MEMORANDUM RANCHO PALOS VERDES

TO: CITY COUNCIL

FROM: MAYOR TOM LONG AND COUNCILMAN STEFAN WOLOWICZ, PENSION REVISION SUBCOMMITTEE

DATE: SEPTEMBER 6, 2011

SUBJECT: PENSION REVISION

RECOMMENDATION

Approve the recommendations made by Management Partners, Inc./City Council Pension Revision Subcommittee regarding revisions to the City's pension program for current employees and new hires, and provide further direction to staff.

DISCUSSION

The City engaged Management Partners to provide an objective look at pension benefits provided in the California local government setting and to identify what options are available to modify the City's current retirement system for greater sustainability, while continuing to meet service demands in the most efficient and effective manner possible. Working with the City Council Pension Revision Subcommittee to identify parameters, the consultant reviewed and analyzed City staff's assumptions and calculations; surveyed competitor cities' retirement benefit plans; researched pensions modifications being considered by CalPERS, the State Legislature and public agencies throughout the state; and researched retirement laws and regulations. The results and the consultant's/subcommittee's recommendations are presented for the City Council's consideration in the attached white paper.

Attachment:

Rancho Palos Verdes Pension Revision White Paper, Management Partners Inc., August 2011

Rancho Palos Verdes
Pension Revision White Paper

August 2011

Management Partners
Incorporated

MANAGEMENT PARTNERS
INCORPORATED

August 31, 2011

Ms. Carolyn Lehr
City Manager
City of Rancho Palos Verdes
30940 Hawthorne Boulevard
Rancho Palos Verdes, CA 90275

Dear Carolyn:

Management Partners is pleased to transmit a draft of the Pension Reform White Paper for the City of Rancho Palos Verdes. In developing this paper we met with the City Council Pension Revision Subcommittee; reviewed and analyzed City staff's assumptions and calculations; surveyed competitor cities' retirement benefit plans; researched pension modifications being considered by CalPERS, the State Legislature and public agencies throughout the state; and researched retirement laws and regulations. These efforts were undertaken to determine:

1. What options are available for the City?
2. What options would the City be precluded from pursuing either on legal, technical or practical grounds?
3. What are the grey areas and uncertainties that must be confronted as the public pension environment shifts?

This paper answers these questions and should help City decision-makers to approach the discussion about what, if any, changes to propose in the current retirement system armed with full information about the state of the industry with respect to such programs. This paper also provides options and recommendations to allow the decision makers to determine what direction will best position the City of Rancho Palos Verdes to continue meeting service demands in the most efficient and effective way possible.

Sincerely,

Andrew S. Belknap
Regional Vice President

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Introduction

The City of Rancho Palos Verdes (RPV) engaged Management Partners to provide an objective look at pension benefits provided in the California local government setting. This was undertaken with a focus on how plans are being modified to be fiscally sustainable over the long term in the current economic environment while still providing competitive and reasonable benefits so cities can recruit and retain the experienced staff they require. Management Partners has reviewed changes being considered by some jurisdictions such as the San Jose ballot measure. We have also reviewed and considered the changes proposed by the Californians for Fiscal Responsibility initiative as well as other initiatives and changes proposed by and being considered by the Legislators. Management Partners does not consider these potential changes as viable to Rancho Palos Verdes at this time. These changes are likely to face legal challenges and lead to prolonged and costly litigation. Additionally, many of the changes require legislative action and/or changes in the law or the State constitution. These changes are not available to Rancho Palos Verdes at this time and, therefore, are not included in the recommendations section of this paper. Should any of these changes survive the legislative process and subsequent litigation and be found legal, the City retains the option of adopting them at that time while avoiding the cost of litigation.

Most cities in California contract with the California Public Employee Retirement System (CalPERS) for the provision of pension benefits and it is one of the largest such organizations in the world. Currently CalPERS serves 284 public agencies and has about 1.6 million members who are public employees, retirees or beneficiaries. It manages approximately $1.7 billion in assets.

The costs associated with providing pension benefits through CalPERS have climbed substantially in the last several years. This is due to losses sustained in agency investments (such as stock market losses) and enhancements granted in pension programs, primarily in the late 1990s and the early 2000s. The most often cited enhancement was the creation of a "3% at 50" program for public safety workers that can result in a pension equal to about 90% of final compensation after a normal 30-year working career. As a result, CalPERS has had to increase payments demanded of its contract agencies, particularly those agencies that have adopted enhanced plans.

Increased payments are being demanded just as the resources available to local governments have suffered severe setbacks. As a result, cities have had to reduce expenditures and services to fund increasing pension costs. This takes place against a backdrop of great economic uncertainty and in an era in which defined benefit plans such as CalPERS have largely vanished from the private sector. Instead, defined contribution plans have become more commonplace. They typically pay a lower benefit and have much greater uncertainty than defined benefit programs. Rancho Palos Verdes has not suffered revenue declines, does not have responsibility for funding public safety pensions, and has not yet had to reduce services to deliver pension benefits. Nonetheless, the city council has sought to modify pensions to assure that Rancho Palos Verdes avoids financial difficulties in the future and to stabilize pension costs as a percentage of payroll.

As a result of pension cost increases, Rancho Palos Verdes, like many other cities, is looking at options for changing existing CalPERS pension benefits. A number of California cities have already introduced lower benefit plans for new workers and raised contribution levels for existing employees.

Rancho Palos Verdes is seeking a retirement plan that is sustainable in the long term. In this case, sustainable is defined as a pension structure with predictable expenditures that are generally a flat percentage of payroll and that are both economical to the City and beneficial to employees. The inability to achieve a sustainable pension structure may result in the need to divert an increasing amount of general fund dollars to pay for retirement benefits. This would require a reduction in City payroll through a reduction in the number of City employees, the elimination of City programs and/or a general reduction in the quality, frequency and number of services provided to the public. The City is understandably concerned about costs, while also conscious of the fact that it needs to remain an employer that can recruit and retain employees in the public employee labor market.

To develop options for the City, the Pension Revision Subcommittee needs a solid analysis of basic facts regarding pension issues. This white paper was created to examine the following issues:

1. What options are available for the City?
2. What options would the City be precluded from pursuing either on legal, technical or practical grounds?
3. What are the grey areas and uncertainties that must be confronted as the public pension environment shifts?

The paper objectively presents the current public pension environment and reform efforts, City pension assumptions, information about how peer organizations structure their plans, and finally, alternatives and recommendations for Rancho Palos Verdes leaders to consider.

Parameters

At the start of this engagement the City's Pension Revision Subcommittee established the following parameters to be used when evaluating alternatives for pension structure changes.

- Long term sustainability. The City is seeking to modify pensions to assure that Rancho Palos Verdes avoids financial difficulties in the future by ensuring that pension expenditures become a predictable and generally flat percentage of payroll and that the pension system remains economical to the City and beneficial to the employees.
- Maintain the ability to attract and retain quality employees. To continue to utilize high-quality staff to provide excellent service to residents, it is important for the City to provide a pension system that is competitive with other jurisdictions competing for the same employees.
- Avoid significant litigation risk. Litigation is costly and lengthy and the City does not wish to incur unwarranted costs in reforming its pension plan. Once the courts have made rulings on litigation over changes made by other jurisdictions, and/or if the State Legislature enacts changes that provide more options for pension reform, the City has the ability to adopt those changes determined to be legal and desirable.
- Provide protection against any possible retirement spiking. The City wishes to preclude the actuality of pension spiking but also any appearance or perception of spiking.
- Maintain the City's non-participation status with respect to Social Security. Social Security is intended to be a safety net by redistributing wealth and is neither economical nor cost-effective as a means of delivering pension benefits to a primarily professional workforce such as that the City employs. It provides

far less value for its cost than is provided by pension benefits. The City wishes to maximize the use of its funds and provide a superior benefit for employees.

Distinction Between Defined Benefit and Defined Contribution

Two basic categories of retirement plans exist: defined benefit plans and defined contribution plans. A *defined benefit* plan is a guaranteed annual pension (benefit) based on retirement age, years of service and salary. The employer contribution is a variable amount actuarially determined as sufficient to provide the guaranteed benefit. A *defined contribution* plan is one in which the employer contribution is a fixed amount. The benefit is a variable based on investment earnings from the fixed contribution offset by expenses. If the City wished to move from a defined benefit (DB) plan to a defined contribution (DC) plan, the following issues would need to be carefully weighed.

First, a defined contribution plan is not available within CalPERS; therefore, the City would have to establish its own defined contribution plan outside of CalPERS. Such plans have their own costs, including administration costs. The City of Irvine had a DC plan several years ago, but they moved into CalPERS in the early 2000s after determining that it was less costly and less burdensome.

The City of Rancho Palos Verdes originally contracted with CalPERS and remains with them due, in part, to legislative rules in terms of the State Constitution and Government Code that make alternatives not feasible.

The cost of leaving CalPERS is substantial. The City would be required to pay an amount to CalPERS to fund its liability for retirees. The amount of this liability charge would have to be negotiated with CalPERS and would include possible later increases in liability because of reciprocity affecting final average compensation of future retirees. Although it is not possible to estimate this cost without a full actuarial study, the cost potentially would be large. In essence, the City would be selling its share of CalPERS assets at a bad time to do so. Other termination costs would also apply.

A related issue is whether the City could remain in CalPERS for current employees but exclude future employees and, instead, put them in a separate, defined contribution plan. We are unaware of any jurisdictions that have done this. Aside from the administrative cost issues related to offering a defined contribution plan discussed above, CalPERS has stated informally, that its position is that agencies cannot keep current employees in CalPERS while excluding new hires. Management Partners' reading of the City's contract with CalPERS is that it prohibits any such exclusion of new employees.

Sections 20502 and 20303 of the Government Code appear to support the ability of an agency to exclude new employees from CalPERS. However, CalPERS would probably challenge such an exclusion and, given the City's stated desire to avoid costly litigation, we do not recommend that the City take this path.

Given the current legislation and lack of alternatives, Management Partners believes the costs and risks associated with moving from a defined benefit to a defined contribution plan far outweigh any potential benefits. We recommend that the City reform its defined benefit plan at this time and retain the option of moving to a defined contribution plan in the future if economic conditions, the job market and legislative changes provide a more sound basis for such a move.

