's anything that you need at all, please, if there's anything you need while you are here, do not hesitate to ask Lee Lipps. He will make it happen.

Have a great hearing. Chairman Parsky, it was a pleasure meeting you. Members of the Commission, have a great morning.

Thank you so much.

(Applause)

CHAIR PARSKY: Well, thank you very much.

Since Commissioner Cogan said we ought to consider casual at one of these meetings, we'll see if we can't pick one. Maybe we'll try the summer months in a warm climate to do it.

Most of the people that are on this table, you know, come from a generation that is used to wearing coat and tie, but we'll see what we can do.

The agenda, I think, has been made available publicly. It's in the back of the room.

We have asked a number of subject-matter experts to brief the Commission today on various aspects of the issue that is before us.

I have started each of the meetings with a reminder of the purpose of the Commission. The area that we are dealing with, which is of critical importance to our citizenry and to the financial health of our state has received a lot of public attention, and there's a lot of information that has circulated about it.

The purpose of our commission is to attempt to identify in a fair and reasonable way the amount of post-retirement pension and health-care liability that potentially will exist in California, to evaluate approaches for addressing these unfunded obligations, and to propose a sensible plan to handle them.

Now, the Governor and the Legislature established this Commission as a truly bipartisan effort. And the leadership on all sides made it clear that promised pension and health-care benefits to existing employees and retirees would be met.

There are a number of people that have expressed concerns about that subject. But on the establishment of this Commission, the leadership said these are promises that will be met.

So a part of our job is to begin to assess the magnitude of those, and to propose ways that these obligations can be met, can be financed, in a way that is reasonable and that doesn't hurt the financial viability of our state.

So we start with that premise.

The only other general comment I would make is that a number of people and some commissioners have expressed concern to me about voter initiatives that are out there and that may come out there, and what that may or may not do to this Commission effort. And individual citizens in California or across our country are free, obviously, to put forward any voter initiatives that they want within the rules of how ballot initiatives can be qualified.

I think it will be important for us, however, to continue our work independent of enough those initiatives, and place them in an appropriate perspective as we come up with our report.

So I think from our standpoint, any initiatives are facts that is out there, but they are in no way determinative of how we will approach our recommendations.

So with that, I think what we'll do now is to move to our public comment period. And we have a number of -- in each of our sessions, we invite the public to comment. And we try to afford enough time to meet our agenda.

I think we have approximately 24 people who have requested to speak. And so I think what we will do in order to meet our time frame, is to ask each person to limit their oral comments to approximately a minute and a half. And they can submit everything in writing. We will carefully read them. But if you could do that. And, again, we'll watch the clock, but we certainly won't be in any way insulting by interrupting people if they really have to make a point. But we hope you can cooperate.

So our first three, if we could just be ready, Barbara LaPlante, Shaun DuFosse, and Ted Rose.

And we'll start with Barbara LaPlante.

MS. LAPLANTE: Good morning. Hi, I'm Barbara LaPlante, and president of CSEA Retirees, Inc. We represent nearly 28,000 employees.

I hope that in the coming weeks, this Commission will cut through the propaganda and political rhetoric, and help Californians learn more about the reality of public pensions in our state. For example, if you read and listen to some politicians, columnists, talk-show hosts, and editorial writers, you might believe that all public employees receive lavish, extravagant, gold-plated pension benefits.

Mr. Chairman, I'm here to tell you that is simply not true.

Prior to my retirement, I worked for the State of California at Cal State Hayward for 20 years. My pension benefit is less than $500 a month.

I would like Keith Richman to look me in the eye and tell me that $496.44 a month is lavish and extravagant.

I am not the exception to the rule. I have a chart here. I have a chart here that I want to submit for the record. It lists the pension benefits CSEA retiree members receive. It shows that nearly 60 percent of our members receive less than $1,600 a month. More than a quarter of our members get less than $800 a month. The average monthly pension benefit paid out by CalPERS is about $1,700 a month for someone with nearly 20 years of service.

Trust me, no one is growing rich on a $1,700-a-month public pension.

Californians should also remember that these benefits are not gifts. Each of us contributed to the pension fund throughout our career.

Mr. Chairman, I hope you and the other Commission members will base your recommendations to the Governor on facts, not on false and misleading political rhetoric.

Thank you very much.

CHAIR PARSKY: Thank you.

MS. LAPLANTE: And I can leave these charts with you.

CHAIR PARSKY: Yes, our staff will be happy to take those.

Thank you very much.

MS. LAPLANTE: Thank you.

CHAIR PARSKY: Shaun Dufosse, is that right?

MR. DUFOSSE: You are right. Thank you, Mr. Chair.

CHAIR PARSKY: Okay, and then Ted Rose and then after –- one more second.

MR. DUFOSSE: Good morning, Mr. Chair and Commission members, my name is Shaun DuFosse. I have worked for the Sonoma County Sheriff's office for more than 23 years.

As you know, there are two issues here: You have pensions and you have medical, retiree medical.

Sonoma is a '37 Act county. I believe, that Rod Dole came and did a presentation to you about our county.

Approximately 94 percent of funds are doing very well. General employees pay, the County pays. We pay quite a bit into our own pension.

We have no automatic COLA, cost of living, in our retirement. I believe we're the only 1937 Act that doesn't. And part of the compensation for that or the trade-off was that we have retiree medical. And since I'm now in contract negotiations, which are at an impasse, we have State Mediation in. You can imagine what the issue is. It's retiree medical.

The County has probably stated they want to save it, but they want to get language out of our contract that will give them the ability to end it at their discretion. That's simply not fair. And it doesn't address the issue. The issue is the cost of medical, not that retirees are getting it, that I'm getting it or that anybody else is getting it. And we need to address that.

We already have major recruitment or retention problems. In my sheriff's office over the last five years, we've had approximately a 98 percent turnover rate. We can't keep people. Other agencies around us pay more, but they don't have the medical. So that's our big bone -- our big attraction -- our carrot, I guess. Not really a bone, it's our carrot. You take that away or diminish it, and we're not going to get quality employees, quality law enforcement people to work the streets up in my neck of the woods. And, you know, I don't think that's in anybody's best interest.

So, you know, we don't want to see the promise broken of the retiree medical. We want to see some fixes.

We want to work. We're working with the county. We want to work with the Commission or anybody else to get it solved.

And thank you.

CHAIR PARSKY: Thank you very much.

Ted Rose, and then Andy Coltart and then Patricia Fink.

Ted Rose?

MR. ROSE: Thank you, Mr. Chairman and Members of the Commission. My name is Ted Rose. I'm the president of the Retired Public Employees Association of California. We represent 35,000 numbers.

Our members have retired under the CalPERS retirement system. Our members include those from contracting agencies from the classified schools and from the State.

The differences between the benefits to our members is large. Some benefits are rather high and some very low. It makes it difficult to find the truth when many in the media continue to make statements about all government retirees having excessive incomes and benefits. This is just not true.

I retired in 1992 from the City of Santa Clara Fire Department after 30 years. I had an adequate retirement.

I thought I had planned well for the retirement, understanding that the City of Santa Clara only pays a minimum amount required by the PEMHCA program, the CalPERS medical program. That was taken into my plans. I pay the balance -- or we do. As you know, the costs have skyrocketed for health care.

We did have a program from the City where the City supplemented the health-care costs up to $86 a month. It wasn't much, but it was something. But as soon as the PEMHCA cost increased to the cities, our city just took that right away from the separate program that they had initiated. So we wound up with zero bonus.

Many confuse the City of Santa Clara with the County of Santa Clara. The County of Santa Clara pays the full medical costs to the retirees. And, of course, the City of Santa Clara doesn't.

People come up to me all the time and make comments about public employees, retirees, and their extravagant retirement benefits, especially for police and fire. In many cases, even in most cases, this is not true.

I am concerned about members who have small retirements to live on. And I have just one short testimony here from a gentleman who lives in Iowa and would like to speak before you, but I will do it for him.

"My name is Ted Gasconi and I'm a PERS retiree since 1993. My PERS benefit is $1,082.

"After deductions, employee association dues of three bucks; health insurance, $812; taxes, $75; my net check is $192. I live on that, plus my Social Security of $1,050. If anyone thinks I'm living the high life, I would like to see them try on this paltry amount.

"And I personally -- I cringe when I hear these things but I know that those health costs are going to be going up and really impacting on our people like this.

Thank you."

CHAIR PARSKY: Thank you very much.

Andy Coltart.

MR. COLTART: Chairman Parsky and Members of the Commission, thank you for letting us speak today.

I'm Andy Coltart. Three years ago I retired from the City of Foster City Public Works Maintenance. As a member of the miscellaneous group, that is neither fire nor police, I was told on my last day of employment that the first 9.9 years of my retirement, my pension would be solely coming from what I put into CalPERS, plus appreciation. None of it would be coming from the City of Foster City. After ten years, then they start paying my pension.

I was also told on my last day of employment that when I asked them would they be contributing towards my medical benefits, I was told, no, they would not.

Last year, the members at CalPERS, when I called, I asked was the City paying anything, because I had heard about this bill that the Legislature had passed, what, five years ago, six years ago or something. That, yes, they were, they were paying $64 a month.

So my retirement, and everyone else in the miscellaneous group -- and I don't know how many other public agencies are set up the same way -- their retirement for the first 9.9 years is what they put in. And if that percentage has dropped from 2 percent -- or 7 percent, down to whatever, over what we would be receiving would be 2 percent or 1 percent, not very much.

Thank you.

CHAIR PARSKY: Thank you very much.

Patricia Fink, then James Ross, and then Paul Tutino.

Patricia Fink?

MS. FINK: I'll stand on my tip-toes.

First of all, I want to thank you for the opportunity of addressing this group. And I'm speaking -- I'm not here to plead poverty, although I have to tell you my pension is as Barbara LaPlante is -- I beat her. I'm just over $500 a month.

And after my health insurance and my long-term care insurance, so I don't become a burden on society, and my RPEA dues, I get $110.35. Again, not enough to live high on the hog.

But I'm really here to ask you to consider those people who have the greatest need. They are not here today, largely because they can't afford to be here or because they have health problems that prohibit them from being here. But those are many of my compatriots and ex-co-workers.

I did have one quick story I wanted to relate. When my husband retired, I was uninsurable and we didn't have retirement benefits through the county. We appealed -- we took the COBRA. And when the COBRA lapsed, we asked for individual coverage, the same coverage under the same company. The premium we were quoted was $36,500 a year for that coverage. $3,042 a month. Obviously, that was not doable. We spoke to an executive of that company who initially said that can't be true, checked on it, called back the next day, and said, "You're right, and we really have no particular desire to provide health insurance for older people." That's one of the things we're up against.

But, again, I want to thank you. And I will submit some written remarks, although I saved trees, so these have things on the back. And maybe I should redo it.

But thank you for considering it. And do think of us who don't have those high pensions.

Thanks so much.

CHAIR PARSKY: Thank you very much.

James Ross.

MR. ROSS: Good morning. My name is Jim Ross, and I've worked for the Santa Clara Valley Transportation Authority for 27 years, and I'm a member of SEIU Local 521. I'm an engineering technician and work supporting engineers on construction projects, and specifically, the BART to San José project. I'm proud to have been a part of making VTA one of the best public transit agencies in the Bay Area.

I'm a member of PERS. And after 27 years, I am planning to retire. I, like thousands of other retirees, rely on PERS benefits to ensure that I have a modest but quality retirement.

PERS is a low-cost, well-managed program that allows us to recruit and retain good public employees while keeping a promise for a secure and well-earned retirement.

CalPERS and other pension plans now provide as much as 75 percent of the cost benefits through investments, so employers and employees pay only 25 percent of the cost. That is efficiency.

As for retiree health benefits, putting money aside to pay for future retiree health costs is a step that we should take now. In fact, SEIU and Santa Clara County have worked together for years to prefund its retiree health-care system. It is now 44 percent funded.

The problem is not retiree health-care costs, but the cost of health care in general. It makes no sense to take away retiree health care while the State is working on universal health care.

Everyone deserves to retire with dignity. Public retirement systems and medical benefits provide us with many of the basic security to be able to live and work with dignity and independence after years of hard work.

Thousands of public employees in SEIU are confident that's exactly what the Commission will find.

CHAIR PARSKY: Thank you very much.

Paul Tutino, then Morgan Brown, then Maya Gladstern.

Paul Tutino.

MR. TUTINO: Thank you, Mr. Chairman. I'm Paul Tutino, Retired Public Employees Association, Chapter 50, Walnut Creek, San Ramon Valley.

I'd like to echo just very briefly what our previous speakers have said, that the pension system does not provide excessive benefits. Most of our people are not living in wealthy mansions or anything like that.

One thing I would like to bring out is that the retired employees, especially the older ones, came from a different generation where they were more frugal, they saved, and especially they invested in their homes. So many of our people have these very low benefits that you've heard discussed, but they're living in properties that is their home, that they've had for maybe 20, 30, 40 years. And those properties would classify them in the seven-figure income, if that was liquidated.

However, they do not want to sell their homes. They are living in places where their property values have increased five or more times since they bought their properties. And so they do live and can afford to live there because they have their homes paid off. Others that do rent have had some savings, so that they've been able to handle those costs, too.

But any reduction in their benefits would be harmful to them. And the older the employee, the older their employment, the less pay that they have.

And then the other thing that benefits them, of course, is the Prop. 13 low property tax, because many of these homeowners are able to survive because they have some of that older home benefit.

So those are the cases I would like to make.

I think of one retired couple that worked for the school system. One was an elementary teacher, the other was a service worker. They are living in property that cost them, I think, something like $20,000 when they bought it. Their children and their grandchildren live on the property. And the property value today is somewhere up well into the seven figures. So it is not anything that they can benefit from unless they sell out. And that would be their home and their surroundings.

So those are considerations, I think, that keep people that have low pension benefits able to survive.

And I think that ought to be a consideration before any reduction in their benefits would take place.

Thank you.

CHAIR PARSKY: Thank you very much.

Morgan Brown, Maya Gladstern, and -- I think we've had Barbara LaPlante. Okay, thank you.

MR. BROWN: Good morning.

My name is Morgan Brown. I'm the current chair of the California Teachers Association Retirement Committee. I'm also a first grade bilingual teacher in an urban school district in Southern California, where I've been working for 13 years.

I come from a long line of dedicated public school employees. As a third-generation STRS member, my family and I understand the importance of maintaining our fair and adequate retirement system.

My grandmother, a school teacher, and grandfather, a school custodian, retired comfortably over 20 years in CalSTRS and CalPERS.

My father retired just four years ago as a bilingual speech and language specialist. And my mother retired less than a month ago as a special education administrator.

Indeed, we have much to be grateful for when it comes to our family's secure financial future, and we owe it to California's stable system of retirement benefits.

As an organization, we, the California Teachers Association, believe that all Americans have a right to retire with dignity, reasonable security, and without discrimination or abuse. We also believe that school, college, university, and county office employees have a right to a retirement income which is fair and just and does not decline in value.

The average STRS retiree retired at 60.7 years of age, with 21 point -- or excuse me, 26.1 years of service, and an average retirement allowance of $2,617 for those with beneficiaries.

Most career educators receive no Social Security at all, as you know. The State contribution to STRS is small. However, the contribution to the state economy by financially secure retirees far exceeds this cost. 75 percent of the benefit received by a retiree is generated from investments made by CalSTRS. These investments further contribute to the stability, strength, and security of our state and national economies.

Currently, hundreds of thousands of public employees count on CalSTRS and CalPERS. Even though I'm younger, I, too, am counting on my retirement benefits to be there for me in the future, like they are now for my parents, like they were for my grandmother and my grandfather when they retired.

Retirement is not a privilege. It is a right and a well-earned benefit from a lifetime of dedicated work. School employees deserve to be comfortable and secure in their golden years after serving and working for California's most important resource: Our youth and our future.

Thank you.

CHAIR PARSKY: Thank you very much.

Maya Gladstern, Terry Sutherland, then Kathy Shaddox.

MS. GLADSTERN: Hi. I'm Maya Gladstern. Thank you very much for allowing all of us to speak.

I have worked for the County of Marin since 1980. I've been a steward with SEIU for 25 years, and now I'm an elected trustee on the Marin County Employees Retirement Association board. We're a '37 Act.

I want to ditto everything that everybody else has said and everything that you're going to hear in all your different meetings and whatever.

There is a group of people I wanted you to be aware of, and that is not only those who are not participating in Social Security, but those who don't participate in Medicare.

I know that for Marin County, employees who were hired before, I believe, it's April of 1987 don't contribute to Medicare. It's not an option, it's not something they can even volunteer to do.

And so when they retire, they won't be able to -- if they don't get health-care benefits from their employer, they won't be able to get any medical care benefits, either. And then what are they going to do?

So I hope you remember that with the people, too.

Thank you.

CHAIR PARSKY: Thank you very much.

Terry Sutherland.

MR. SUTHERLAND: I'm Terry Sutherland, a member of CalPERS.

In 1999 CalPERS' CEO James Burton and the Governor's labor guy, Marty Morgenstern concocted Senate Bill 400's disaster.

Burton was ready to retire and wanted his pension spiked. It was jacked up 30 percent. The present value was about a quarter of a million dollars. He increased my pension 3 percent.

There was still Morganstern. In addition to his pension increase over 100 percent, Marty delivered for the Governor for the first and only time in CalPERS' 75-year history, the State paid nothing for two years.

San Diego had the same deal. Insiders got pension hikes in exchange for lowering city contributions. District Attorney Bonnie Dumanis charged six officials with felony criminal acts. U.S. Attorney Carol Lam indicted five.

Two modest proposals.

First, make CalPERS subject to ERISA. Give us the protection private workers have.

Second, allow supervisors, without bargaining rights, to elect to have the State's pension contributions go to our 401(k).

I contribute to my 457, 401(k), Roth IRA, and 415(c) plans.

Let me manage my own money. Give me a fighting chance at a decent retirement.

Thank you.

CHAIR PARSKY: Thank you very much.

Kathy Shaddox, and then Henry Jones, and I think it's Hene Kelly -- Henry Jones.

MS. SHADDOX: Hi. My name is Kathy Shaddox. I'm president of CSEA Chapter 233 in Daly City.

I'd like to speak on behalf of our classified school employees who will be hurt the most out of the all the various groups who are paying in to CalPERS, mostly because our salaries are the lowest.

Our school employees, clerical, custodial, maintenance, food service, and instructional aides will be left with a financial pitfall if their pensions are reduced.

Many employees are forced to work until the age of 65, and are no longer able to be covered by their school district for medical benefits. They must pay up and above $300 out-of-pocket to purchase their Senior Advantage health insurance.

We all left higher-paying jobs to work for school districts because of the students and because of the job security. We know that we worked for lower wages and pay our share of our retirement every month in order to receive our pension from CalPERS when we decide to retire.

We knew that private industry paid more, but we agreed that a future retirement at our cost was more important.

A huge number of school employees are working part-time while many are using their salary to purchase health insurance that their district does not provide for them. Those part-time employees who work 30 years and reach the age of 60 are also told that they only earn 15 years of service with CalPERS. Those employees lose even more in retirement benefits.

Let's be honest and admit what the real issue is. It is not that we are going to receive benefits that we do not deserve or that we did not help pay for. The real issue is that our politicians are trying to blame retirement costs for our State's budget problems.

The truth is, our politicians want to try to raid our retirement fund because, obviously, the PERS system is financially solvent.

Our retirement fund is paid for by both our classified employees and our school district employers and your investments.

The truth is, our politicians want to use our retirement funds to support their attempt to provide a health-care program for others at our expense.

Please remember that classified employees now have a huge cost of their medical premiums paid from their modest pension, and cannot be expected to secure a meek retirement if monies are taken away from the retirement allotment.

After 38 years of service, I just turned 65, and I'm not able to retire. For the last six years, our district gave us a 3 percent salary increase. Knowing that I must pay for my own health premiums and now face the threat that you may allow our politicians to raid my future retirement check is not good.

Please help all classified employees to retire in dignity and comfort with the retirement plan that was promised to them when they were first employed many years ago, and worked year after year to obtain the security they need in their old age.

Tell our politicians that they must come up with a health-care plan that is not funded by stealing from the average hard-worker's retirement fund. Leave CalPERS alone, as this fund is earmarked for those who pay into it.

Perhaps you should tell the politicians to take a better look and support SB 840.

Thank you.

CHAIR PARSKY: Thank you.

Henry Jones and then Hene Kelly and then Marcia Fritz.

Henry Jones?

MR. JONES: Good morning, Mr. Chair and Commissioners. My name is Henry Jones. And I thank you for the opportunity to address the Public Employment Post-Retirement Benefits Commission.

I'm gratified to know that all of you have committed your time and your energy to make sure that a secure retirement is a priority for all Californians. And I expect that your research and your deliberation will help make sure that future generations will enjoy a post-work security that recognizes their contribution and respects their commitments to this state.

I am here to address you today both as someone who currently receives a secure retirement from the California Public Employees Retirement System, and as the former chief financial officer of Los Angeles Unified School District.

I was fortunate to work my way up at LAUSD in the years before my retirement, and was responsible for implementing the fiscal policy set by the school board, implementing a budget of $6.4 billion and directing a staff of 500 people. During that time, I also served as the treasurer for the Council of Institutional Investors, which is a group that is made up of public, labor, and corporate assets totaling $1 trillion. I also served as associate professor at California State University in the graduate program teaching school finance.

I'd like to briefly share a few thoughts with you about the importance of preserving the benefits for those who have worked so hard for this state.

First, public service is a calling. And those who take the obligation to serve the people of California dedicate themselves to assuring we have quality service. While none of us in public service expect to garner a fortune from our work, we do expect that our commitment will be honored with an equal commitment to secure our financial future.

That is why I'm very pleased that the starting point for this Commission is to honor all commitments to men and women who serve the people of California.

Second, while most of us go into public service because we care about our community, we also have to earn a living. Competition to recruit the most qualified people to serve as police officers, teachers, firefighters, nurses, clerks, and custodians is increasing every day.

I know from my tenure at LAUSD how difficult it is to first recruit quality personnel, and then also to retain them in your system.

Those who serve the public get great rewards from seeing a student succeed or helping a patient recover or saving a life at an accident scene, or solving a crime against someone in the community.

But they also need to know that they will at least get the security of a total compensation package that includes health coverage and retirement security for their commitment.

As you wrestle with the need to protect the health security of California retirees, it is important to remember our commitment to those who serve. The health-care problem is bigger than this commission. However, this commission can make recommendations that encourage the option of establishing a health-care trust fund to protect public servants.

I am proud of my commitment to public service, and I hope I contribute during my career to making California a better place to live. I want my legacy to future generations to be one which helps to expand financial security for all Californians.

I hope you recognize that public service is vital to the future of our state, and you work to make sure that each generation of Californians have more incentive to serve the public rather than less.

Thank you.

CHAIR PARSKY: Thank you very much.

Hene Kelly, and then Marcia Fritz, and then Ted Costa.

MS. KELLY: And I also wear a coat and tie to work all the time.

CHAIR PARSKY: Great.

MS. KELLY: And thank you for pronouncing my name right.

Ladies and gentlemen of the Commission, my name is Hene Kelly. I'm a retired teacher from San Francisco. I'm a member of our Retired Division of the United Educators of San Francisco, a life member of CTA, NEA, and chair of the Retirement Committee of the California Federation of Teachers. I speak to you today in that capacity, as chair of CFT Retirement.

I retired after a classroom career of 35 years.

I am now 65. I have been retired for four years. My husband is also a teacher and is still working.

Together, we were able to buy a home in the seventies, before Prop. 13, put two children through public schools and the State college and university system.

We were never able to save a lot of money. We lived from month to month, and on many occasions we lived on next month's money well before we got paychecks to tell us that the month had arrived. We scrimped, and we got by. I reserved the financial care of my latter years for the pension I knew I would receive. I have been lucky, but I believe the rewards of my post-teaching career are just and well-deserved.

It is my hope that those who follow in my footsteps, like my two children, can do as well or better. They are teachers now.

Defined benefit retirement allows them to know what they are building up and know how to plan around it. A defined contribution will only let them know what goes in, not what will come out. As teachers, they do not want or need that degree of uncertainty about the future.

Do you know that one of the first items on the agenda for teachers when they organized in California was pensions? Around 1916, when pensions were first achieved in San Francisco, the Board of Education promised that every retiring teacher would receive $50 each month when the money is available. And as you can imagine, the money was not always available. Teachers and other educational workers do not deserve that kind of cavalier treatment. The defined benefit retirement that we now have is the product of struggle and sweat. We do not want to see it set aside for those who follow us in the profession; nor do we want to see changes that will further restrict the ages at which individuals can retire with benefits.

Different people hit the wall at different times. Some leave at 55, some stay until 70.

I'd like to use the analogy of sports broadcasters. My son-in-law is one. They are there for the game, and doesn’t do any good to make them sit and describe the field just to keep them on the clock. So, with teachers, there are already factors that will benefit them to staying longer, but sometimes the game is over, and it is time to leave the booth.

I ask you to support and encourage the teachers of California. They teach our future. They teach our children. Allow them to plan for their own futures. Retain the defined benefit. Do not further restrict the retirement age.

And as an addendum, I agree with the classified employee who spoke briefly. 840 will solve the health problems, and maybe allow us to have enough money for pensions for people who deserve it.

Thank you very much.

CHAIR PARSKY: Thank you.

Marcia Fritz and then Ted Costa, and then Kristine Hunt.

MS. FRITZ: Good morning. My name is Marcia Fritz. I am a CPA in Citrus Heights, and vice president of the California Foundation for Fiscal Responsibility, CFFR.

Today you are scheduled to hear from CalPERS chief actuary Ron Seeling about the funding of retirement systems. CFFR firmly believes that our skyrocketing retirement benefit costs must be addressed. Less costly benefit levels for new employees must be embraced. There's no time to waste.

As you can see from the CalPERS package that is being handed to you, back in 1999 CalPERS sponsored SB 400, which granted large retroactive increases in pension benefits for State employees. At that time CalPERS actuaries calculated that the benefit increases would be paid from high market returns earned during the dot-com boom of the late 1990s.

If you turn to your tabs in the package that we handed to you, you will see that CalPERS states, without qualification, that the increase in benefits will not cost taxpayers any more money than was contributed in 1998. In two places, they said it.

That is not what happened.

As you can see from the chart of actual contributions, CalPERS grossly underestimated the State's pension obligations. Instead of paying $760 million as projected for this year, the State will spend $2.7 billion, four times what CalPERS projected. That is not a rounding error.

The cumulative error alone, since SB 400 was passed, has been $9 billion. We are drowning in debt.

The $2 billion error for this year alone is a substantial portion of the State's structural benefit -- or structural budget deficit, one that is keeping legislators from passing a budget today. It would also cover the State's annual required contribution to its OPEB debt.

I hope Mr. Seeling will tell us why this year's actual contributions are four times more than his department estimated.

Of course, the only practical way to trim long-term pension costs is to reduce pension benefits for new employees, to protect those that are receiving them and have been promised them as of now.

By extending the retirement age to Social Security age for non-safety employees, and adjusting the pay-out formulas, the normal cost for most employees drops for more than 16 percent of salary today, to 5 percent.

Over the next 30 years, the savings -- nearly 500 billion for all state and federal local agencies -- must be used to eliminate unfunded pension liabilities, pension obligation bonds, and pay retiree health-care costs.

We need pension-benefit cuts to reduce both pension debt, the bond debt, and unfunded pension and retiree health-care liabilities. They are swamping us. We are going to drown in this debt.

CFFR looks forward to briefing the Commission staff soon to present our initiative in greater detail.

We hope your excellent work in describing our retiree benefit crisis will result in a meaningful solution. With hundreds of billions of dollars at stake, California needs a strong solution, and it needs it now. We are going to drown in this debt.

Should a meaningful solution elude you, our initiative will be ready for voter approval and consideration.

We cannot afford to promise budget-breaking retirement benefits to hundreds of thousands of new public employees. We'll drown in that debt, and so will our children.

Thank you.

CHAIR PARSKY: Thank you.

Ted Costa and Kristine Hunt and Albert Carlson.

MR. COSTA: How do you do. I'm Ted Costa. I'm the CEO of People's Advocate. I'm also the chairman of the California Taxpayers Coalition, a coalition of about 32 taxpayers’ organizations around the state.

I make no bones about it. I’m right up-front about it, I represent the taxpayers, those people who pay the bills. I don't make any bones about that. And that doesn't mean that the taxpayers don't want people to have good pensions.

Now, I only have a minute and a half. But Mr. Chairman, it's not enough time. I would like to have time on your next agenda so a group of taxpayers can come here and make their pitch.

The broad overview is that there are hundreds of thousands of teachers, there are hundreds of thousands of state employees.

You've heard a lot of them right here, that are playing by the rules. And there's a handful of people, mainly in the special districts of this state, and the public employee union bosses with them, which are manipulating their pensions. I'm talking about pension spiking. And we hear about honoring commitments. No commitment by the people of the State of California was ever made that people could spike their pensions or manipulate their pensions.

"Oh, Joe Schmoe is a good guy. We'll make him assistant fire chief this year and we'll let him use all of his unused sick leave time and vacation time, and we'll give him a big bonus," and he'll go right down the road with a $200,000 pension when the lady is here with a $500 pension. It is wrong.

As Abraham Lincoln said about slavery: It might be legal, but it is wrong. And it is wrong for people to spike their pensions. And we can't put our heads in the sand. We must face that issue.

Now, maybe the Governor doesn't want to face it right now. But publicly, he said he has. And, Mr. Chair, you should broaden your thinking and you should look into that. It's only going to get worse amongst the special districts.

I think it's to the point now where it's just about institutionalized corruption. It is accepted. It is, “Ho-hum,” when these kinds of things happen, but it's running into the billions of dollars. And PERS’ reaction to it, the PERS Board which has a fiduciary duty -- remember, I was the proponent of Proposition 162, to see to it that the Governor and the Legislature did not raid the PERS funds.

Unfortunately, we did not allow for PERS being raided from within, and that's what's happening right now. So there needs to be some structural changes. Not on STRS, not on State employees, not on the clerks, but on those people who are out to manipulate their pensions.

It is awful what is happening. I beg of you to give the taxpayers in this state time to come in here, present a paper about pension-spiking and give you some solutions.

CHAIR PARSKY: I will make that time available during the course of one of our hearings.

MR. COSTA: Thank you.

CHAIR PARSKY: Kristine Hunt.

