Bill Number: AB 7 (Portantino) as introduced December 6, 2010

SUMMARY

AB 7 prohibits state employees whose base salary is greater than $150,000 per year from receiving a salary increase or a bonus while employed in the same position or classification until January 1, 2014. This bill exempts a person whose compensation is governed by an operative memorandum of understanding, a person who is exempted by executive order of the Governor or a person whose salary is set pursuant to the California Constitution.

PURPOSE OF THE BILL

To limit the compensation paid to higher paid state employees, to help mitigate California's current budget shortfall that has been complicated by economic conditions and has grown to an estimated $25.4 billion budget deficit through 2011-12.

Board Position

Oppose Unless Amended to delete the bills' application to CalSTRS. This bill would significantly affect the retention and recruitment of key CalSTRS classifications with a base salary of $150,000 or higher. Currently, the board has the authority to fix compensation for chief executive officer, general counsel, system actuary, chief investment officer, and the other investment officers and portfolio manager positions the Government Code designates as managerial.

LEGISLATIVE HISTORY

AB 53—Portantino (Held in Assembly, 2009) placed a freeze any state employee's salary whose base salary is $150,000 or higher until January 1, 2012 and prohibited those employees from receiving payment for overtime work and exempted a person whose compensation is governed by an operative memorandum of understanding and a person who is exempted by executive order of the Governor or a person whose salary is set pursuant to the California Constitution.

Chapter 333, Statutes of 2007 (AB 1317—Mullin) expanded the CalSTRS Board's current authority, which was established by Chapter 856, Statutes of 2003 (SB 269—Soto), to set salary level and performance standards to include General Counsel.

Chapter 856, Statutes of 2003 (SB 269—Soto) allowed the Boards of CalSTRS and CalPERS to set salary levels and performance standards for the positions of Chief Executive Officer, System Actuary, Chief Investment Officer and investment managers, consistent with the authority established in Proposition 162. SB 269 also restricts for two years after leaving CalSTRS employment those individuals who were employed for less than five years in these positions from being paid to influence the actions of the CalSTRS or decisions of the Board.

The California Pension Protection Act of 1992 – Proposition 162 of 1992 granted public retirement system board's plenary authority over investment decisions and the administration of each retirement system in a manner to assure prompt delivery of benefits and related services to members and their beneficiaries.

PROGRAM BACKGROUND

The Teachers' Retirement Board is responsible for designing and implementing a set of compensation principles to support CalSTRS' long term human resource and investment objectives. These compensation principles are based upon the philosophy that:

- To achieve its business and investment objectives, CalSTRS must be able to hire, motivate, and retain high-quality executive management and investment staff. A reasonable and competitive pay program is critical to accomplishing these objectives.
- While CalSTRS is a public organization, private sector firms are a key labor market for CalSTRS' executive management and investment professionals.
- For executive management and investment professionals, private sector pay levels are generally higher than public sector pay levels, with much of the difference attributable to relatively higher private sector cash incentives/bonuses.

Recognizing this philosophy, the CalSTRS Compensation Program:

- Is structured to provide pay opportunities consistent with a peer group weighted 67 percent to other leading public funds and 33 percent to a broad range of private sector firms.
- Reinforces performance-based incentive pay. In particular, under CalSTRS' incentives plan:
  - Investment-related bonuses are only earned when investment performance is above defined benchmarks (i.e., when value is created for members, beneficiaries and taxpayers).
  - Maximum incentive payouts are calibrated to represent a very small portion of the above-benchmark value that staff could create. That is, at maximum payout levels, staff bonuses equal about $32 per $10,000 of above-benchmark performance.

In keeping with best practices and in order to satisfy our long-term objectives, the board assesses relevant competitive market compensation survey data at least every two years. Such data is secured from reputable, third-party sources.

ANALYSIS:

Existing Law:

The Department of Personnel Administration generally establishes and adjusts salary ranges for each classification in the state civil service, based on specified merit limits. The salary range is set based on the theory that like salaries shall be paid for comparable duties and responsibilities. In addition, the state is able to enter into a memorandum of understanding relating employer-employee relations with employee organizations representing certain state employees.

Current law authorizes the Board to fix compensation for the chief executive officer, system actuary, chief counsel, chief investment officer and the other investment officers and portfolio manager positions at a competitive level commensurate with the knowledge and experience that their work demands, which provides CalSTRS with a larger candidate pool and has enabled them to retain well-qualified staff in these positions.

This bill:

AB 7 prohibits state employees whose base salary is greater than $150,000 per year from receiving a salary increase or a bonus while employed in the same position or classification until January 1, 2014. This bill exempts a person whose compensation is governed by an operative memorandum of understanding, a person who is exempted by executive order of the Governor or a person whose salary is set pursuant to the California Constitution.

Imposing a salary freeze and eliminating incentive compensation could make it very difficult for the board to recruit and retain experienced and talented staff. In comparison, some of the larger county retirement systems, such as Los Angeles and San Francisco, which have less than 5 percent of the asset size as CalSTRS, pay salaries and incentives above $150,000. As a result, if AB 7 is enacted it could have a significantly negative impact on CalSTRS investment results and will directly affect its current and future recruitment and retention efforts for qualified, experienced senior investment professionals and senior executive management.

The Teachers' Retirement Board has spent considerable hours working with personnel experts to develop a comprehensive and market competitive compensation program. AB 7 would negate all of that work effort. To date, CalSTRS has experienced a much higher retention rate of seasoned investment and executive professionals compared to other public pension systems in and outside the state and compared to current averages of the financial services industry.

In addition, internal investment managers cost approximately one tenth as much as external investment managers. In the spring of 2011, the Teachers' Retirement Board is reviewing plans to bring investment assets in-house to dramatically reduce costs. This bill would restrict CalSTRS ability to manage assets internally, and likely require additional movement of assets to external managers. This will result in considerably increased CalSTRS costs.

This measure could result in CalSTRS losing highly qualified, high performing investment staff as the best and brightest are the most marketable and most likely to leave, especially as the financial markets improve. A loss of this caliber investment staff could result in CalSTRS losing more than an estimated $1 billion in potential gain combined with higher costs.

FISCAL IMPACT

Benefit Program Cost – Potential loss of hundreds of millions in annual investment earnings.

Administrative Costs/Savings – There may be a potential savings of $1.5 million to $3 million per year, as a result of eliminating the incentive compensation of some CalSTRS employees.

SUPPORT

None Known

OPPOSITION

None Known

SUPPORTING ARGUMENTS

PROS:

- There may be potential short term savings of $1.5 million to 3 million per year as a result of eliminating incentive compensation of some CalSTRS employees.

CONS:

- Potential loss of hundreds of millions in investment earnings.
- Increased difficulty recruiting and retaining experienced and highly qualified staff which could result in higher investment staff vacancy rates, higher recruitment costs.
- Increased costs for an externally managed investment program.

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