Background

Retirement Benefits in the Local Government Sector

The California Public Employees Retirement System began operation in 1932 as the retirement system for state employees. In 1941, CalPERS first began contracting with public agencies and school districts. CalPERS is the largest public pension fund in the country with over $217 billion in assets. As of June 30, 2010, 1,568 agencies with 1.6 million members contracted with CalPERS.

Public sector agencies in California have historically packaged relatively modest compensation with more generous benefits, including a defined benefit pension program. This was partially in recognition of the fact that local government employees were not initially covered by Social Security; many are still not covered - including those in Rancho Palos Verdes. Since public sector employees obtained the right to collectively bargain in the 1970s compensation has become more competitive with private sector levels.

Private industry has the choice of multiple pension administrators and investment advisors to provide pension and investment services. These alternatives are not financially feasible for California municipalities the size of Rancho Palos Verdes.

General law cities and counties almost universally contract with CalPERS for their retirement system. Based on CalPERS' statistics it appears that approximately 85% of California cities are covered by this system. Some charter cities and counties maintain their own retirement systems but this is practical only for large cities and counties. To maintain its own retirement system, an agency must establish a treasurer function and must have the staffing and ability to invest funds to maximize returns. Setting up and establishing investment systems is cost-prohibitive and inefficient for small agencies. Agencies which elect to leave CalPERS are required to pay significant termination costs to cover future retirement cost liabilities.

Most local government executives serve with multiple agencies during their careers. It is, therefore, important to have the availability of reciprocity (portability), provided by CalPERS for members who move from one agency to another.

Rancho Palos Verdes' Retirement Plan History

The retirement plan provided to employees of Rancho Palos Verdes has changed twice since the City first incorporated in 1974. The chronology of the plan changes follows:

- On December 1, 1974, the City of Ranchos Palos Verdes established a 2% @ 60 retirement formula based on three-year average final compensation
- On April 21, 2001, the City changed to the 2% @ 55 formula and went to the single highest year final compensation.
- On September 29, 2007, the City changed to the 2.5% @ 55 formula while maintaining single highest year final compensation.

The decisions to enhance the retirement formula in 2001 and 2007 were based on surveys of cities' benefits with whom Rancho Palos Verdes competed for talent. The changes were made to ensure that Rancho Palos Verdes was able to attract and retain high-quality staff. Due to the downturn in the economy as well as pension reductions made by competitor cities, it is not currently necessary to offer the existing retirement formula to attract and retain high-quality staff.

Chronology of Rancho Palos Verdes' Pension Revision Subcommittee Activities

On November 4, 2010, Councilmember Steven Wolowicz presented a memorandum on Pension Revision to the City Council, recommending that the Council appoint a two-member subcommittee to work with City staff to select a consulting firm to analyze and make recommendations for a new retirement plan. Councilman Steven Wolowicz and Mayor Tom Long were appointed to the subcommittee.

On November 30, 2010, the Mayor and City Council members participated in a Pension Workshop facilitated by CalPERS Senior Actuary Kung-Pei Hwang and retirement plan consultant John Bartel.

On December 7, 2010, the subcommittee presented its first report to the City Council (see Appendix A).

On January 18, 2011, Bartel Associates, LLC submitted a report on the City's CalPERS Unfunded Actuarial Accrued Liability (UAAL).

On June 7, 2011, the subcommittee presented its second report (see Appendix B).

On June 17, 2011, Finance & IT Director Dennis McLean and Human Resources Manager Eric Mausser presented a memorandum to the subcommittee providing an update on the request for qualifications (RFQ) and proposals for an independent retirement plan consultant to analyze possible alternatives of the City's existing pension plan.

On July 1, 2011, the subcommittee presented its third report to the City Council (see Appendix C).

Management Partners has reviewed and researched the preliminary findings of the subcommittee and have had those findings reviewed by an attorney experienced in public pension law. We have determined that these preliminary findings are valid and realistic. The California Constitution and the regulations of CalPERS greatly limit the alternatives available to public sector agencies in terms of pension benefit options. The options that are available as well as various efforts by public agencies and the legislature to increase those options through legislative proposals, initiatives and ballot measures are discussed in detail in below.

Revision Efforts

Some local agencies have established a second tier of benefits for new employees and greater cost-sharing by current employees. Both approaches are possible through CalPERS. There is some movement in Charter cities to amend basic parameters in pension plans even for existing employees, but there is great uncertainty about the question of vested rights.

The City of San Jose is currently considering a Charter change that would overhaul pensions for future as well as current employees. However, for local agency members of CalPERS, reform options are limited absent state legislation. Any more significant change must, therefore occur at the state level through the legislature or through the initiative process in order to allow greater flexibility to those agencies contracting with CalPERS.

The following sections present current efforts to affect change for public sector pension options.

City of San Jose Ballot Measure

On May 13, 2011, Mayor Chuck Reed, Vice Mayor Madison Nguyen and Councilmembers Rose Herrera and Sam Licardo placed presented an agenda item to the City Council recommending that the City: 1) declare a fiscal and public safety emergency, and 2) amend the City Charter to limit retirement benefits and require voter approval of increases in retirement benefits. The specific recommendations were as follows:

- For new employees, absent voter approval for enhancements or increases, limit retirement benefits to a hybrid plan that may consist of social security, defined benefits or defined contributions with maximum City contributions in total being not less than 6.2% or greater than 9% of base salary or 50% of the costs of the benefits whichever is less.
- For existing employees, without voter approval of enhancements or increases, limit retirement benefits as follows:

- Benefits earned and accrued to date would not be reduced but additional pension benefits shall accrue at a maximum rate of 1.5% per year of service.
- The age of eligibility for service retirement would be increased by six months annually on July 1 until the retirement age reaches the age of 60 for police officers and 65 for all other employees.

- For existing and future retirees, without voter approval of enhancements or increases, institute the following changes:
  - Limit increases in pension payments to retirees to the increase in the Bay Area CPI, not to exceed 1% per year.
  - Allow bonuses or other supplemental payments only to long term service retirees or disability retirees whose household income falls below the poverty level.
- Place additional limitations on growth in retirement benefits if the fiscal and public safety emergency gets worse.

Four legislators asked the Office of State Attorney General to review the San Jose emergency proposal. The response was that "unilateral impairment" of any contract "causes us deep concern." This phrase indicates that legal action would be taken against the City of San Jose in response to this proposal. Rancho Palos Verdes and similar cities cannot ignore such expected litigation costs.

Californians for Fiscal Responsibility Initiative

The Pension Revision Subcommittee requested that Management Partners identify the provisions of the Fair and Sensible Public Employee Retirement Plan Reform Act. This initiative is sponsored by the nonprofit organization Californians for Fiscal Responsibility. The stated provisions of the Fair and Sensible Public Employee Retirement Plan Reform Act are as follows:

- Aligns state and local government retirement benefits with those offered by the federal government and large private employers.
  - Employees hired after July1, 2013 are eligible for a defined contribution (DC) plan.
  - Defined benefit (DB) pension for new employees will not exceed the plan offered to federal workers on July1, 2011 (1.1% of highest three-year average at age 62 multiplied by years of service).
  - Qualifying compensation will not exceed 75% of taxable social security wages.

- o Defined benefits are payable when employees reach the retirement age established by Social Security (currently age 62).
  - o Employees not covered by Social Security shall be provided with a supplemental defined benefit equivalent of social security.
- Public employees and taxpayers share costs.
  - o Current and future employees pay half the cost of pension and retiree health benefits.
  - o Defined benefits shall be based on an average of three years of qualifying compensation which excludes overtime, sick, vacation, bonuses and severance.
  - o Retroactive benefit increases are prohibited.
  - o New employees may not receive lifetime medical benefits prior to age 65.
- Improves efficiencies in benefit delivery.
  - o Disability benefits are provided by a joint powers authority, self-insurance or private companies.
  - o Public employers shall provide competitive life insurance and disability benefits integrated with retirement benefits and other insurance.
  - o Public employees may opt out of their retiree health plan.
- Improves governance and accountability of public pension plans.
  - o Two-thirds of a public pension plan's governing trustees shall be independent of the retirement system and two-thirds of independent trustees shall be certified or licensed financial, actuarial, accounting, legal, benefits or investment professionals.

State Legislature Bills

The unsustainable reality of current pension systems and associated liability has resulted in numerous efforts by the legislature at reform. In 2010, two bills, AB 194 and AB 827 were passed by the Legislature but then vetoed by the Governor.

AB 194 would have limited the maximum salary upon which retirement benefits are based to no more than 125% of the salary recommended by the California Citizens Compensation Committee for the position of Governor. AB 827 would have prohibited an employment contract for a local excluded employee from including any clause that provides for an automatic renewal, an automatic compensation increase, or an automatic compensation increase in excess of a cost-of-living adjustment. The bill would also have required local agencies to complete a performance review for any excluded employee before an increase in compensation in excess of a cost-of-living adjustment may be implemented for that individual.

So far in 2011, a number of Assembly Bills and Senate Bills have been proposed that would make significant changes to pension structures. The fate of these bills remains to be seen. Among these bills are:

- AB 344, which would place limits on final compensation and on post-retirement employment.
- AB 646 which would prohibit a public agency from implementing its last, best and final offer in bargaining until at least 10 days after a fact finders' written findings of fact and recommended terms of settlement have been submitted to the parties and the agency has held a public hearing regarding the impasse.
- AB 875, which would prohibit public employees first hired on or after January 1, 2012 from using credit for accrued leave or overtime for purposes of determining final compensation.
- AB 961, which would exclude matters relating to pension benefits from the scope of representation of public employees, thereby prohibiting employee organizations from negotiating pension benefits with public employers.
- AB 1184, which would require the contracting agency from which a non-represented CalPERS member retires to pay that portion of the liability for creditable service performed for a prior contracting agency that exceeds 115% of the last salary paid by that agency. It would also prohibit contracting agencies from establishing their own plans for individuals that first become CalPERS members on or after January 1, 2013.
- AB 1248, which would require a local public employer to provide coverage under the federal Social Security system to all employees who are not covered by a defined benefit plan.
- AB 1320, which would establish a Taxpayer Adverse Risk Prevention Account for each CalPERS employer whose assets would be invested with other CalPERS assets and be available to pay employer retirement contributions that exceed the normal cost of benefits.
- SB 27, which would provide that any change in salary, compensation or remuneration principally for the purpose of enhancing the benefits of a member (known as spiking) would not be included in the calculation of the member's final compensation. It would also prohibit any member who retires on or after January

1, 2013 from performing services for any employer covered by their retirement system for 180 days.