MS. HUNT: Good morning. My name is Kris Hunt, and I'm the executive director of the Contra Costa Taxpayers Association. I'm also one of the proponents of the Public Employee Benefits Reform Initiative.

I would like with my brief time here this morning to urge the Commission to recommend a statewide cap on retirement benefits for new government employees.

As my home county has all too clearly demonstrated, most local officials simply don't have the guts to stand up to the public employee unions and make the benefit changes needed to protect taxpayers and secure vital government services.

A month ago, the Contra Costa Grand Jury issued its sixth report since 2002 on a retirement benefits crisis. This one was entitled “Mayday, Mayday, Mayday, the County Drifts Ever Closer to the OPEB Rocks.” Their report concluded that the county is mortgaging the county's future, and, quote, “The difficult choices must be made now. Inaction by the Board of Supervisors, while it continues to ‘study the problem’ only postpones steps that are ‘clearly required,’” end quote.

So what was the response to this latest plea for fiscal responsibility? Did the Board of Supervisors take the Grand Jury's “clearly required” steps? Not a chance.

The Board of Supervisors, once again, kicked the can down the road with a meaningless promise to divert to retirement costs the money currently paying for other projects as those obligations are fulfilled in the next 16 years, if that money actually materializes. Then the supervisors only mustered enough courage to adopt a

40 percent funding target for OPEB, leaving the future taxpayers and elected officials the real problem of solving the $2.6 billion OPEB problem that we have.

Waiting for local governments to take serious action on retiree benefits is like sitting in that field, waiting for Charlie Brown's Great Pumpkin to arrive. Every year, taxpayers are disappointed and precious time is wasted on that charade.

A statewide cap on pension and retiree health-care benefits for new government employees, as our initiative proposes, could save $500 billion over 30 years and cover the unfunded liabilities for current employees, all of these good folks here, while protecting vital government services to make our communities safe and promote the quality of life.

In closing, I hope this commission musters the courage to recommend the meaningful statewide retirement cap and stop the abuses that plague our retirement system. There is not the time for half measures that mollify the inattentive and appease special interests. The cost of this fiscal crisis grows day after day after day.

California needs strong leadership from all of you. And in the words of the Contra Costa Grand Jury: “Mayday, Mayday, Mayday.”

Thank you.

CHAIR PARSKY: Thank you very much.

Two more. Albert Carlson.

MR. CARLSON: I'm willing to give up my time.

CHAIR PARSKY: You do?

Okay, Catherine -- now, you're going to have to help me here, "Kah-ku-ah"? Is that right?

MS. KEKAUOHA: "Kay Kah-u-o-ha."

CHAIR PARSKY: Kekauoha. Okay, I tried. Sorry.

MS. KEKAUOHA: Good morning. I'm Kay Kekauoha, and a member of CSEA and CalPERS. I'm employed by the San Mateo County Office of Education.

A few months ago, I read in the paper that public pension members had it better than the private sector. If one wanted a good retirement, they should work in the public sector.

That article made it seem that, A, the public sector has a much easier job -- not only has a much easier job, but also has a better retirement to boot.

I question whether the reporter or reporters who wrote that article realize that we, the employees of the public sector, do contribute towards that retirement, too. I thought if they also realized that the retirement system, CalPERS, the public sectors have excellent people overseeing our fund and making wise investments, thus providing longevity.

Rather than weaken a secure retirement system that's working, we should be trying to assure that all workers have safe, dependable retirements. We also have a legislative protection, which is Prop. 62, but that goes by the wayside sometimes.

Our situation is not all gravy. Some of us work less than eight hours, thus end up working more years in order to be vested.

Since the Bush Administration, the public sector has been threatened with the change from defined benefits to defined contributions, which would hurt us. The defined contributions will weaken the retirement system. A generation before us worked long and hard hours. They should be able to have a decent and livable retirement until they die.

The last thing I want my own parents to do is worry about where they're going to get their next meal after working 40 years. Shame on the leaders and lawmakers of today.

Thank you.

CHAIR PARSKY: Thank you very much.

And that completes our public comment period. I want to thank everyone for their discussions and presentations. And, of course, we'll be more than happy to receive all of your statements in writing.

Just a few other brief announcements.

Our next meeting is going to be -- I think it's been posted, but it will be in San Diego on July 27th. It will be at the great institution, the University of California in San Diego. And we'll focus on pension and health-care needs of California's schools.

And I think that we've circulated some information about prospective witnesses. We welcome any of those suggestions from Commission members or anyone. I just want to make sure everyone knew that.

We've also developed a proposed schedule for the rest of the year. And that also has been posted. There are a couple of locations that are still under advisement, but we're trying to have an appropriate balance north and south vis-à-vis California, and have our meetings cover as much of the state as is possible.

Just a few other administrative announcements. Two staff members I just wanted to make sure I introduced. Stephanie Dougherty is here who is the research director, and has a background in state government as well as Blue Shield as well as Deloitte Consulting. Stephanie is here.

Anyone that wishes to question her on her background or her other views is welcome to do that, but I think she'll be a terrific addition.

And Richard Krolak, who will be on loan from CalPERS, and provides some real expertise in the health-care area.

Anne, any other administrative --

MS. SHEEHAN: Just a couple of things -- thanks, Gerry.

As you know, we have been surveying the cities, counties, special districts, school districts for both their OPEB and their pension liabilities, with the help of all the various associations in Sacramento. And I want to thank those associations for helping us.

So far, we have responses from 76 percent of the counties, 47 percent of the cities, about a quarter of the school districts, special districts only about 10 or 11 percent, And then also about 43, 44 percent of the community colleges. So we will still be continuing to follow up on our survey to get those numbers from them.

In addition to the survey, we are also doing, as I've mentioned to some of the commissioners, some case studies about how some of the locals are handling this issue. We really want to get a cross-section of the various approaches that cities, counties, school districts, and others have taken in addressing these issues.

So I do have a list of these cities, counties, districts, school districts we're looking at. We are still open to suggestions for those who may feel that they've got some unique approaches to dealing with these.

I think that's pretty well it.

As you said, we are scheduled at our next couple of meetings. We are open to suggestions for witnesses, testimony, and other experts who can come and present to the Commission.

Thanks, Gerry.

CHAIR PARSKY: Thank you very much.

Before we get started with the proceedings and our first panel, I appreciate your patience. We try to stay on schedule, but there's a little bit of flexibility there.

I would like to introduce Grant Boyken, who is from the California Research Bureau. And he will present a brief report, his second to the Commission.

I think everyone should remember that at our request, the Research Bureau has undertaken certain studies. In his first report, Funding the Golden Years in the Golden State, was presented. This will be his second.

And today's report is on the survey that the Bureau has conducted on public pensions in California.

Grant?

MR. BOYKEN: Thank you, Mr. Chairman and Members of the Commission. I appreciate an opportunity to present results of this survey.

At the request of your staff, I conducted a survey, the purpose of which was to examine the unfunded liability for the State's public retirement systems.

"Unfunded liability," of course, as most of you know, is the difference between the pension obligations that have already accrued to current employees and retirees and the assets currently available to pay those obligations.

So the survey involved sending out electronic surveys to all 86 of the State's public employee retirement systems. And 57, or about two-thirds, responded.

But these two-thirds were really quite representative because based on the 2003-2004 State Controller's Office report of public retirement systems, those 57 that responded constituted about 99 percent of all pension system members, and 99 percent of pension system liability.

Before presenting the results, I just want to make a few points to get a better understanding of the nature of the data. And the first thing I wanted to point out is that the survey asked retirement systems for their most current actuarial data. And in most cases, this is June of 2006. There's a one-year lag in the time that retirement systems conduct their actuarial evaluations.

Four systems indicated that they provided data from 2005, but it is possible that there were other systems that had older data as well.

The second point I wanted to mention is that the survey results do not capture pension obligation bond debt, and this is because pension systems, retirement systems, don't necessarily track the bonds that are issued by their plan sponsors. This is very clear in the case of CalPERS, which has literally hundreds of public agencies, and there's no sort of functional need for them to track that bond debt.

Okay, the other thing that I wanted to point out is that it was very clear in the survey responses the variation in accounting and reporting practices, and actuarial methods and assumptions can have an impact on a plan's reported assets and liability. And this can make it difficult to make accurate comparisons among systems and over time. You've had actuaries testify at these hearings before who have suggested that there should, indeed, be some variation and that, presumably, economic and demographic assumptions and decisions about how to value gains and losses are based on the unique experiences and long-term funding needs of each plan. Nonetheless, I just want to point out that this variation should -- it makes it such that you should approach making comparisons between systems. You should approach that somewhat cautiously.

Okay, this table represents the survey results that were reported, the assets, liability, unfunded liability that were reported by all the systems. There is an estimate for the systems that did not respond, and the estimate for the assets and liability of the systems that did not respond was based on the assumption that they accounted for about the same proportion of assets and liability as they did for the last two periods covered by the State Controller's annual reports that look at public employee retirement systems. And that was fairly constant over those last two reports.

So as you look down at the totals column, the total system assets for paying pensions, $516 billion. Liability, $579.5 billion. Leaving an unfunded liability of $63.5 billion, or an unfunded ratio, which is the assets as a percentage of total liabilities, of

89 percent.

And you can see some variation in the funded ratio, the State being the highest at about 91 percent; schools, 86 percent funded ratio.

So the question is what to make of this $63.5 billion unfunded liability. And later today, you'll be hearing from an actuary, an economics professor, and probably others who are more expert than myself at giving you the tools to allow you to evaluate and conceptualize what this unfunded liability means.

But before concluding my remarks, I would like to make two points of my own.

The first point is that even though $63.5 billion is undoubtedly a very large sum, it's important to keep in mind that unlike retiree health and other post-employment benefits, there is a fairly effective mechanism already in place to fund those benefits.

Historically, retirement systems, according to most estimates, have been able to fund 70 to 75 percent of the cost of their benefits from investment returns rather than from employer and employee contributions.

And the second point that I wanted to make, as represented by this graph, when you plot the assets and the liabilities of all of the systems in California as a whole, since 1990, there doesn't appear to be a sudden shift, a sudden upward trend in unfunded liability.

Certainly, after the downturn of the market in the early 2000s, the unfunded liability went –- or the funded ratio went from a high, down -- and it definitely did decrease. But if you look at today's unfunded liability, or funded ratio, it's about equal with the early 1990s. So less dramatic then some would characterize it as.

And that's the end of my prepared remarks, but I'm willing to answer any questions that the Commission might have.

CHAIR PARSKY: Before we move on -- thank you very much for that report. And it's obviously an important piece of data for us and the public.

Any questions of Grant?

MR. WALTON: If I could.

CHAIR PARSKY: Yes, please go ahead.

MR. WALTON: Just a clarification, Grant. Wherever you use assets, that's the actual value of assets, not necessarily the market value of assets?

MR. BOYKIN: Yes, and we tried to clarify that in the survey, that that was the actual valuation value of assets, the assets available to pay pensions.

MR. WALTON: Thank you.

CHAIR PARSKY: Okay, thank you very much, Grant.

We can now turn to our panel discussion for this morning, generally called "Overview of Pensions: Public and Private Sector.”

We have two panelists. We thank you very much.

And why don't you proceed?

And I think, Keith, you're first; right?

MR. BRAINARD: Thank you.

I've been following the issue of retirement benefits in California for a number of years. And I appreciate the work that the Commission is about, and I appreciate the invitation to be here today.

You asked that I prepare an overview of the public pension community with a focus on a national basis.

Roughly, 16 million folks work on a full-time basis for state and local government in the United States. That comprises more than 10 percent of the nation's workforce. And that proportion is similar in the state of California.

I think it's notable that nearly two-thirds of public employees nationally are employed in the fields of either education, public safety, or corrections. The reason that that is notable is that traditionally, those have been positions that we have sought to have people pursue a career in, or at least have a long-term orientation. And traditionally, that has been one of the purposes for providing a traditional pension plan, has been to encourage, among others, to encourage longevity in employment among public employees.

According to the latest count by the Bureau of Labor and Statistics, 90 percent of state and local government employees have some form of a defined benefit plan. Traditional pension is their primary retirement benefit. And based on the latest count by the Federal Reserve Board, the aggregate held in the United States broke the $3 trillion benchmark as of the end of March of this year.

In terms of the benefits they distribute -- this information is supplied by the United States Census Bureau; they're always a little bit behind some of the other federal agencies in terms of the data that they are reporting. But based on 2005 data, public retirement systems nationally distributed roughly $140 billion in benefits. That's a big amount.

To identify and sort of put that into some context, we compared that to some other sources of income in the United States. And as the chart indicates, the amount distributed by state and local government retirement systems in '05 exceeds the personal income generated from the nation's farming, fishing, logging, and hotel-lodging industries combined. It is a substantial figure.

As I mentioned, roughly 90 percent of public employees have some form of a traditional pension plan as their primary retirement benefit.

If you read only the newspapers, you might not believe this because there have been a lot of commissions and legislative bodies that have studied the issue of retirement benefits. There's been a lot of talk about switching plan types and switching over defined contribution plans. But the reality is that that figure has changed only slightly.

Drilling down on that for just a moment, on a statewide basis for broad employee groups, that is public school teachers, general employees, public safety personnel, that is excluding groups such as legislators and judges, there are only three instances where there is only a defined contribution plan as the primary retirement benefit. That is general employees in the District of Columbia since the mid-eighties have had only a DC plan. School teachers, public safety personnel in D.C. do have a traditional pension plan.

In 1997, Michigan closed off its defined benefit plan for state employees only, not school teachers. And Michigan has many, as California does, many county and city plans, almost all of which continue to provide some form of traditional pension plan.

And then one year ago, Alaska closed off its defined benefit plan to all new hires beginning on July 1st, 2006. So all newly hired employees in the state of Alaska since a year ago have only a 401(k)-type plan.

Just in the last couple of years, there are a couple of other switches that are worth noting.

In 2002, the Nebraska Legislature closed its defined contribution plan, which had been the only retirement benefit available for state and county workers in that state. The Nebraska Legislature commissioned a benefits-adequacy study and found that Nebraska state and county workers who were in this 401(k) plan were arriving at retirement significantly unprepared, less prepared on a national basis and compared to their peers in adjoining states. And the Legislature responded to that by closing off the defined contribution plan to new hires and opening up a cash-balance or hybrid-type plan in its place.

For most of the 20th century, the West Virginia Retirement Systems Association operated -- it was a traditional pension plan, but it operated mostly on a pay-as-you-go basis. And the numbers caught up with them in the 1980s. And in 1991, they closed off their defined benefit plan for school teachers and opened up only a defined contribution plan in 1991.

So beginning in 1991, West Virginia school teachers had only a defined contribution plan. In 2005, the state actuary went to the Legislature and said, "You are not saving any money with your defined contribution plan," or stated differently, “You could have a defined benefit plan for the school teachers at the same cost as the defined contribution plan is costing.”

The Legislature looked at and reopened the defined benefit plan to newly hired school teachers since 2005. There's been some controversy in the interim about what to do in the window of the school teachers who were behind between 1991 and '05. But the point is that West Virginia has reopened its defined benefit plan for public school teachers and, as I mentioned, Alaska.

So these are three notable switches on a statewide basis for broad employee groups that have occurred in the past few years. And I think it's worth noting that two of those three switches were from the DC side to the DB side.

You know, it used to be that the only broad employee groups in the public sector that had any sort of a choice with regard to their retirement plan were university faculty and staff in a number of states. And that has begun to change. This decade, a number of states have begun to open hybrid -- I'm sorry, have begun to open up their retirement plans to choice. And now that group represents at least five states where broad employee groups can choose from at least from a traditional defined benefit plan or DC plan, and in a couple of cases, there's also a hybrid available to these folks.

Hybrids have been introduced, especially in the last ten to 15 years. Washington state, many new hires in Washington state have only a hybrid as their primary retirement benefit, as do all new hires in the state of Oregon. Ohio folks may elect to participate in the hybrid, and I mentioned the Nebraska employees.

Substantially all public employees in the state of Indiana have only a hybrid. And in Indiana, that hybrid takes of form of a traditional defined benefit plan, but it's a more modest defined benefit plan combined with mandatory participation in a garden variety defined contribution plan.

Also, the Texas Municipal Retirement System and Texas County and District Retirement System offer a form of cash balance plan, which is a different kind of hybrid than the one in Indiana.

I've provided a list of what I perceive as core elements for a traditional pension plan. You know, we talk a lot about, “Well, what is a DB plan and what is a DC plan?” Sometimes I think we don't always focus on just what that means. And I'd like to briefly walk through some of these concepts.

First, prefunded benefits, Grant talked about the portion of -- and some other folks this morning as well -- have talked about the portion of retirement benefits in a traditional pension plan that are financed with investment earnings, and certainly the ability to leverage contributions into investment earnings is a bulwark of a traditional pension benefit.

We're pooling risk in these plans, among large groups of workers and not just a single peer of workers, but among multiple cohorts. So we've got people who are just newly entering the system, seasoned but active public employees, and also retired public employees all in the same pool. And that certainly helps pool the risk among large groups.

I think that one of the notable features of the public pension system in the United States is they're low cost. In the median, public retirement systems operate at around 30 basis points, or a little less than one-third of 1 percent. And that's the administrative costs and the investment expenses.

And the reason they're able to do that is simply their sheer size. They're able to spread their costs among large numbers of workers, and also to use that size to negotiate much more favorable fees with regard to investment management.

I think if you were to look at the traditional defined contribution plan, typically their annual cost is somewhere closer to 100 or 150 basis points, or one to 1½ percent, several times the cost of a traditional pension plan.

You know, if you look back many years, for most public employee benefit retirement plans -- and probably California would hold true as well -- the most reliable, consistent source of income into these pension plans is the employee contributions. That's the one constant in these plans. Investment earnings, of course, go up and down, employer contributions in many plans will go up and down. But in many plans, the one reliable source of income is employee contributions. I think it's worth noting that substantially all public employees in the United States are required to make contributions.

Unlike on the private side, most corporate employees are now required to contribute to their pension plan, most public employees are.

Last year, the United States Congress passed a Pension Protection Act, which applies primarily to pensions outside the public sector. But one of the things they did was to allow 401(k) plans to automatically enroll their participants. And this had been something that 401(k) service providers had been asking for some time. And academics believe, and I think quite rightly, that automatic enrollment will increase retirement plan participation.

Public employees have been doing this all along, substantially all public employee retirement systems require mandatory participation and, of course, those folks are automatically enrolled.

Finally, I think a distinguishing feature of the public sector retirement benefit community is the fact that there's not a one-size-fits-all, top-down regulatory structure, as is the case with corporate pension plans. There's no sort of a single ERISA set of regulations. ERISA was passed in the 1970s, with the best of intentions by Congress to try to support corporate pension plans; but one result of ERISA in my view has been a significant decline in the number of traditional pension plans for folks outside the public sector. And one of the reasons that we've experienced that decline for corporate pensions is that ERISA makes maintaining a pension very expensive and very onerous, and a lot of employees have just thrown up their hands and said, "I'm better off going with the 401(k) plan."

Public-sector pensions are exempt from ERISA regulations that make these plans expensive to administer and maintain.

You should have a handout of my remarks. And that handout includes this bubble chart. This bubble chart is plotting actuarial funding levels of 116 plans. The assets and participants that are reflected in these plans represent roughly 85 percent of all assets and participants in the public pension community today. So this does represent a critical mass of the community.

And the size of the bubble is roughly proportionate to the size of the plan's liability. So big plans have big bubbles and the opposite is true as well.

Just to point out a couple -- well, let's see, I think that will point those out next.

You can see in the aggregate, on a national basis, public pension plans are funded somewhat between 85 and 86 percent. Median, slightly lower than that.

Focusing just on some plans in California, I maintain a database of public pension data called the Public Fund Survey, and this information is taken from that. And in the Public Fund Survey are included these plans in California, the two big statewide plans, CalPERS and CalSTRS, as well as four county plans. And I've delineated the position of those plans on this chart.

On a national basis, in the aggregate, public pension funding levels have been on the decline as one would expect in the last few years. But you can see if you go back a little bit further, beginning in the early part of the 1990s, public pension plans in the aggregate were funded significantly below where they are today. They enjoyed a steady rise, thanks in no small part to the strong investment earnings of the 1990s, and have declined since then.

2006, I am certain, will represent the low point, and the 2007 figure is certain to be higher, possibly sharply higher, perhaps by as many as two or three percent.

Focusing on just California plans, this is a snapshot of California pensions as of 2005. Roughly 1.7 million active or working contributing participants. About half of that number -- I'm sorry, about 850,000 are annuitants. That does not include the active working participants, of course. Combined assets in excess of half a trillion now.

And you can see the sources of revenue. This happened to be a relatively good year, but this is not unusual for other states or for the long-term, in terms of the sources of revenue for public pension funds.

Continuing to focus on the snapshot of California pension plans as of 2005, distributed roughly $22 billion in benefits to those 850,000 annuitants. And, again, California is similar to the nation as a whole in terms of its personal income exceeding the income from farming, fishing, and the mining industries combined.

These charts are comparing the revenues to California pension funds and the benefits that were distributed. And if you look at the ten-year period beginning in fiscal year 1996, you can see that investment earnings and employee contributions comprised a little more than four-fifths of all revenues, employee contributions made up a little less than one-fifth. And also the benefits distributed.

I've got a chart here that is plotting or comparing the debt and unfunded liabilities of major public-sector sources of debt and unfunded liabilities. And, you know, starting on the left is Medicare. And, you know, I think there's a consensus that the nation's

Medicare liability are unsustainable. We're going to have to make some fundamental changes to those.

Outstanding residential mortgages, just shy of $10 trillion, which does represent a form of, of course, consumer debt.

The federal debt, not counting Medicare and not counting Social Security, of course, is a little under $9 trillion. Social Security’s unfunded liability over its funding horizon of 75 years is a little less than $5 trillion. And then you can see the figures for state and local debt, GASB OPEB –- GASB OPEB is retiree medical benefits, as you all know -- and state and local pension. The GASB OPEB figures are estimates. I do not know of a single source that has calculated all those, but there seems to be a consensus gathering around roughly the $1 trillion figure for state and local unfunded retiree medical liabilities.

I thought this chart was interesting, though, because I think sometimes the media focuses an awful lot on the unfunded liabilities of public pension plans. And certainly there is cause for concern in many cases. But I think if you take a look at the bigger picture, that unfunded liability really is not nearly as bad as I think some folks may have implied.

On a national basis, roughly one-fourth of all employees of state and local government do not participate in Social Security. That figure is high in California. I do know what it is in this state. But certainly, we know that all or substantially all public school teachers do not participate in Social Security, and many of the police officers and firefighters do not participate as well.

I think it's useful to think about what that means in terms of its practical or financial effect, not participating in Social Security. And I just took one example, taken out of the CalSTRS fiscal year 2006 comprehensive annual financial report. Since all, or substantially all, of CalSTRS participants do not participate in Social Security, we can use them as an example. The combined payroll of all the participants in CalSTRS right now is in the ballpark of $24 billion.

If those people were participating in Social Security, the State and school districts, whoever is paying their salary, would have sent $1.5 billion to Social Security. No small sum of money.

And I think it's always important when contemplating retirement benefits for public employees to recognize the availability or non-availability of Social Security.

Sometimes I will hear from either members of the media or policymakers, and they'll say, "Gee, traditional pension plans have gone away in the private sector. Why should public employees have the retirement benefit that no one else can have?"

First, I remind them that they haven't gone away in the private sector, although it is true that roughly 20 percent of folks outside the public sector have a traditional pension plan. And certainly that number has diminished in the last few years.

But also, unlike the private sector, the public-sector employers also, the population as a whole has a compelling interest, in my view, in making sure that at least certain key positions remain filled with qualified, skilled personnel. And traditionally, one of the ways that the public sector has been able to do this has been to offer a pension benefit.

Also, as I mentioned, ERISA, the body of federal laws that govern corporate, do not apply to the public sector. And ERISA has been a primary reason that many private-sector pension plans have closed.

Also, increasingly people are realizing that the life cycle of the traditional corporation in the United States is not long enough to sustain a traditional pension plan. It used to be to be that GM or U.S. Steel, they thought they'd be in business forever and be able to pay their pension benefits forever. And now the corporate world just doesn't operate that way anymore. The public sector is here into perpetuity for all intents and purposes. And the public sector can leverage that very long-term focus into providing a traditional pension plan.

Revenues into state and local governments rise on a very consistent and steady basis, usually somewhere between 4 and 8 percent each year, which creates an ideal funding stream from which to make pension payments.

Similarly, I will often hear from policymakers, members of the media say, "Gee, Social Security seems to be going off a cliff. Aren't public pension plans in the same boat?" And the short answer is, “No, really not at all.” Social Security operates pretty much as a pay-as-you-go plan where current revenue from payroll taxes are being used to pay current obligations. As a result, Social Security is very sensitive to demographic changes. And we all know within about ten years Social Security is going to reach a tipping point where it's going to go cash-flow negative. That is, the receipts from Social Security are going to be insufficient to meet the current obligations, and Social Security is going to have to dip into the trust fund.

Congress and presidents have spent all of the trust fund and put in its place IOUs. And so Congress and presidents beginning in that year, roughly 2017, are going to have to be, again, either increasing taxes or drawing on other federal revenue sources or cutting spending in order to meet some of their obligations.

By contrast, public pension plans are primarily prefunded. As we mentioned, roughly 85 to 86 percent in the bank. As a result, public pension plans are far less sensitive to demographic changes.

As I mentioned, public pension plans have roughly $3 trillion. These are tangible assets, these are not IOUs. They are equities, real estate, et cetera.

Also, I know that this Commission is not today entertaining information on retiree health care. And I will not go through all of these bullet points except to say only that it's imperative in my view to recognize that pensions benefits, retiree health-care benefits are fundamentally different, the factors driving them are different, the solutions are going to be different, and they ought to be thought of in a completely different mindset.

I mentioned the public-sector employee is more than 10 percent of the nation's workforce. Government is uniquely situated as both a policy maker and a major employer.

What this Commission comes up with and what retirement benefits the public sector provides is much more than just an academic exercise; it has real and practical meaning. Of course, to these, more than 10 percent of the folks who are employed by the public sector, but also the government can serve as an example of creative and innovative retirement policies for the rest of the nation's economy.

That's the end of my prepared remarks.

Again, thanks for the opportunity.

CHAIR PARSKY: I really appreciate it.

I know we'll have a number of questions.

Why don't we complete the panel discussion, and then we'll come back and ask either or both some questions?

Don, why don’t you go next?

MR. FUERST: Thank you very much, Chairman Parsky and Members of the Commission, for giving me the opportunity to be here today and share with you some thoughts on a truly important policy issue.

I am privileged to be here with you and share some of the insights that I've gained from my career working with retirement plans, primarily in the private sector. And those are primarily the thoughts that I'll share with you today, but not exclusively. I have done some work in the public sector also.

Financial needs of everyone in retirement are increasing today. Longevity increases cause longer retirements, and medical-care expenses in particular continue to increase for all Americans, but particularly for the elderly.

Yet, private-sector retirement plans are trending toward a structure that will provide substantially less financial security to elderly Americans, and result in a greater divergence between the wealthy and the poor in our society. This decreasing financial security is the result of less diversified financial resources, less risk-sharing, and smaller employer contributions towards retirement plans.

The past 20 years have seen an overwhelming trend in the private sector toward what I'll call individual-account-based plans, or "defined contribution plans," and away from lifetime income plans, or what are often called "defined benefit plans."

Overreliance on these individual account plans concentrates multiple risk factors on the individual, lessens the diversification of the retiree's financial assets, and foregoes all the benefits of risk-pooling.

Individual-account-based plans are an essential element of financial security. Changes in legislation in the United States over the past 30 years have strongly encouraged these plans, resulting in many more Americans participating in them, and accumulating significant assets for their retirement. These changes are very desirable and they've been successful. Approximately 90 percent of private-sector workers have access to defined contribution plans now, versus only about 38 percent in 1979.

Unfortunately, excess reliance on these plans is likely to reduce financial security of retirees. Financial security is enhanced by diversity of the sources of income, such as Social Security, pensions, and personal savings; not just diversification of individual investments. Diversity of income sources has declined over this same 20-year period, as defined benefit coverage has decreased, from about 84 percent of the private sector in 1979, to only 37 percent in 2005, and it's continuing to decrease rapidly, as more employers close or freeze their pension plans.

Furthermore, the amount of the contributions that employers make to defined contribution plans is often much less than what they were making to the closed or frozen pension plan. Almost every announcement of a pension close is accompanied by a statement of how much savings the company will experience over the next several years. That savings is at the direct expense of future retirees. No, adjustment in pay is made for the foregone benefits. Sometimes an additional contribution is made to the defined contribution plan, but it's almost always substantially less than what was going into the pension plan.

The private sector has recognized that individual savings are an essential part of retirement. Matching contributions in 401(k) plans provide a very strong incentive for individuals to save. That's good. But the private sector may be going too far in this direction. As companies close pension plans to new hires or freeze benefits for existing employees, enormous strain is placed on individual account plans to provide the primary, perhaps the only source of retirement security.

While individual account plans are very important to a secure retirement, they're far from perfect retirement vehicles.

Many individual account plans rely on voluntary employee contributions, and employer contributions are often contingent on the employee contributing. Unfortunately, many workers in our society are not able to take full advantage of these opportunities.

Despite the significant increase in

opportunities for Americans to save on a tax-favored basis, the overall savings rate in America has declined from 10 percent in 1980, to less than 2 percent in 2003. And in 2005, it actually went negative. Such saving rates are not likely to finance a secure retirement.

Furthermore, personal savings and participation in voluntary retirement plans is generally less prevalent among low-paid workers than among high-paid workers, thus increasing the gap between the wealthy and the less fortunate.

The private-sector trend to greater reliance on individual account plans is not being matched by increased worker savings rates. Without a dramatic change in these savings rates, inadequate retirement resources are likely to place a severe strain on our welfare system for the elderly.

Individual account plans also depend on long-term investment returns and the decisions made by individuals.

Regardless of the amount of investment education we provide to these participants, there's always going to be winners and losers. Unlike Lake Wobegon, not everyone can attain above-average results.

The nature of the investment markets, the laws of mathematics make it absolutely certain that half will experience less than median returns.

Again, it's likely that this half is going to have a greater share of low-paid workers, thus increasing further the gap between the wealthy and the less wealthy.