- SB 520, which would require CalPERS to establish a hybrid retirement plan for public employees who become members on or after January 1, 2013 and would prohibit those plans from creating a vested property right for members with respect to any employer contributions before retirement.
- SB 526, which would specify for employees hired on or after January 1, 2013 that final compensation means the highest annual average compensation earnable during a consecutive 36-month period of membership. The bill would also prohibit the addition of compensation for accrued leave or overtime work in the calculation of final compensation.

Initiative process

In addition to the bills moving through the Assembly and State Senate, there is a state initiative called the "Public Employee Pension Reform Act" (Initiative 11-0007) that would change the State Constitution and:

- Set the retirement age at 62 for current and new employees.
- Limit pensions to 60% of a three-year average salary.
- Require employees to match public agency retirement contributions.
- Allow public agencies to modify pensions.
- Prevent pension changes through collective bargaining.

CalPERS Position on Reform Efforts

In July 2011, CalPERS issued a paper titled *Vested Rights of CalPERS Members* (included as Appendix D). The document states:.

- A public employee's right to the retirement benefits earned during employment is generally a vested right.
- Public employee retirement benefits are contractual obligations entitled to the protection of the "Contract Clause" of the State Constitution as well as provisions of the Federal Constitution forbidding the impairment of contracts.
- Promised benefits may be increased during employment but not decreased, absent the employee's consent.
- The courts have established that this rule prevents not only a reduction in the benefits that have already been earned, but also a reduction in the benefits that a member is eligible to earn during

future service. This statement is particularly pertinent to the San Jose ballot measure.

- Employees to be hired in the future do not have vested rights to any particular retirement benefits and there is no constitutional impediment to unilaterally reducing (or even eliminating) retirement benefits for new hires.
- Some employers may choose to pay a portion or all of the retirement contributions otherwise required of their employees. These payments typically are negotiated during collective bargaining and the law provides that the employer may "periodically increase, reduce, or eliminate" such payments.

This paper suggests that CalPERS would go to court to protect the rights of its members as outlined above.

Rancho Palos Verdes Data and Assumptions

The following section of this white paper presents key data elements and assumptions that contribute to retirement cost projections.

Turnover Rate

Rancho Palos Verdes staff assumes a turnover of two employees per year. For the period of January 1, 2005 through April 30, 2011, turnover averaged 2.8 employees per year. This equates to an average annual turnover rate of 5%. This calculation does not include two employees who were laid off during that period.

A 5% turnover rate projection is conservative as turnover will probably increase when the economy improves. Additionally, a number of City staff members are approaching retirement age which could also accelerate the rate of turnover. As of this writing, City staff are re-calculating a range of projected savings, using a low of two employees leaving per year and a high of five leaving per year. Higher turnover will result in additional savings for the City as current employees under the 2.5% @ 55 formula are replaced by new employees with a different retirement tier (with a lower formula).

Salary Increases

Rancho Palos Verdes staff assumed annual salary rate increases of 3% based on historical data (2.8% annual cost of living adjustment [COLA] increases and 2.2% merit increases). Even though salary increases may average less than 3% over the next six years, we are using that projection as Management Partners does not want to overstate the savings which will be higher if salary increases average less than 3%.

Projected Savings

If the City were to grant a one-time 5% pay increase in exchange for employees paying the full 8% employer retirement contribution (instead of paying 1.5% as they currently do), and establish a 2nd tier with a

2%@60 formula and three year average compensation basis for new employees, projected savings from current pension costs would range between approximately $81,000 and $98,000 in year one based upon a turnover rate of 5% and 7%, with increased savings each subsequent year rising to approximately $347,000 to $478,000 in year six. Therefore, the total pension savings over the initial six years would range between $1.2 million and $1.6 million. Savings calculations based on lower average salary increases and/or higher turnover will increase these projected savings.

Employee Retention

An unintended consequence of the 2.5% @ 55 plan is that by having the retirement formula top out at age 55, employees do not have an incentive to remain employed beyond age 55 even though they may still have much to contribute. In fact, many public employees, after reaching age 55 and retiring from a public agency, continue to work for another employer or become self-employed.

The 2% @ 55 and 2% @ 60 formulas both reach their maximum percentage (2.418%) at age 63. Under both of these formulas, employees have an incentive to remain with the public agency beyond age 55 and up to the more realistic retirement age of 63.

CalPERS Contribution Projections

Under the current 2.5% @ 55 formula with single highest year compensation basis, and assuming an ongoing investment returns of 7.75%, CalPERS projects the following employer contribution rates for the next five years:

- 2012/13 - 13.8%
- 2013/14 - 15.5%
- 2014/15 - 15.8%
- 2015/16 - 16.1%
- 2016/17 - 16.4%

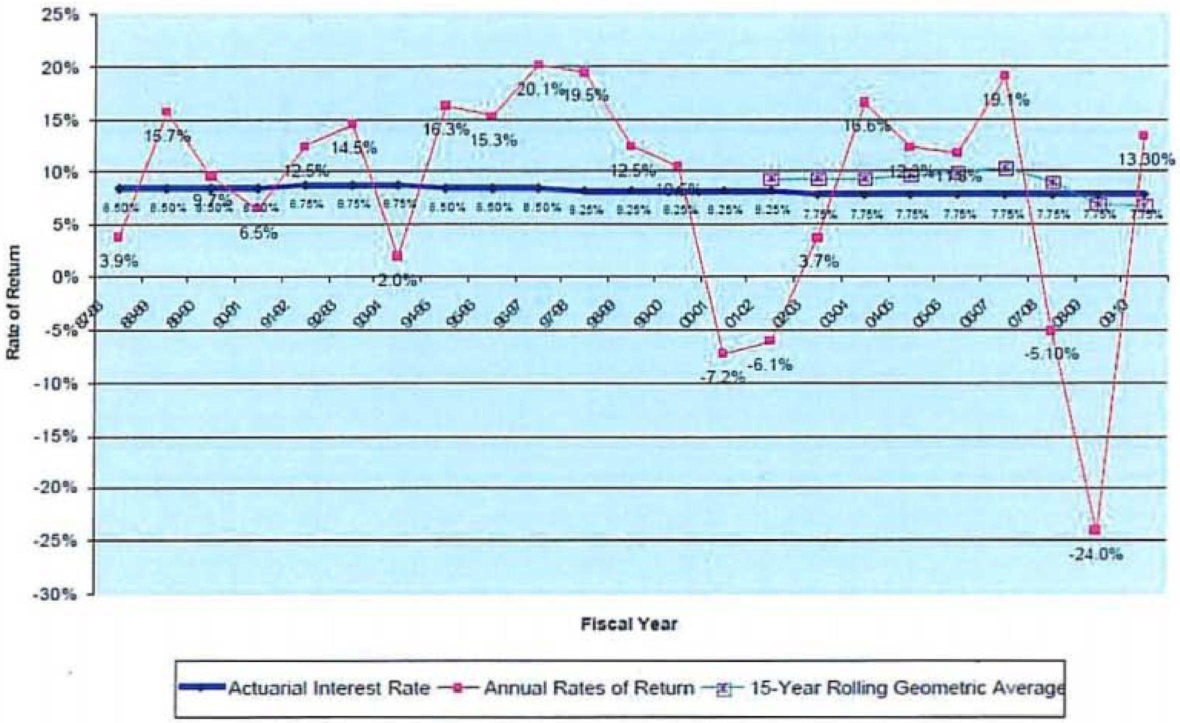
These increases are not sustainable as defined by the subcommittee. The rate increases can be mitigated by moving to a second tier for new hires, as illustrated in Table 1. CalPERS provided the following rates for new hires under three retirement plan scenarios.

Table 1. CalPERS Rates under Various Scenarios

Fiscal Year	2.5%@55 1-year	2%@55 3-year	2%@60 3-year
2010/11	10.263%	8.475%	6.755%
2011/12	13.353%	9.539%	7.733%

Figure 1 shows CalPERS' historical investment returns.

Figure 1. CalPERS Investment Returns[1]



[1] *Source: Actuarial Presentation for the City of Rancho Palos Verdes by Kung-pei Hwang, CalPERS Senior Pension Actuary, 11/20/10*

Observations and Options

It is neither practical nor feasible for the City to move out of the CalPERS retirement system and into another system. Rancho Palos Verdes is a General Law City rather than a Charter City. This alone severely limits retirement system options. Even if the City could move out of CalPERS, there are no practical alternatives for a small city such as RPV. Additionally, in order to move out of CalPERS, the City would have to pay a large "termination fee" to cover liability for future retirees, pursuant to the existing agreement with CalPERS. This is something the City cannot unilaterally change. Given the realities of remaining within the CalPERS system we looked at the options that are available to the City within CalPERS.

There are three primary factors that determine the City's retirement costs:

- Type of retirement formula offered to employees,
- Final compensation basis that is used for benefit calculations, and
- Any portion of the employer retirement contribution that is paid by the City (referred to as employer-paid member contributions [EPMC]).

An additional factor that may impact costs is whether employees have the ability to increase the compensation basis during their final year(s) of service ("retirement spiking").

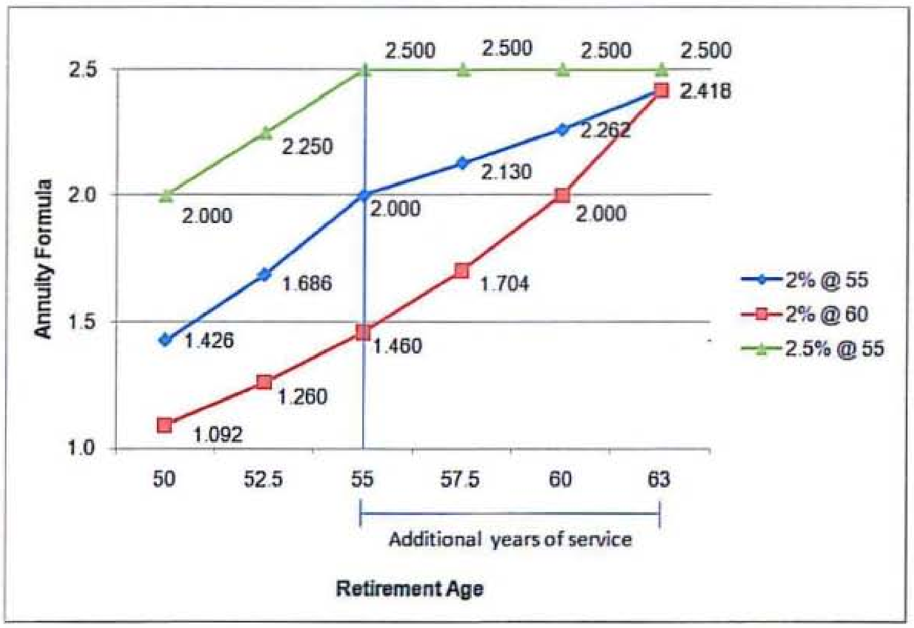
Retirement Formula

City employees are currently under the 2.5% @ 55 formula. With this formula, at age 55 an employee's retirement benefit is calculated by multiplying the years of qualified service by 2.5% and then multiplying final compensation by that percentage. For example, an employee 55 or older with 25 years of qualified service would receive 62.5% of their final compensation (2.5% x 25 years). Under this formula, the multiplier (2.5%) does not increase after age 55.

Another formula commonly used by public agencies is the 2% @ 55 formula. Under this formula, at age 55 an employee's retirement benefit is calculated by multiplying the years of qualified service by 2% and then multiplying final compensation by that percentage. For example, an employee aged 55 with 25 years of qualified service would receive 50% of their final compensation (2% x 25 years). With this formula, the multiplier (2%) increases up to 2.418% at age 63 or older. So, an employee who is 63 years old and has 25 years of qualified service would receive 60.45% of their final compensation.

A third possibility that some agencies are beginning to implement for new employees is the 2% @ 60 formula. With this formula, at age 60 an employee's retirement benefit is calculated by multiplying the years of qualified service by 2% and then multiplying final compensation by that percentage. For example, an employee who is 60 and has 25 years of qualified service would receive 50% of their final compensation (2% x 25 years). Under this formula, the multiplier (2%) also increases up to 2.418% at age 63 or older. So, an employee who is 63 with 25 years of qualified service would receive 60.45% of their final compensation. Figure 2 below illustrates the different levels of final compensation under these three plans at various ages.

Figure 2. Percentage of Compensation Under Various Plans



Final Compensation Calculation Basis

For current City employees, the final compensation basis is known as single highest year. The employee's single highest year compensation (based on 12 consecutive months) is used in the benefit calculation. Normally, but not always, the highest compensation occurs in the employee's final year of service.

An alternate final compensation is known as three-year average. In this case, the employee's highest average compensation over 36 consecutive months is to calculate the benefit. Normally, but not always, the highest average annual compensation occurs in the employee's final three years of service.

Employer-paid Member Contributions

CalPERS has set the employee contribution for the 2.5% @ 55 plan at 8% of salary. Of this 8%, the City currently pays 6.5% and employees pay 1.5%. The current employer contribution rate for both the 2% @ 55 and 2% @ 60 plans is 7% rather than the 8% contribution rate for the 2.5% @5 5 plan.

For both current and future employees, the City could decide to pay all, part, or none of the employee contribution. So, for employees under the 2.5% @ 55 plan, the City could reduce its EPMC to 0% or any other percentage with employees paying the remainder of the 8% employee contribution.

The City also has the latitude to establish different EPMC percentages for different plans. For example, the City could set a 0% EPMC for employees under the 2.5% @ 55 plan with employees paying the full 8% while setting a different EPMC percentage (e.g., 3%) for employees under a 2% @ 55 or 2% @ 60 plan.

Retirement Spiking

As noted above, the retirement benefit is calculated by multiplying final compensation by a percentage factor based on the employee's age and years of service. Also, final compensation is based on either the employee's highest 12 consecutive months of compensation or the employee's highest average compensation over 36 consecutive months. It is in the City's interest, and in the interest of taxpayers, to ensure that employees do not manipulate their final compensation for the purpose of increasing their retirement benefit.

One way in which spiking can occur is to promote an employee at the end of their career or explicitly to increase their final compensation. Other forms of increasing salary include special assignments that pay a differential or acting pay. The City should be diligent in reviewing any such late career salary increases to ensure they are based on need and are in the best interests of the City and that they are not being implemented to increase final compensation for retirement purposes.

CalPERS has instituted a number of regulations to limit opportunities for retirement spiking. For example, EPMCs are not counted in final compensation by CalPERS unless an agency specifically elects to do so through a memorandum of agreement or ordinance. Employer cash-outs of accrued but unused vacation and sick leave are also now excluded from final compensation by CalPERS. CalPERS does allow unused sick leave to count toward additional service credit (but not toward final compensation). For every 250 days (2,000 hours) of unused sick leave, the employee is credited with one additional year of service. This credit is mandated for pooled agencies such as Rancho Palos Verdes. CalPERS estimates the cost this benefit as 0.2% to 0.7% of payroll depending on the amount of unused sick leave accrued by employees upon retirement.

Current Options Compared with New Employee Options within Subcommittee Parameters

The following applies to **current employees**:

- Cannot change formula
- Cannot change compensation calculation basis
- Can change EPMC

Additionally, the City could provide a voluntary deferred compensation plan with or without the City making a contribution to assist in retaining employees who reach the current retirement age of 55. This option has not been fully studied by Management Partners or by the subcommittee and is not part of our recommendation. However, we do recommend that it be studied further in the future.

The following applies to **new employees**:

- o Can change formula
- o Can change compensation calculation basis
- o Can change EPMC

Additionally, the City can provide a voluntary deferred compensation plan with or without the City making a contribution.

Table 2 below summarizes the City's ability to change basic attributes associated with the CalPERS plan based on current legal understandings and CalPERS positions.

Table 2. City Discretion with Changes to Basic CalPERS Attributes

Retirement Component	Current Employees	New Employees
Change to pension formula	Cannot change	Can change
Change to compensation calculation basis	Cannot change	Can change
Change to employer paid member contribution	Can change	Can change

Options for Consideration

The following options could be considered by City Council.

- Adopt alternative CalPERS formulas for new hires
    - 2%@55
    - 2%@60
- Institute a three-year salary basis for new hires
- Modify EPMC for new hires and/or current employees
- Offer a deferred compensation plan supplement for 2% @ 55 or 2% @ 60 plans

Approaches utilized by benchmark cities are presented in Table 3.

Table 3. Peer Comparison

Peer City	Retirement Formula	Salary Basis	Employer Contribution to PERS	Employee Contribution to PERS	Employer Paid Member Contribution	Total Employer Contribution
RPV	2.5% @ 55	Single highest year	15.1%	8.0%	6.5% - employee pays 1.5%	21.6%
RPV Proposed Tier 2	2%@60	Average of three highest years' salary	6.755%	7.0%	0% - employee pays 7% but City contributes 1%-1.5% to Deferred Comp Plan	7.755% to 8.255%
Rolling Hills Estates[1]	2% @ 55 July 1, 2011 2% @ 60	Single highest year July 1, 2011 Average of three highest years	20.5%	7.0%	0% - employee pays 7%[2]	20.5%
Calabasas	2% @ 55	Average of three highest years' salary	10.9%	7.0%	7% - employee pays 0%	17.9%
Laguna Niguel	2% @ 55	Average of three highest years' salary	10.539%	7.0%	7% - employee pays 0%	17.539%
San Juan Capistrano	2.7% @ 55	Average of three highest years' salary	Classified: 27.11% Management: 27.11% Executives: 27.11%	Classified: Less than two years of service 4.47% contribution; after two years of service 6.26% contribution. Management: 5.01% Executives: 7.74%	Classified staff for first two years: 3.6% -employee pays 0.87% Classified after two years, Management, Executive: City pays 100% of employee's share.	Classified: 33.37% Management: 32.12% Executive: 34.85%
Goleta	2% @ 55	Single highest year	10.338%	7.0%	5.25% - employee pay 1.75%	15.588%
La Canada Flintridge	2% @ 55	Single highest year	12.73%	7.0%	7% - employee pays 0%	19.73%
Malibu	2% @ 55	Data not available	Data not available	Data not available	Data not available	Data not available
Walnut	2% @ 55	Single highest year	11.751%	7.0%	7% - employee pays 0%	18.751%

[1] *City implemented Tier 2 (2% @ 60 with three-year average) 7/1/11.*
[2] *A one-time 7% salary increase was provided as an offset.*

Recommendations

Based on the parameters identified by the Pension Revision Subcommittee, analysis of available options, and review of peer jurisdiction systems, Management Partners offers the following recommendations.

Current Employees

The City should retain the 2.5% @ 55 formula and retain the single-highest year basis. In addition, Management Partners recommends that the City:

- Decrease EPMC from 6.5% to 0%.
- Grant a one-time 5% salary increase in conjunction with increasing the employees' portion of retirement contribution from 1.5% to 8%. This results in a net savings to the City of 1.5% of payroll in year one and in each subsequent year.

Note: Prior to 2007, the City paid the entire employee retirement contribution and employees paid no portion of the contribution. In 2007, City employees were asked to vote on whether to increase their contribution from 0% to 1.5% in conjunction with improving the retirement formula from 2% @ 55 to 2.5% @ 55. The employees voted to do so.

Although we believe the City has a good legal basis to reduce the EPMC for current employees, City employees might take the position that since they voted on setting the EPMC at 6.5%, the 6.5% EPMC is a vested right. This specific issue is untested in litigation. To minimize the costs of potential litigation, we recommend that the one-time 5% salary increase be implemented to partially offset the 6.5% EPMC reduction. This offset will greatly reduce the potential of litigation alleging that the 6.5% EPMC is a vested right.