Even the median return on these plans is generally substantially lower than the investment returns attained by pooled defined-benefit plans. Thousands of individual employees making decisions produce an aggregate return that's almost always less than investment professionals attain for pooled defined benefit plans. And this is especially true for the elderly during their retirement years, when individuals must invest more conservatively, must maintain higher levels of liquidity. And if they withdraw to have a steady income, their assets -- they're subject to the perverse opposite of dollar cost averaging. They must sell more assets when prices are down to maintain the same level of income.

These plans also experience substantial leakage throughout an employee's career. The availability of loans, in-service withdrawals, and lump-sum distributions upon termination of employment are almost irresistible to many employees, and gradually erode the assets intended for retirement. Even at retirement, a substantial portion of retirement assets are often used for a major purchase or for debt reduction, not for the intended purpose of retirement income.

Individual account plans also accentuate the problems associated with economic cycles. Companies faced with difficult economic challenges sometimes are forced to lay off employees. Sometimes people are required to retire earlier than they expected. Retirement-age employees, terminated when the markets are down, have even fewer resources than they expected for their retirement.

Finally, individual account plans, and perhaps most substantially, individual account plans are less efficient in providing income to retirees that will last a lifetime. The inefficiency results from the absence of risk-pooling, longevity-pooling. Individuals needing to provide a lifetime income can't base their plans on surviving an average life expectancy. More than 50 percent of the people are likely to outlive that. Workers, even actuaries, don't have a crystal ball on how long an individual is going to live.

If their assets are exhausted by the time they reach the average life expectancy, the consequences are far too severe. Consequently, true financial security for someone depending on an individual account plan is attained only if they plan to survive substantially beyond the average life expectancy.

The only way to make the financial resources last that long is to either spend less or have accumulated much more. We estimate that to increase your odds from 50-50 at the average life expectancy to nine out of ten, it costs 30 percent more in an individual account plan.

These shortcomings of individual account plans are the reason we should avoid overreliance on them to provide retirement security. They're essential elements of retirement income, but overreliance results in less diversified financial security and a less efficient retirement income.

A balance of individual account retirement plans and lifetime income provided through employer-sponsored defined benefit plans results in much better diversification and a more secure financial retirement. Defined benefit plans offset many of the shortcomings of individual account plans. Pension plans generally provide universal coverage for all employees, and usually don't require employees to contribute to the plan in order to get a benefit. That's in the private sector.

In the public sector, usually contributions are required; but they're mandatory, they're not optional.

DC plans could be designed that way, but they generally aren't. The benefits from a pension plan are generally uniform for all employees, and aren't influenced by the individual investment decisions that people make. Investment returns on pension plans are generally greater than individual account plans, owing to the professional asset-allocation decisions, lower transaction costs and other expenses, and generally lower liquidity needs.

There is usually no leakage from pension plans because most of them don't allow loans, they don't allow in-service withdrawals, and the majority do not provide lump sum distributions at retirement. Although in the private sector, that is changing.

Pension plans offer the ability to provide special benefits to workers forced out of employment due to layoffs or other unforeseen events. Special window benefits for employees near retirement can provide a humane cushion when individual account benefits have declined.

But finally, and again most substantially, longevity-pooling in pension plans allows the sponsor to fund for the average life expectancy of the participants, thus producing significant efficiencies in the funding of the plan.

Despite these many advantages of a balanced retirement system, the past 20 years have seen an enormous shift in the private sector toward a system that relies exclusively on individual account plans. If this trend continues over the next 20 years, we'll experience a far less efficient and less reliable retirement system for most Americans.

Why is this happening? If pension plans are so good at balancing the shortcomings of DC plans, why is corporate America moving away from them? The answer is because pension plans have some serious shortcomings also. Many of them, particularly the financial shortcomings, have only recently become apparent to most people. Private-sector pension plans grew rapidly in the 1950s and 1960s. Favorable tax rules, relatively little funding requirement, and lax accounting treatment made it easy for companies to establish pension plans and promise employees significant deferred benefits at a relatively low perceived cost. But the real cost may have been much greater. Many, but not all employers funded these pension plans responsibly. A few very well-publicized plan terminations highlighted the pitfalls of inadequate funding when a plan sponsor becomes insolvent. This led to the passage of ERISA and the adoption of minimum-funding rules for private-sector plans, and the creation of the Pension Benefit Guaranty Corporation.

Minimum funding rules originally were not very onerous, but they also weren't adequate. Sponsors could choose one of six different funding methods, could make relatively optimistic assumptions regarding investment returns, could smooth volatile investment returns, and could amortize liabilities over as much as 40 years. If you were improving the benefit for a retiree, you could amortize the liability over 30 years. But the retiree is very likely to have received all of their benefit and to have died before you finish amortizing that liability. The rules simply were not adequate originally.

But the rules did change over the years, with generally shorter amortization periods and much more emphasis on current funded ratios, solvency ratios. Even before the adoption of the Pension Protection Act last year, many companies' contributions were driven by relatively short amortization periods and low interest rates based on Treasury securities. The recent passage of the PPA changes the focus of private-sector funding from that of a long-term cost with substantial smoothing of volatility, to attaining 100 percent funding ratio on an accrued benefit basis and with assets and liabilities determined on a market-value basis.

The establishment of the PBGC also

significantly affected pension plans. Seen by many as a mixed blessing, the PBGC provides a ultimate guarantee of certain pension benefits -- not all benefits, but a certain level of benefits -- for the individual, but it also creates considerable unintended consequences throughout the system. The premium structure was originally very minimal, but has grown to a significant cost. Sponsors view this cost as an added cost of pension plans that's not required for defined contribution plans. The existence of the PBGC creates potential hazards to pension funding also.

Weak plan sponsors may be encouraged to take more risks than is appropriate, knowing that if their risky investments prove beneficial, they win, their costs go down. And if they lose, the PBGC may ultimately take over their benefits.

Strong pension sponsors with well-funded plans feel they may be incurring that additional cost because of the indiscretions of the weak sponsors.

Multiple accounting-rule changes and the evolution of financial theory have increased the emphasis on transparency and reporting pension obligations on a current-value basis with both liabilities and assets market to market. The combination of these funding rules and accounting changes that both focus on transparency and market values for reporting is pushing many plan sponsors toward benefit designs under which cost is certain and predictable and stable. Defined contribution plans provide that cost certainty and complete transparency.

The sponsor's cost is simply the contribution made each year. There are no liabilities and no funded status to report.

Defined benefit pension plans present much greater complications. The ultimate cost to the plan can only be estimated. We don't know what it is. These estimates entail many assumptions.

To determine just the benefits that will be paid -- just the benefits -- one must estimate how long employees will work, how much they'll be paid, when they'll retire, and how long they and their spouses will live. That's the easy part.

The hard part is one must also determine the asset amount to provide these benefits. And that requires estimating current and future interest rates and investment returns.

These estimates involve a great deal of uncertainty. And as estimates change, the cost and reported fund ratios become very volatile. Past funding and accounting rules made it easy for a sponsor to adopt relatively optimistic assumptions and low estimates of cost.

When these optimistic assumptions didn't pan out, the costs increased dramatically. The current demand for more transparency and greater emphasis on predictable results makes these plans much less attractive to corporate sponsors.

Pension plans are sometimes perceived as more expensive than defined contribution plans. There's a few reasons for this.

First, pensions often provide a higher level of benefits. But that's an unfair comparison. When evaluated on the basis of providing comparable levels of retirement income, pensions are actually less expensive.

Second, pensions are perceived as having much greater administrative cost. This perception results almost entirely from the fact that in the private sector, the plan sponsor must pay all the administrative expenses of the plan, while in a defined contribution plan, they can pass that expense on to the participant in lower investment returns.

Think about maintaining these plans, individual account plans with thousands, millions of individual accounts that are reconciled every day. We do have efficient computer systems, but it's very expensive to maintain those.

Pension plans do have the added expense, though, of PBGC premiums, though. Definitely an extra cost.

Not all the shortcomings of pension plans are related to the finances. The private-sector employers have experienced a much more mobile workforce over the past 30 years. Less emphasis on career employment.

DC plans are often seen as more attractive than traditional final-pay pension plans to a mobile workforce. But this is really an issue with the design of that final pay pension plan, not the difference between defined benefit and defined contribution.

Final pay pension plans were designed for career employment, and they reward the 30- or 40-year employee. They do not reward -- they actually penalize the employee who works for four or five different firms throughout a career. But pension plans can be designed to reward the mobile employee and to be portable.

Cash-balance plans and variable annuity plans are both examples of defined benefit plans that can be very attractive to a mobile workforce and provide meaningful pension benefits and portability.

Public-sector plans are affected by many of the same issues that drive the private-sector employer to DC plans. Although solvency is seen with bankruptcy in the private sector, it is less of an issue in the public sector -- not entirely a gone issue, but less of an issue.

Equity among various generations of employees and taxpayers is extremely important to maintain a stable system. If you make poor estimates of the cost, it can lead to substantial intergenerational risk transfer. Excess risk transfer is quickly going to lead to an unstable system, and demands for change, even termination of what are perceived as unfair and inequitable benefits and costs.

The private sector is constrained in its response by extensive regulation of federal law and rule-driven accounting systems. Creative responses are relatively uncommon. Most hybrid pension plans, what are referred to as “cash-balance and pension-equity plans,” are simply defined benefit plans that are designed to look like DC plans, but they still involve all the inherent uncertainties and estimates of traditional pension plans.

Government plans aren't quite as constrained, at least with regard to future employees, and may consider some creative alternatives. We seem to be locked into a mentality that retirement benefits must be either defined contribution or defined benefit.

In a DC plan, the sponsor contributes a fixed amount, but the ultimate benefit is entirely uncertain.

In a DB benefit, a DB plan, the participant's benefit is fixed and certain, but the sponsor's cost is only estimated. Very uncertain.

But the efficiencies I've described of pooling longevity risk and providing lifetime income can be accomplished without strict adherence to the traditional defined-benefit model. For example, in some European countries, benefits and contributions are fixed initially, but periodically adjusted if funded ratios exceed or fall below certain predetermined levels.

Both the participant and the sponsors share in that adjustment. This provides a lifetime income for the participant, although the amount may change somewhat, greater cost stability for the plan sponsor.

Even here in the United States we do have a few creative responses. A few plan sponsors have adopted what we call variable annuity plans. These plans transfer the investment risk and reward to the participant, but pool the longevity risk. They provide a lifetime income to the participant, with the potential, but not the guarantee, of inflation protection.

At the same time, they provide a very high degree of cost certainty to the sponsor with no potential for large unfunded liabilities. Liabilities and assets remain balanced as part of the plan design.

These are innovative variations of the traditional DB/DC model. They compromise. They adopt some of the best features of both plans.

Our workforce is aging. We're faced with a future in which an ever-larger percentage of our population will be retired. If these retirees face widespread economic challenges, it's going to be detrimental to our entire economy and strain our public welfare system.

The looming retirement of the Baby Boom generation provides the catalyst to design a retirement system that will work for many future generations. A successful system will have a balance between capital accumulation and lifetime income plans. But the allocation of risk and cost may vary significantly from the paradigms that we see today.

An effective retirement system should be diversified. The three-legged stool analogy is in serious danger. Individual account plans essentially convert employer contributions to the employee savings leg of the stool, since after the employer contributes those funds they have little risk or responsibility with respect to them any longer. The employee bears all the investment risk and all the longevity risk.

The original concept of the three-legged stool involved each leg bearing risk and responsibility, not just contributing funds and subsequently having no involvement.

We have an opportunity to restore balance to this analogy before it becomes excessively lopsided.

I urge the Commission to adopt recommendations that will enhance the diversity of financial sources for future retirees and provide a balance to the retirement system.

Thanks very much for letting me share these thoughts with you.

CHAIR PARSKY: Thank you.

We'll ask some questions, I think, of either panelist.

Let me just start with our last speaker. I think you've done a relatively good job of garnering support from those people that might like or advocate a defined benefit plan at the beginning, and then you took them down a little bit. And you did the same thing with respect to those that might advocate a defined contribution plan, and then you took them down a little bit. And then you kind of threw the ball back to the

Commission, it seems to me, to say, "Well, come up with some recommendations."

I just wanted to see if I couldn't push you a little bit farther. Your comments about a variable annuity plan, were they meant to suggest that those plans combine the pluses of both? Or what are you really advocating?

MR. FUERST: Thank you for the opportunity to expand on that a little bit.

I do believe that a balance of lifetime income and capital accumulation plans is very important. I believe that all three legs of the stool need incentives. Individual savings is important. I think we need a balance.

In the private sector, I think we're going too far towards individual account or DC plans.

In the public sector, although I don't work there that frequently, my observations have been that many weight too much to the DB side and not have incentives for employees to save also. Matching contribution is the most common incentive.

I think some form of balance between those two is very important.

In dealing with the lifetime-income plan and the variable annuity plan in particular, I'm a very big fan of the variable annuity plan. I believe that it allocates risk in a much more acceptable manner. It provides lifetime income to the retiree, but yet it lets them share in good investment results. It increases their benefits when investment results are good.

And as I think some of the speakers this afternoon are going to talk about, over the long-term, the investment results of most of these plans has been very good. They do suffer when we have severe bear markets and benefits decline. But I think allowing the retirees to share in those investment gains over the long-term through variable annuity plans would be very beneficial, and also provides a much greater certainty of the cost, allocation of the cost, and better equity between different generations of employees and taxpayers. They truly pay for the benefit they receive.

CHAIR PARSKY: Thank you.

Just one question I would have for Keith, and then we'll open it up.

The combination of your presentation and Grant's presentation, was the message that you were trying to deliver one of relative optimism on the pension side of the funded status of the public pension plans and the fact that investment returns have been positive in terms of the closing the gap? Or clarify exactly what the message was you were trying to give.

MR. BRAINARD: Mr. Chairman, in the aggregate, I am optimistic. And I think that we are right at an inflection point in terms of overall funding levels for the public pension community. But that's the aggregate.

And there are two issues that have to be qualified with that. One is, there are some plans -- not necessarily in California, but on a national basis -- that are severely underfunded.

Secondly, there are some plans, perhaps some in California, that have relatively high employer contribution requirements. And so actuarial funding level is an interesting and useful figure, but it doesn't tell everything about a plan. But in general, I'm optimistic about the near term of the public pension community and its funding status.

CHAIR PARSKY: Well, since this Commission, thank goodness, is only focusing on California, I think we'll leave the concerns to others about non-California plans. But thank you.

Questions?

Dave?

MR. LOW: Mr. Brainard, along that point, I noticed on your chart, nationally, you show that there was an aggregate, 85.7 percent funded status, and the previous speaker talked about in California now we're at 89 percent. So it appears that California plans generally are performing at a better funded status than plans nationally, on the average?

MR. BRAINARD: I would agree with that. And if I could just add briefly, I think one of the reasons for that is that California has laws that empower most or all of its boards to secure contributions where, in many other states, legislatures have more control over contributions and have failed to make those required contributions. I think that's probably the single greatest difference.

MR. LOW: And on one of your other charts it showed that, nationally, there was sort of, at about 2000, when the stock market took a plunge, that the funded status of the plans dipped precipitously, and then you said they're bottoming out, you think, in 2006 and going back up.

The figures I've seen in California, at least for CalPERS, STRS, and some others, is that actually the funded status for the last several years has already moved up. And I believe that I think we may hear testimony today that the CalPERS plans, at least, are approaching 100 percent funded status again.

MR. BRAINARD: Yes, I think that we may see almost as precipitous an increase in aggregate funded levels as we saw a decrease in the last few years. It will be difficult to get to full funding, but we're going to see some sharp increases in the next few years. And I suspect that the 100 percent figure you may be referring to was on a market basis.

MR. LOW: Yes.

MR. BRAINARD: And, of course, the actuarial basis always lags the market basis by a little bit.

MR. LOW: That's correct, that's correct.

And in terms of this issue with regard to employer contribution rate, they do have the ability to adjust the employer contribution rate up and down. And, for example, I represent school employees and CalPERS, they've gone from, back in 1979, 1980, 12.15 percent, the next year, 13 percent, and it progressively went down. There's a period of time from 1989 to 1999, for a four-year period the employer contribution went to zero, they stopped contributing into the fund, and then it went to 2.8, and then it jumped up to 10 after the market.

Give me your impression on that as a policy.

MR. BRAINARD: Some other statewide plans had a similar experience, where employer contribution rates drifted to very low levels, including as well as zero in some places. And I think that the public pension community is wiser now than it was before. There was once a time when I think many public employee retirement systems were understandably proud to be able to go to the Legislature and say, "Gee, the investments returns have done so well, we don't need any contribution from you for the next year." It happened in New York. It happened in Arizona and New Jersey. Not necessarily no, but very low contribution rates.

In retrospect, we realize that that came at a financial cost, it came at an actuarial cost, it also came at a political cost, as some -- it provided some fodder for opponents of traditional pension plans to sort of bash defined benefit plans.

MR. LOW: I have a question for Mr. Fuerst.

Your last comment struck me in the respect that you talk about a balance between defined benefits and defined contributions and creating incentives for employees to save money, and the fact that the private sector has trended very far sort of towards this DC concept.

Earlier in your discussion, you talked about the fact that the savings rate has dropped from 10.10 percent to 2.6 percent; and then now, it's actually dipped into the red zone. And so given the fact that private-sector employers have moved towards this, incentivize people, maybe even provided employer contributions, but what we're actually seeing in fact is people saving less and less and dipping into their savings, how can we reconcile that in the public sector? I mean, I don't see why this incentive certainly hasn't worked in the private sector, apparently, based on the figures.

MR. FUERST: I think much of the reason for that is tax-driven. Our tax system encourages people to make contributions to 401(k) plans, for instance. They can do it on a pretax basis, shelter the income from taxation. But then at the same time, they can borrow more money on the equity of their home and spend that money. They might be putting money into the 401(k) plan and borrowing and spending even more of the equity of their home.

That person's net savings rate is negative, even though they're putting up money into that retirement plan.

They can also then, at a later point, take the money out of the retirement plan. They can borrow against the balance of that 401(k) plan, and gradually repay it. Or at certain points, they can take in-service withdrawals and actually spend the money, although they pay a tax penalty if they do that.

When they change jobs, they will frequently get a lump-sum distribution of the entire balance. And it often doesn't get rolled over.

I believe the EBRI statistics on that show that more than 60 percent of lump-sum distributions are not rolled over.

So you can have people saving money in these plans and collecting the matching contribution, that's the financial incentive: Put the money in, you save on taxes, and you get the employer matching contribution. But the overall savings rate of the individual might be declining, might actually be negative.

MR. LOW: And what we end up with is -- you talk about this excess risk transfer of a defined benefit plan. What we end up with some of these saving situations is at the end of people's lives, if that's what's occurring, and we still have an excess risk transferred to the current generation of providing for millions of poor elderly people on welfare in their future years.

MR. FUERST: Yes, that's part of our welfare system. And that certainly is a risk that all of our taxpayers bear.

If I could just comment a little bit on the corporate side of the earlier comment about funding holidays, public plans that made zero contributions. This was actually much more serious in the private sector because the federal tax law prohibited organizations from making contributions to their plan if their funded ratio was over 100 percent. They'd actually have to pay an excise tax if they put money in. So in the 1990s, entire generations of management at many companies became used to the idea that pension plans are free, or so they thought, at least, because they had to make no contributions. They were prohibited from making contributions. But all of that time, there was a very real cost accruing. People were earning more benefits. And there is a very real economic cost to that, which they weren't paying.

When the bear market came and funded ratios dropped significantly, suddenly they realized that they had to make large contributions, not just for the benefits that were accruing, but to make up for what they didn't fund when the markets were very good. So this problem of funding holidays is not just a public-sector problem. It's very severe in the private sector also.

CHAIR PARSKY: Just to stay with that for a minute. Inherent in what you just said also is the importance of not looking at a snapshot year or two, either with respect to what funding is needed or with respect to what investment returns are achieved. That's one of the reasons that it's important to look at things over time, so that you achieve the right balance; is it not?

MR. FUERST: I agree with you completely.

As I mentioned in my testimony, funding ratios are simply estimates. They are never exact. They're almost never right. They change over time. A snapshot funding ratio is not going to provide a great deal of meaning to you. You need to look at how they change over a period of time and what it is that's causing that change also.

CHAIR PARSKY: Exactly.

Thank you.

Teresa?

DR. GHILARDUCCI: As you answer more questions, I have more questions. But I only have four short questions that may elicit four short answers. And I have questions to --

MR. FUERST: I have a hard time with short answers.

CHAIR PARSKY: "Yes" or "no" would be okay.

DR. GHILARDUCCI: It won't be that.

I'd like to take advantage of your vast wealth of data that your firm might have and that you have available.

So, first of all, as I understand it, there's been this big shift in the private sector from DB to DCs, mainly because employers can get away with it. That DC plans are cheaper for employers, they provide cheaper benefits, and employees pay the administrative cost, and because there isn't universal participation in 401(k) plans. If everybody did participate, it would cost the employer some more -- I estimated 28 percent more, actually.

But another reason why employees might prefer defined contribution plans or 401(k) plans is because they don't sufficiently appreciate or understand their defined benefit plan.

MR. FUERST: Right.

DR. GHILARDUCCI: And I'm concerned about that in the public sector. I was a trustee of the Indiana plan, and our participants really didn't understand the value of their DB plan.

In your experience, what employers do the best job of helping their employees appreciate the defined benefit plans? You know, what kinds of communications work best, if you know?

MR. FUERST: I'm not sure I can point to many employers that do an exemplary job of this. Some do better than others, and there's a tremendous difference in the defined contribution versus defined benefit area here, too. And you can see that, almost all defined contribution plans have Web sites that you can go to and see what the value is every day.

DR. GHILARDUCCI: Right, right.

MR. FUERST: And you can see how it changes every day.

Defined benefit plans don't have that.

DR. GHILARDUCCI: Can I ask you –– can I just stop you? Could defined benefit sponsors provide kind of a net present value?

MR. FUERST: They certainly could.

DR. GHILARDUCCI: Okay.

MR. FUERST: Absolutely. They could design Web sites that show the increase in benefits as retirement income on a payroll basis.

DR. GHILARDUCCI: Right, right.

MR. FUERST: Every pay cycle, the benefit increases. That could be done.

DR. GHILARDUCCI: So do you ever -- does your firm ever advise your DB sponsors to do that?

MR. FUERST: We certainly do. They don't always take our advice, though.

DR. GHILARDUCCI: Could you provide the

Commission some examples of employers -- you don't have to tell us who they are -- just so we could look at how they do that? Because that would benefit, if a public employee could ask, "Oh, my promise is worth a quarter of a million dollars today."

MR. FUERST: Yes.

DR. GHILARDUCCI: Okay.

MR. FUERST: The way we would like that to show is what would you have to accumulate in assets.

DR. GHILARDUCCI: Right, yes.

MR. FUERST: It's usually not the net present value that you hold as the reserve, that the actuary would calculate. But what would it take you to --

DR. GHILARDUCCI: Right.

MR. FUERST: -- but what would it take you, as an the individual, to produce this income for a lifetime. Yes.

DR. GHILARDUCCI: That would be interesting for us to look at, these communications.

MR. FUERST: Yes, we can provide you with some examples of that. I'll follow-up and do that.

DR. GHILARDUCCI: That would be great.

Also, your data that showed that because individuals don't know when they're going to die, that they tend to oversave or they underconsume.

MR. FUERST: They should oversave or underconsume. I'm not sure they always do.

DR. GHILARDUCCI: Yes, but do you think they -- I know of some studies show that if retirees only have lump-sums or defined contribution accounts, that they tend to cut back on their consumption.

MR. FUERST: Yes.

DR. GHILARDUCCI: And that's a real serious concern.

MR. FUERST: It absolutely is. And they never get it right, either. They never spend the last dollar just as they expire. They either have a lot of money or they pass a lot on to their children. They never get it right.

DR. GHILARDUCCI: Right.

CHAIR PARSKY: Let's move the focus away from when people expire.

MR. FUERST: I'm sorry. I'm morbid.

DR. GHILARDUCCI: And the last question: You and Mr. Brainard also pointed out that public employees usually are different than a lot of public-sector employees; that we want loyalty from public-sector employees, that their jobs kind of require a lot more trust. It's harder to monitor their productivity.

In the private sector, when you have the same kinds of employees that you do in the public sector, where you care about longevity and loyalty, do you see more defined benefit plans?

MR. FUERST: Yes, we absolutely do. And there is evidence that it promotes --

DR. GHILARDUCCI: Loyalty, trust, yes.

CHAIR PARSKY: -- longevity of careers.

But there are certain industries where they're much more prevalent. And they're primarily -- some of the ones are scientific research.

DR. GHILARDUCCI: Got it. Okay.

MR. FUERST: Where continuity of employment and the intellectual capital that goes along with that is very important.

DR. GHILARDUCCI: Right, yes.

MR. FUERST: You really want all of your benefit programs to support longevity of career employment.

DR. GHILARDUCCI: So, like, pharmaceutical companies?

MR. FUERST: They're one of the best examples.

DR. GHILARDUCCI: Okay.

MR. FUERST: Pharmaceutical companies are perhaps the best example.

DR. GHILARDUCCI: Do you have data that you could share with us that shows that, do you think?

MR. FUERST: I'm not sure, but I will look and see if we do.

DR. GHILARDUCCI: Thanks.

And then I'd like to ask you, Mr. Brainard, if you think that if states had actuarial review panels where it was sort of a common practice for legislators to hear from actuaries about how reasonable the actuarial assumptions were, that some of these contribution holidays wouldn't have happened.

I'm leading up to wondering if the Commission should consider recommending that we have actuarial review panels? Or are the benefits of that exaggerated? That's a leading question. I meant it to be.

MR. BRAINARD: The bigger problems that I have seen have not been so much from diversions from actuarial assumptions as much as they have been from a combination of approving benefits whose cost was not fully recognized up-front.

DR. GHILARDUCCI: Okay.

MR. BRAINARD: And also, not making adequate contributions.

DR. GHILARDUCCI: So runaway actuaries, actuaries assuming too high of returns is really not the problem?

MR. BRAINARD: I don't see that.

DR. GHILARDUCCI: Okay.

MR. BRAINARD: As you know, there are two or three actuarial assumptions that are key.

DR. GHILARDUCCI: Right.

MR. BRAINARD: Investment return being one of them.

And then in the last few years, all of the plans in the database that I maintain that had an actuarial assumption for investment return above 8½ percent have reduced theirs. And as a group, they have reduced theirs.

But if you look over the 20-year period, for example, investment returns for the public pension community have well exceeded the assumed return.

DR. GHILARDUCCI: Thanks.

CHAIR PARSKY: John?

Sorry, Leonard.

MR. LIPPS: Mr. Brainard, first of all, I found your presentation very, very helpful and enlightening. I have just one technical question and then one a little bit more probative.

When Alaska switched its new hires from defined contribution to defined benefit plans for state new hires, did that include teachers?

MR. BRAINARD: Yes, sir, it included all public employees in the state.

MR. LIPPS: All right. And I'm now returning page 4 of your presentation. In those states where -- and we're referring to hybrid plans, and not commenting upon the merit of the hybrid plans that may or may not be in place in these states -- when workers have a choice to make between defined benefit, defined contribution, or some hybrid, are those choices in those states, do they tend to be irrevocable or is it something that they can rethink at some point and move back to something else?

MR. BRAINARD: The opportunity to choose your retirement benefit in Florida and South Carolina and Ohio, at least, and it allows employees at some juncture, typically five years, to make at least a one-time switch. So you can be five years and do public employment, for example, in Florida and say, "I picked the defined benefit plan. I wish I would have done the opposite," or vice versa.

MR. LIPPS: And then finally then, among those groups where you do have a choice, is there any data that indicates in those states, for state workers, do they tend to choose defined benefit programs or defined contribution programs?

MR. BRAINARD: In each case, where choice has been offered, the overwhelming majority have elected the defined benefit plan, either by active election or by default.

In Florida and South Carolina, I will say that since they had the onset of open enrollment for all the existing participants in the traditional pension plans, in those cases, 95 percent or so chose to stay, actively or by default, with the defined benefit plan, but new hires in those two states since then who have had the choice, roughly 17 percent have elected the defined contribution plan.

So still an overwhelming majority have elected by default or active election the DB plan. But in those two states, a higher proportion has begun to select the DC plan.

MR. LIPPS: Thank you very much, sir.

CHAIR PARSKY: John?

MR. COGAN: Mr. Brainard, thanks very much for your testimony. It was terrific.

My question relates to governance and then follows up on Teresa's question. You mentioned that, as I understood it, that, in general, state pension funds are pretty well-funded, some are very well-funded, and others not so.

The governance structures play a critical role in that. And are there recommendations that you could make to the Commission for proper governance structures that will maintain better financial integrity of pension funds?

MR. BRAINARD: Can I get away with a "yes"?

MR. COGAN: Could you give it to us down the road?

MR. BRAINARD: No, I'd be happy to share some thoughts.

There are an awful lot of different governance models to emulate or contemplate. And certainly some of them are right here in the state of California, with Proposition 162, that came up earlier, that creates some amount of separation between the Legislature and the retirement board's ability to administer those plans.

I often refer people to the Georgia state legislative model that requires -- that was a year ago also, emulated by the State of Oklahoma, that requires any legislative proposal that would have any actuarial effect to be introduced in the first legislative session after an election, and then costed out during the interim, and cannot be considered for a vote until the second legislative session. And that way, when they vote on it, everyone has a very clear understanding of what they're voting on.

MR. COGAN: Right, right.

MR. BRAINARD: And then further, that statute requires that the first year's costs be funded -- included in the budget, and if it's not, then the legislation becomes null and void.

MR. COGAN: Wow. Very interesting. Very interesting.

CHAIR PARSKY: Yes?

MR. HARD: This is a question for both of you.

Both have mentioned, you know, the pool -- the larger pool of risk in the intergenerational risk, and then, of course, there's private-sector, there's market risk. And, however, I am wondering what you think about the question of also the ratio of workers to retirees and dependents. That issue of demographic ratios and the size of the pools that share this risk, and the question of being able to try to project 40 years out for a corporation or -- and it's probably less significant for government. But nonetheless, these projections. And yet I haven't heard any suggestion that as a solution there might be the idea of creating greater risk pools.

So what do you both think about that, those two issues?

MR. BRAINARD: Are you referring in the public sector to expanding the risk pool beyond public employees?

MR. HARD: Not necessarily. I'm just throwing out -- I'm just trying to think through what both of you presented, and as a different possibility that I haven't heard raised here.