New Hires

Management Partners recommends that the City change to 2% @ 60 formula. In addition, we recommend that the City:

- Change to three-year average basis.
- Institute EPMC of 0% with employees paying the full 7% employee contribution.
- Offer an optional deferred compensation plan [401(a) or 457(b) plan] with the City contributing up to 1% or 1.5% to new employees who elect to participate in and make contributions to the plan. In the interest of fairness and practicality, once established, the 1% to 1.5% City contribution amount should remain at that level unless it is necessary to change it due to severe and unanticipated financial circumstances.

Note: The cost to the City for the 2% @ 60 plan with a matching 1.5% contribution to a 457(b) plan is slightly less than the cost of the 2% @ 55 without any matching. Since both plans "top out" at 2.418% at age 63, the benefit to employees who work until age 63 is significantly greater under the 2% @ 60 plan with the 1.5% match than under the 2% @ 55 plan without the match.

Moving the age at which the retirement formula "tops out" to 63 has benefits for both the City and its employees. The City will retain experienced employees beyond the current retirement age of 55 while also reducing recruitment and training costs for senior level positions. Employees who retire at age 63 rather than the current age of 55 while enjoying a City contribution into a deferred compensation play will enjoy a more secure retirement in several ways:

By working for the City to age 63 rather than age 55, employees will retire with more years of service which is a major factor in the retirement benefit. Since employees who retire from the City at age 55 often continue in employment elsewhere, the employee's work years will, in many cases, remain the same.

The 2.5%@55 tier has a maximum benefit of 2.5% while the 2%@60 tier has a maximum benefit of 2.418% (less than 0.1% difference). The cumulative effect of the City's deferred compensation contribution of 1%-1.5% over the course of employees' careers more than makes up for the minor difference in the maximum formulas in the two tiers.

Current Employees and New Hires

Management Partners recommends that the City closely review and limit any final year compensation increases to preclude spiking.

Under these recommended reforms, the City will achieve immediate first year savings of 1.5% of payroll. Absent any current staff leaving the City, ongoing annual savings of 1.5% will be realized. Significantly higher savings will be achieved as current employees who are under the 2.5% @ 55 formula are replaced by new employees under the 2% @ 60 formula.

Appendix A – First Pension Subcommittee Report

First Report of the Pension Subcommittee of the City Council for the City of Rancho Palos Verdes

Members: Stefan Wolowicz and Thomas Long

Initial Meeting: December 7, 2010

Although the subcommittee anticipates conducting additional meetings and working with an independent consultant to attempt to formulate one or more proposals for possible pension revision to be considered by the city council as a whole, the subcommittee felt it would be useful to issue a set of preliminary observations and common agreements under which the subcommittee is working for the purpose of providing information to those interested in the subcommittee's work. These observations and common agreements are subject to revision if the independent consultant presents information not currently known or considered by the subcommittee.

Observations:

A. The average benefit collected from the City of Rancho Palos Verdes pension plan by retirees is approximately $1,000 per month. Rancho Palos Verdes employees do not earn Social Security benefits based on their time with the City. According to the speakers at the December 7, 2010 meeting the City's pension benefits are about average when compared to those offered by other comparable cities.

B. Funding the City's pension benefits, even after significant investment losses have required large increases in contributions, consumes about 3% of the City's general revenue budget. Protective service employee pension costs are not under the control of the city council. Fire Department pensions are under the fire department's budget within the County of Los Angeles. Sheriff Department's pensions are under the control of the Sheriff. Although the City contracts with the Sheriff to provide police services, the City has no control over the Sheriff's pension policies.

C. Prior to the initial subcommittee meeting the City Manager relayed a concern expressed by Staff that included in the concept of "vested benefits" is the percentage of employees' portion of contribution. While the core elements of the existing employees plan should not change, the discretionary latitude of this percentage needs to be clarified and understood. Moreover the independent consultants may identify other factors that are not now known for consideration.

D. The subcommittee was established by the Council to address concerns expressed by council members about the City's rising pension costs both in terms of absolute dollars and as a percentage of covered payroll. The subcommittee was also tasked to consider the potential impact, if any, of underfunding of vested benefits.

E. Various factors contribute to the complexity of the subcommittee's tasks and may be beyond the control of the council and the City. These include:

(1) Unpredictable and uncontrollable impacts on investments from market performance and changes in actuarial factors that affect the costs of benefits.

(2) CalPERS offers only a limited set of options. Based on comments from the speakers during the December 7, 2010 it is our understanding that CalPERS does not provide service for Defined Contribution retirement plans. CalPERS would require cities offering a second tier defined contribution plan to place the defined benefit plan with another plan administrator.

(3) Adopting changes to the City's pension plan that would reinstitute Social Security benefits or adopt currently unavailable formats may require agency rulings, judicial interpretations, and/or legislative action.

Common Agreements:

1. **The subcommittee is considering changes in pension formulas, contributions, and benefits only for newly-hired employees.** The subcommittee is not now considering any changes, whether it is in benefits or funding of contributions, for existing employees and retirees of the City of Rancho Palos Verdes.

2. **The subcommittee is not considering options which involve the City departing from the California Public Employees Retirement System ("CalPERS").** Given the preliminary comments received, the subcommittee has found that departing from CalPERS is not now practical or cost-effective.

3. **Any revisions made to the City's pension benefits should not degrade the City's ability to recruit and retain high quality professional employees.** The City has a long established policy of attempting to provide compensation at the 75th percentile when compared to other comparable California cities as a way of recruiting and retaining skilled employees.

4. **The primary purpose of pension revisions is to control costs and to provide a sustainable pension plan.** It may be found that given viable alternatives now available retirement costs cannot be significantly reduced but only limited in the increases. The purpose of pension revisions is not to cut pension benefits to existing employees or otherwise disrupt the City's relationships with its employees or with potential recruits. Instead, the purpose is to assure that pension contributions both appropriately fund promised benefits but also are within the City's abilities to support. Future pension cost increases should be controlled such that the City's overall pension costs remain a relatively low share of the City's budget and do not grow disproportionately compared to other of the City's costs. A sustainable pension plan providing good value benefits is in the common interest of both the City's employees and its residents.

5. **Broader pension revisions are likely to be effective, if at all, only at a higher government level.** Members of the subcommittee and/or members of the public may support different and more considerable revisions to pension benefits for public employees. However, a broader scope of revision may not be possible at the level of a City the Consultants will be asked to identify viable (practical and cost-effective) alternatives. Significant alternatives may be made available to municipalities through action by the governor, legislature, ballot initiative, or new models developed for municipalities. The current or future Councils should be free to consider those alternatives as they arise.

As the subcommittee proceeds forward, it hopes to develop a consensus as to whether or not a viable revision to the City's existing pension program is necessary and possible. If such a consensus in favor of a revision emerges, the subcommittee will either reach a consensus on a single proposed option for a revision or perhaps two or more options for the entire Council to choose among. We anticipate at least one additional report summarizing the results of recommendations from the retained independent consultant and our additional work.

Dated January 4, 2011

Sincerely,

Pension Subcommittee
City of Rancho Palos Verdes City Council

Thomas D. Long, Mayor

Stefan Wolowicz, Councilmember

Appendix B – Second Pension Subcommittee Report

Second Report of the Pension Subcommittee of the City Council for the City of Rancho Palos Verdes

Members: Stefan Wolowicz and Thomas Long

Date 7 June 2011

This report supplements the Subcommittee's earlier report of December 7, 2010, a copy of which is attached for your reference. The Subcommittee reaffirms the observations and common agreements announced in its first report of December 7, 2010. The purpose of this report is to advise the Council, the City employees and the public of further efforts by the Subcommittee since the time of our last report.

The Subcommittee is continuing to study options designed to assure that the City's pension plan remains sustainable and practical. Based on information gathered and pending meeting with an advisory consultant the Subcommittee has tentatively concluded that the present range of options available to it is fairly limited. The Subcommittee tentatively does not expect to recommend that Rancho Palos Verdes leave CalPERS. These tentative conclusions have been reached due to two primary reasons. First, the City is too small to bear the costs of maintaining its own pension plan and presently securing an alternative plan and sponsor does not appear viable, accordingly leaving CalPERS is not a viable option at this time. It is expected that ultimately major reform by the state legislature will be necessary to provide the levels of changes now required by CALPERS. Second, the Subcommittee hopes to avoid recommending changes to the City's pension that could pose a significant risk to the City in litigation.

With the above restrictions in mind, the Subcommittee is continuing to work to develop a consensus proposal to the Council for changes in the City's pension plan that will bolster its sustainability by stabilizing the City's pension costs as a percentage of payroll. The Subcommittee is exploring creating a second tier pension plan for new employees. The Subcommittee is also exploring adjusting the contributions of current employees toward the pension plan coupled with an equitable adjustment in the salaries of current employees. Staff has presented the Subcommittee with a number of options and predicted savings from each of the options. The Subcommittee needs additional time to study these options and needs to confer with an independent pension consultant. We hope to select and begin conferring with the independent consultant within the following month.

In its first report, the Subcommittee indicated that it was planning to work with an independent consultant. Staff promptly prepared a request for proposal but received only one bid in response to that initial proposal. The Subcommittee felt it was necessary to circulate a new proposal and to solicit additional bids. Through no fault of the staff, the process of obtaining an independent consultant has, unfortunately, been delayed. Nonetheless, the Subcommittee anticipates conferring with an independent consultant to confirm its own assumptions and the information that staff has provided to it and developing a final report to the Council with either a consensus recommendation or viable alternative proposals for the Council to consider within the next three months.

The Subcommittee attended a recent presentation of the Los Angeles Division of the League of California Cities on Pension Reform. A handout containing some background information discussed at that meeting is also attached to this report. The Subcommittee is providing this report and the attached information and will be prepared at our meeting on June 7, 2011 to respond to questions by the Council.

Dated June 7, 2011

Sincerely,

Pension Subcommittee
City of Rancho Palos Verdes City Council

Thomas D. Long, Mayor

Stefan Wolowicz, Councilmember

Appendix C – Third Pension Subcommittee Report

Third Report of the Pension Subcommittee of the City Council for the City of Rancho Palos Verdes

Summary of Meeting of July 1, 2011

Members: Councilmember Steve Wolowicz and Mayor Tom Long

Consultants: Andy Belknap and Tim Sullivan, Management Partners, Inc.