MR. BRAINARD: One thing that we have learned is that with regard to public pension funds, size does matter. And, for example, in Massachusetts, they're going through some political consternation right now because there are a number of local plans that have significantly underperformed, investment-wise. And the state has sought to take them over; it is in the process of doing exactly that.

In addition to underperforming in their investments, their costs are also significantly higher than larger plans. And so as I mentioned during my presentation, size really does make a big difference with regard to public pension funds -- the larger, the better -- in any number of ways, including administrative costs, investment costs, but also pooling of risk.

MR. FUERST: I'd like to comment on the part of your question that dealt with the ratio of workers to retirees. And that is a concept that is often used in describing the funding problems of Social Security. When Social Security started, the ratio of workers to retirees was 40-to-1 or something like that. And in the near future, it's going to be more like 2-to-1. That is a very important ratio and a real problem in a pay-as-you-go system like Social Security, because it's today's workers that are paying the tax that provides the benefits to today's retirees.

It is much less relevant in a prefunded system such as you have in California and such as most of the private sector is designed to be.

If plans are funded properly, even if the -- let's say the sponsoring organization, the workers' ratio goes to zero -- maybe the job -- the company finishes their job, it's done, all the people have worked and now they're retired with great benefits. The ratio of zero to all of these retirees should be irrelevant because the plan should be properly funded, there should be enough assets in the trust to pay that benefit. So the ratio of workers to retirees in a well-funded system should be irrelevant.

If the system has a large unfunded liability, it is not irrelevant. And that's a situation that some of our very mature corporate plans have come to where they have many more retirees than they do active workers, but they haven't funded the plan properly.

Now, they're a much smaller business, and they have to expense that over a very small group. And it becomes very expensive. You don't want to let your plans get in that situation.

CHAIR PARSKY: Bob?

MR. WALTON: Thank you.

Mr. Fuerst, I really enjoyed your comments. There was some question I had when you talk about diversity of plans. I firmly believe that, just like there are differences between public employees and private-sector employees, there's also differences within the public sector. And a concern I have in, for instance, using a DC-type plan that may have incentives for the employees to contribute, we have classes of employees that just don't have the financial resources. They don't have discretionary income. And so to provide a huge incentive for them to contribute may be meaningless simply because they don't have discretionary income. So I think we have to be careful in designing anything that one-shoe-fits-all.

Would you agree with that?

MR. FUERST: I definitely agree with that.

I think I used the term "balance" several times in how I described this. And I don't believe that the balance should be the same for all organizations and all plans. It should vary significantly.

Some workforces may benefit and do very well with the balance weighted towards defined contributions. Others may not be as successful with that type of weighting, and should do it the other way. So I believe you should make that balance dependent upon the workforce.

MR. WALTON: And adding to that, some employers may believe that a very mobile workforce is beneficial to their role in life as opposed to others may believe a very stable and experienced workforce.

MR. FUERST: Yes, yes.

MR. WALTON: It depends on the situation.

MR. FUERST: Yes, I agree with you. Thanks for clarifying that.

MR. WALTON: Thanks.

CHAIR PARSKY: I want to thank both of you very much for the very interesting presentation, and any follow-up information you can provide would be appreciated.

We're going to take a lunch break now for about 30 minutes to 35 minutes.

I think there's a list of restaurants for those in the audience that want to know where you might go close at hand.

Thank you all very much.

(Midday recess taken from 12:38 p.m. to 1:28 p.m.)

CHAIR PARSKY: Okay, the next part of our presentation, unfortunately our agenda says 12:30 to 1:30. That gives us about two minutes for this, but it's not going to be that way. Don't worry.

The funding of retirement systems. And I've been promised that actuarial discussions will be made exciting in this. And so I think some of us will believe that when we hear it, but that's fine.

We thank you both very much for being part of this.

Ron, I think you're going to begin, and then we'll let Bob speak, and then we'll have some questions.

DR. SEELING: Thank you.

Is this on?

CHAIR PARSKY: Try again.

DR. SEELING: Okay, can you hear me now?

CHAIR PARSKY: Yes.

DR. SEELING: Okay, and if I'm not exciting, I'll dance for you at the end or something.

Before I get started in my presentation, it's hard to sit in the audience and listen to questions and answers, as I've been an actuary since 1979. I was with Mercer for many years. And so you have your own answers.

And so I just thought I'd get a couple of things out that I would throw into the mix of answers you already got when you questioned the first panel.

First, I want to straighten out an answer that your own staffer gave you when Mr. Walton asked the question of, “Are the slides that were prepared by your own staff based on the actual value of assets or the market,” and his answer was, “It's on actuarial value.” And then he mistakenly said, "That's the value of assets available to pay benefits." That's not the case. The actual value of assets is smooth, it's a funding mechanism, it's an artificial device. It's the market value that's the assets available to pay benefits.

And every slide that I have that refers to "funded status" will be on a market-value basis, at both the highs and the lows in the history of CalPERS. So that's point one.

A question was asked about communicating the value of benefits to participant. And back in Mercer, years and years and years ago, I think the answer you got was a pretty good one, responding in terms of, “Let me tell you how much you would have had to save to get this." Because if you tell people, "Here's the net present value," there's an expectation that they can have it and most public plans don't pay lump sums. The

CalPERS board has, for example, consistently refused to allow a lump-sum distribution for obvious reasons. The people get their Winnebago and then they're on food stamps shortly.

Then the risk-pooling, I just wanted to –- the question Mr. Hard was asking about risk-pooling. CalPERS did that. We have almost 2,000 separate pension plans at CalPERS, and 1,500 of them were less than 100 people. Hundreds of plans with less than ten people in them. And the actual math plain old doesn't work for such small groups. So we got legislation and the board authorized -- and we have now created ten pools. And every employer in California with a plan of less than 100 people are in one of the ten pools, and that will do a tremendous amount to stabilizing employer contributions due to demographic risk-sharing. It does nothing with regard to investment risk-sharing, but it does dampen that.

And then one last thing -- I'm sorry, I'm rattling on here -- but the ratio of retirees to actives, and the comment was pretty clear, that that doesn't really play a part in the public-sector role. That's more a pay-as-you-go system. On the other hand, you should be well aware that most governmental plans are funded as a level percentage of payroll. That is, the actuary spreads the cost in such a manner as to attempt, albeit not so successfully sometimes, but to attempt to keep the rate the same percentage of pay year after year. To the extent that payroll is declining, that's a problem. The rate starts going through the roof.

To the extent you close a defined benefit plan and say, "All new members go into some different plan," the accounting standards require that you stop paying for the old plan on an increasing payroll basis and start doing it as a level dollar or as even a declining percentage of payroll, which immediately jacks up the cost. It's like a "pay me now, quick" approach that the accounting standards demands. So that's all part and parcel of -- okay, so here's what I'm going to -- I'm clicking the left button.

Time for the dance, huh?

Okay, my messages are this: That you've already heard from the first panelist that there's a real difference between public-sector and private-sector employers. And I, for one, am here to say that the long-term nature of an employer's existence is of great benefit to hosting defined benefit plans. And I'll have more to say about that. But that's one of my key messages, is that you can take a long-term approach. And even for the OPEB stuff, I think as the Controller said, “Let's take a long-term approach.” That's something that needs to be really thought out because I don't think you should try -- it's just too onerous to do things over the short-term. And I'll demonstrate that mathematically for you.

When we polled all these 1,500, 2,000 employers across California, they overwhelmingly said, "We want stability. We need predictability." That's one of the reasons that they give for going to defined contribution plans.

There's certainly this cost savings, "I really want to just save money." But one of the ostensible reasons they give is the stability and contributions and the predictability.

I claim that that can be better managed through the actuarial process on a defined benefit plan.

The strong markets of the 1990s resulted in a substantial surplus across all of Cal-PERS. And, yes, there were some benefit improvements -- SB 400, et cetera. But that used a very small portion of the then-existing surplus.

Ms. Fritz asked me publicly to describe why the projections were wrong, and so I will, for the fiftieth time in the last five years, and maybe Ms. Fritz can write it down this time: The stock market crashed, period. CalPERS experienced the first time, and only time in its 75-year history two negative, back-to-back returns.

The assets at CalPERS on a market-value basis after SB 400 went from 172 billion, to 126 billion in a two-year period. And I have graphs that will show you exactly what happened to the rates and why it happened, and it is not because of SB 400. If anything, we actually overestimated the cost of SB 400 by building increased retirement probabilities into the cost. And when we did the next retirement study, they were not that high, so we wound up lowering them.

And finally, the markets are very much on the rebound. And I have some very good news in that regard, which I'll save as I do my dance.

The next slide, please.

First of all, just the tenuous nature of actuarial science. Actuaries, all we're trying to do is come up with long-term assumptions about the future. You've got this unknown future. And some of the next slides will say it, and I'll probably wind up repeating myself. But, you know, you hire some new employee at age twenty-something, and you've got to worry about when is this person going to leave, what will I owe them, how much service will they have, what will their salary be?

And they're going to make assumptions about all of that. And you do these studies, and you make your best assumption about the future. And the fact that it doesn't work out on a year-by-year basis is no great surprise.

CalPERS has consistently beaten its actuarial assumptions with regard to investment return. I have a graph that you'll enjoy in a little bit. But we've got in excess of a 10 percent investment return over the long run. But that came with the high of 20.1 and a low of -7.23. The returns doesn't come in nice, neat little packages. They come the way they come. And the question is, how is the actuary going to respond to that and change employers' contributions? And you will see that what appears to be a very conservative, well-intentioned approach that we had been using, backfired. It generated contribution holidays that we wish we had never done. But it was based on a very conservative actuarial model at the time. And I'll explain that to you.

Our long-term assumption is 7¾, which we think -- this I've pretty much said. You know, you've got all these probabilities of the future for each employee: When will they die, when will they become disabled, when will they retire, at what age, how much service? You're just making a bunch of assumptions about the long-term. And to the extent that you're right in the long-term, your cost will be reasonable on the long-term, but the fluctuations from year to year are there. And there's nothing you can do to completely eliminate it.

Next, please.

The three key numbers that an actuary computes in a valuation -- and I apologize, this is probably the most technical slide.

The present value of benefits in just English is all the money you'll ever need to pay the benefits. If I had this much money in the bank, I could just quit.

Now, that's not for anybody that's not yet hired. But I could just take the money and go home. And if all the assumptions are met, we've got it.

We had almost 60 percent of all public plans in California at CalPERS in this state, the assets exceeded the present value of benefits.

The normal cost is the annual premium in the absence of unfunded liability or surplus that the employer must contribute to fund the plan. So that amount of pay with employee contributions and interest pays for everything.

And the accrued liability is simply what is the current value of assets that you'd like to have right now. If all these past normal costs had been collected and you were earning all the interest that you expected to earn, here's the schedule. I liken this very much to a family trying to collect enough money to send their child to college. You estimate what college will cost in the future, you set out a schedule, "How will I invest?" And five or six years into there, you start measuring yourself and, woe, the cost of college hasn't done exactly what you thought, and you haven't, in fact, gotten the exact investment return, so you need to redo your schedule: "I'm a little behind," "I'm a little ahead." "I need to tweak my schedule." "I may even need to have a conversation with this kid about the value of work experience."

But nevertheless, that's exactly what actuaries do. We set out a schedule, and sometimes we're behind. And 50 percent of the time we'll be ahead of schedule, 50 percent behind schedule. And the question is, what am I going to do to the employer contribution in this fluctuation of market returns and people retiring out of schedule, the people who quit, they hang on to their jobs in tough economic times, when you think that they were going to leave? So assumptions are not realized year by year, but are long-term predictors.

I think that much too much is made of funded status. This notion that somehow we're drowning in some unfunded liability is total nonsense. I often ask people, there are two pension plans, one is 70 percent funded and one is 80 percent funded. Which one would you like to be in? And they'll say, "80 percent funding, surely." And I say, "Well, the 70 percent funded used to be 40, and has gradually worked its way up to 70, and shows every reason to believe that it will continue to improve. And the 80 used to be 120, and it has, because of a lack of contributions or poor investment decisions, just deteriorated.

Now, which one would you like to be in?

It was said by another panelist, "You must look at the trends." And I have graphs that will tell you the trends for CalPERS.

At the height of our stock market boom in the late 1990s, on a market-value-of-assets basis, CalPERS overall had 138 percent of its liabilities in market value.

I would tell you about SB 400. The State, in and of itself, had $13 billion in surplus over and above the actuarial liability. $4 billion was spent on the past service cost of SB 400, leaving $9 billion of surplus to continue to lower the employer's future contributions, whereupon the markets crashed.

And as I told you a few minutes ago, we went from $170+ billion dollars in assets, down to 120.

The $9 billion was preparing us for a rainy day, and we needed Noah's Ark. And that's what took place. And I can't say it any clearer than that. It is not SB 400 that's got us in the position we're in.

And, in fact, the State's contribution, for example, is now 16.6 percent of pay to the biggest state plan.

If we had never done SB 400, that cost would be 14 percent of pay. It's about 2 percent of pay to pass SB 400. The rest is stock-market crash. And I will show you pictures of how taking a longer-term approach to funding can eliminate these tremendous fluctuations.

The next slide -- one more, please.

There you go.

Anytime you go to -- I'm on slide 10 -- anytime you smooth, it's at the risk of the funded status of the plan. I want to make it abundantly clear, if I didn't smooth at all, if I said any drop in the funded status must be made up in the coming year, you would have employers bailing out so quick. This year, the rate is 32 percent of pay, next year it's 6, the year after that -- and you'll see some investment returns that will convince you of that fact. So you start doing smoothing.

And the question is, how fast am I going to try to get back on track to 100 percent funded? And it's a spectrum. At one end of the spectrum is, "I'm going to go slowly and build stability into employer contributions." The opposite end of the spectrum is, I am going to hurry up and get 100 percent funded quickly, and I'm going to damn the torpedoes, full speed ahead, with regard to employer contributions.

The next slide.

It's already been mentioned here by the first panel, the significant difference between private-sector and public-sector, where I put it is in many instances, the life expectancy of private-sector companies in the U.S. are shorter than the pension promises being made by those companies. They get purchased, they dissolve. In fact, I wish I had the statistics, but the gentleman who used to be the head of the PBGC, I listened to a speech by him, and he gave a speech in which he indicated what percent of the Fortune 100 companies, 20, 30 years ago, is still in the Fortune 100 companies? And it's dismally low. Companies come and go. And yet they're making pension promises that last for 70 and 100 years.

The problem there is that now the federal government and its entire legislative package has totally removed itself from the concept of long-term funding of pension plans, and has moved completely to short-term solvency. If the company goes out of business next week, we'd better have all the accrued benefits completely funded. And you've got seven years to become 100 percent funded. That's the new federal law. No thought to long-term.

I think that public-sector plans -- and, yes, there's some wild exceptions of potential local governments that may have politically, legislatively mandated sunsets, a traffic district or whatever, or a county that gets into some terrible problems, with some very rare exceptions there, may be some potential insolvency of a government. But for the most part, governments are very long-term in nature, and you can afford to take the long-term approach to funding and, hence, concentrate on stable employer contributions that employers can tolerate, as opposed to ones that drive them away from the plans.

I also want to say that this lack of symmetry, it's -- yes, there we are, over on the right -- God, you're good.

You know, our prior funding methods at CalPERS had what anybody would call very conservative mathematical and actuarial practices. We amortized investment gains and losses over about ten years. We took 10 percent. We spread asset gains and losses over three years. We recognized a third of all the asset gain and loss. And in a situation where you have an unfunded liability, that's going to really hurry up and get you back to 100 percent quickly, which is where we started.

Now, witness the incredible stock-market boom of the late 1990s. And everything that was an unfunded liability turned into plus, and now you're given surplus back to the employers through reduced contributions over three-year periods, and it resulted in 75 percent of all CalPERS employers contributing zero.

So what was really conservative approaches, let's hurry up and pay off unfunded liabilities," completely backfires. So you almost want to say, "Well, when you're in an unfunded liability, let's have this policy, and when you're in surplus, let's have this," and the fiduciary counsel for the CalPERS board of administration has consistently opined, "Can't do that. Must be symmetric." So there you are.

So here's what we did about smoothing -- and I will try to hurry -- we picked 32 different smoothing methods: Amortization periods and everything. We did what are called “stochastic scenarios.” We generated 1,550 years’ worth of investment returns using normal distribution with our market asset allocation as the basis. We then studied each of those as to their impact on future employer contributions and the funded status.

Remember, this is a give and take between funded status and contribution volatility.

We set the following objectives:

We wanted to negatively impact the funded status as little as possible.

We wanted to try to simultaneously minimize the employer's volatility.

When you do this, you increase the average employer contribution -- and I know this is really technical and ugly -- but the answer is it's not symmetric. You can't make an employer's contribution go less than zero, but you can make it be 10,000 percent of pay. So by doing this extra smoothing, you're essentially non-symmetrically raising the employer contribution on average, and you will see the results. It's very slight.

And we wanted to select a method that would be in compliance with the Accounting Standards Board.

And here is the prior method and the new method. We went from three-year smoothing of asset gains and losses, to 15-year. We will broaden a corridor around market value that says, "I will stay within 10 percent of market” to “I will stay within 20 percent of market,” which is the federal guideline for private-sector plans.

We used to take 10 percent of the unamortized amount and build it into an employer's right. Now we put about 6 percent of that in.

There used to be no minimum contribution, zero. We now say that if you have surplus, I will spread it over at least 30 years in your contribution.

And I think that what's missed a lot about the politician folks is that that's not near the end of the story. We have not changed at all the means of paying for plan benefit improvements. That's still 20 years straight-line amortization. That has not changed. We are not spreading the cost of plan improvements.

Here's the results of what that did:

It reduced the volatility in employer contributions by 52 percent.

It increased the average employer contribution by two-tenths of one percent of payroll.

It produces rates that are compliant with GASB 27.

And on the next slide, you'll see -- again, bear with me -- this is a probability distribution function. The blue curve is the old method. And if the bottom -- the X axis is funded status. So if you said, for example, “What's the chance that you'll be 50 percent funded?” You follow that up to the blue line, and you got, oh, about a 40 percent chance that you'll someday drop to 50 percent funded status.

Under the new method, that goes up to maybe 60 percent chance or 50 percent chance that you'll drop that.

So we have, at the risk of increasing -- or at the cost of increasing the risk of funded status, spread out the cost over longer periods of time.

Now, the next slide -- I'd be glad to answer any questions -- but anyway, here is the individual year-by-year investment return at CalPERS since 1987-88. That's the blue. And you can see a peek of 20.1 in the 1990s. Two back-to-back negatives: -6.2, -6.1, not to mention a 3.7. That's three years in which you got less than your expected 7¾. And you have to measure the difference between what you got and what you expected.

So a 7.2 negative is essentially about a 15 percent loss. This was horrendous. Nevertheless, if I take ten-year periods and compound those investment returns over rolling ten-year periods, I get the green line. And if I compound them over 15 years, I get the reddish lines, which ends in 10 percent.

And I would like to indicate -- well, I'll save it -- of what happened this past year as a going-away present.

The next slide is, the red curve is the actual rates that we have established for the State's largest plan. It started off at about 11 or 12 percent of pay back in 1995-96. That dollar amount was $1.2 billion. It went down to $156 million in 2000-2001, at the height of the market.

Now, I need to say one more time: I think it's very disingenuous for those that have a political agenda to start measuring things at 2000 and 2001, and say, "Here, look at what's happened to the rates since then." It's just disingenuous, period.

The rates have gone from $1 billion to over 2 billion, but it's the market return.

The blue is what would have happened, had we put these new smoothing techniques in place back in '95-96. We would have cut those changes in rates from year to year in half or more. And the plan would be better funded than it is right now.

So I just want to -- and I would also point out that I've got an SB 400 little arrow there. That blip in going from about a zero rate to about 4 percent of pay plus was the total recognition of SB 400. Everything after that was investment return.

I am quickly coming to the end of all of this.

Here is the average employer contribution rates for local governments and the miscellaneous plan, non-safety folks. The blue line is the normal cost. The red is the actual average rate. Averages can be terribly deceiving. But nevertheless, you'll see that the rates are back where they were 20 years ago, and with significant benefit improvements to boot.

The safety plans is on the next page. The same story, although they're a bit even higher than they were 20 years ago. And the normal cost has gone up significantly because of benefit improvements, the introduction of the 3 percent at 50, et cetera. There is no question that that's got a cost.

General remarks: We introduced this -- we had a study in November of 2002 or so, in November, we started studying all of this and asked ourselves, "What should we do about this rate volatility?" We did not know then, nor do we know now which direction markets will go. We've had an incredible market run for the past several years. And that's the message I will wind up on here in a few moments.

But I will tell you that the smoothing techniques that we have put in, taking the long-term approach, is working.

This past fiscal year, from '05-06 to '06-07, three-quarters of all of those 2,000 local governments had an employer contribution rate that changed by less than 1 percent of pay, and yet their funded status has steadily increased.

From the graphs that follow, you're going to see the trend of funded status on a market-value basis. And so here's my big revelation: CalPERS will announce sometime this week a return for fiscal '06-07 in excess of 18 percent. And that will pretty much make almost all the plans at CalPERS 100 percent-funded on a market-value basis. And we'll see that in the graphs that follow.

But the notion that we are drowning in unfunded liabilities, sorry, the markets have returned us.

Now, the trick is how do I get the employer's contributions in for a soft landing and not have them stuck either very high, or if we were going in the opposite direction, stuck very low? I do not want to be labeled as political because we just automatically drop the State's contribution by 6 percent of pay. I need to worry about how are we going, now that we've had these tremendous market returns.

This is the State's funded status for many, many years, at the height of the market boom of 131 percent funded. It dropped to 115 percent funded after the recognition of SB 400. Then we had two back-to-back negative investment returns, and it dropped to 82 percent funded.

As of a year ago, we were 88.6 percent funded. A nice, healthy trend back towards full health. And now, with an 11 percent return in excess of our 7 percent assumed return, all else being equal, it would be 99.6 percent funded.

Now, I can guarantee you that that's not going to be the case. The actuarial science isn't that precise. There has been any number of demographic issues. And at the risk of being very frank, the State of California, in particular, has fiddled with its pension plan almost every year. They introduced a two-year lag of, "Let's not let new hires come into the pension plan for the first two years." And then after that, they have four years, they can decide whether to buy back the first two years. We've allowed the purchase of air time, which is -- you know, you don't have to really have worked here, you just send us some money. Those things change people's behavior. And actuaries are trying to predict people's behavior.

It makes it impossible for us to do our job. It's like I'm trying to shoot this bear in the shooting gallery, and somebody's whipping it back and forth really fast. I'm not going to hit my targets.

So somebody's got to quit tinkering with the pension systems all together and let us get back to 100 percent funded.

The schools were 98.7 percent funded. I think that they'll be well over 100 percent funded, as high as 106, 109 percent funded.

Public agencies were 95.2 percent funded. That's 106 percent funded with an 11 percent gain. This is all on a market-value basis.

And the overall PERF, the Public Employees Retirement Fund, was 93.1 percent funded. And if you add 11 to that, you get 104.

So the notion that we are drowning in unfunded liabilities is simply wrong.

Now, what the market has given, the market can taketh away. Hence, our smoothing. If we drop from 100 percent funded to 90 percent funded in one year, we don't want to bounce the employer's contribution back and forth: You know, up 6 percent of pay, down 6 percent of pay. So we're trying to still stick with our smoothing methodologies.

And the last thing I wanted to say was that we are studying -- we are in the process, almost ready to deliver to the Board, an improvement to the funding status, where as you become 100 percent funded, you move the contribution rate back to normal costs, so that you're not stuck with rates that are very high or rates that are very low.

And that concludes my presentation.

CHAIR PARSKY: Thank you very much, Ron.

Before we ask you to come to the middle of the room and dance, we'll let Bob speak first, and then we'll --

DR. SEELING: You may want to take me in the backroom and watch me dance before you ask me to do that.

CHAIR PARSKY: Yes.

Bob?

MR. PALMER: Mr. Chairman and members of the Commission, my name is Bob Palmer.

I love technology, don't you? I mean, you work so hard on your speech and then you get this kind of stuff.

I'm Bob Palmer. I am the retirement administrator with San Joaquin County Employees Retirement Association. And on behalf of the board of retirement for San Joaquin, I want to thank you for the opportunity to appear before you today.

I am not an actuary, and yet I am opposite one of the most knowledgeable people in the business. So what can I add? What can I bring to you that would be of interest?

First of all, San Joaquin County is not the largest pension in California, it's not the smallest. It's not the best-funded. It's not the worst-funded. But I think it sits as a very good example of pensions in California. And so that's why I want to showcase today. And I want to showcase it from the point of view of looking at long-term concepts on our pensions.

So, Crystal?

Great, thank you. I love technology.

Okay, and so I want to spend time from a practitioner's point of view about what I see in the funding process over my career with San Joaquin County.

Crystal, next page, please.

This has been talked about -- not only from people in the audience, but also by some of the presenters earlier, our funding source. Where do we get our funds for paying for our benefits? And as I point out in my chart up there, we get employee contributions, those employee contributions are either fixed by law or they're subject to collective bargaining on how the employee will make a contribution to his or her retirement system.

A second piece of that is the employer

contributions. And the employer contributions is the result of past performance and actuarial studies.

And finally, investment returns. Investment returns is the largest part of our sources of funding. And you had Keith Brainard here earlier. It was his research that found that 74 percent of our funds are derived from employee contributions and investment returns.

My pension has been around since 1946. So for 60 years now my pension has been in business. And the funding over those 60 years, looking back historically, 74 percent of the money came from two sources, not from the employer and not from the taxpayer. And I need to get that message out. People are missing that point, that over 60 years, 26 percent of the money came from taxpayers.

Next slide, please.

I also want to get a message out because I heard the audience -- and I'm glad I have this slide. There's several people in the audience that are quite concerned about their benefits and whether their benefits will be taken away. And I want to point out to you that based on California law and federal court cases and California cases, those pension benefits that have been promised to you are going to be there. Those benefits are, if you will, ironclad. And it's the responsibility of the boards of retirements and board of administration systems and/or the retirement administrators to make sure that those promises are met.

When I see our funds in California, I don't think anyone would disagree, we believe they're well-managed, they're well-funded, and our investments are relatively safe investments.

And what I mean by "well-managed," I mean that on an annual basis, based on laws -- I know Mr. Cogan was asking questions earlier, but under California law, especially from the 1937 Act, there are certain requirements in law. We have to have annual audits. We have actuarial reviews. We have a yearly valuation from our actuary, which looks at the economic factors of our systems, and most of us use a three-year, or tri-annual model for economic responsibilities. So we are well-managed on that level.

The second piece is “well-funded.” As previous speakers have said, and I have a chart that will show you, we are well-funded. We have all dipped down because of investment happening in the investments for those 36 months of pain. We are all coming back close to 100 percent in the next couple of years.

And finally, our investments are relatively safe. In California, we operate under the Prudent Man Rule, which is a part of our Proposition 162, as well as is in our Government Code. We utilize consultants. We have return-risk models. We use all the time for determining investments. We maximize our returns while minimizing our risk. And we utilize correlation studies to a large extent to try to find the best opportunities for return with the lowest amount of risk involved. So I just want to highlight that I think our methodology for investing is quite good.

Next slide, please.

A lot of the discussion has been today on the funding ratio. The ratio, that's the ratio of assets to liabilities. We've had that several times.

Would you bring up the next slide, please?

This is the funding ratio for my county. It is kind of coincidental. In 1990, when I was hired, that's where it was; and when I walked out the door last week, that's where we were at the other end.

I'll take credit for it. I'll take the blame for it. It happened under my watch. But what is particularly important up there to look at, is that there were eight consecutive years of over 100 percent funding. This is largely the result of well-managed investment returns by my board of retirement, similar to other boards of retirement. They're very proud of that. But you can see the dip down in the funding. And it goes back to what Ron was saying earlier, those 36 months were extremely painful to our pension systems.

But our systems are designed to go look long-term. We've been in business for 60 years. CalSTRS and CalPERS have been in the business even longer. The City and County of San Francisco, even longer. So there's a long, historical look you need to look at.

If you just look at the funding ratio at one point in time, or as Ron pointed out, if you pick the wrong point in time and build from there, you get a totally distorted view of how well we are funded. You've got to look at the long-term on that.

The next slide, please.

There's a rate of return on investments. And, actually, Ron has done a very nice job of setting it out. There's two aspects to that. There's the actual investment returns and there's the expected returns. The expected returns is a model that we build when we are trying to develop our investment-return portfolios.

Next slide, please.

And you'll see here something very interesting. You'll see that back in 1990, for San Joaquin County, the assumed return was 8¾ percent. And over time, we've had to move that down. I think we've seen that from –– we heard Keith talk about that. All the public sectors have had to move down their assumptions over time.

The other thing you see is this zigzag that goes back and forth on this. If we didn't have smoothing techniques, the employer's rate from year to year would be jumping all over the place. But what this does show is we've had many years of closure that far exceed the assumed rate of return.

And a little side pick on this. You know, I have an accountant, and I have an investment officer. And the accountant only cares about four days a year on investments. It's the last business day of the quarter when they close their sections.

My investment officer only cares about one day a year. And so, you know, it's just kind of like -- that's bizarre, this business. It's bizarre because our business moves up and down 1 percent a day. And everybody's looking either at the end of the fiscal year or the end of the calendar year, and that's the target date that everybody brags about.

I've always wanted to close my books on the 15th of December and beat everybody out, get away from the end of the turmoil at the end of the market. My actuary and my auditor have told me I get a one-time lifetime change. So if I can choose the wrong date, I'm stuck with it.

So I'm with everybody else in the herd. We look at the last business day of the month.

But our business goes from day to day to day. But we need to realize that, that that's just a point in time.

The next piece I want to talk about is the interest-fluctuation reserve. You have asked, as a commission, for us to come to you with some ideas for consideration.

Under the 1937 Act, we have something called the interest-fluctuation reserve, or IFR. It's the reserve that we set aside for the purposes of handling these movements in our marketplace. When we have an underperformance, we can dip into that reserve.

In the 1937 Act, which was written in 1937, coincidentally, there is a requirement in there that you have to have 1 percent of your assets set aside for this interest-fluctuation reserve.

And if you go back to 1937, it was probably reasonable to consider that at that time. We were entirely in bonds. That was the way we looked at it. And our methodology was to look at the cost of the plan. We did not look at market.

Since that period of time, we have moved away from that. We have moved to more volatile markets. We have 60 percent or better of our investments are in equities or alternative investments. The market is very volatile. It's not unusual for us to see the market move 1 or 1½ percent a day up and down.