The Subcommittee reaffirms its observations from its initial two reports. For ease of reference those two reports are attached.

Goals of the project

- Consider recommendations to the Council for possible changes in RPV's pension structure to assure long term sustainability that does not expose the City to risk of litigation or deteriorated employee relationships.
- Provide the Subcommittee with advice and confirmation of issues that the Subcommittee has encountered during the preliminary gathering of information. Also include comments and advice as to the potential implementation or probable roadblocks of the adoption of a defined contribution-type plan.
- Sustainability generally means ensuring that pension expenditures become a predictable and generally flat percentage of payroll.
- Management Partners will assist the Council Subcommittee in reaching a recommendation and will prepare further interim reports after each meeting with the sub-committee.
- Present a final report to the City Council in September, ideally at the first meeting of that month.

Areas to consider in formulating recommendations:

Given the preliminary information obtained by the Subcommittee, the Consultants are to provide advice as to the expected viability of adopting an expected "second tier" defined benefit plan for new employees.

- Whether to move from a single highest year salary basis to a three year average salary basis.
- How to provide protection against any possible retirement spiking, by for example converting vacation or sick leave into compensable pay for purposes of retirement calculation
- Whether to offer a one-time 5% salary increase in exchange for increasing employee contribution from 1.5% currently as follows:
    - Current employees pay 8% retirement contribution and stay in 2.5% @ 55 plan
    - Future employees pay 8% retirement contribution and move to 2% @ 55 plan or 2% @ 60 plan.

- Whether to offer a Second Tier Plan to current employees on a voluntary basis with some incentive such as lower contribution rate or employer matching in a Deferred Compensation plan. Also consider employer matching in a Deferred Compensation plan generally for the possible Second Tier Plan.
- Determine how to ensure that any new pension plan does not require Social Security coverage

Desired action items:

- Examine and comment on assumptions in the Subcommitee's two prior reports.
- Confirm staff's data as submitted to the Subcommittee and the Consultant.
- Determine the City's actual turnover rate for the past 10 years.
- Determine if the annuity percentage for 2.5% @ 55 and 2% @ 55 even out at any age.
- Cite potential pension reform ballot issues (David Crane and Marcia Fritz or other credible expected sponsors of pension reform initiatives likely to be proposed to California voters) in the report.
- Explore the assumption and explain why it is not feasible or practical to move beyond the concept of sustainability (i.e., a defined contribution play).
- Establish the credibility of the data and numbers.
- Determine which cities to include in comparisons:
    - Coastal contract cities without public safety employees
    - Those with similar demographics
    - General Law
    - High cost of living
- Show the experience agencies with their own pension plans (e.g., Orange County) have had.
- Gather historical records of CalPERS contributions for unfunded future liability.
- Address the issue which some raise that pension reform must come from the State level.
- Be able to say to staff, "Yes, these changes will cost you more but it will assure plan sustainable. You don't want to be a member of a retirement plan that is not sustainable. "
- Also be able to explain the reasons that now exist which are likely and valid reasons which now prevent discontinuation of defined benefit plans in favor of defined contribution plans.

Questions to answer by the Consulting Advisors:

- If the City moves to a two tier plan (2.5% @ 55 for current employees and 2% @ 55 for new employees with all employees paying 8% retirement contribution) will they reach a level percentage of payroll within 3-5 years? If not what would be a reasonable period of time within which to reach a level percentage of payroll?
- Assess the uncertainties associated with CalPers including:

    - Variability / volatility of contribution rates?
    - Unfunded future liability? Note: It is expected that the Advisors must be prepared to fully explain the importance or lack of importance as to this issue,
- What is the status of the IRS ruling on Orange County?
- For the possible new Second Tier Plan, is it possible to include a voluntary DC Plan (457 Plan)?
- Can a 2% @ 60 Plan be enriched by adding a deferred compensation component?
- Is it legal and otherwise advisable for the City to make contributions to a deferred compensation plan based on age or years of service (as an incentive for staff to work beyond age 55)?
- A critical and important part of the consultants' advice includes a full description of all viable, legal and practical alternative retirement plans which reasonably considered for adoption by the City.

Timeline:

Develop a draft report for review by the Council Subcommittee, in advance of a final report presentation for the September 6, 2011 Council meeting.

Appendix D – Vested Rights of CalPERS Members

Vested Rights of CalPERS Members

Protecting the pension promises made to public employees

July 2011

CalPERS

CalPERS Profile

The California Public Employees' Retirement System (CalPERS) is the nation's largest public pension fund with assets of approximately $240 billion.

Headquartered in Sacramento, CalPERS provides retirement and health benefit services to more than 1.6 million members and 3,033 school and public employers. The System also operates eight Regional Offices located in Fresno, Glendale, Orange, Sacramento, San Diego, San Bernardino, San Jose, and Walnut Creek. Led by a 13-member Board of Administration, consisting of member-elected, appointed, and ex officio members, CalPERS membership consists of approximately 1.1 million active and inactive members and more than 500,000 retirees, beneficiaries, and survivors from State, school and public agencies.

Established by legislation in 1931, the System became operational in 1932 for the purpose of providing a secure retirement to State employees who dedicate their careers to public service. In 1939, new legislation allowed public agency and classified school employees to join the System for retirement benefits. CalPERS began administering health benefits for State employees in 1962, and five years later, public agencies joined the Health Program on a contract basis.

A defined benefit retirement plan, CalPERS provides benefits based on a member's years of service, age, and highest compensation. In addition, benefits are provided for disability and death.

Today CalPERS offers additional programs, including a deferred compensation retirement savings plan, member education services, and an employer trust for post-retirement benefits. Learn more at our website at www.calpers.ca.gov.

Contents

I. Introduction

Recent economic crises affecting the world's governments and markets have brought fiscal pressures on state and local budgets in California. Budgetary constraints have focused attention on the cost of providing public services, and no cost has received more attention than the compensation and benefits earned by our public employees. Commissions, political leaders and private citizens all have weighed in on the subject, each proposing wide-ranging "reforms" aimed at reducing the retirement benefits earned by public servants. Proposals have included, for example: moving to less advantageous benefit formulas, imposing caps on pensionable compensation, changing the definition of pensionable compensation to exclude items that are currently included, lengthening the "final compensation" period on which benefits are calculated, restricting employees' rights to purchase additional service credit, lengthening eligibility periods, increasing employee contributions and eliminating employer paid member contributions. Many of these proposals seek to apply these "reforms" to currently active employees as well as those who may be hired in the future.

Understandably, this attention on the compensation and benefits of members of the California Public Employees' Retirement System ("CalPERS") has raised concerns as to the level of assurance the law provides that promised pensions will be available upon retirement.

CalPERS has prepared this paper for two purposes:

- To articulate the current state of California law regarding the nature of its members' pension rights and the extent to which such rights have become "vested" and may not be impaired; and
- To explain the role of CalPERS in ensuring that its members' vested rights are honored.

This paper is not intended to respond to any particular proposed legislation or initiative. Rather, it is intended to present CalPERS' institutional views in the broader context of its primary governing laws: the California Public Employees' Retirement Law (Gov't Code §§ 20000, et seq.) (the "PERL") and the California and United States Constitutions. The merits and enforceability of any new proposal must be analyzed on its own unique terms and conditions.

Finally, although some of the general principles and authorities discussed in this paper may be relevant to plans CalPERS administers other than the Public Employee Retirement Fund defined benefit plan, this paper is not intended to address any issues related to the CalPERS' health benefits plans, defined contribution plans, the Legislator's Retirement System or the Judicial Retirement Systems (I and II).

II. Overview: Member Benefits And Contributions

California law clearly establishes that public employee retirement benefits are a form of deferred compensation and part of the employment contract. Rights to this deferred compensation are earned when the employee provides service to the public employer.

By statute and contract, public employers, not CalPERS, decide how much of an employee's compensation will be paid currently and how much will be deferred and paid in the future. Simply put, employers grant the benefits owed to CalPERS' members. CalPERS in turn serves as the trustee of the trust created to fund these benefits, through the prudent administration and investment of the retirement fund.

The rights of all CalPERS members are established by statute. In the case of local agencies, members' rights are also governed by the contract between the agency and CalPERS. When contracting with CalPERS, local agencies may choose from a menu of options. Benefits for CalPERS members are often the product of collective bargaining.

This section provides a general overview of the core benefits earned by CalPERS members. It is not intended to be a comprehensive description of all benefits and rights of all CalPERS members.

A. Service Retirement Allowance

Each CalPERS member earns service credit towards a lifetime retirement allowance after employment, calculated under a formula which accounts for the member's years of credited service, the member's "final compensation" and the member's age at retirement. Each benefit formula is commonly referred to as a specified percentage of a member's "final compensation" for each year of service, based on a particular age at retirement. For example, under a "2% at 55" benefit formula, a member receives 2% of his or her "final compensation" per year of credited service, if that member retires at age 55. If the member retires earlier or later than age 55, the member receives a lower or higher percentage of "final compensation," according to a statutory table. For example, under the "State 2% at 55" table, a member retiring at age 50 receives 1.1% of "final compensation" per year of credited service. A member retiring at age 63 or older receives 2.5% of "final compensation" per year of credited service.

As noted, each formula applies a multiplier to a member's "final compensation." For some members, "final compensation" means the highest one-year average pensionable "compensation earnable" that they earn during their careers. For other members, the highest annualized three-year average "compensation earnable" that they earn during their careers is used. In general terms, "compensation earnable" includes the member's "payrate" (essentially base salary) and certain items of "special compensation," which are established as pensionable by law or regulation. "Compensation earnable" generally does not include items such as overtime pay and amounts that are not available to employees in the same group or class of public employment.

B. Disability Retirement Allowance

If a member has an injury or illness that prevents the member from performing the customary duties of his or her regular position, the member may be eligible for a disability retirement. If a member's disability is the result of a job-related illness or injury, and the member is a school, local or State safety, State peace officer/firefighter, State industrial, or State patrol member, the member may be entitled to an industrial disability retirement. Local miscellaneous members also may be eligible if their employer contracts with CalPERS to provide for an industrial disability retirement.