And so I'm asking for the Commission to give some consideration to rethinking that concept.

If you would give me the next slide, Crystal, please.

Look what happened to us in San Joaquin County for the years 2001, 2002, and 2003. You'll see there in that period of time, the market went down for us one-tenth, and then -5.5 and then -- that number is not right -- I'm sorry, on there. But our underperformance would be made up by the interest-fluctuation reserve.

And what I would like to suggest to you is that 1 percent is not realistic anymore.

And if I could go a little farther out on a limb -- I can feel the arrows starting to come in my back right now -- is that you consider a recommendation that our interest-fluctuation reserve be one standard deviation. Why one standard deviation is because each of our systems build our models for investment. We do actuarial studies to determine the range of risk we're willing to take on that. If you want to take more risk, you're going to have to have a wider standard deviation.

And I think if you want to take on that kind of responsibility, that we ought to have the latitude to be able to build our interest-fluctuation reserve parallel to our investment philosophy.

So if we are looking at a risk-factor standard deviation of, say, 10 percent, I expect a return of 8 percent, plus or minus 10 percent is my standard deviation, give me the authority to set aside 10 percent of the pool for that.

If I had had that 10 percent, those 36 months would have been a lot less painful on the fund and on the employer as well on that.

The next slide, please.

Let's talk a little bit about employer contributions, because my suggestion to you actually helps the employer. The employer is very sensitive to a number of factors. They're sensitive to the economic assumptions that we make, they're sensitive to demographics, benefit changes, and investment performance. And what I mean by "economic assumptions," I'm talking about the investment assumptions of, are you going to expect an 8 percent return or 7¾ percent return. that's the real rate of return you're going to see in the marketplace, what are you putting as the CPI, what is your merit and longevity factors that you're putting into play to determine what your overall design will be.

On demographics, we have the issues of longer-living members. I think that's not a surprise to any of us. What is of interest to me is that I'm noticing that we also have a higher percentage going forward of married couples moving forward. That's a change I am seeing as I'm looking at our database on that.

So we're not only having demographics of members living longer, but we're also seeing their spouses living even longer on that side.

On benefit changes, what I'm referring to there is the opportunity through collective bargaining, where we've improved either the cost of living, we've included the formulas and things of that nature.

And finally, the investment performance, which we only measure once a year, which I think is kind of an absurdity.

But all four of those of factors drive the employer's contribution rate.

If you look at San Joaquin County, here's the chart showing what the employer's contribution rate looks like going back to 1990 through 2005. The red line represents the general members and the employer contribution rate; and the blue line represents the safety members. You'll see that they were fairly stable going forward, up to about 2001.

2001, interesting year, that's the Ventura year. That's the year that our systems, our '37 Act systems were either in class-action cases or litigation matters. And we each chose different ways of resolving that matter.

For San Joaquin County, part of the resolution was to bring in new formulas for our members. So we improved both the general and the safety. It also, at the same time with what Ron Seeling was talking about, it was worst of years to move and to improve yourself. You got caught with improving benefits that are lifetime-guaranteed to the members; and at the same time, the market knocked us -- it chopped us right off at the knees.

And so as a result of that, the employer's sensitivity rose quickly on that. And so you see that particular rise right there.

The next chart, please.

So let's talk about employer costs, because I think what I'm hearing is that it's not a question so much about employer costs and funding, it's really taxpayer dollars that's the issue that I'm hearing.

So how do we control employer costs? And we have actually three ways of controlling costs.

First, we can improve investment returns. We can ask our board of retirement to take more risk to improve the returns on their numbers. Our board members are all fiduciaries. They're very careful on what they will do; they're very cautious. They understand the principles of this.

My suggestions to you on the standard deviation may help them on improving investment returns, improving investment returns leads to bringing the employer costs down.

A number of our plans have pension obligation bonds. And that's what we talked about a little bit earlier today. We can spend more time on that, but I'll just quickly go over that. That's an option. It actually moves things out of my right pocket and moves it into the left pocket. But if it's an 8 percent pocket to a 5 percent pocket, it was a good idea. But if the 8 percent pocket now returns at 6 percent, it was not a good idea. But that's another story.

The other piece that's missing from discussion is controlling employer costs, is the negotiations to reduce benefits. That has not been discussed. Now, I think you need to step back and realize, our pension plans, like I said, the 1937 Act plans go back to 1937. And if you look at over the years, you will find that in times when the employer has difficulties meeting costs, they have negotiated with their employee groups to reduce benefits.

Los Angeles County, for example, Los Angeles has a tier A, they move to a tier B, which is lower, to a tier C, to a tier D, to a tier E. Each one of those were lower costs to the employer. It came about through collective bargaining.

Most of our 1937 Act plans have multiple tiers in them. And if you unwind the onion, if you will, and you look inside, you'll see that the decision was made that the costs were just so prohibitive that there were decisions to be made to revise the benefits, and the benefits were made for future members. None of the existing members were harmed in that. That tool still exists.

A lot of people have forgotten about that. But if employers really want to look at reducing their costs, one of the ways to do it is to bargain for lower benefits.

This past year, you saw a piece of that. That was with the safety group out of Contra Costa, where the safety members met with management, and there was a discussion going forward on reducing costs.

So I just want to highlight that there are ways of reducing employer's costs. I believe they fit in these three categories.

Another area that I'm particularly concerned about is normal costs. And you heard Ron earlier talk about normal costs. I love being number two in this because he gets all the front end and I get back-end stuff on this.

Normal costs is ongoing costs of our systems. And this I'm particularly concerned about, because this is the cost. If we had no unfunded liability, all that was taken off the books, we never bought any old benefits and had any prior costs going forward, what do we look like?

This is San Joaquin County. If you look at the going-ahead costs for general members, it's risen over time. It continues to rise over time. And that's a value -- in safety, you can see the particular jump up. When you go from a 2 percent at 50 formula to a 3 percent at 50 formula, you're going to see huge costs increase. So that's not a surprise. But what is a surprise is the continuing rise in normal costs. And that's because our members, they're coming to work for us at an older age, they're working for us for a shorter span of time, they're retiring younger, they're leaving with a spouse, and they're living many, many years in good retirement. And so those normal cost numbers continues to rise. And that's a particular problem that I see. I see those numbers are not sustainable going forward. We're going to have to step back and figure out what that means and where we will go with that.

The next slide, please.

One other piece that has been talked about is talking about our retirees and their benefits. We get a lot of press about the costs of how rich our retirees are in retirement. This is an actual year-after-year-after-year presentation of our retirees. You'll see our general members have risen to a monthly retirement benefit of $1,500. Our safety members, some $3,200. Our safety members are not in Social Security. You have to realize that that's a factor in that.

But our typical retiree is retiring on $1,513. And that number seems pretty close to what Keith presented on a nationwide system. That is not a lot of money for long-term career employees.

Next slide, please.

And my point here is that for career employees who commit themselves to the public sector, those are not overly generous benefits. And it's been portrayed in the press that they are overly generous.

Let me just move on from this to step over into another piece, health care. I want to just kind of weave this back into funding, if you wouldn't mind.

Recently, the newspaper here in California had an article that said that there was an 87 percent increase in the past ten years for the cost of health care here in California. It's rising faster than the cost of living -- twice as fast as the cost of living, three times as fast as the cost of living.

The health-care problem is a systemic problem. It is not something that I think we can sit down here and figure out. It is major. It's larger than California.

What is particularly problematic to me is the impact it has especially to fixed-income members like our retirees.

The next slide, please.

I pointed out to you that the average retiree benefit for us, for safety members, is some $3,200 a month, and for a general member, it's $1,500.

And the next column over is the typical health-plan cost for San Joaquin County, which is a rural county. I mean, we're not talking a metropolitan area; we're talking a rural area.

And so you see for over 65, for a couple, it's $689. For a couple under 65, it's $1,185.

Let's look at that a minute. On the left side, those are gross dollars. So the general member is $1,500 and the safety member is $3,200. That's a gross dollar number. The numbers on the right side, those are net dollars. So you can see that the costs of health care are just growing at an extra fast rate that are causing this.

Looking at health care, I think our retirees have a perspective on two points, the first being concerns about the benefit, and then the second piece being on the funding.

And let me see here.

By the benefit, I'm talking about the concerns in that area is that is it available throughout California. We don't have equal balance on health care. There are certain pockets in California that does not have adequate health care available.

The second piece about availability is the quality. There is a lot of question about the quality of health care that we are receiving on that.

On the funding side, there's an issue of increasing costs, and there's also the issue of who will pay. Those are both big open issues.

And so I come to these last two slides, the health-care benefit is an issue between the employer and the employee, and can and does impact retirees.

Retirees don't sit at the bargaining table in California. The decision on bargaining for health care is with the active members; it's not with the retirees. And sometimes my retirees feel like they're left out, but that's the way the model is built.

Next slide, please.

So I raise a couple of questions for consideration going forward with the area of health care. Will management and labor be willing to bargain and agree to fund the future promise for health care the way they have bargained for defined benefit retirement? Is that something that they're willing to do?

And the second question which is parallel to that is, will they forego negotiating present-day benefits for future entitlements?

I think those are two major questions that my retirees have posed to me with regard to health care, OPEB, and the funding of the retirement system.

Mr. Chairman, thank you very much for this opportunity.

CHAIR PARSKY: Thank you very much.

We'll open it up to some questions.

Let me just start, Ron, with you don't have to dance, it's okay.

DR. SEELING: Thank you.

CHAIR PARSKY: Just to make sure that it's clear on the message you are providing, I think it was clear that you indicated that we shouldn't think we're drowning in unfunded liabilities. That message came clear.

DR. SEELING: On the pension side.

CHAIR PARSKY: On the pension side.

DR. SEELING: Right.

CHAIR PARSKY: Right, just pension side.

However, I guess the question, though, is, you seem to emphasize the need to not fall into the trap, if you will, of failure to have employer contributions.

Is that a message that you want to give to this group?

DR. SEELING: Yes. And I think the CalPERS Board has already taken that position.

If you notice, there is a slide in which we compare the prior method and the new method.

Under the prior method, there was no minimum employer contributions; and under the current method adopted by the CalPERS board, I have to amortize surplus over at least 30 years. So to the extent that you build up such a huge surplus that 30-year amortization is greater than the normal costs, you'd still get a zero rate. But you've got to have a ton of surplus before that would happen.

So when we were in the height of the stock market build-up, we kept seeing year after year of, “We know there's more investment gains coming.” And perhaps shortsightedly, we said we would go no lower than a five-year amortization of surplus. So if your surplus would cover your normal costs for five years, we'd let you have a zero rate. And now we've said no, 30 years, it's got to be able to have 30 years. So we've got a minimum built in.

And I think that, in retrospect, having said that, let me make it abundantly clear that assets at CalPERS are probably six times the active-member payroll. So that when you say, "Let me make a minimum contribution of 6 percent of pay," for example, that's the equivalent of getting a 1 percent return on your assets.

So the asset return is infinitely more important than the employer contribution. It is literally like -- CalPERS assets will be approaching $250 billion. And I told you that not too long ago that we were at 126. So we've doubled our money in the last several years. But having an employer contribution is very much akin to putting the finger in the hole in the dam. What's important is to get reasonable asset returns in the long run. Employer contributions are just not going to make up that kind of shortfall.

CHAIR PARSKY: And consistent with that would be an outlook on returns that doesn't take a snapshot at any one period; right?

DR. SEELING: Absolutely. I think you will hear this afternoon, one of your scheduled speakers is an economist, which --

CHAIR PARSKY: Be careful, we've got some.

DR. SEELING: These are folks who are referred to as financial economists. And some go so far as to say a pension plan should not invest in equities at all, that you should use a discount rate of 5 or 6 percent to measure your liabilities.

I'm just in total opposition to that prospect. I think that it ignores all the -- if you assume 8 percent and you can -- even if you, in the long-term, get anywhere near 8, you have kept employer contributions at a level that allow for the investment in infrastructure, in roads and schools.

If you sit there and enforce that you have to fund your plan on a 6 percent investment return assumption, deliberately essentially overfunding your plan, if you're all going to invest in equities, you're going to deny all the future generations those advantages of the money that could have been available to do other things with governmental money, so --

CHAIR PARSKY: But commensurate with that is not to assume that you can achieve 12 or 15 or 20 percent return.

DR. SEELING: No, absolutely not.

And when I came into CalPERS, there was an 8½ percent investment return assumption. We've lowered it twice over the last 14 years, down to 7¾ percent.

CHAIR PARSKY: Thank you.

Yes?

MR. HARD: Mr. Seeling and Mr. Palmer, can the 1937 Act systems, the charter cities and counties, adopt the same smoothing mechanisms as CalPERS?

DR. SEELING: I think they're free to do that. I think that their actuaries don't necessarily agree with our methods at this point. I think that we need a track record of -- again, this is the cutting edge of how far you're willing to stretch. You know, we went from a three-year smoothing of assets to 15. We think it's working.

I have said consistently, in front of employer groups, I reserve the right to change it. I reserve the right to take it back to the board. And at the slightest hint that things aren't going well, to say, "Wait, this didn't go well."

Right now, it's going extremely well. We have marched right off to 100 percent funded. We've kept employer contributions relatively stable. All of the pictures of employer contributions have flattened out. So, yes, they could adopt it; but you've, in fact, got some actuaries for local systems in the audience who would probably love to jump at the opportunity to come up here and say, "But I'm not going to do that.”

CHAIR PARSKY: Yes, Bob?

MR. WALTON: Thank you.

Mr. Seeling, you're, obviously, a strong advocate in my experience working with you of properly funding retirement systems; and retirement, of course, is the focus of today's hearing. But I know CalPERS has recently done work about properly funding health-benefit programs for retirees.

And I assume you support proper funding of retiree health programs the same way as you support pension programs.

DR. SEELING: Yes, absolutely. I have argued for many years at CalPERS that it was a grave mistake to leave out post-retirement benefits other than pensions --

medical, dental, vision care -- leave that out of the process of prefunding. There is absolutely no excuse for saying, "I've got to prefund pension benefits, but I should leave health benefits on a pay-as-you-go basis."

So, absolutely.

And CalPERS has recently opened up a trust fund to accept money from local government employers. In fact, the State could put money in it. We can send the Governor a little note, we can do that. They're free to put money in our trust fund.

We've had a couple of employers join up. And it's very much the same message -- what I say is –– 75 years ago some group of people sat around and said, "Do you think we ought to have a pension system?"

And they said, "Yeah, let's do it."

And now 75 years later, we have what we have. But the best message that could be delivered is 75 percent of the costs are not coming out of the budgets of the employer or the pockets of the employees. They're coming out of investment returns.

For our health-care and OPEB benefits, 100 percent is coming out of the pockets of employers and employees. And there's no excuse for that whatsoever. You've got to prefund. And someday down the road, build up yourself to the point where 75 percent of those costs can be handled through investment returns.

MR. WALTON: Well, following that logic, if we would have had the foresight, government, many, many years ago, to properly fund health benefits the same way we did pension plans and we are at or near 100 percent funding for your health plans, I know we hear the numbers of this huge liability, but I always think it's better to put this, at least in my mind, in better perspective, is what's the normal cost of health benefits? If we did it on a current basis, normal cost, what's the percent of payroll, the current health program, the value is?

DR. SEELING: The actual report that was authorized by the State Controller's Office, Gabriel, Roeder & Smith, a national actuarial firm did the work. The normal cost was just in excess of 5 percent of pay.

MR. WALTON: So if the health plans for state employees had been properly funded, the cost would be about 5 percent of pay today?

DR. SEELING: That's right. And I think the total cost, without having prefunded any money, is up around 16 percent of pay. So that's the price we've paid for not prefunding all these years. But it's a 5 percent or slightly above 5 percent of pay benefit.

The pension plan, for example, for state miscellaneous has a normal cost at slightly less than

10 percent.

So the health-care cost is roughly half the cost of the ongoing pension cost.

MR. WALTON: Thanks.

CHAIR PARSKY: John?

MR. COGAN: Thank you both for your testimony.

A question first for you, Ron.

I like this idea of smoothing over 30 years. I think it really is a good way to deal with the normal pressures that arise when you have a series of very, very high returns.

I guess I'm trying to get a handle on how important it would be for the future. And let me get at that by asking a question about the past.

If you had had this new formula in place during the bubble, would we have been able to justify on a cost basis either the benefit increase that was granted or the contribution reduction that was allowed, or both?

DR. SEELING: Well, both the old method and the new method use the exact same approach to putting a cost on a benefit increase: 20 years straight amortization.

MR. COGAN: Right.

DR. SEELING: So what we would have said is the cost, which we would have said is about 2 to 4 percent of pay, it would have been unchanged.

On the other hand, the fact that we had driven employer contributions to essentially zero, and it looked like 4 percent of pay doesn't seem like much, I'm going to go from zero to 4, was a very hypnotic thing.

If I had said no, this is going to get you from 10 to 14, it's a different message. So that's the best answer I can deliver.

MR. COGAN: And it does strike me that the problem with legislative bodies -- and it really is a human problem, in a sense, is that they're not symmetric. When they see a surplus, they spend it; and when they see a deficit, they rarely do anything about it. And so I think the policy of a 30-year smoothing of a surplus is a very good policy for dealing with the pressures that arise because you have spikes -- large, positive, spikes in returns.

But I wonder, if we go through a period of very low returns and the system becomes seriously unfunded, does this smoothing technique, if applied in a symmetrical way, does it reduce the propensity of the Legislature to fix the problem because the actuarial calculations will show, since you're spreading their fix over 30 years, it would just show that, oh, you're only taking care of 10 percent of the problem, where the old method would have taken care of 60 percent of the problem?

DR. SEELING: I certainly understand your point. I think that that's why I believe that disclosing how well-funded you are on a market-value basis is important. It may be smoothing for the sake of the employer contribution; but you're going to tell people, "I'm now 62 percent funded on a market-value basis." Because the new method allows us to use up to 120 percent of market value in the actuarial value.

That's Monopoly money. You don't have that 20 percent cushion to spend. That's just an official device to smooth employer contribution.

So it's essential that people focus on the market value of assets that are available to pay benefits and not just the employer's contribution.

MR. COGAN: Right.

And, Bob, your standard-deviation approach is designed to do the same kind of thing?

MR. PALMER: Yes, that was my -- looking back, our systems weren't designed for 36 months of a down market. I mean, it was designed for, you know, like a ping-pong ball. If we had bounced back the second year, we would have rolled right through it. Not an issue. But 36 -- and the more you get into it -- there are steep market cycles, and they tell us they're coming again, so that's why I'm proposing another approach on that.

MR. COGAN: And one final point, Ron. If those capitalists that tell you that you should invest the fund all in Treasury bills, ask them whether they're investing their retirement in Treasury bills.

DR. SEELING: Yes, you'll have that opportunity this afternoon to ask one yourself.

CHAIR PARSKY: Yes, go ahead.

MR. COTTINGHAM: Actually, for both of you, I think you mentioned there were several years where the employer made no contributions because of the funding level.

In how many of those years did the employees get a pass on making a retirement contribution?

DR. SEELING: For all of CalPERS' employers, employee contributions are statutorily required. So there's no change in employee contributions, no matter how well-funded the plan is.

MR. COTTINGHAM: So employees always contributed?

DR. SEELING: Correct.

MR. COTTINGHAM: And we keep kicking around that what we have now is, I think from both of you, that only about 26 percent of the funding comes from taxpayers. Most of it is from the employer, the employee, and actually the investment returns. But I think what gets overlooked is the fact that the public employee is a taxpayer also. I mean, I don't think you have any public employees in your systems that don't pay taxes.

MR. PALMER: I don't know if the Commission is aware, CalPERS and CalSTRS has developed an economic footprint, where they look at that very aspect. And SACRS is also working on that very piece to look at the economics that our retirees put back into the community in a retirement sense as their money spins through their system. I believe SACRS will have a presentation on that in August, when they get their data.

But I believe CalPERS already has that on their Web site right now.

DR. SEELING: I would simply want to clarify one quick thing. When you asked the question, you said "employees, employers, and taxpayers." Employers and taxpayers are one and the same. That's where the employer is getting their money. So it's employees and taxpayers. And, of course, employees also double as taxpayers, as you have pointed out.

MR. COTTINGHAM: I think sometimes in this debate, though, that seems to get lost. They seem to be pitting public employees versus taxpayers, and it gets lost on the fact that we're all taxpayers.

Both of you gave a model of several years of funding, where you are down, up, and then down again, ranging -- San Joaquin from 1990 to 2005, and CalPERS from 1992 to 2006.

Was there any year in those down years where either system was in endanger of not being able to meet their benefit obligation?

DR. SEELING: No, not even close.

MR. PALMER: It's by design, you know. We're a long-term business, if you will. So the fact that the market gyrates from year to year is not an issue.

DR. SEELING: To the best of my knowledge, annual pay-outs back then at CalPERS were in the neighborhood of $5 billion to $6 billion a year; and at the low point, we had $126 billion in assets. So we could have paid out benefits for a very long time.

MR. COTTINGHAM: Okay, thank you.

MR. HARD: I had a question for Mr. Palmer.

You brought up the option of negotiating lesser benefits for various public employees. And certainly I'm aware that that's a possibility, having engaged in some of those discussions over the years.

But I was wondering if you were advocating for -- certainly, it's an option. But your numbers up there -- and I think your comments were these benefits were not extravagant, I don't know if you used that. But there were -- and I'm wondering if you are advocating that or what you think about the issue of then recruitment and retention in terms of long-term employment in government versus maybe shorter-term employment in the private sector?

MR. PALMER: Sure. The one I'm focusing on is that some people get a very short-term look at our business. They look at this year -- they may look at last year to this year.

Well, I'm trying to point out historically. We have a tool that we have used in collective bargaining between management and labor. When times were tough, they would bargain for future hires to be at a lower tier. When times got better, they negotiated them back up to a tier with the existing workforce.

What I was trying to point out is that tool already exists. It's there. The employer has the ability to use that. And what I'm indirectly saying is I don't think there's a need for an initiative. If the concern is the costs, let the employer step forward and bargain it with the local organizations to accomplish what they need to accomplish.

MR. HARD: Thanks.

CHAIR PARSKY: Thank you very much.

I really appreciated -- hold on, one more.

MR. BARGER: That's the danger of being way down here at the end.

CHAIR PARSKY: No, no, no. I look far to my left at times. It's okay. Don't worry about that.

MR. BARGER: I was wondering about one of the things I've been having trouble thinking about is this open versus closed group. Your analysis, obviously, is on a closed group. But, obviously, government employment grows every year, in addition to government receipts.

How do you sort of think about that in terms of thinking about what obligations and liabilities are, and how do you do the modeling out what the costs are going to be?

DR. SEELING: When we do our stochastic analysis out into the future, we're generating -- we're bringing in theoretical new entrants, so it's an open group.

But when you do the annual rate-setting valuation, you are doing it on folks that are already there. You're not building into that an assumption about people not yet hired.

Now, having said that, as people are hired, long before they show up in any actuarial work, contributions are being made on their behalf. They're starting to contribute to the retirement system and the employer is contributing whatever rate is set by the actuary to the retirement system on their behalf.

And to the extent that they look demographically like the people that were already there, they come in with assets that match their liabilities. So they come in 100 percent funded.

To the extent that they -- as Bob was saying, his cost has continually been rising because they keep hiring older people.

Well, stop that, Bob.

It's like, to the extent that the new entrants come in demographically looking differently than the people you've had in the past, to the extent that they come in younger, your costs -- the rate you're paying for them overfunds them and helps out. To the extent that they come in older, you're underfunding them.

And so new entrants come in with their own gains and losses. And that's just part of the fluctuation in rates that get amortized over time.

MR. BARGER: But is the analysis the same when you look at health-care benefits as you've looked at pensions? Because those are obviously unfunded.

DR. SEELING: The actual valuation for health care looks almost identical to the actual valuation for a pension. You've got -- every employee that's on board -- and it's usually a closed group -- you project out their probabilities of making it to retirement. Most times, they don't get -- it's less complicated than pensions because if they quit early, they don't get anything. They don't get a disability, perhaps; they don't get a termination refund.

So you're just saying, what's the chances that you'll make it out there to be eligible to receive post-retirement medical? And now instead of valuing that a pension is payable out there into the future, you have to project out what will health-care costs be out in the future.

MR. BARGER: For the closed group.

But then if you say, okay, it's actually an open group, it's not a closed group, correct, and there's no funding assumption on --

DR. SEELING: Well, again, I think the notion of funding is that you pay for public servants while they're delivering a service to the taxpayer.

MR. BARGER: So the presumption is they are funded --

DR. SEELING: You start paying for them the day they start delivering service, and be finished paying for them by the time they leave, to the extent, as was said by an earlier panel, that sometimes the retiree has received all the benefits, and dead, you're still paying for them, that's not the general -- that's not the best approach to things.

Theoretically, you'd like to pay for them. And the accounting standards have been typically set up to try to account for these costs as an annual cost that's commensurate with the employee's career. Start paying for them when they begin offering a service, and be finished paying for them by the time they leave.

Now, you can't –- here, you’re talking about human nature. You say that there's a 3 percent chance that a 55-year-old will come in and retire. But if ten do, you know, you've got a loss that you're passing to future generations. If one does, you've got a gain you're passing on to future generations.

MR. BARGER: Can I just sort of follow up with another question, which is the notion of spreading the benefit increases out over 20 years. What's the logic of that, sort of along the same lines? Why don't you do it immediately or over five years or --

DR. SEELING: I think that that's a matter of budgeting. That is, if an employer said, you know, "Here's a check for $50 million or $50 billion to pay for that," we'd certainly take it.

But the notion of how long should I amortize benefit improvements, the accounting standards, again, come into play and talk about amortizing things over, for example, the expected future working lifetime of the employees. And 20 years is not that in excess of expected future working lifetime.

So I think it's a fairly good standard of practice. I think that it's been done across the country, to the extent that you can be more conservative and make it paid for more quickly. I don't know how else to answer your question. There's nothing magic about 20 years.

MR. BARGER: My question, in essence, was, was that one of the contributing factors to why it was, in essence, easy to raise benefits back when --

DR. SEELING: Again, for SB 400, for example, there was $13 billion in surplus. And this past service cost that would have normally been amortized over 20 years was, in fact, instantly amortized. It was, $4 billion was taken out of surplus. And so instead of amortizing $13 billion to reduce employee contributions, $9 billion of surplus was amortized.

So, in fact, the prior service cost of SB 400 was paid for instantaneously. We just happened to amortize the remaining surplus over this -- we didn't change the amortization period at all; we just amortized $9 billion instead of $13 billion.

MR. BARGER: One last question.

CHAIR PARSKY: Go ahead.

MR. BARGER: I was interested, you said you had some comments about pension obligation bonds, that it was sort of taken out of one pocket and putting into another. Would you mind just sort of expanding on that a little bit?

MR. PALMER: Sure. We have used that quite a bit here in California amongst the various systems. But you can arbitrage, and that's what the sponsor of the plan, the employer, tries to do. And so I am coming to my plan sponsor and saying, you have, let's say, $100 million unfunded liability. I'm going to charge you 8 percent for that funded liability. You, as the sponsor of the plan, can go into the open market, and let's suppose you can get that for 5 percent. So you give me $100 million, and your obligation now is to pay that off. It comes off of my books, but it's on your books as part of your sponsor's books, and you're going to pay off that $100 million at 5 percent.

Well, you gave me the $100 million, making the assumption that I'm going to be able to get 8 percent on that. And if I get the 8 percent, you've got yourself a good deal on that. You've just saved that arbitrage difference.

But if I take that $100 million and I underperform, I don't make the 8 percent, I make 7 or I make 6 percent, that 2 percent shortfall turns into another unfunded liability that falls back on your books.

DR. SEELING: If I could just quickly add a comment. It's essentially an asset swap. You're saying, I don't like the way the plan is investing in assets and bonds and equities. Let me put more of my money in bonds –- or more in stocks, rather. Because you're saying, I'm going to sell this money, borrow this money, and I'm going to invest it in equities, thinking I can get a better deal. And if you can't get a better deal, then you've really screwed up.

CHAIR PARSKY: Thank you both very much. We really appreciate it.

I'm going to ask my Commission members, several of you suggested that we keep an open discussion around this table. In light of the fact that dinner won't be served, do you think it would be possible if we postpone the open discussion until our next meeting? And if it's all right with everyone, we'll move on to the City of San Diego.

Does that seem okay with everybody?

Okay, let's move ahead.

And I apologize to our, quote, “court reporter.” Are you okay here? I mean, we've been working you heavily.

THE REPORTER: I'm fine. Thank you.

CHAIR PARSKY: Okay. David, you're --

MR. WESCOE: No dinner, but there's See's candy.

CHAIR PARSKY: Only from the City of San Diego could this be offered.

That's truly remarkable. I love it.

Yes, San Diego comes with sweets, no matter what.

Thank you very much, David.

Go right ahead.

MR. WESCOE: First of all, I want to thank you for having here me today, and I also want to thank each of you for your service to the Commission and to the state of California.

Issues involving the San Diego City Employee's Retirement System, which I sometimes refer to as the underfunded, over-indicted pension system, have been widely reported and intensively investigated.

I will provide you with an overview of what happened and where SDCERS is today.

Because I joined SDCERS after the following events occurred, my historical overview relies exclusively on the three investigation reports that I cite in End Note 2. And given that these reports exceed 800 pages in total, my overview is necessarily an abridged one.

Let me start first with the world of SDCERS. SDCERS is a public employee retirement system established pursuant to the San Diego City charter for the purpose of administering the City of San Diego's retirement system. Pursuant to that charter, SDCERS also administers the retirement systems of the San Diego Unified Port District and the San Diego Regional Airport Authority. Under the California Constitution, SDCERS’ board of administration is vested with exclusive fiduciary responsibility to manage the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries.

Neither SDCERS nor its board has any role whatsoever in negotiating or establishing retirement benefits. And the board's duty is to the system's participants and their beneficiaries take precedence over any other duty of a board member.

I want to start in 1991, because in 1991 the precedent for SDCERS's funding issues was established when in that year San Diego increased retirement benefits to its employees, but made these increases explicitly contingent on the SDCERS board changing its actuarial method from “Entry Age Normal,” or EAN, to “Projected Unit Credit,” or PUC. That will be my last reference to any actuarial term.

While both EAN and PUC are GASB-approved funding methods, changing to the PUC method at that time had the impact of lowering San Diego's actuarially required contribution, or its ARC, to SDCERS. There was no purpose whatsoever for the change, except to lower the City's ARC. And the SDCERS board voted to do so.

Later, in 1996, SDCERS’ then-actuary was revising certain of his actuarial assumptions that would result in an increase in the City's ARC. At that time, the City's labor negotiations had resulted in significantly higher benefit obligations to City employees. The recently adopted PUC funding method had made the City's ARC less predictable, and the City was preparing to bear the expenses associated with hosting the Republican National Convention.

All of these factors led the city to seek a reduction in its ARC payment to SDCERS. And at that time in 1996, the city's fund ratio was 92.3 percent.

However, as it had in 1991, the City, in an arrangement known as Manager's Proposal 1, or MP1, conditioned negotiated benefit increases to city employees upon the SDCERS board agreeing to a new funding formula that was not GASB-approved but would reduce the City's contribution rates to SDCERS. This condition placed the City and union representatives on the SDCERS' board in a very awkward position. Both the City and its labor positions supported MP1, but the benefits were dependent on the board's approval to accept reduced funding from the City to pay for the benefits.

After SDCERS' then-actuary and it's then-fiduciary counsel and the City's own fiduciary counsel blessed MP1, the board voted to approve it.

Fast-forward to 2002. After MP1 was adopted, City employee retirement benefits were increased, and the City began paying SDCERS an amount less than its ARC required. In addition, in 2000, the City settled litigation that also had the impact of increasing employee benefits.

These factors, coupled with the investment market downturn in 2000, 2001, and 2002, resulted in the City's funded ratio dropping precipitously.

However, MP1 had contained a safeguard for this eventuality. If the funding ratio drop was significant enough, then a trigger would require additional City payments to SDCERS.

In 2002, the stock market slide raised serious concerns that that trigger would, indeed, be pulled. The economic implications of this to the City were substantial; and, again, the City sought a way to avoid a financial hit. And the City sought a way to make a solution that new City benefits would again be explicitly contingent upon SDCERS providing additional funding relief to the City.

In the summer of 2002, the City proposed a modification to MP1 to provide for an incremental payment schedule if the trigger were pulled. Under MP2, the City's employer contribution to SDCERS were set below the actuarially calculated rates, which increased both the unfunded actuarial accrued liability and future City contribution requirements.

In addition, MP2's actuarial assumptions were more aggressive than the best estimates initially recommended by SDCERS' then-actuary, which increased the risk of a negative actuarial experience. This would lead to increases in actuarial liabilities and an increased City contribution rate in the future.

Again, after SDCERS' then-actuary and it's then-fiduciary counsel voiced their approval of MP2, the

SDCERS board voted to approve it in July of 2002.

On June 30 of 2003, SDCERS' funding ratio as a result of MP1 and MP2 and other issues, which I'll discuss, had dropped from 92.3 percent to 67 percent, and would bottom out at just about 65 percent funded. At that time SDCERS retained Mercer to audit the City's June 30 actuarial evaluation in 2003, to evaluate the events that occurred between 1996, MP1, and 2003, MP2.

Mercer's audit estimated the impact that various factors had on the City's unfunded liability during that time period, and they estimated that approximately 26 percent of the liability resulted from City-negotiated benefit increases, and 18 percent resulted from City contributions that were less than actuarially determined.

Investment asset performance during this period, 1996 to 2003, which included some of the highest and lowest returns in recent history, accounted for only 7.5 percent of the unfunded liability.

So, historically, that's the predicate to what happened at SDCERS. And I'm going to provide now some personal observations on how it happened.

The first is that it was the City, not the retirement system, that was the moving force behind these issues. In January of 2007, Judge Jeffery Barton of the

California Superior Court issued a decision in consolidated San Diego pension litigation, and he had this *to say about how MP1 and MP2 happened. Quote:*

"The evidence is clear that with regard to both MP1 and MP2, the City was the moving force in creating, lobbying for, and implementing the plan to increase retirement benefits, while at the same time reducing contributions to a level below that actuarially required. The plan at each step was authorized by the City through its highest-elected and management personnel. In both 1996 and 2002, the then-City managers presented the proposal to cut the benefit enhancements with reduced contributions to the City Council and Mayor, before ever raising them with the employee union, representatives, or SDCERS itself."

Number two, the City of San Diego purposely placed the SDCERS board in the position of approving City employee benefits instead of simply administering them, making MP1 and MP2 contingent on actions by the SDCERS board, placed the board in the middle of the City's labor negotiations, and conditioned the City employee benefit increase on an action by the SDCERS board. This compromised the board's independence and improperly embraced SDCERS in the position of approving benefit increases that resulted from the City's labor management negotiations.

Succumbing to a plan sponsors’ dictates that were inconsistent with the best interests of SDCERS’ financial soundness led subsequent investigations to conclude that those trustees who voted in favor of MP1 and MP2 violated their fiduciary duty to SDCERS.

A third observation: A majority of SDCERS trustees were either City employees and/or member representatives of the system. Then, as now, SDCERS Board has 13 members. During the consideration of both MP1 and MP2 and prior to the enactment of Proposition H in 2004, nine of the 13 SDCERS board members were current or former City employees. The City's manager, auditor, and treasurer were represented on the board, and there were six elected board members who were also members of the system. That said, some trustees who were members of this retirement system voted against both MP1 and MP2, while some appointed independent trustees voted in favor of both MP1 and MP2.

Fourth, MP1 and MP2 happened in broad daylight. The SDCERS board meetings where both MP1 and MP2 were discussed and approved took place in open session and were reported extensively by the media.

And perhaps most interesting to me, both MP1 and MP2 happened with the experts' approval. They were both approved by the board’s then-actuary and then-fiduciary counsel.

And I might mention as an aside that there are some board members who undoubtedly voted in favor of both proposals on the advice of the counsel of their fiduciary counsel and the actuary who are now under indictment in state or federal court.

Now, as a non-partisan professional, I want to stress three of the lessons I've learned from SDCERS' recent experience.

The first lesson is that proper board governance practices can prevent the problems that occurred in San Diego. As a former lawyer, financial executive, and investment manager, my focus has been working with the SDCERS board to establish a governance structure to ensure that past SDCERS mistakes can never happen again. And I believe that governance structure is in place today.

Even before I arrived at SCERS, reforms embodied in Proposition H that were passed by San Diego voters in 2004 were already having a positive impact. They included changing the composition of the board to require that a majority of seven trustees be professionals with at least 15 years' experience in related fields and with no financial interest in SDCERS.

These trustees were limited to two four-year terms. Having a majority of trustees who have no personal financial interest in the retirement system but who do have relevant professional education and experience, I believe, is critical.

In addition, I believe permitting SDCERS members to serve on the board is also appropriate. I have seen system member trustees add invaluable insight and leadership to board discussions. Therefore, recommendations to eliminate system trustees completely from retirement board service I think go too far.

However, no matter how experienced or effective a particular trustee may be, I also believe that term limits included in Proposition H are appropriate. Limiting trustee terms allows new energy, ideas and insights to come forward and also prompts a healthy re-examination of board policies and strategies.

But most importantly, any trustee must always put the interest of the system ahead of any other interest. This is the obligation of the fiduciary, and it must be observed at all times. When the board's search committee questioned me about SDCERS' past problems, my response was that certain former trustees had simply forgotten the apostrophe. It's the San Diego City Employees' Retirement System. A trustee's paramount duty is to the retirement system's members, not to the plan sponsor, not to the taxpayer or the trustee’s employer, labor union, or own self-interest. My guiding principles as administrators is to always remember the apostrophe.

Now, in addition to the Proposition H reforms and the board's reconstitution in 2005, there have been numerous recent positive changes at SDCERS, including the hiring of a new actuary, new fiduciary counsel, a new CEO, a new general counsel, and a new chief financial officer. In addition SDCERS’ new board and executive staff have worked together to improve SDCERS’ governance, actuarial soundness, and tax compliance. Examples include commissioning an independent Navigant Consulting Report and convening an ad hoc committee of the board to address the report's recommendations.

Creating a truly independent audit committee with a majority of independent non-board members, which I think may be the only one of its kind in the country.

Creating an internal audit position that reports directly to the audit committee of the board.

Creating a chief compliance officer position that reports directly to the business and governance committee of the board.

Commissioning an actuarial funding study that resulted in the adoption of more conservative and widely accepted methods and assumptions.

Applying to the IRS for a tax-determination letter to confirm SDCERS' status as a tax-qualified governmental retirement plan.

And finally, entering into the IRS's Voluntary Correction Program to work cooperatively to resolve past mistakes in administering the trust fund.

The second lesson: San Diego's trials, quite literally, and tribulations should not be used to support an attack on defined benefit plans in general. Blaming San Diego's pension problems on the defined benefit plan structure is like blaming a pen and pencil for a misspelled word.

Defined benefit plans provide employers, employees, and retirees with significant advantages over defined contribution plans.

A recent study that criticized the defined benefit plan of the Ohio State Teachers Retirement System advocated for a move to a defined contribution or hybrid plan. A spokesman for the study summed it up this way, quote: *"It's saying to people you have to make decisions* *yourself. Here are some mutual-fund options*," close quote.

Unfortunately, this facile philosophy ignores investment reality. Studies show that individual investors, for a host of reasons, tend to underperform the market and significantly so.

And let me provide just one powerful San Diego example. As SDCERS' administrator, I sit on the board that oversees the City's 401(k) and supplemental pension savings plan, both of which embody the traditional elements of a defined contribution plan.

The graph included in your material -- and I had a slide for it but it didn't come through, but you have it in your materials -- shows the returns that are based on the actual asset allocation of the two DC plans beginning in the third quarter of 1997 through the first quarter of 2007, compared to SDCERS' actual performance during the same time period. This comparison illustrates the significantly lower investment returns realized by most San Diego City employees in a defined contribution plan as compared to the returns generated by the professional money managers retained by SDCERS.

For example, $10,000 invested in 1997 in the two city DC plans would be worth approximately $18,600 today -- or as of March 31st, excuse me -- compared to

$26,900 if invested during the same time period by SDCERS, which is a 45 percent differential in investment returns, or just about 3½ percent a year, compounded over a ten-year time period.

This significant differential in returns has a significant impact on employees' retirement security.

Given the choice, I think everyone would prefer to participate in a defined benefit plan because, in addition to superior professional management and investment performance, they provide guaranteed lifetime income and survivor and disability protections, among other attributes.

Finally, my third lesson is that fundamental human resource management principles that provide the foundation for private-sector compensation practices should play a more prominent part in public sector compensation decisions. It is axiomatic in the private sector that compensation systems should be designed to recruit, retain, and motivate employees. Yet in both 1996 and 2002, San Diego provided its employees with significant benefit enhancements for politically expedient reasons, having little relation to whether the benefit enhancements were necessary to recruit or retain City employees.

When benefit increases are implemented

primarily for political purposes, they undermine the foundations of principled compensation decision-making. San Diego's mayor recently took steps more in line with the traditional human resources approach by decoupling police and fire employee compensation packages. While this seems like a textbook human-resource response to two very different recruiting and retention issues for these two groups, it's very controversial. The ultimate outcome of the mayor's approach will have a significant impact, I predict, for San Diego and other governmental entities.

Now, in conclusion, while the City still faces financial challenges, there is no pension crisis in San Diego today. SDCERS is actuarially sound. The City's funded ratio as of June 30, 2006, was 80 percent.

A federal judge recently opined that, quote, "Undisputed evidence," close quote, shows that SDCERS is able to pay all current beneficiaries, and is capable of servicing planned pension obligation debt to cover accrued liabilities."

Investment returns have been stellar. And while we did not achieve 18 percent as of the end of the fiscal year, we did achieve 16 percent, double our actuarially assumed rate of 8, and we did it with less risk than other plans because we invest in neither hedge funds nor private equity.

Trust fund assets are at an all-time high. The City is paying more than its full annually required contribution. Bankruptcy, a financial option that the City's mayor and CFO have emphatically rejected, is no longer a serious topic of civic conversation. The City Attorney's case to roll back certain pension benefits has, in his own words, been gutted. And the state and federal criminal cases against certain former SDCERS trustees and staff, while they are still in procedural stages, have had the legal foundation of the underlying criminal claims called into serious question by the judges in both actions.

So during the past two years SDCERS has opened its doors to investigators, auditors, media, stakeholders and the public. The new board has studied SDCERS' recent past and implemented meaningful change to ensure these problems won't recur.

The unreported pension story in San Diego today is SDCERS' proactive solutions to its past problems that should serve as the standard for public pension plan governance across the country.

Thank you very much.

CHAIR PARSKY: Thank you very much for that.

Questions?

Yes, Ron?

MR. COTTINGHAM: Mr. Wescoe, under governance, because that's been discussed today, we know that with SACRS, the 1937 Acts and CalPERS and CalSTRS, I guess UC Regents, they are -- legislation comes out to create rules under the Government Code as to how they will operate and how they will function. And I'm not sure, since you just came in to San Diego, if you would have the background to know that, had they not been a charter city that can set their own guidelines, could they have done what they did to underfund their system? In other words, would the governance kind of -– would it have been in place if they had been operating under the laws of California that govern our other retirement systems?

MR. WESCOE: Well, as you have prefaced the question, as not being a '37 Act expert, I can't answer the question. My guess is the answer is no, but I can't speak definitively on that question. I can get you an answer for it in writing.

MR. COTTINGHAM: Okay, I am interested in that. Because I'm from San Diego, not the city, I'm from the county. But it seems like the county system is operated differently, and they haven't done the same things.

MR. WESCOE: Well, the county system is certainly operated differently. They issue pension obligation bonds, which they don't include in their unfunded liability, and they also pay retiree benefits out of surplus earnings.

MR. COTTINGHAM: All right.

CHAIR PARSKY: Dave, you'll provide an answer to that question?

MR. WESCOE: Yes, sir.

CHAIR PARSKY: Thank.

Teresa? Nothing?

DR. GHILARDUCCI: No. Believe it or not.

CHAIR PARSKY: You're not focusing on San Diego quite yet?

DR. GHILARDUCCI: Not yet.

CHAIR PARSKY: Okay.

MR. WESCOE: That hurts my feelings.

DR. GHILARDUCCI: We're not dead yet.

MR. LOW: On the unfunded liability presentation, you said it was 26 percent of it resulted from the negotiated benefits, 18 percent from the City contributions, and 7.5 from the drop in the market.

Where did the rest of the 51.5 percent of the unfunded liability come from?

MR. WESCOE: I knew you were going to ask me that question. It's in the end notes, and I don't have the end notes with me.

But if you look at the end notes in the testimony that you have --

MR. LOW: I see it.

MR. WESCOE: -- you'll see it.

And I outlined it explicitly. You might want to read it for your colleagues, if you can find the note.

MR. LOW: I see it.

MR. WESCOE: Got it?

MR. LOW: Yes.

CHAIR PARSKY: Dave, if you see it, why don't you let the -- either the left-hand side of this equation or the right-hand side --

MR. LOW: It says here on Note 15, Mercer, Audit of Actuarial Work, May 11, 2004, at pages 44 through 47. Other causes of the unfunded liability included the use of reserves for additional benefits, 30 percent; actuarial assumption changes, 5 percent; and non-asset experience, 14 percent.

CHAIR PARSKY: Bob?

MR. WALTON: Thank you.

I found this report -- I've always heard about San Diego, the city and its problems, but this is an excellent review of how it took place, I think from a person that stood back and took an objective look.

I noted that at least it appears that a large part of the blame for this situation, at least on what you've prepared here, was based on the fact that the political body, if you would, put conditions to the board of the retirement system on these benefits will only be approved if you take X, Y, and Z actions.

Would you support changes in the administration that would preclude some actions from taking place? In other words, conditions -- preconditions couldn't be placed on benefit improvements or changes in any way, shape, or form?

MR. WESCOE: Well, I think that's one of the lessons of San Diego. And I think the reforms of Proposition H in 2004, by changing the mix of trustees, has gone a long way towards alleviating that problem.

As I mentioned in my remarks, when you have 9 of 13 members who are City or system members and they sit on the pension board, and the City -- either their employer or their bosses have conditioned a benefit on their action, it's very, very difficult for someone to resist that kind of pressure, particularly when the two experts sitting in front of you, the actuary and the fiduciary counsel, ultimately bless the transaction.

But I think Proposition H has really moved the board to a new place with a majority of non-system, non-financially-interested parties.

MR. WALTON: Well, I think it may. But I think outside independent can have pressure on them also to make these political decisions, if you would.

MR. WESCOE: Yes, sir.

MR. WALTON: Like supporting a convention coming to the city, as used in your case. So I think, really, to get to the root of the problem, it's precluding government, if you would, placing conditions on independent pension boards, no matter how they're composed --

MR. WESCOE: Well, I certainly --

MR. WALTON: -- of preconditions, if it changes.

MR. WESCOE: Yes, sir, I totally agree with that.

And I think in the environment, one of the lessons of SDCERS is that whenever a condition like that crosses the door, the antenna of the fiduciary counsel, the inside general counsel, the administrators and the trustees ought to begin to really go off with bells and whistles. Because the fact of the matter is the job of the pension system is to administer the system for the benefit of the members, not to follow the dictates of a plan sponsor, particularly when the dictate to the plan sponsor excludes specifically underfunding their otherwise GASB-approved annual required contributions.

MR. WALTON: I would agree. Thank you very much.

CHAIR PARSKY: Yes?

MR. LIPPS: Thank you, Mr. Wescoe.

After looking at Footnote 15, I would like to ask, what is a non-asset experience, or an example of that?

MR. WESCOE: A non-asset experience is, in my understanding, if the assumptions turned out not to be true. As someone mentioned earlier, you hire an older, decrepit bald man into the system, your assumptions are going to be different than if you hire a younger, more vigorous person. And so some of the assumptions that were set up weren't achieved, in retrospect.

MR. LIPPS: Wouldn't that be covered, though, under -- the previous category does say actuarial assumption changes accounting for 5 percent, and then it goes into non-asset experience, 14 percent.

Were they overlapping or --

MR. WESCOE: They may be overlapping, but that's my understanding. But, again, I'll provide a follow-up for that question, too.

CHAIR PARSKY: Thank you very much, David. We really appreciate it.

Next on our agenda, Pensions as a Part of Total Compensation, David Janssen.

DR. JANSSEN: Thank you, Mr. Chair.

As far as I can tell, I'm the only person here who's not an expert in anything

CHAIR PARSKY: No, no, there are other people around this table. It's okay.

DR. JANSSEN: As a matter of fact, I didn't realize until Monday that I was supposed to send in written documents that you could actually post. So I put them together very quickly.

Thank you for inviting me. I have comments both on the retirement side and the retiree health side, even though you're focusing only on retirement today only because I won't have an opportunity to come back. And I should say at the outset, I am not speaking on behalf of the Board of Supervisors of Los Angeles County, and I'm not speaking on behalf of CSAC. And because I know that Keith Richman is looking at an initiative, everything I say from this point on I will disavow, even though it's being recorded.

So with that, let me say, I've been involved in, as I sit here, in labor relations since 1975. I was responsible for Governor Brown's negotiating with CSEA in 1975 -- I've totally forgotten about that -- his proposal to pay all state employees a flat increase. As I recall it, it was $30 or $60 a month. That resulted in CSEA walking out. And so I had a picture of CSEA walking out because of Governor Brown's fair proposal to pay everyone the same amount of money, no matter how much you made.

So I've been at this for a very long time.

Let me just say, first of all, Los Angeles County, Fortune 500, we are 111. 111. That's the size of Los Angeles County. The budget is $21.7 billion. 102,000 employees. Population, 10.4 million. We have 54 bargaining units and two fringe tables. And we are right in the middle of three labor agreements, so I have to be very careful about what I say on both sides of the bargaining issue.

As we have said before, we have seven different pension plans in Los Angeles. Although most of the employees are in Plans D, E, and Safety, Plan D, which is 2 percent at 61 has 50,000 members. Plan E, which is a non-contributory plan, has 27,000 members. Those were both established in the seventies. The richer plans, if you will, are almost through. Safety is still 2 percent at 50. And we have about 11,000 members in that. Ten-year vesting requirement.

Pension has 35 billion in assets, funded at 90 percent. We dropped to 82 percent, I think, as a result of the stock market. And it has come back up to 90 percent.

The thing that is very interesting to me, in listening to the experts, is all of this is very, very interesting, but I wonder how much of it actually gets to the people that make the decisions. You can't legislate behavior.

I agree with what David just said about San Diego. We have a tendency -- our political system has a tendency to react to incidents in bad situations; and we make law to make sure it never happens again.

Instead of stepping back and taking a look at the situation and finding out if it is, in fact, unique, and if it is unique, are there other things that need to be done or, in fact, do we need to do nothing? And I think part of what you're looking at as well: Does something need to be fixed here?

In retiree health, to switch just a minute, our actuarial results were released the week I went back to New York to the rating agencies, which I thought was just wonderful timing, to explain to them the $20 billion unfunded liability for retiree health at 5 percent -- at their 5 percent assumption, at 7.75, which our retirement system uses for investments, it's 12.3 billion.

The ARC for that is one and a half billion. At the 5 percent, it's 1.03 billion, at 7.75 percent. We are pay-as-you-go.

A lot of interesting data in that document. 85 percent of the liability is in health care. We have 38,000 retired members, 19,000 spouses and dependents. The system is 10 years minimum at 40 percent, and then 4 percent for every year after that, up to 100 percent. I don't think that's unique. It's not particularly unusual for public service.

What is unusual is how it happened in Los Angeles. And this does not exist anywhere else. And one thing I would say is I don't think you're going to find a lot of similarity up and down the state in various pension systems or retiree health systems, in how different governments have approached the problem. Los Angeles is unique because in 1982 the board negotiated an agreement with the employees and with LACERA to assume responsibility for paying retiree health. At that time, it was less than $5 million, it seems to me. And it seemed like a good idea at the time. It seemed like such a good idea that they also agreed to put it in statute.

And I think you have the language here of the statute, which actually the statute is there to say that the retiree health is not a vested benefit except in counties of five million or more. And there's only one, and that's Los Angeles. And the statute requires us to pay retiree health as long as we are paying active health.

And I ask my people, can I recommend that they eliminate that statute? And they say no, you can't do that, that would be an unfair labor practice. So I'm not going to recommend that.

The cost of the health, we've been looking -- we've been aware of it for about seven years or so. But as a practical matter, and when you get down into the trenches where we are, it's all about decisions about money. It's all about what can you afford. It's about what are your demands, what are your problems, what are your issues? And for us, the major problem in 1996, when I started, was the cost of the retirement system. The county was using surplus earnings to pay its entire contribution. We never got to a point where there was no contribution, but the county was using surplus earnings, the negotiated agreement with the retirement system to pay its full contributions.

That, to me, was a disaster waiting. It took us ten years to buy our way out of that. We have done that this year. And we did it when contributions to the retirement system went from $300 million to $800 million a year, which is where we are this year, about $800 million. So we have resolved the problem of surplus earnings that we had at that time.

Retiree health, $347 million a year, pay-as-you-go. It's estimated to reach a billion in 2017. 1.79 percent of the budget. And the reason that we didn't do anything about retiree health is we were trying to do something about the retirement system, plus jails, Child Protective Services, Mental Health, roads -- you name it, all of the other demands that you have on the budget. You can only do so much. And the priority at that time was to do something about the use of surplus earnings.

We have active negotiations now with all of our bargaining units on the retiree health issue. It is an issue that needs to be addressed. We cannot afford to continue forever pay-as-you-go. The statistics are dramatic, obviously. The unfunded liability is a concern. But the pay-as-you-go statistics are really, really dramatic. And we are making good progress with our unions in negotiating options that we have, given the restraints that we have had in the state law that says we have to continue to provide the benefits. And we have to provide them at the same level that we were providing them in 1982. That, in itself, is an interesting challenge.

The question that I was asked was, in part, how did Los Angeles avoid going to 3 percent at 50? Because the county -- we were faced -- in 1999-2000 when all of the retirement systems up and down the state had a lot of money. I think we were at 112 percent in '99. The demands for 3 percent at 50 for public safety, 2 percent at 55 for general, even 3 percent at 60 for general members, which several jurisdictions went to.

The simple reason was the board refused to do it. They believed that we had a very sound, fair, retirement system at 2 percent at 55 for safety, 2 percent at 60 for service. And because we do three-year forecasts for everything we do, we had the preliminary data from our own actuaries that this was going to be unaffordable, and that the retirement system was looking ahead at problems as well. And it took us four years of negotiations, fighting, whatever you want to call it, with the employee unions, particularly safety; but we did reach agreement. And we reached agreement on a longevity formula which Ventura County did. Instead of a vested right, we agreed to something that could be unnegotiated, if necessary, in future years, where retirement benefits cannot. But it was simply a matter of looking at the data, using the data, and really having an elected board who was willing to say "no."

That's why I'm not sure how much the State or anyone can do to effect the behavior of individual local governments. We've got 58 counties, 470 cities, 6,000 special districts, all with elected bodies, a lot of whom have the authority to make these kinds of decisions. And they're made based on very difficult negotiations. And we were able to avoid it only because of the Board's willingness to take a tough position.

The only enhancement actually since 1980 was, we increased the death benefit to $5,000.

In looking at this, it reminded me that retirees don't have a place at the table. The unions arguably represent the retirees, but they don't really. They represent their active members. They're concerned about the people that are paying dues.

We're concerned about recruitment retention. We're concerned about whether we have enough deputy sheriff's or have enough nurses, can we get the job done, how do we compete with other people in the active world? And the retirees, while they will periodically come up, are not at the table. And I think that may be what happened with retiree health, is we weren't paying attention. None of us. And the retirees were looking at their individual concerns. In our case, it was death benefits. And we turn around, and all of a sudden, GASB 43 and 45 said, "Wait a minute, we need to shine the spotlight on this problem."

And I wasn't happy at the time they did it because we didn't know it was 20 billion at the time. We thought it was closer to $5 billion or $6 billion about seven years ago, which it may have been. But it's now become the elephant in the room. It cannot be ignored, it has to be addressed, and that's a very good thing.

The retirees all of a sudden -- and their benefits are now at the table. And the reason, the practical reason -- and I note this here -- is that sooner or later it's going to show up at the table because there's only so much money. And the money is either going to go to salary increases for actives, the increasing cost of benefits, health benefits for actives, or it's going to go to pay down the retiree health cost.

And you can't afford to do all three. That's why I think the unions, the employees are very interested in figuring out a way to mitigate the future cost of retiree health, whether it's through the establishment of trust, different benefits, contributions, et cetera; because eventually it's going to come down to there's only so much money around. And the retiree health is an issue that cannot be ignored any longer.

Comments, OPEB bonds. Los Angeles issued pension bonds. The City's comment was very good. People forget about the cost of pension bonds. We pay $358 million a year for pension bonds in Los Angeles because they issued pension bonds, which help fully fund the retirement system at the time the market took off, thereby resulting in 112 percent funded, thereby having all this extra money. Well, of course, that's nonsense because the cost of those pension bonds is at least double what they actually issued.

The Bond Buyer, Steve Gauthier said, “Pension bonds are tricky, OPEB bonds are even trickier.” I would never touch an OPEB bond because we simply don't know where health-care costs are going, we don't know where benefits are going, and you're going to lock yourself into an incredible cost long-term.

The financial market would love you to do it, but I just don't think it makes any sense.

You know, four is a personal concern. Unions won't like this. But in San Diego, Los Angeles City County, we're ratcheting each other up. I mean, we're competing with each other for the same employees. The City of Los Angeles gives its -- because it has a good year, the police negotiate a good agreement, the deputy sheriffs come back the next year and say, "Well, wait a minute, we're losing members to the police. We've got the cities, they have the whole independent jurisdictions. You know, we need to stay with them." And because of the difference in City and County budgets, we're on different cycles. I mean, they could be down, we're up. Right now, the City of Los Angeles has a lot of budget problems.

The County, because of incredible, tremendous, wonderful management --

CHAIR PARSKY: You've only got one of those here.

MR. JANSSEN: Yes, that's okay. That's it. In any event, the City's hurting now because we were able to and needed to give our deputies a good three-year contract. The City is over there now going, "You guys, you're not helping at all by doing this." There's nothing you can do about it, it's just a fact of life in local government.

And salaries and benefits, to the extent this is total equivalent compensation, we did it in San Diego. They all should be negotiated at the same time, so that everybody understands there's only one pot of money for benefits and salaries, and you can't afford to do everything.

So let me stop there and see if anybody has any questions.

CHAIR PARSKY: Thank you.

Questions?

Yes? Lee?

MR. LIPPS: Actually, just a request, Dr. Janssen. I'm referring to the bottom of page 2 of your handout, where you refer to the cost of retiree health in the current year and express it as a percent of your budget, and then what it's going to look like in 20 years from now.

DR. JANSSEN: Right.

MR. LIPPS: We had a very similar type of presentation from Peralta College at our last meeting. And at least in that case, the data to back that up, the assumptions that were used, the trend increases and all the rest of that were provided.

Could you provide us with that same data for these figures here?

DR. JANSSEN: Sure, absolutely.

MR. LIPPS: Thank you.

DR. JANSSEN: A better comparison is also the cost against salaries. But you really need to go and look at the difference in the budgets behind these as well. Schools are funded very differently than counties. But I will do that.

CHAIR PARSKY: Questions?

Thank you very much, David. We really appreciate it.

DR. JANSSEN: Thank you.

CHAIR PARSKY: Okay, our next item is the '37 Act County Retirement Systems. We have two.

CHAIR PARSKY: Richard, are you going to go first or second?

MS. TERRIS: Chair Parsky and Members of the Commission, thank you very much for this opportunity to testify.

I am Shawn Terris, president of the State Association of County Retirement Systems, also known by its acronym called “SACRS.”

On behalf of SACRS, I'd also like to thank Commissioner Cottingham and Chair Parsky for calling out time from your very busy schedules to talk to the SACRS membership in May. The information you provided was very helpful in our membership understanding and appreciating the enormity of this Commission's task, and the very small time frame in which you have to get it done.

Over the next 30 minutes we hope to provide information to the Commission that you'll find helpful in developing recommendations for the Governor.

But before I forget, the staff to the

Commission has been terrific. And I want to mention them by name. Crystal, Margie, Jan, and Tom.

Next slide.

CHAIR PARSKY: Compliments to the staff are perfectly acceptable. That's okay.

MS. TERRIS: Very good.