A member who is granted a disability retirement receives the greater of the service retirement allowance (if eligible) or an allowance based on a specified formula applicable to that member. A member who is granted an industrial disability retirement allowance receives the greater of his or her service retirement allowance (if eligible) or a specified percentage of the member's "final compensation" (usually 50%, but 60% for some members), plus an annuity purchased with his or her accumulated additional contributions.

"California law clearly establishes that public employee retirement benefits are a form of deferred compensation and part of the employment contract."

C. Purchase of Service Credit

If they meet eligibility requirements, active members are entitled to purchase additional retirement service credit, which increases their retirement allowance. Additionally, where eligible, members can purchase service credit for prior public service, military service and certain other types of service. The member's cost to purchase additional service credit is set by statute and is based on actuarial assumptions and methodologies determined by the Board of Administration ("Board").

D. Death and Survivor Benefits

CalPERS provides benefits to the beneficiaries of active and retired members upon the member's death. Benefits and eligible recipients vary based on whether the member was still working at the time of death or was retired, and by the member's employer, occupation and the specific provisions in the contract between CalPERS and the employer. Additionally, a member may opt to have his or her retirement allowance reduced in order to increase the benefits that will become payable to the member's beneficiaries after the member's death.

E. Cost of Living Adjustments

A member's (or beneficiary's) initial allowance is subject to annual cost-of-living adjustments ("COLAs") that account for changes in the applicable cost of living index each year. Members and beneficiaries also may receive additional "Purchasing Power Protection" when annual COLAs have been substantially eroded by inflation over time.

F. Member Contribution Rates

Members generally contribute portions of their paychecks towards the cost of their future retirement benefits. These member contributions are established in various ways, including among other by statute, ordinance and memorandum of understanding, and they vary widely based on such things as the member's employer, occupation and bargaining unit, if any. In general, member contribution rates are established as a percentage of the member's monthly compensation. With respect to member contributions established by statute under the PERL: "The Legislature reserves the right to increase or otherwise adjust the rates of [member] contribution ... in amounts and in a manner it may from time to time find appropriate." Some member contribution rates also are expressly subject to collective bargaining.

Some employers may choose to pay a portion or all of the retirement contributions otherwise required of their employees. These payments typically are negotiated during collective bargaining and the law provides that the employer may "periodically increase, reduce, or eliminate" such payments.

G. Reciprocity

The "reciprocity" provisions of the PERL (and related provisions in the retirement laws governing other California public retirement system) provide for certain reciprocal retirement benefits for a person who works for two or more public employers during his or her career, with membership in two or more California public retirement systems.

The primary purpose of reciprocity is to "eliminate[] the adverse consequences a member might otherwise suffer when moving from one retirement system to another." Reciprocity provisions accomplish this in a number a ways, including, for example, allowing a member to use his or her highest compensation in any reciprocal system to determine the compensation used to calculate benefits from all such systems.

III. Overview: Employer Funding Obligations

The California Supreme Court long ago established that a promise of a pension made by a public employer to its employees is a promise the employer must keep. In other words, public employers in California are legally required to honor promises to current and former employees regardless of how much money they have set aside for that purpose.

In order to ensure that their promises are kept, the law requires California's public employers to pre-fund the benefits they owe by making contributions to CalPERS along with the contributions of their employees. By investing the combined contributions of members and employers, CalPERS is able to pay all of the benefits as they come due.

To successfully fund all promised benefits, the law requires the Board to maintain an actuarially sound retirement fund. As one court explained: "Actuarial soundness of [CalPERS] is necessarily implied in the total contractual commitment, because a contrary conclusion would lead to express impairment of employees' pension rights." Further, employees have a vested right to statutorily required employer contributions, even where those contributions are not linked to providing an "actuarially sound" retirement system.

> "...a promise of a pension made by a public employer... is a promise the employer must keep. In other words, public employers in California are legally required to honor promises to current and former employees..."

The California Constitution provides that the Board "shall [] have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries" and "consistent with the exclusive fiduciary responsibilities vested in it, shall have the sole and exclusive power to provide for actuarial services in order to assure the competency of the assets of the public pension or retirement system." The Board has authority to determine an actuarially sound rate of contributions that, together with investment earnings, will "assure the competency of the assets" of CalPERS such that all promised benefits are paid now and in the future. It is the Board's exclusive responsibility to determine the contributions that will be required of the participating employers and the participating employers then have a mandatory "ministerial" duty to pay the contributions that the Board determines are necessary. This obligation will be quickly enforced by the courts, by writ of mandate, if an employer fails to meet it.

As stated by the United States Supreme Court, a defined benefit plan "is one where the employee, upon retirement, is entitled to a fixed periodic payment. The asset pool [available to pay benefits] may be funded by employer or employee contributions, or a combination of both. But the employer typically bears the entire investment risk and ... must cover any underfunding as the result of a shortfall that may occur from the plan's investments."

IV. California Contract Clause as Applied to Public Employees' Retirement Benefit Rights

A "vested" benefit is one that has matured into an irrevocable contractual right, which cannot be taken away or otherwise impaired without the member's consent, except in extremely limited circumstances. A "non-vested" benefit, on the other hand, is one that has been promised conditionally. It is generally alterable or completely revocable by the appropriate authority (usually the Legislature or the employer) without the member's consent. A public employee's right to the retirement benefits earned during employment is generally a vested right.

California has a strong public policy, enunciated through published legal decisions over the past half century, establishing that public employee retirement benefits are contractual obligations entitled to the protection of the "Contract Clause" of the State Constitution. That clause, found at Article I, section 9 of the California Constitution provides: "A ... law impairing the obligation of contracts may not be passed." (Article I, section 10 of the United States Constitution similarly prohibits a state from impairing the obligation of contracts.) This means that an employee's vested pension rights may not be impaired except under extremely limited circumstances.

The fundamental doctrine protecting California public employee pension rights is succinctly stated: "A public employee's pension constitutes an element of compensation, and a vested contractual right to pension benefits accrues upon acceptance of employment. Such a pension right may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity."

This doctrine has been applied and refined by dozens of California appellate cases since the 1940s. Several general rules have emerged through this jurisprudence:

RULE 1:

Employees Are Entitled To Benefits In Place During Their Employment

Public employees obtain a vested right to the provisions of the applicable retirement law that exist during the course of their public employment. Promised benefits may be increased during employment, but not decreased, absent the employees' consent.

These rules apply to all active CalPERS members, whether or not they have yet performed the requirements necessary to qualify for certain benefits that are part of the applicable retirement law. For example, even if a member has not yet satisfied the five year minimum service prerequisite to receiving most service and disability benefits, the member's right to qualify for those benefits upon completion of five years of service vests as soon as the member starts work.

The courts have established that this rule prevents not only a reduction in the benefits that have already been earned, but also a reduction in the benefits that a member is eligible to earn during **future** service. For example, a ballot proposition that purported to eliminate future benefit accruals for legislators was held unconstitutional because legislators were entitled to continue earning benefits under the law in place when they were first elected.

RULE 2:

Employees Are Entitled Only to Amounts Reasonably Expected from the Contract

Vested rights protection does not extend to unreasonable or unanticipated windfalls. In other words, the Contract Clause only protects the benefits that are reasonably expected from the contract, and does not protect "unforeseen advantages."

RULE 3:

Only Lawful Contracts with Mutual Consideration Are Protected by the Contract Clause

"The contract clause does not protect expectations that are based upon contracts that are invalid, unenforceable, or which arise without the giving of consideration. Nor does the contract clause protect expectations which are based upon legal theories other than contract, such as quasi-contract or estoppel."

For this reason, it is not an "impairment of contract" for CalPERS to correct an error by a member, the member's employer or CalPERS' staff that may have resulted in more favorable treatment to the member than the law allows. The PERL specifically authorizes CalPERS to correct such errors.

RULE 4:

Future Employees Have No Vested Rights to the Current Statutory Scheme

Employees to be hired in the future do not have vested rights to any particular retirement benefits because they have not yet entered into public employment. Thus, there is no constitutional impediment to unilaterally reducing (or even eliminating) retirement benefits for new hires of public employers, even if the public employers historically have provided such benefits to their employees as part of past employment contracts.

RULE 5:

Retired and Inactive Members Have Vested Rights to the Benefits Promised to Them When They Worked

Like active employees, retirees and inactive members have a vested right to the benefits that were in place when they were employed. However, retirees and inactive members generally do not have vested rights to beneficial changes created **after** their employment terminates. This is because a "member whose employment terminated before enactment of a statute offering additional benefits does not exchange services for the right to the benefits." An exception to the general rule that benefits granted after retirement are not vested arises when the retiree or inactive member gives up another right acquired during employment in exchange for the right to receive post-employment improvements. In that case, the right to a post-employment improvement is generally a vested right.

RULE 6:

Active Employees' Vested Rights May Be Unilaterally Modified Only Under Extremely Limited Circumstances

Active public employees have a vested right to a substantial pension, but, under limited circumstances, the terms of their retirement rights may be modified before they retire. The California Supreme Court has explained: "[V]ested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Nonetheless, such modifications must be reasonable, and to be sustained as such, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages. Further, it is advantage or disadvantage to the particular employees whose own contractual pension rights, already earned, are involved which are the criteria by which modifications to pension plans must be measured."

There are numerous California published decisions that discuss the circumstances under which modifications to the vested rights of active employees may be permitted. There are four primary steps for determining whether a modification is permissible:

(a) The first step in determining whether a modification is permissible is to determine if the unmodified right is in fact vested, meaning neither the employer nor the Legislature reserved the right to change the benefit. This is because the applicable retirement laws often contemplate changes. Indeed, the laws sometimes expressly reserve to the employer or the Legislature the right to modify or eliminate certain benefits. A member's vested right is only to the law as it is written at the time of employment, including all of its conditions.

(b) If a vested right exists, the next step is to determine whether that vested right has been changed in a way that is disadvantageous to the member.

(c) If it is determined that a vested right has been changed in a way that is disadvantageous to a member, the next step is to determine whether the change has a "material relation to the theory of a pension system and its successful operation." If it does not, then the modification is not permissible. Case law is clear that "changes made to effect economies and save the employer money do bear some material relation to the theory of a pension system and its successful operation," but, as discussed immediately below, this finding alone is not sufficient to justify a disadvantageous change to a member's vested rights.