This first slide just gives you an overview of SACRS. Who are we? We're a non-profit association that was established in 1954. Our membership consists of 20 counties, and the retirement systems are governed by the 1937 Act. And as you already heard the reason why it's called the 1937 Act is because it was enacted in 1937. We like to keep things simple here.

The next slide is a map showing all of the SACRS counties, and they are depicted in the yellow. You can see it represents almost all the Southern California counties except for Riverside and San Luis Obispo counties. And then we pick up a half a dozen other counties through the Central Valley, make a left-hand turn, we pick up most of the counties around the Bay Area, and then go up the coast, pick up some counties there, up to Mendocino County.

The thing we take away from this slide is that we represent over 75 percent of county employees and retirees.

Collectively, our 20 members have $100 billion in assets, which is larger than 46 of the State retirement systems. And we provide benefits for 400,000 county employees and retirees.

The next slide.

When looking at the retiree health care, it varies among the 20 systems in SACRS. And what I mean by that, it varies in terms of benefits. Some retirees from those counties receive no coverage. In fact, one-third of them receive no coverage, and all the way up to 100 percent coverage.

Number two, the sponsor is either the county or the retirement system. And I was remiss in including the retirees. We have two systems where the retirees paid full cost of the benefits, and one-third, we don't have any coverage. And of the remaining systems, some counties pay the retiree health care, and others, the retirement system pays for the retiree health care.

And our funding values from zero percent funded pay-as-you-go, which you know that's basically Social Security's method of payment, all the way up to 100 percent funding. And about a third of the systems that do provide retiree health-care benefits are 100 percent funded. But we do have one that is pay-as-you-go, and then everybody else falls in the middle there.

So that's the health-care side of our business.

For the pension side, the average pension funding within SACRS is 86 percent as of last year. And as you've heard over and over again today, the investment returns have surpassed the assumptions rates that each system have determined. So the 86 percent, I guarantee you, is going to be even higher when we update it.

The next slide.

I want to just take one minute to touch on what does "percent funding" really mean. And everybody's been using this term. But if you're 100 percent funded, that means your system has all the money that you need to pay the benefits of all current employees and retirees. It's not just for the retirees, it's for the employee who was hired yesterday.

We looked at 40 to 60 years, because you're going to work 30, 40 years, and you're going to live for another 28 years after that.

On the other hand, on the other end of the spectrum is zero percent funded, pay-as-you-go, which means the money that's coming in from the County and the employees is immediately going right back out to pay the current retirees. So 86 percent funding is really good.

Long-term funding is appropriate. You've heard that from the CalPERS actuary and several other experts who testified today. For example, how many of you paid cash when you bought your first house? Raise your hand.

Let the record note that no commissioner paid cash for their first house.

In the audience, did anybody pay cash when you bought your first house?

Let the record show that no one paid cash for the first time they bought a house.

And so you ask, "Well, why didn't you?"

On the other hand, how many of you took out a 15-, 20-, 30- or 40-year mortgage?

Go ahead, raise your hands.

So some of the commissioners don't own homes.

And members of the audience, how many in the audience?

Okay, let the record show that most people did not pay cash; they took out a mortgage.

And the same reasons why you don't pay cash when you buy your first house is the same reason why we fund pensions over time.

This next slide is just a one-page snapshot of all public pensions in California. The Commission's heard several times from CalPERS and CalSTRS, which are the number-one and number-three largest pension funds in the United States, but there is also SACRS. And we're introducing you to SACRS now. And there are the independent systems, too, which primarily is made up of the UC System and the City of L.A. and the City/County of San Francisco.

The thing to take away from this slide is that there's about 3 million employees, public employees and retirees in the state of California. So that's about less than 10 percent of the population.

Well, this next slide is not a secret. The health-care system in the United States, it's broken. And it's been a problem for the last 40 years. So identifying feasible, long-term solutions that go to the core driver of public retirees' health-care problem may take longer than the one-year life of this Commission. There are certainly Band-Aids that could be placed on it. But to go to the core, that's a whole, big task.

The next slide just shows that the health-care costs have been outpacing all others. For the last 40 years, the health-care costs have increased twice as fast as inflation. What is even more alarming is that the share of the U.S. economy devoted to health care has tripled during that same time frame. So what that means is there's more money being spent on health care, and it means there's less money going to other programs, like

Mr. Janssen talked about public roads, and other responsibilities that cities and counties have to carry out.

We think it is definitely prudent to look at funding shortfalls and develop a plan. However, since my membership is in the business of providing mandated public health, we're intimately familiar with the problem on that side of the house. Private citizens have a much larger problem. Taxpayers are paying health care for 37 percent of Californians under the age of 65. That's one-third. And that’s because one out of five don't even have any health insurance whatsoever, and then another one out of six gets assistance through Medi-Cal.

Now, when you compare that, 37 percent are being funded by taxpayers. When you compare that to public retirees, public retirees only make up actually less than 3 percent of Californians.

So you might think, well, what's wrong with this picture? To make an analogy would be like, as if you had your car was broken, and your mechanic tells you in order to fix the car and make it run, you have to replace the engine. Yes, it's going to cost a lot of money, but it's going to fix it for the long-term. But you decide instead that that's too expensive. That's too expensive to fix the car. I'll replace those worn-out tires. They're still functioning, but I'm going to replace them because they're a lot cheaper.

The problem is, you still haven't fixed the problem. That car is still not going to run. That broken engine in that car is equivalent to the broken health-care system in California. And those tires that don't have 100 percent tread, that's equivalent to the public retiree health-care benefits not being 100 percent funded.

Now, when you add Medicare into the mix, you have got even a greater problem. Medicare provides health care for those who are older than 65 years old, primarily. They also cover those who are disabled and survivors.

Medicare, as -- I can't remember who presented this morning showed -- Mr. Brainard from NASRA showed the problem that Medicare has. Medicare is going to run out of money in 12 years. Twelve years. That's just around the corner. That's going to happen before I retire.

And while Medicare, you think, well, it's a federal program, Shawn, so I'm not worried about it. Well, the counties, we are worried about it because by state law, if a citizen in California does not have health-care coverage, we have to cover it -- the counties do. And that's in accordance with the Welfare and

Institutions Code, 17000.

This cartoon came out right at the same time I was putting my presentation together, and was one of my colleagues, Liz, who passed it on to me. And while it depicts the strain between public workers and politicians in regards to costs for pensions and health care, you can really take out the public workers, put private workers there, take out the politicians and put corporate CEOs. The thing is, health-care costs is a growing concern for everybody.

So what has SACRS been doing? We've been proactive. Last year, we wrote up Assembly Bill AB 2863, which the Governor did sign, and it allows both the Board of Supervisors and the retirement board to set up a trust fund to start prefunding these benefits.

Now, remember back in the beginning of my presentation, some retirees’ health care is covered by the county, some is covered by the retirement system. So this bill authorizes both boards to create that trust fund. And, actually, Rich Stensrud, who will be speaking after me, he is the chair of the legislative committee, and they were the ones who put that bill together.

So what are our recommendations to the Commission? We have two immediate recommended actions.

Number one, direct agencies to start prefunding retiree health care using the same proven and successful funding model as public pensions. And based on the presentations your commission received in May, I think by CalPERS and the LAO, that you would realize an immediate 35 percent discount due to investment returns.

And the second immediate recommended action is to ask you to encourage the Governor to consider signing into law bills that propose solutions to health care for all Californians. You know, not just public retirees, but all Californians, because that will address and solve the problem for everybody. And specifically, AB 8 and SB 840 should get to the Governor's desk no later than September. And I think some of the public comment actually brought this up.

If the Governor doesn't agree with the solution in those two bills, then we will recommend a long-term alternative recommendation. And we would categorize this with, "Fix that broken engine." Don't worry about the worn tires, go to the core driver of this problem.

And we would request that state leaders partner up with private businesses, health-care entities, taxpayers, labor, and other stakeholders to identify feasible solutions for all Californians, not just public employees.

This next slide, I know you've heard this several times, but it really needs to be said again. The information that's provided out in the media and policy-makers and decision-makers oftentimes only shows one part of the equation. And there's three parts to the equation.

There's a liability side, and you hear, okay, there's $20 billion in liability. Okay. Well, what about the assets side? Maybe you have $20 billion in assets? That would make you 100 percent funded. And the timeline to fund those. So we think it's irresponsible and misleading when analysts focus only on the liability side of a plan without looking at the asset side of it and the appropriate timeline to fund those liabilities.

Remember that example we used about buying the house? Would you pay cash today? No. The same is true with retiree health.

So to summarize the SACRS story, pensions are well-funded and well-run. On the other hand, the health-care side, it's all over the board. The funding, the level of benefits, and who pays for them varies greatly.

But the thing you want to point out is that one size -- meaning, one solution -- does not fit all. As you saw on the map, we're all over the state of California. So people down in San Diego might have a desire for certain kind of benefits that mean absolutely nothing to Mendocino County. So it's really important that the boards of supervisors continue to have that discretion to grant whatever benefits is important to their staff.

And our final thought is actually best said by Sandra Day O'Connor while she was working as a U.S. Supreme Court justice. She said, quote, *"I don't know that there are any shortcuts to doing a good job,"* close quotes. And we submit that what is really going to be required to resolve this health-care problem that's been around for 40 years is for all the stakeholders to, first of all, get in the same room. And that's going to be a tall task. Once you get in the room, then you have to identify what each of your needs are. And then identify from those needs where there is common ground, and build from that common ground. I guarantee you, no one's going to be completely happy. I guarantee you, everybody will have to make compromises. But unless there's a political will to take on this problem and resolve it, it's not going to go away, it's just going to get worse.

That concludes my presentation.

Rich Stensrud, who is the chair of the SACRS legislative committee, and also the administrator for Sacramento County Employees Retirement System, will present and he'll actually give you some more detail.

CHAIR PARSKY: Thank you.

Richard?

MR. STENSRUD: Mr. Chairman, Members of the Commission, thank you for your time and endurance.

As Shawn indicated, I'm going to drill down a little bit into some of the information about our retirement systems; and along the way, speak to some myths that are out there about public employee retirement systems; discuss a little bit about some of the lessons systems that are learned, coming through the difficult market period that we've just transcended and some of the challenges we face going forward, and leave you with a couple of closing thoughts.

I know in some cases some of the points I'm going to touch upon you have heard before, so I'll try not to belabor them.

But starting first with the 20 county retirement systems that are governed by the 1937 Act, we range in size from the Los Angeles County Employees Retirement Association at the big end with $35 billion in assets and more than 145,000 participants, down to a system like Mendocino County Employees Retirement System on the small side, with about $315 million in assets, approximately 2,300 active employees and beneficiaries, recipient of benefits.

All of our systems are governed through a system of local control with a retirement board comprised of key stakeholders in our communities. The makeup typically consists of four individuals appointed by the County Board of Supervisors, two individuals elected by the general members of the retirement system, a safety trustee and an alternate safety trustee, and then a retiree trustee and an alternate retiree trustee. And then finally an ex officio member, the county treasurer or the treasurer equivalent in that county.

We are obliged to bring annual audits by independent outside auditors. We have annual actuarial valuations by independent outside actuaries. We are subject to all of the state Open Records and Open Meeting laws.

Our administrative costs for managing our benefit plan are constrained by law to be less than .18 percent of our plan assets.

There are, however, a number of various benefit formulas that are applied by our different systems. You heard Mr. Janssen discuss a moment ago that Los Angeles County chose to not pursue benefit formulas that had been adopted in other counties, and that is just one example.

The decision on the benefit level in the county is determined by the County Board of Supervisors, working off a menu of benefit formulas that are offered by the 1937 Act.

Each of our 20 systems independently manages its own assets through a diversified professionally managed investment portfolio. Collectively, in 2006, our systems earned 11.84 percent. And you can see that we have performed well over every time period, including going back 15 years.

The message in this particular piece of data is that notwithstanding some very difficult periods in the market in this time frame, our systems have shown that we can manage assets well, deliver returns, and then be able to utilize those investment returns to pay for a substantial segment of the benefits that we ultimately provide.

Our systems have substantial investments within the state of California. For example, my system, Sacramento County, we have more than $747 million invested in companies that are headquartered in California or in real estate in California. The SACRS system is in the process of compiling this kind of California investment data for all of our systems; and we will provide that to you.

We make collectively $4 billion in benefit payments per year. With 87 percent of the recipients of these payments being in California, this means about $3.5 billion of benefit payments are flowing into our local communities and local economies. Once again, we are in the process of gathering all of this data for all of our 20 county systems; compiling that in the form of economic-impact analysis similar to what has been done by PERS and STRS. We'll provide that information to you.

Turning to some of the myths, and I think you have, as alluded earlier, heard some of these things mentioned, spoken to from different directions.

One myth is that the cost of public employee retirement systems has skyrocketed. Our data shows that over the last 15 years, expressed as a percentage of payroll, the costs have been really quite stable. The average employer cost today is only about 4 percent -- expressed as a percent of payroll -- higher than it was in 1990.

And I think in making this point, it is important not to be misled by people who compare costs today to the costs at the low point, when the investment market was booming in 1998 through 2000.

The other point I'd like to make -- and I think it has been addressed, at least in part by one of your membership -- is that in contrast to employer costs which dropped during the boom period but have now returned to normal levels, employee costs have trended consistently upward over the 15-year period. And the bottom line there means that over this period, employees have been paying for an increasing part of the cost of their benefits.

The next myth I'd like to speak to is that taxpayers bear the brunt of the cost of public employee benefits. As I've suggested earlier, our investment programs have been very successful. Our data shows that approximately 75 percent of the benefits that are paid by our systems come from investment earnings.

Another myth is that taxpayers are on the hook for huge unfunded liabilities that will break the back of government. The reality is that paying off unfunded liability is built into the funding model that is used by our retirement systems. And as with all benefit costs, unfunded liability will be substantially paid off through investment earnings.

I would note, and I think it's important to keep in mind that while a statement about unfunded liability is good information about how you are doing in terms of meeting your funding goals, the progress you've made towards meeting those funding goals, it is different in the public sector than it is in the private sector because our systems don't shut down, freeze benefits, and go out of business. We are not allowed to do that by law.

And so while, again, the number is informative, it does not have the same real impact as an unfunded liability number does in the private sector.

You've already heard the reference repeatedly that unfunded liability in our systems is paid off like a mortgage. Except in this case, our mortgages have the benefit of a rich uncle. "Uncle Investment Earnings." And so in the end, unfunded liability ends up getting paid off substantially out of investment earnings.

So the specter of that huge number today, whatever it might be, is not, in reality, going to be an ultimate price tag that will be borne by taxpayers.

Let me give you a concrete example of why I can say this with confidence.

In Sacramento County, like virtually all of our systems, we utilize a smoothing technique in which investment returns and losses are blended so as to maintain stability in the funding. Each year, depending on whether there are net gains or net losses that need to be folded in, we do that at the end of the year. We will be incorporating or applying net deferred investment gains to our actuarial valuation this year, which will reduce our unfunded liability by about 26 percent, one year, good years. A product of several good years. But it is reflective of the fact that our model is designed to pay off unfunded liability, and does so successfully.

Another myth that you often hear expressed is that public employees retire with big pensions. The reality is, among our systems, the average general member gets an annual retirement benefit of about $22,000 a year. The average safety member gets an annual benefit of $44,000 a year. You combine the reality with debunking another myth, which is that public employees get to retire younger, after short working careers. Again, the reality is that our general members are retiring at an average of 58, after an 18-year career. The average safety member is retiring at age 52, after a 21-year career.

And I think a very important thing to note about this data is that the average retirement age and length of career has virtually unchanged over the last 15 years. There is not a phenomenon out there of public employees suddenly striking it rich and getting able to retire young and not work for their retirement benefit.

While we think we have a very good story to tell about the way our pension plans work, there certainly have been some challenges that we've had to wrestle with as we went through the experiences over the last several years.

There is a term used in the 1937 Act which has become very problematic. It's the term "excess earnings." And it refers to that investment return on an annual basis that is in excess of what your actual earnings target is.

A lot of people fell into the trap of thinking that there would always be excess earnings and that excess earnings were permanent. We realized -- we're reminded, again, that what the market giveth, the market can taketh away. And it doesn't just happen one year at a time, but can happen over a multi-year cycle.

And so the challenge for us, in administering our retirement systems, is to move away from the trap of thinking about excess earnings as something that happens every year and can be looked at for alternative purposes every year; but, instead, to look at our systems from the perspective of whether or not we have excess funding. Whether our funded status is going to be strong enough to allow us to sustain a protracted market downturn and/or to handle any other costs that we might want to utilize and address through the retirement system. That's also going to be a challenge.

You have heard about the tremendous burdens that are falling on people as a result of health-care costs. And it is easy to look at the retirement system as offering solutions. But it is an approach that bears risk, and it's tied to the "no free lunch" rule. Every dollar that is utilized for something other than securing the funding of the core vested benefits is a dollar that's not going to be available to address possible future disruptions in the funding stream for those core vested benefits.

There are reasonable, legitimate ways that dollars can be spent; but just we, as administrators of our system, have to recognize the risks in deviating too far from our core mission, which is to secure the funding of our core benefits.

To address these things, I think we've come to recognize -- and you've heard another speaker allude to earlier -- the importance of maintaining substantial contingency reserves. This is the cushion that can help a system and an employer ride through a difficult market environment.

And while viewpoints may vary on what an appropriate level of contingency reserve should be, it is extremely valuable.

In our system in Sacramento, we have made reestablishing our contingency reserves, which we were fortunate to have substantial reserves going into the difficult market period, and allowed us to stabilize costs in a very important way; but to reestablish those contingency reserves at a level where we can make a meaningful impact on mitigating potential cost increases associated with protracted market downturns.

You've also heard a reference to the fact about the importance of maintaining a reasonable contribution stream even if the markets are booming and our funding is strong. People are always happy to smooth when you're smoothing losses. People love to front-load the gains. It's a challenge. It's a challenge for all of us in remembering that, ultimately, the credibility of our systems is tied, in large part, to the consistency of our philosophy in managing our business.

A couple of closing points. I've already suggested that our systems have shown that we can withstand substantial market disruptions, we can do that in a way that maintains relative cost stability. I think our model works.

The last thing I would note is that I think, without question, our defined benefit plans are the most efficient and cost-effective providers of annuitized retirement income. We do it better than anybody else. We do it because we can spread the annuity risk and the annuity cost over a larger pool and a longer time horizon. That allows us to provide a stream of lifetime benefits to our retirees, which is a critical feature for maintaining security and dignity in retirement.

And with that, I'd be happy to answer any questions that you might have.

CHAIR PARSKY: Thank you very much.

Mr. Cottingham?

MR. COTTINGHAM: Mr. Stensrud, just to start, as part of your closing or the last part when you said no free lunch -- every dollar that is drawn off to cover supplemental non-vested benefits is not there to be available to address possible disruptions, and in '37 Acts, health care is not a vested benefit.

MR. STENSRUD: That's correct.

MR. COTTINGHAM: Okay, so are you saying that '37 Acts should not be involved in making health-care contributions?

MR. STENSRUD: No. The 1937 Act authorizes retirement boards to retirement boards. And I think it's an important distinction between the County Board of Supervisors, which normally adopts and sets benefits, but it authorizes retirement boards to provide supplemental non-vested benefits out of excess earnings.

And in the past, our retirement boards have provided -- a number of our systems have provided various forms of supplemental benefits out of the excess earnings that we hold.

(Mr. Cappitelli left the meeting room for the day.)

MR. STENSRUD: We have, primarily through 401(h) plans, a tax-authorized plan, utilized our retirement systems to provide health-care subsidies to our members. We've also provided supplemental cost-of-living adjustments to our members, retired members whose buying power has diminished at a greater rate than could be replaced by the cost-of-living adjustment they might otherwise be entitled to.

So the answer to the question is that our systems have the authority to provide assistance for supplemental non-vested benefits. And the question or challenge will be, what role should we play, and how does that role get balanced against the obligation to secure the core vested benefits.

MR. COTTINGHAM: I think part of that is something we’ve heard from Shawn, and I think from Dr. Janssen and yourself. It sounds like you all favor local control in deciding how these benefits will be implemented.

MR. STENSRUD: We do believe in the model of local control. We think ultimately that provides for the greatest accountability for the decision-making that's made in the administration of our systems. Whether it is in the level of health-care benefit, how we invest our assets -- the whole range of issues. We think it's a good model, and it works for us. And we say that with all due respect to the tremendous ability and expertise that's captured in a large statewide system like a CalPERS or a CalSTRS.

MS. TERRIS: If I can add to that also?

Counties are a political subdivision of the state. And as such, about 15 percent of the board of supervisors' budget is discretionary. Meaning, the other 85 percent, they have no discretion in it. The State is paying the counties to do this, that, and the other thing. They have no discretion over that. So to maintain local control when it comes to your staff's benefits is really critical.

CHAIR PARSKY: Teresa?

DR. GHILARDUCCI: You said that employer costs went up 4 percent since 1990. That was your slide. And then you said in terms of payroll.

So would that be four percentage points or --

MR. STENSRUD: Correct. If you think of pension costs, as they are often expressed as a percentage of payroll.

DR. GHILARDUCCI: So what is it? What is it now?

MR. STENSRUD: So in 1990, the average cost for a general member in our system was approximately 11 percent.

DR. GHILARDUCCI: Okay.

MR. STENSRUD: It is now somewhere in the neighborhood of about 15 percent.

DR. GHILARDUCCI: Okay.

MR. STENSRUD: And on the safety side, because the salaries are generally higher and the benefit formulas are higher, the cost is higher, and it was approximately 21 percent in 1990, and now it's somewhere in the neighborhood of about 25 percent on average, among our 20 systems.

DR. GHILARDUCCI: And then on top of that, is the 7 percent, 7.2 percent for Social Security or Medicare?

MR. STENSRUD: For those systems that participate it in Social Security, there would be the additional cost of Social Security.

DR. GHILARDUCCI: What portion of your counties' employees are in Medicare and Social Security?

MR. STENSRUD: I don't have that information for you, but I can get it.

DR. GHILARDUCCI: Is it like half or --

MS. TERRIS: It varies. Actually, as you have gathered, SACRS is an association, not an organization.

DR. GHILARDUCCI: Yes.

MS. TERRIS: And so we periodically conduct surveys. And we actually conducted a survey years ago. And within each county --

DR. GHILARDUCCI: There's --

MS. TERRIS: -- some employees have the coverage and some don't. So it's all over.

DR. GHILARDUCCI: But do you have that data? Because that would be really useful to us.

MS. TERRIS: We'll get it to you. It's several years old, though.

DR. GHILARDUCCI: Okay.

MR. LOW: L.A. is not.

DR. GHILARDUCCI: Okay, thanks.

CHAIR PARSKY: Any other questions?

(No audible response)

CHAIR PARSKY: Thank you both very much. We really appreciate your participation.

Next on our agenda is the subject of Actuarial Assumptions: Private and Public Sectors.

And John Shoven is going to present.

He's not going to dance, but he'll present.

DR. SHOVEN: I'll try to be relatively brief and help you with your timing. Let me see if I can figure this out.

Well, I might add just one thing to my brief bio, in the sense that in addition to being a professor at Stanford, until quite recently, I was a board member of Watson Wyatt. And as you may know, Watson Wyatt is in the business of human resources actuarial consultants, and their largest business is pension-plan design and actuarial work about it. So that gave me a little bit of insight into this topic.

So we could kind of move to the slides, and you have to pitch them several times, okay. And this will be fine.

So I think I feel, and we all feel the same way, that the obligations to pay these pensions is a certain obligation: It's not something we want to pay if we can, but we're going to pay this for sure. And so I call these -- maybe it's not politically correct, but call it “come hell or high water” obligations. We're going to pay these.

And the issue that we want to discuss is what discount rate should we apply to these liabilities -- from the State's point of view or the county's point of view, these are liabilities to pay them -- in order to determine what the present value of the liabilities is so we can compare that number to the assets we have on hand to figure out whether we're fully funded or not.

And we've heard a number of numbers already. We're 80 percent funded, we're 96 percent funded. Well, this discount rate is what gets you to those figures. And so you know how funded you are.

So if we could go to the next slide.

Now, I used as somewhat illustrative, but I think it's a common practice in the state, an 8 percent discount rate. I know that other systems are using 7.75. And to tell you the truth, none of the experts, certainly myself included, are a quarter of a percentage point smart. I can't tell you whether 8 is right or 7¾ is right. But we're not that smart.

But basically what's being done statewide is roughly 8 percent discounts are being used. And we don't know what future rates of inflation will be, but markets might indicate 3 percent, 3½ percent, something like that. And many of the systems are assuming that this 8 percent discount rate corresponds to about a 4¾ percent real interest rate or real discount rate.

And so one of our things we want to talk about, are those reasonable numbers or not? And I realize there's lots of different asset pools behind the various pension plans in the state; but I did look up CalPERS' pension portfolio, and it's about 60 percent, 62 percent in stocks; about 24 percent in bonds, if you want to call it, fixed-income bonds; 6 percent in these private equity funds; and about 8 percent in real estate.

And if I were to apply the kind of expected return, average return that you would get on these asset classes, deduct a reasonable amount for investment management fees and administrative fees, the answer I get is that 8 percent is reasonable, 7¾ is also in the about-right category.

And if you want to know the kind of numbers I was using to come to that conclusion, I think that the expected return on equities -- this is nominal now, not real -- in the order of 9 or 10 percent. Bonds, we know current bond yields are around 6 percent. And private equity, 15. And real estate, perhaps 8.

Now, you might ask, well, why do some of these assets pay 15 and some of them 8? The answer is risk. So you've got to know that, that the ones that pay 15 are a lot riskier than the ones that pay 8, and the ones that pay 8 are a lot riskier than the ones that pay 6.

In fact, there's this one editorial I'll make, I've been here about an hour and I've heard a couple of times, you know, "Our investment returns handsomely exceeded our assumptions." And I think what all members of this committee should think when you hear that is, that means they also could have fallen short of the assumptions. That is, anytime you beat the assumption by 8 percent, you didn't do that by skill, you did that largely by luck.

And then sometimes these are risky assets. Sometimes they pay a lot. But when I hear somebody say, "I got 16 or 20 percent," I immediately conclude, "You took a lot of risk." And so far, so good.

So if we were to look at where this 8 percent comes out, even though I think it is about the right value for the average or the median return, that means there's about a 50 percent chance you'll come up short of that, and about a 50 percent chance you'll exceed that.

In fact, if we were to try to be more precise, the way returns are distributed is probably about a 60 percent chance of a shortfall and about a 40 percent chance of more than this return.

The reason it's 60/40 is that returns are skewed to the right. That is, there's a chance that you'll do really, really well. And that's pulling the expected outcome up to about 8 percent.

So if we could go to the next slide. What I'm basically saying is the liabilities are certain. They're safe. You're going to pay them no matter what.

The assets used to finance them are risky. And there's about a 50 percent chance that you'll earn more than 8 percent, and there's about a 50 percent chance you'll earn less than 8 percent. You might earn in the vicinity of 8 percent. You might get 7 or 9. But there's also a chance that you're going to miss by a lot, either way.

And so what I thought I'd do is look at history. And by the way, I don't think looking at the last 15 years is an adequate look at history. So while I looked back to 1946, I could have looked back much further, and looked at how a portfolio such as this, this particular portfolio is 70 percent stocks and 30 percent bonds, how is it done over 15-year intervals? So these are long horizon intervals. These are 15-year intervals. And this is just -- count, how many times in that period did you earn between -2 and -1 percent? That's a bad 15-year stretch. And the answer is four times.

How often did you earn 12 or more percent? The answer is four times.

So -- three times, I guess it is, looking carefully.

And what we're assuming, 4.7, it's kind of in the middle. In fact, if anything, in this history, it's a little bit below the middle.

But the point is there have been long stretches where markets are way off of the assumptions that we're making. If you get into one of those -- if you think you're fully funded now, and the next 15-year stretch is one of these -1's or -2's, you're going to be far from fully funded. You may be 50 percent, 40 percent funded at the end of that 15-year stretch.

By the way, these really bad stretches are not that long ago. The worst stretch was in the 1970s, the 1960s to the early 1980s, which was a really bad stretch in terms of markets did have positive returns, but they didn't match inflation for at least a decade.

So my conclusion at this point is that this 8 percent is a perfectly reasonable number. On average, you're going to get it. On the other hand, you can't count on the average. And you might get something quite distant from it.

So if we could go to the next slide.

So if you really wanted to be safe, you would finance these certain liabilities with certain assets. That is, safe assets backing safe liabilities would be, obviously, a more prudent standard. I'm not necessarily proposing you do that, but you should be aware that what you're doing is risky.

If you did that, if you backed -- if the assets were safer -- there's primarily bonds -- you would end up with a discount rate on the order of 5 or 5.4, and not 8.

So I guess the real point is, taking certain obligations that you're going to pay for sure, using these risky asset expected discount rates, leaves the taxpayers in a risky situation, you may have to contribute more or you may have to contributes less, it depends on how it comes out. And I'm not talking year to year, I'm talking 10-, 15-year stretches. And there's about 50 percent chance, even if you think you're fully funded, that you're not because of the way that financial markets will perform.

Go to the next slide.

Now, I'm pretty familiar with how corporations do their pensions, their defined benefit pensions. The answer is it's pretty much the same. Pretty much the same you're doing it. They tend to use discount rates on the order of 7¾, 8 percent.

On the other hand, you should know, and I think you all do know that DB plans are absolutely losing ground dramatically in the corporate world. Corporations are dropping them frequently. Some troubled companies, like United Airlines have given up their plans. But other strong companies, like IBM, have given up their plans. And one of the reasons they've given up the plans is, from their point of view, the funding risk is just too uncertain. They don't know how much to set aside. They know whatever there plan is to set aside, they might have to set aside two times that or nothing at all.

Sometimes the market performs so well that the government won't even let them put more money in their plan even if they wanted to. But they see a fairly widely fluctuating contributions to these plans. And when they add that to their -- I'm talking pensions now -- when they add that to their health-care liabilities, they say, "We don't need this," and they go to a defined contribution plan.

So that's what's going on in the corporate world.

If anything, the government liabilities, the state government liabilities, county liabilities are more certain than any corporate DB plan because the corporation has the possible out. They're really not hell-or-high-water liabilities, as United Airlines attests. That is, if things go badly enough, they just turn their plan over to the Pension Benefit Guaranty Corporation, and they have somebody to turn their plan over, and then it becomes the PBGC’s problem, ultimately it may become the U.S. taxpayers’ problem. But they do have a way out, which in the State, we have no way out. So if anything, we should be a little more cautious than the corporations because we have no way out of paying these obligations.

And the next slide.

Now, my bottom line is that the theoretically right thing to do would be to use a safe discount rate, something on the order of 5½ percent. On the other hand, I do want to assure you -- I'm not sure that's really what you should do. You should be aware of that.

I also want to assure you, though, what you're doing is absolutely mainstream. What you're doing is what almost everybody does. 8 percent is a reasonable number, it's the expected return in the market, or market for these kind of assets. But there's no guarantee that you're going to get the expected return. That's the point. Nothing like a guarantee you're going to get the expected return.

In fact, if you were absolutely fully funded, there's about a 50 percent chance you still will have to throw in more money to meet the obligations that you thought you had fully funded.

So there's nothing -- we heard sort of a no-free-lunch quote earlier. It's really true in finance.

This 8 percent is a pretty good return, but there is no free lunch. Why is it more than 5 percent? It's more because of the risks that you took. And the risks that you take, sometimes you pay for it and sometimes you don't. So what we're doing is financing certain obligations with risky assets.

When we do it with our eyes open, we can recalculate this every year; and if we have to throw in more money, we will. We don't have to wait 15 years to figure out whether we're in a 15-year bad stretch.

So I'm not necessarily suggesting you change; but I am saying that you shouldn't confidently say when a plan is 100 percent fully funded, that, "Hey, we've got enough money, we're all set." You have to see how these markets perform. And there's a lot of risk in the market.

That's all I've got.

CHAIR PARSKY: Questions?

David?

MR. LOW: So you say there is about a 50 percent that you're going to underperform. Wouldn't that also assume there's about a 50 percent chance you're going to overperform?

DR. SHOVEN: Absolutely. Absolutely. That's why this is the expected outcome.

And you could have a ten-year, 12-year, 15-year stretch of getting 12, 15 percent returns. In fact, I believe the last 15 years have been a particularly favorable stretch of time. In fact, I'd go back as far -- well, about since 1987, since that crash, which is now 20 years ago –- this has been 20 great years for the market, despite the 2001 debacle. And it's probably been a more favorable 20 years than average.

CHAIR PARSKY: And what might that say about the next 20 years, though?

DR. SHOVEN: Almost nothing.

I honestly don't think that you should get discouraged and say that, "Boy, we're due for some bad times." But I also don't think you should say that the last 20 years proves that our model works because we made it through the last 20 years.

When you talk about retirement, 20 years is not a long stretch of observations.

CHAIR PARSKY: Yes?

MR. LOW: When we're talking about investments, I mean, risk is sort of inherent in the whole investment scheme. So I guess the question becomes, as you're talking about a more conservative risk assessment and, you know, where's balance? Where does balanced risk come in? Because I think that, you know, public pension systems are investing for the long-term, their history has shown that this 8 percent is borne out. So it seems like there is a relative amount of balance here.

DR. SHOVEN: Well, but let me give you an example of what I'm talking about. Let's say your neighbor was investing in the market, and came to you and said, "You know, I think the average return is 8 percent. Would you be willing to ensure that I'll get 8 percent?" You'd say, "No."

But, in fact, the California taxpayers are sort of ensuring that these pools will earn 8 percent, and that's an uncomfortable position to be in.

I'm not saying we should get out of it, but we should at least be aware that we're in it.

MR. LOW: Should we also be aware, though, that the byproduct of assuming less than 8 percent means the taxpayer is on the hook for a higher contribution rate to make up that shortfall?

DR. SHOVEN: Well, in the long run, it would all come out the same. In the long run, the taxpayers are going to pay for the benefits, and no more and no less. It's just a matter of timing. That is, are we paying enough now?

But if you pay more now, you will pay less later. So I would not say that the taxpayer would pay more if they used a lower discount rate. It's just retiming of when they pay.

MR. LOW: My last question relates to the public sector versus private sector. You made some comparisons with regard to what's happening in the private sector.

Now, we've heard a lot of things about the PBGC. And my understanding is now that the private sectors have to run their plans on a termination basis. So there's a lot of differences in the private sector that have caused these types of decisions that don't really apply to the public sector; aren't there?

DR. SHOVEN: Well, I think there are a lot of differences, I think that's fair. But I do think that there are two reasons that would come right to the front of why corporations don't like these plans. One is the uneven contributions, the risk of how much they're going to have to contribute. That would be, I think, shared with the government plans.

The other reason that might not be so shared, and that is the sort of regulatory and bureaucratic burden of running one of these plans for particularly a small corporation. It's quite high. And so they like the simplicity of a defined contribution plan.

MR. WALTON: A question -- actually, two parts.

First, I would be interested if there's been any calculation -- look at the last 25 years for CalPERS or all public systems in California -- what would have been the cost to the taxpayers if we would have used 5½ instead of the assumed rate that we did? It has to be in billions and billions of dollars, I would assume.

DR. SHOVEN: Well, if it was billions and billions of dollars, those billions of dollars would still be there. The plan would have all those more assets, and future taxpayers would pay less.

MR. WALTON: Well, let me get to that point, but those are billions and billions of dollars that would not have been available for schools, for safety, for other public programs.

When you say in the future it would be less, if you stuck to the premise that you used 5½ and were an ongoing concern into the perpetuity, when would it ever be less? If you're always using 5½ instead of 8, they're always going to pay more than they would have paid had it been 8. Always.

DR. SHOVEN: Well, you may be right. But in the end, the taxpayers are just paying the benefits. It's just a -- when you put the money in -- if these returns are so great, if you put in the contributions earlier, you would enjoy all those higher returns even sooner.

MR. WALTON: Which, again, would leave less money for other programs within the state.

CHAIR PARSKY: Well, I guess just to follow that. If you were making the 8 percent assumption --

DR. SHOVEN: Right.

CHAIR PARSKY: -- and you were in a 15-year period and you ignored what might be a down 15-year period and didn't provide incremental contributions, then at some point during that period you're going to have to pay the piper; right?

DR. SHOVEN: Right.

CHAIR PARSKY: Isn't that part of what you're saying?

DR. SHOVEN: Right.

I think on the very long horizon, you pretty much pay the same, no matter which assumption you use. You pay for all the benefits that have been generated in the last hundred years or whatever.

MR. COGAN: That is, if you assume a static benefit, what we've observed from legislative bodies, as we've seen several times today, when plans get perceived to be overfunded, benefits get expanded. I would make the case that when you set too high of a discount rate or assumed rate of return on your assets, you're going to end up with a higher cost to the taxpayers because you're more likely to get an overfunded pension plan at some point in time, as you calculated, and the consequence of that is going to be expanded benefits. So I'm not sure that it's neutral with respect to the taxpayer once you account for very predictable behavior on the part of legislative bodies.

DR. SHOVEN: If the Governor -- you know, I don't think there's a huge disagreement. I think we know what the 5 percent means and what the 8 percent means. All I'm trying to suggest is sort of the risk inherent in our plan, as we're doing it.

If the State were to borrow a lot of money -- say, issue a huge bond issuance and pour some more money into a pool of these assets and say, "Wow, we're borrowing at 5 and we think we can get 8 with this pool of assets," well, first of all, if we were really sure of that, why wouldn't we do it? And then I think that's transparently risky. That's buying on margin. And it's transparently risky.

And what we're doing now has risk to it. It's kind of similar. You've got certain obligations. They're just as certain as if we had to pay off some bondholders. We've got to pay off these pension claimants. And we're financing it with a risky pool of assets.

You know, my own view is we should do -- we may want to continue to do this, but we should do it with our eyes open. We should expect that from time to time we're going to have to really -- that what we thought was fully funded will prove not to be fully funded.

CHAIR PARSKY: And we have to be cautious of what John was saying. I don't know how you build that into the system of caution with respect to how benefits are increased.

MR. COGAN: It also creates a -- when you have too high of a discount rate, it creates an incentive to engage in financing schemes like pension obligation bonds. They look a lot more attractive the higher the assumed rate of return on your assets. And you can really get yourself in a lot more financial trouble by making a very bad investment in a POB.

CHAIR PARSKY: Yes?

MR. HARD: It makes sense what you're saying -- to me, anyway. However, I thought we heard the Los Angeles County, the State of California talk about the length of time they have been operating. And whereas I certainly see this health-care issue which is, to me, very separate and a different problem, this increase seems to be steady, it doesn't seem -- you know, in the cost of 4 percent over a certain amount of time, and these plans seem to have tracked right along pretty well over a long period of time.

So I see your theoretical point of view. But in practicality and in history, it hasn't turned out to be a giant risk in the long run.

And then secondly, I'd like you to comment on the fact that the pay-out to retirees and dependents is annually, but these investments are, you know, actuarially projected for 30, 40 years. And since it appears to me, at least what I heard, that it's going along, and actually PERS was over their 2 percent -- you know, 10 percent instead of 8 percent -- it seems like you have a theoretical point of view, but it hasn't proved out in practice to be damaging to these pension funds at all. I mean, it seems that they're working.

DR. SHOVEN: So I guess what I would respond to that is that pretty much the same kind of thing I already have, namely, I don't think -- relative -- we heard somebody saying today that some of these pensions, they're providing for money that might be collected 60 years from now. A long time. 50, 40, 30. So I don't think a single stretch of 20 or 25 years of good performance necessarily means there's no risk.

If you were to look at the 20th century, when you were to look at just ten-year periods, and just the decades, well, at least two of the decades were pretty terrible, the 1930s and the 1970s. So that's two out of ten.

I mean, I just don't know what to make of the fact that things have been okay for 20 or 25 years. I don't believe you should conclude the risk isn't there.

CHAIR PARSKY: I think that's true.

Yes, Matt?

MR. BARGER: One thing I was surprised about in your testimony, the corporate plans discount their liabilities at their assumed investment rate. My understanding was that they used a liability rate. That FASB and GASB are different in that regard.

DR. SHOVEN: Yes, I don't want to -- the numbers, I think -- 8 and 7¾ are in the range that a lot of corporations are using.

MR. BARGER: For investment returns but not for discounting their liabilities.

DR. SHOVEN: You probably know more than I do on that.

DR. GHILARDUCCI: Yes, but PBGC requires that it be lower.

DR. SHOVEN: Okay, I back off my statement on that.

MR. BARGER: I'm not sure that that's right.

The thing that strikes me, sort of the point of this in terms of, you know, “Do you pay more now or more later” isn't -- you know, “If it's a liability, you have to pay no matter what and the State's always going to be there,” and it's really, “So what?” It's a little bit of a generational=transfer issue. It's whether I'm paying it or my children are paying it, to some degree, is what you're saying. And how do you determine sort of what the safe thing to do in that regard is. And that's sort of the question to me.

DR. SHOVEN: Well, that's a question of not necessarily what's a safe thing to do, but what's the ethical thing to do. It is almost of that nature.

MR. BARGER: Do you have a sense of what a sensitivity of 1 percent on a discount rate means in liabilities this long?

DR. SHOVEN: I have a sense, but not precisely. But let me give you the sense that I have.

These liabilities are fairly far in the future; right? So I don't know if the average duration might be 15 years in the future. So, obviously, you change the way you discount them, 1 percent, that's going to, roughly speak, change the present value by 15 percent. I'm not even doing fancy compounding. I'm just saying --

so it's a big multiple. A 1 percent change will change these numbers by, I would guess, 15 percent.

MR. LIPPS: Mr. Shoven, you've suggested a 5.5 percent discount rate. What would the probability of hitting that 5.5 percent be?

DR. SHOVEN: If you don't change the portfolio -- that is, if you continue to use this portfolio, which is a reasonable portfolio -- I don't have the exact number, but instead of having a 55 or so percent chance of not making the 8, you'd probably have a 30 percent chance of not making the 5.5. Even it would not be guaranteed. There's only one way to get 5.5 guaranteed, and that would be to buy safe bonds and put them in the portfolio.

Private equity may have had a good run for five or ten years and it may have an expected return of 15 percent, but it could easily be -15 percent as well. I mean, that's why it has these returns. So 5½ would not be a guaranteed return. You shouldn't think of it that way.

MR. LIPPS: Well, now, I wasn't thinking of it as a guaranteed return. I was just trying to get a sense, a perspective with respect to the 8 percent assumed return, or 7¾, since we're not going to quibble over quarters --

DR. SHOVEN: Right.

MR. LIPPS: -- being a 50-50 proposition.

What is the basis -- maybe I should back up.

It's not my sense that the actuaries have come up with a number like 8 percent as a safe return on investment. Usually they're pushing the envelope in terms of aggressiveness and riskiness when they set those kinds of actuarial rates. And I guess I would refer my fellow commissioners to, behind tab 5, if we take a look at the rate of returns from CalPERS, compared to the 7¾ percent assumed rate of return, and we can see that only four times since 1988-89 did it drop below the 7¾ percent. And each of those four times they still would have been below the 5½ percent also being recommended.

I don't know that it makes a big deal of difference except in terms of how much money we put up first as opposed to waiting -- because when do the taxpayers have to pay? They would have to pay if there was a prolonged downturn and now our pay-out was going to exceed our asset pool. That's sometime far in the future, I believe. So that's the purpose of smoothing and dealing with the fluctuations of the market.

DR. SHOVEN: You know, as I've tried to say repeatedly, personally I think history, since 1988 is a favorable history.

But one thing you might have in mind is, Social Security studied a great deal of various proposals for individual accounts, and so they had a lot of study about what would be a reasonable return on equities. And what they concluded is pretty much consistent with your analysis, around 6½ percent above inflation. But that's just for the equities. And you've got equities and bonds, and that's before expenses. So you're going to get from that to about your 4¾.

But my interpretation of these numbers is the average, or expected outcome. And they certainly have the right order of magnitude. They're consistent with that interpretation. And all I'm saying is these distributions are wide. So if that's your average outcome, that means there's a good chance you'll fall far short, and there's a good chance you'll end up with more.

CHAIR PARSKY: Go ahead.

MS. CONWAY: Just really quick. I'm a basic thinker --

MR. SHOVEN: Me, too.

MS. CONWAY: -- so this question may illuminate the unbasicness of my thought.

But I'm looking for your response to explaining the term "fully funded." Because in my world, with all these different plans, it's a whole lot of things. And we throw around "fully funded."

Is there a comparative -- in other words, if you're not funding your fund with pension-obligation bonds, are you more fully funded than someone who borrowed to fully fund their fund?

I don't know about that question. It's at the end of the day.

I don't know, did that make sense to anybody? Do you guys know what I'm saying? I mean because when we say “fully funded,” is there a universal definition of “fully funded,” or is it whoever is saying it is saying, “My plan is fully funded.” Well, how did it get fully funded?

DR. SHOVEN: I don't know if this is consistent with what you're saying, because if the government borrows money to get the money to put into the pension plan, the government as a whole isn't any better funded than they were at the beginning. That's just kind of a shell game.

The pension plan might be better funded but the taxpayers aren't in any better shape.

CHAIR PARSKY: Some people refer to some of that as off-balance sheet financing, but we'll leave that for another date.

DR. SHOVEN: Yes, strike the "shell game."

MR. BARGER: I think I can square this out a little bit on what you're talking about, which is I think the 5½ is -- or something like that -- is a very appropriate discount rate for the liabilities.

DR. SHOVEN: Right.

MR. BARGER: And then you have a decision about how much risk you want to take in your asset portfolio, basically. I mean, one thing is a liability you have to pay no matter what. It's, in a sense, just like debt. And then you have a set of assets you want to invest in. And that makes an assumption about what that might reasonably return and how much risk you want to take. And you might want to take even more risk. I mean, you can go out and leverage those portfolios as an example. There's nothing stopping you from doing that. You could earn more than 8 percent.

At some point, you're taking a big risk with sort of the future of whether or not, you know, that was a reasonable thing to do, whether the next 20 years are going to be horrendous and you've just stuck your children with a big bill. I mean, it's sort of weighing those two, I think, as the issue.

DR. SHOVEN: I associate myself completely with what Mr. Barger said. In fact, if you're just trying to get the present value of the liabilities, the certainty of those liabilities would suggest you should use a certain discount rate, which is going to get you to that of 5½. Then the question as he said is, well, how much money risk should we take on our assets? And what you've got is kind of a -- you know, 60/40, 70/30 kind of equities bonds, kind of a common mix. It's okay, but it's not certain, by any means.

CHAIR PARSKY: Thank you very much, John. We really appreciate it.

Okay, our last part of our presentation before dinner is Legislative History. And we will try to proceed through this efficiently.

MR. ELDER: Thank you, Mr. Chairman and Members.

In the interest of time, I'm going to shorten this up. This is already down from a 35-page report that I did some years ago. But I would just start off by saying that maybe defined benefit pension plans are rumored to be sick and not doing well. But since I left the Legislature and started working in business, I started my own defined benefit pension plan. And two years ago I put $142,000 in my DB plan. Last year, $102,000. And this year, I'm putting in $110,000. So I think they're doing famously well compared to what corporate America may be facing.

I think one of the things that PERS has going for it is, aside from the corporate side, you know, they're not -- most of the people are trying to do their best and there's no larceny involved, as opposed to some of the people who have retired with golden parachutes.

I’ve got some good news for all of you. The market closed up 283 points today so we may have solved this problem while we're sitting here.

In the interest of time, I'm going to go to page 3 -- I'm going to go to page 3, the middle of the paragraph, the middle of the page, starting with the California Teachers Association. That's the second paragraph, the middle of the paragraph.

The California teachers retirement system was started in 1913 and required a two dollar per month contribution for teachers and provided only a $500 annual benefit.

In 1931, CalPERS was started and provided a benefit of 1.43 percent per year at age 65. It is interesting that this benefit was higher than the 1.25 percent benefit at age 65 for the State's second tier started in 1984 in my AB 529. Obviously, these factors reflected the change in real salary levels and the fact that Social Security or Medicare did not exist in 1931.

An important factor, while not in the information I had reviewed, was the economic environment that existed in 1931. The Great Depression precipitated by the stock market crash of 1929 was probably an important motivation in providing some form of economic security for retirees and to encourage retirements to provide employment for new, younger workers.

The huge stock market losses of 1929, where millions of Americans' savings were wiped out, also caused the CalPERS enabling legislation to limit equity holdings on stocks to 25 percent, and it set up a separate trust account for pension assets.

This restriction was lifted in the early 1980s in favor of the prudent-person rule, which allowed CalPERS to reap huge returns that have propelled CalPERS from a $28.6 billion fund to one of over $240 billion today, after less than 20 years.

My legislation in the 1980s required that the real-estate portfolio must be praised annually and market to market, rather than held at book value, which had been the previous practice.

Last year, the real-estate portfolio at CalPERS showed a phenomenal return, but will not repeat that level of performance next year, according to Wilshire, CalPERS’ excellent investment advisor.

Taking a long view explains why the CalPERS system has evolved to behave as it has. I think it's safe to say that the benefits have been enhanced about as far as possible, barring the prospect of runaway inflation. What remains to be done is to focus on the total compensation package of California public employees rather than just their pension benefits so they can be compared to non-public employees.

In the private sector, we do not have sworn police officers with the authority to arrest. There are very few firefighters in the private sector, except in specialized areas like oil refineries. We do have professional teachers outside the public school system. And most non-teaching school-district employees have their counterparts in the private sector.

There are other problems with trying to compare compensation such as turnover rates. We are aware of the teacher nursing shortages that are very serious and getting worse. Prior to 1984, the average career for a correctional officer in California was four years, whereas today it has increased to 14 years. The current shortage of correctional officers, even with their one-year-old 3 percent-at-50 retirement formula is 4,000 positions. Despite the same 3 percent-at-50 formula for correctional officers and highway patrol officers, the 2007-2008 contribution rates are substantially different, at 25.5 percent for correctional officers versus 32.2 percent for highway patrol officers.

This difference is partially explained by the fact that correctional officers normally start working at age 30.3, versus 26.3 for highway patrol officers. The average retirement benefit for a correctional officer in 2006 was $47,639, and $62,360 for Highway Patrol officers, a difference of $14,721. And I think it's important to recognize that the highway patrol officers give us tickets.

If we look at some of the reasons defined benefit pensions exist today, we see that they're attributable to common values held by most Americans. I think there is a sincere desire by the public to recognize and reward the work of public safety officers, including our military, police, fire, correctional officers, that others perform to help protect our lives, property, and way of life.

This is particularly true following World War II. Also, there was a concern during and after the Great Depression to provide some measure of economic security to our senior citizens so they could retire and their jobs would go to younger workers rather than have them live with relatives, as my paternal grandmother did. Even more concerning was the prospect of living in old folks homes if no relatives were available or willing to take care of them.

Undoubtedly, of more importance today is the tremendous voting block seniors have become with their networking and high voter-participation rates. As people have begun to live longer, they plan and expect to eventually retire so they see the need for predictable income when they stop working.

Lastly, what may be viewed by some as governmental paternalism in providing pension benefits is really a recognition that otherwise the cost of caring for a potentially destitute and growing aged population will become the burden of government and, therefore, future taxpayers.

An example of what could happen to a large portion of our senior population comes from Jeremy Segal in one of his recent books. Professor Segal states that in order to have a 95 percent chance of stocks earning more than a savings passbook, you have to have your money invested for 19 years. Public employees' money is almost never invested that long, even in a 30-year career, in that it is typically deposited on a monthly basis and not all at once.

The problem of end-period dominance means some people's assets will be reduced dramatically just as they seek to retire. This is kind of like buying a life insurance policy from a company that only paid off 95 percent of its death claims.

Keep in mind that 5 percent of California's population is almost 2 million people.

Getting back to the current STRS funding problem requires a look at my bill in 1980. That measure originally called for the State to contribute 4.1 percent of teacher payroll to STRS each year, rather than the $500 million previously contributed, which is well short of what would put the system on a sound footing.

Governor Wilson asked that the State not make any contribution during the first year following the enactment of my measure because of State budget shortfalls. The Governor's amendment was incorporated into the bill, but I insisted that the State's contribution rate be increased from 4.1 percent to 4.2 percent of teacher payroll in order to pay off the unfunded liability in the same period. That measure also called for the State to increase its contribution by another quarter percent each year if 4.2 percent of payroll was insufficient to fully fund the system.

Since that time, teacher retirement benefits have been increased from 2 percent at 60 to 2.4 percent at age 63, or for members who have at least 30 years of service credit, not to exceed 2.4 percent per year. Also fixed-dollar increases were granted for teachers with 30 to 32 years of service ranging from $200 to $400 per month.

After these modest benefit increases became law, the State’s contribution was reduced from 4.2 percent to only 2.017 percent. And the teacher member contributions to STRS was reduced by 2 percent through the year 2010, with that money put into a separate defined benefit supplement program.

In short, benefits were increased slightly while contributions were dramatically reduced. These changes were made possible from spectacular stock market performance which eliminated the prior unfunded liability earlier than expected. These market gains were soon after reversed and that led to the current underfunded status of STRS.

The solution to the STRS funding shortfall can most easily be achieved by three relatively simple steps.

First, allow the 2 percent teacher employee contribution to the separate retirement account to sunset at the end of 2010, and start putting that 2 percent into the STRS fund where it was going before it was diverted to the separate account.

Second, retain the State's current contribution rate to avoid any future legal challenges.

Third, start raising the school district employer contribution by one-quarter percent per year until the fund is actuarially sound. If the STRS fund gets into an overfunded status, then the district's rate should be reduced by a quarter percent per year, until the overfunding is reduced to a level that preserves a prudent reserve.

By no means should teacher retirement benefits be reduced since the 2 percent in 60 formula is lower than they have of the overwhelming majority of California public employees.

Also, any suggestion that teacher member total contributions be raised above the current 8 percent level is an obscene idea, since school employees who are in the CalPERS system contribute 7 percent for a 2 percent at 55 formula. In other words, the janitors, bus drivers, school secretaries and other non-teaching employees have a better pension than teachers.

Non-teaching school district employees are also in the Social Security system. School districts in California are paying 9.306 percent of payroll to CalPERS, plus 7.65 percent for Social Security and

Medicare, for a total of 16.956 percent for non-teaching employees.

School districts and the State of California are paying 8.25 percent; and 2.017, respectively, CalSTRS; plus 1.45 for Medicare, for a total of 11.717 percent. Therefore, school districts are paying over 5 percent more in payroll costs for non-teachers than the State and school districts are paying for teacher retirement costs.

A simple way for school districts to pay the extra STRS costs would be require new-hire non-teaching school employees to go into a 2 percent of 60 retirement formula, which in the past ranged from 3 to 9 percent lower employer contribution than the current 2 percent at 55 formula.

Another approach that may be more palatable to the California School Employees Association would be to allow non-teaching school district employees to join the State Teachers' Retirement System, and have the districts pay the State's 2 percent contribution to STRS. The savings to the districts that voted to join STRS would be about 3 percent of payroll, with a 5 percent savings for a school district non-teaching employees.

These are some of my observations regarding California's public pensions and a few of my recommendations to secure the unfunded status of the State Teachers' Retirement System.

It's been my pleasure to share my thoughts on this important area of public policy.

I would be pleased to answer any questions you have concerning my presentation or public pensions in general.

CHAIR PARSKY: Thank you, Dave, very much.

MR. ELDER: I tried to get through that as quickly as possible.

CHAIR PARSKY: I appreciate your going through it quickly. It took a lot of effort to put it together, so we appreciate it.

Any questions for Dave?

Yes, Dave?

MR. LOW: I know it's late. We were doing so well until you got to the end here, David.

So let me get this straight. Because the State reduced its contribution rate for teachers' pensions, and they don't have as good a formula, the solution is for classified school employees. My four-hour food-service workers who is making 12 bucks an hour and retiring with a very minimal pension, to reduce their pension benefits and pay for the teachers, is that your solution?

MR. ELDER: Well, I might point out that these are part-time workers. It's not a career position. They have an average of 16.4 years of service. They start working at age 40. This is not like a teacher that starts at 23, works until 63 to get a 2.4 percent retirement benefit. I don't think that they're all comparable. I mean, why don't we just pay everybody the same amount of money?

MR. LOW: That's a better solution than me.

Go tell my members that they're career workers. Go tell the custodians and the folks that are working 30, 40 years.

MR. ELDER: Well, it is an average of 16.5 years. PERS says they were 16.5 years.

MR. LOW: 16.5 is an average, which means that -- and because of your food service worker working four hours, you need to work two years to get one year of service credit. So if you get 16.5 years, you've got to work 33 years in a cafeteria to get 16.5 years. I just think your proposal is insulting.

MR. ELDER: Well, I mean, 2 percent at 60 with Social Security is more than an adequate pension. I mean, pardon me, the teachers don't have Social Security.

MR. LOW: And that's the classified employees' fault, so they should pay for it.

MR. ELDER: No, I'm just saying, resources are scarce, decisions have to be made. The funding solution for the State Teachers’ Retirement System in no way involves the non-teaching employees.

MR. LOW: Correct. So why are we being asked to pay for the solution?

MR. ELDER: You're not.

And what I suggested was that the 2 percent that is devoted go back to STRS, the State's contribution be held level, because we've got to get a signature from a governor; and the third part is that the District's contribution be raised a quarter of a percent per year, until the fund is actuarially sound. It has no effect on non-teaching employees.

My comparison is that -- I don't think it's fair that teachers have a 2 percent at 60 formula, whereas non-teachers have a 2 percent at 55 formula. The retirement costs are 5 percent greater to the school district for non-teaching employees. I just think that that needs to be said -- you know, get a little sunshine on it. That's just my observation of looking at this thing over a great many number of years.

I would close with something that I -- not to change the subject, but this has been fascinating -- what I would suggest, that I heard today, is that public pension funds operate on about 30 basis points. My research shows that in the 2005 fiscal year, that it was about 128 basis points at PERS. And that is a significant difference.

I think if we look at 2006, the number is going to be somewhere around 85 basis points. So it's substantially a more expensive public employee system. So something that has a cap on the total number of basis-point charges for running a pension system might be a good idea.

MR. LIPPS: Mr. Elder, first of all, I agree with all of the things that Mr. Low has said.

I would also like to point out the school classified employees that work 4 or 4¾ hours per day, generally speaking, would like to be full-time workers and get full-time service credit, but they're generally held below the 4¾ hour threshold level, so that they will not qualify for even partial medical benefits; unlike the teachers who, generally speaking, will qualify with 50 percent credit.

MR. ELDER: Well, they do have Medicare.

CHAIR PARSKY: Teresa?

DR. GHILARDUCCI: I have a hypothesis but would like some data; and facts would change my mind.

I would like to know this in terms of the history of the way benefits are decided, that it seems as though when the funds are well-funded, when there's good investment returns, that there is a tendency to want to improve benefits. We've formulated this hypothesis. I’ve seen this in multi-employer plans.

MR. ELDER: That's particularly true when there's no money.

DR. GHILARDUCCI: Sure. We heard this from San Diego.

MR. ELDER: In other words, when you enhance the retirement benefit, you push those costs into the retirement system, and they're funded over 30 years.

DR. GHILARDUCCI: I know, but I have another part of the question.

Is it also true when the funds are not well-funded, measured, when they're less than 100 percent funded, that there is a tendency not to improve benefits?

MR. ELDER: That's correct.

DR. GHILARDUCCI: So there's this kind of symmetry behavior there?

MR. ELDER: Right. When you look at it over time, what will happen is that -- there was a period of time the State workers didn't get a raise for five years.

DR. GHILARDUCCI: They hold them constant. They don't cut them. So it's not --

MR. ELDER: State workers didn't get a raise for a five-year period.

DR. GHILARDUCCI: Right.

MR. ELDER: So I mean that has an impact.

DR. GHILARDUCCI: Yes, yes.

CHAIR PARSKY: Dave, thank you very much.

And I had a 45-minute presentation I was going to make now. But given the time, I want to thank everybody very much. It was a very full agenda. It's very important that we try to get through all of these subjects. And we're going to meet again on July 27th.

Thank you all very much.

(Proceedings concluded at 5:10 p.m.)

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REPORTER'S CERTIFICATE

I hereby certify that the foregoing proceedings were duly reported by me at the time and place herein specified;

That the testimony of said witnesses was reported by me, a duly certified shorthand reporter and a disinterested person, and was thereafter transcribed into typewriting.

I further certify that I am not of counsel or attorney for either or any of the parties to said deposition, nor in any way interested in the outcome of the cause named in said caption.

IN WITNESS WHEREOF, I have hereunto set my hand on the 17th day of July 2007.

DANIEL P. FELDHAUS
California CSR #6949
Registered Diplomate Reporter
Certified Realtime Reporter