(d) If the change bears a "material relation to the theory of a pension system and its successful operation," the final step is to determine whether the disadvantaged employees will receive a "comparable new advantage." When a court conducts this analysis, it looks specifically at what may be taken from and provided to the individually impacted employees. This member-by-member analysis, however, does not necessarily take into account each member's unique personal circumstances. Thus, a member does not get to pick and choose which advantages or disadvantages will apply to him, and then argue that his vested rights have been unconstitutionally impaired.

RULE 7:

The State's "Emergency" Powers Are Extremely Limited and Cannot Be Used to Reduce the Benefits that Have Been Promised

The courts have carved out one narrow exception to the constitutional prohibition against the impairment of contracts, although there is no case where a court has actually applied that exception in a way that has reduced the long term costs of public retirement benefits in California. Both the California and United States Supreme Courts have held that "a substantial impairment may be constitutional if it is "reasonable and necessary to serve an important public interest" during an emergency. The courts pay little heed, however, to the "legislative assessment of reasonable and necessary," because "the State's self-interest is at stake [and a] governmental entity can always find a use for extra money, especially when taxes do not have to be raised." Thus, the courts apply a rigorous four-prong test when determining if this limited exception applies: (a) the legislative enactment must serve to protect "basic interests of society;" (b) there must be an "emergency justification for the enactment," (c) the enactment must be "appropriate for the emergency;" and (d) the enactment must be "designed as a temporary measure, during which time the vested contract rights are not lost but merely deferred for a brief period, interest running during the temporary deferment."

Thus, even if vested pension rights may be temporarily impaired in a true emergency situation, it is clear that the State's emergency powers do **not** enable it to solve its budgetary problems by eliminating or reducing the long term benefit promises it has made.

V. Federal Contract Clause as Applied to Public Employees' Rights in California

As stated above, it is clear that the "Contract Clause" of the California Constitution provides broad protections of the vested pension rights of California's public employees. Some current "reform" proposals suggest changing the State Constitution to reduce or eliminate public employee retirement benefits, in some instances even amending the Contract Clause itself. Presumably, proponents of these measures assume that by amending the State Constitution, they can avoid a constitutional challenge to their proposed impairment of vested retirement benefits. The assumption is misplaced, for two reasons:

First, if a proposed pension reform were to be enacted in the form of a constitutional amendment, it would still have to pass muster under the Contract Clause of the State Constitution. In other words, any new provision of the State Constitution would still be subject to the requirement that it not impair the obligation of contracts. Absent actually eliminating the entire Contract Clause, the fact that a pension reform measure may be adopted by way of a constitutional amendment would not assure its validity.

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Second, even if a proposed amendment eliminated the State Constitution's Contract Clause in its entirety, *the Contract Clause in the United States Constitution would give rise to the same protection of vested pension rights* as the State Constitution. Most of the published California cases that have analyzed the constitutionality of modifying vested pension rights of public employees have not meaningfully distinguished between the Contract Clause in the California Constitution and the Contract Clause in the United States Constitution. In 1991, the California Supreme Court removed any doubt that the United States Constitution protects public employee pension rights in California to the same extent as the California Constitution, by explaining that prior case law had "never rejected the federal clause as a source of protection" and "in light of prior California decisions consistently extending federal contract clause protection to state public officers, it is simply 'too late' to retreat from the clear implication of those holdings."

Therefore, amending the California Constitution likely would not open the way to lawfully impairing vested pension rights. All of the rules discussed in Section IV above likely would still apply, no matter how the California Constitution may be amended, so long as the Contract Clause of the United States Constitution remains unchanged.

VI. CalPERS Members' Rights

Based on the legal analysis set forth above, CalPERS here articulates its understanding of the current state of vested rights law in California, as it applies to CalPERS members' benefits. Analyzing any particular member's vested rights, however, must be done on a case-by-case basis. Thus, nothing in this section is intended to express a view on any individual member's rights or any specific legislative or constitutional proposal. Further, the discussion in this section is not intended to be exhaustive, but rather to provide a general overview of our members' primary rights.

A. Vested Rights

In general, CalPERS members have vested rights to:

» Have their service retirement allowance determined based on the benefit formula that existed in the law when they provided service, if they satisfy all eligibility requirements.

» Have their retirement allowance based upon all service credit that they accrued by providing service or by purchasing service credit.

» Have their retirement allowance calculated using the definition of "final compensation" that existed in the law when they provided service.

» Have their "final compensation" determined according to the definition of "compensation earnable" that existed in the law when they provided service.

» Receive a disability allowance or an industrial disability allowance determined in accordance with the law that existed when they provided service, if the member satisfies all eligibility requirements.

» Purchase service credit under the terms that existed in the law when they provided service, if the member satisfies all eligibility requirements.

» Receive cost of living adjustments to their retirement allowance under the terms that existed in the law when they provided service. This includes "Purchasing Power Protection."

» Have their beneficiaries receive death and survivor benefits provided under the terms that existed in the law when the member provided service.

» Receive the benefits of reciprocity that existed in the law when they provided service, if they satisfy all eligibility requirements.

» Withdraw their contributions, plus accrued interest, upon separation from employment, when eligible for such a withdrawal.

» Have an actuarially sound retirement fund, which requires (a) that the CalPERS Board establish employer contribution rates sufficient to maintain the actuarial soundness of the system so that the competency of its assets is assured, and (b) that the employers timely pay those rates.

Because the above rights of CalPERS members are vested, they may only be modified if such modifications are "reasonable, and to be sustained as such, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages."

Finally, there remains a question as to whether vested rights may be consensually modified through collective bargaining without offending the Contracts Clause.

B. Non-Vested Rights

In general, CalPERS members do not have vested rights to:

» Benefit improvements that are granted to them after they have terminated employment (e.g., the "ad hoc" cost of living improvements granted to retirees based upon retirement date), unless such benefit improvements have been granted in exchange for a vested right that the retired members gave up voluntarily.

» Windfall benefits that arise out of circumstances that were never contemplated to be part of the employment contract.

» Payments in excess of those authorized by law, or arising from an error by the member, the member's employer or CalPERS.

» Perpetuation of the Board's discretionary actions affecting contributions and benefits. For example, the Board may change its actuarial assumptions and methodologies for calculating the cost for purchasing service credit, or for determining actuarial equivalency (for a variety of purposes). The Board has full authority to change actuarial assumptions and methodologies in the sound exercise of its discretion, and doing so does not impair any vested right, even if a change does not appear favorable to CalPERS members.

» Continuation of a benefit or contribution rate where the benefit or contribution rate is subject to change under the terms of the applicable statute, memorandum of understanding or employment contract.

» Continued employment with their employer or the continuation of the historical compensation practices of that employer, even if those practices impact the calculation of members' "compensation earnable" and "final compensation." For example, an employer may have historically paid certain premium amounts that qualify as pensionable "compensation earnable." While the member has a vested right to have such amounts included in "compensation earnable" when paid, the member does not have a vested right to continue to be paid those amounts.

Because the above rights are not "vested" under the Contract Clauses of the California and United States Constitutions, there is no constitutional impediment to the Legislature or a member's public employer (or the Board, in the case of its own discretionary acts) from unilaterally altering those rights. Unless and until such alterations are made, however, members of course have a right to receive all benefits provided to them under law. Further, other laws may limit the ability to make such alterations. For example, although specific employment practices may not be vested in perpetuity, the terms of a collective bargaining agreement must be honored during the period of that agreement's applicability.

VII. The Role of CalPERS in Protecting Members' Vested Rights

Under the State Constitution and the PERL, the Board (which is the 13-member governing body of CalPERS) has the exclusive and plenary authority and fiduciary duty to administer CalPERS in a manner that will assure prompt delivery of benefits and related services to the members and beneficiaries of the system. Board members are either elected by members of the system, appointed by State elected officials or sit ex officio.

One court explained the fiduciary duties of members of a public retirement board thusly: "[A] trustee's primary duty of loyalty is to the beneficiaries of the trust. The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary. The trustee must not be guided by the interest of any third person. This unwavering duty of complete loyalty to the beneficiary of the trust must be to the exclusion of the interest of all other parties. Under the rule against divided loyalties, a fiduciary cannot contend that although he had conflicting interests, he served his masters equally well or that his primary loyalty was not weakened by the pull of his secondary one."

The California Constitution provides: "A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty." The California Supreme Court has explained: "[P]ension plans create a trust relationship between pensioner beneficiaries and the trustees of pension funds who administer retirement benefits and the trustees must exercise their **fiduciary trust** in good faith and must deal fairly with the pensioners-beneficiaries."

The Board will act consistently with these principles. With respect to legislative and constitutional proposals that may impact its members' vested rights, the Board will exercise its best judgment and act appropriately under all existing circumstances. In doing so, the Board will observe certain general guidelines, including:

» CalPERS will make reasonable efforts to keep its members and beneficiaries apprised of changes or potential changes to the law that may impact their rights and responsibilities.

» CalPERS will ensure that funds spent in any process relating to potential changes in funding or benefit structures are appropriate expenditures of trust funds under Article XVI, section 17 of the California Constitution and other applicable law.

» CalPERS' actions will be carried out in a manner that implements the law. In the event CalPERS questions whether changes in the PERL or other applicable law may cause an unconstitutional impairment of its members' vested rights, CalPERS will exercise its best judgment, based on all existing circumstances, as to whether to initiate or participate in judicial challenges to such changes.

VIII. Conclusion

CalPERS is dedicated to administering the system in a manner that will ensure that the promises made to CalPERS' members and beneficiaries will be kept. CalPERS acknowledges the budgetary challenges that the State and other public agencies throughout California are presently facing, and will play an appropriate role in the addressing these challenges. In this process, it will be vitally important for all interested parties to heed the legal rules protecting the vested rights of CalPERS' members, which have developed over the course of many decades. Without due consideration of these rules, well-intentioned proposals may not achieve the purposes for which they are designed; indeed, they may lead only to additional litigation and administrative costs, which can only increase the long term cost of delivering the benefits that have been promised to CalPERS members. It is the hope of CalPERS that this paper will provide guidance to all parties as they address these challenges.

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