Bill Number: SB 1368 (Anderson) as amended on April 16, 2012

SUMMARY

SB 1368 prohibits the annual rate of salary of a state officer or employee, including a CalSTRS employee, from exceeding the annual salary authorized to be received by the Governor on or after January 1, 2013.

BOARD POSITION

Oppose. This bill would significantly affect employee retention and recruitment for key CalSTRS classifications, which could affect the ability of the system to provide retirement benefits in a cost-effective manner. Currently, the board has the authority to set compensation for the 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.

SUMMARY OF AMENDMENTS

April 16, 2012 amendments:

- Clarified that it is the intent of the Legislature that this bill apply to all state employees who are not constitutional officers or who are not currently subject to an existing memorandum of understanding or employment contract with the State of California prior to January 1, 2013.
- Clarified that it is the intent of the Legislature to apply this bill to all state agencies and positions not exempted by the California Constitution, including the Department of Corrections and Rehabilitation and the California State University System.
- Exempts compensation for an exempt public safety employee that exceeds the Governor’s annual salary, if the salary is approved by the department head or the chief administrative officer and defines a public safety officer as a correctional officer, officer of the California Highway Patrol, or other public safety officer whose job duties are essential to the immediate preservation of public safety.
- Exempts state employees if the Governor declares a state of emergency and determines that is necessary to exceed the Governor’s annual salary.

REASON FOR THE BILL

To protect the taxpayers of California by limiting the salaries of state officers and employees from exceeding the annual salary authorized to be received by the Governor especially since California continues to face budget shortfalls that have been complicated by economic conditions leading to an estimated $10 billion budget deficit through 2012-13.

ANALYSIS:

Existing Law:

The California Citizens Compensation Commission (Commission) sets the salaries and medical, dental, insurance and other similar benefits of Members of the Legislature and the state's other elected officials. The Commission is prohibited from increasing elected officials' salaries during budget deficit years. The seven members of the commission are appointed by the Governor for six-year terms and are required to meet by June 30 of each year to decide what changes to make, if any, the following December. Actions of the commission are effective on a December-to-December basis. The current Governor's salary is $173,987. It was lowered in December 2009 from $212,179; prior to December 2006, the Governor's salary had remained unchanged at $175,000 since December 2000.

Current law authorizes the Teachers' Retirement 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:

SB 1368 prohibits the annual rate of salary of a state officer or employee, including a CalSTRS employee, from exceeding the annual salary authorized to be received by the Governor on or after January 1, 2013.

The rationale for establishing compensation policies and procedures for executive and investment management positions is based on consideration of the labor market conditions affecting recruitment and retention. The board has adopted a compensation program designed to recruit and retain the highly-skilled executive management and investment staff needed in key positions.

SB 1368 would infringe on the plenary authority of the board to set compensation as specified in current law, directly affecting CalSTRS' ability to attract and retain high quality executive management and investment staff. Furthermore, this bill raises both legal and constitutional concerns related to employee rights, such as what, if any, notice will be given to affected employees. Although it is unclear as to what happens if the commission lowers or raises the Governor's salary during a particular year, the board may have to include disclaimers when setting salaries for executive management and investment staff that state that if the commission lowers the Governor's salary at any point during that year, their salary is subject to change. This could cause undue hardship to employees and potential litigation costs could be incurred by CalSTRS and the state should this bill be enacted into law.

Imposing a salary cap of $173,987 would result in reduced salary ranges for approximately 14 staff, including the CEO, Chief Investment Officer, Investment Directors, Portfolio Managers, System Actuary and the General Counsel based on the following current salary ranges.

Position	Minimum	Midpoint	Maximum	Difference v. $173,987	Difference %
CEO	$240,000	$275,000	$315,000	-141,013	-44.8%
CIO	275,000	320,000	365,000	-191,013	-52.3%
Investment Directors	170,000	205,000	240,000	-66,013	-37.9%
Portfolio Managers	145,000	170,000	195,000	-21,013	-12.1%
System Actuary	135,000	155,000	175,000	-1,013	-5.8%
General Counsel	170,000	205,000	240,000	-66,013	-37.9%

The reduction in pay opportunity is considerable and will result in a compensation structure that is no longer competitive with the private sector or peer public funds. It is the author's intent that the reduced salary structure affects new employees as well as those employees reappointed as of January 1, 2013; however, the bill is not clearly drafted to reflect his intent. The inability to provide reasonable and competitive compensation will have a severe impact on CalSTRS' ability to attract, retain and motivate key employees, no longer making CalSTRS an employer of choice over private sector firms or other large public funds.

Additionally, employees hired in non-managerial investment classifications after January 1, 2013, may not be willing to continue their employment with CalSTRS for the duration of their careers because the motivation to promote to the higher level investment positions will be decreased due to the potential to obtain higher compensation in the private sector. After gaining valuable experience from CalSTRS, these individuals will be able to leave the organization and obtain employment in the private sector or at peer public funds, making CalSTRS a training ground for organizations it competes with in the labor market.

For example, if CalSTRS were to lose 20 percent of its senior investment staff, the board would be required by its fiduciary responsibility to outsource more of the portfolio management, which would cost 10 times more than current internal asset management staff, as found by a joint 2003 CalSTRS and CalPERS study by McKinsey & Company. Internal investment managers cost approximately one tenth as much as external investment managers. CalSTRS has been in the process of bringing the management of assets in house to reduce costs. This bill would restrict CalSTRS ability to manage assets internally and likely require additional movement of assets to external managers. This would result in a considerable increase of CalSTRS costs.

LEGISLATIVE HISTORY

AB 7- Portantino (Held in Assembly Appropriations Committee, 2011) prohibits certain state employees whose annual base salary is over $150,000 from receiving a salary increase or a bonus until January 1, 2014. Specifically, this bill: (1) Applies to person employed in the same position or classification. (2) Applies to persons employed by the executive, legislative or judicial branches of government, appointees to state boards and commissions and employees of the California State University system, but not local trial court employees. (3) Exempts from these provisions state employees whose salaries are governed by a memoranda of understanding, a person who occupies a classification that is deemed necessary to public safety and security by the governor through an executive order or a person whose salary is set by the State Constitution. (4) Authorizes the Controller to reject a request for payments that violate these provisions. (5) Urges the University of California system to adopt this policy.

AB 1764—Portantino (Held in Assembly Appropriations Committee, 2010) prohibits certain state employees whose annual base salary is over $150,000 from receiving a salary increase until January 1, 2013. Specifically, this bill: (1) applies to individuals employed by the executive, legislative or judicial branches of government, appointees to state boards and commissions, and employees of the CSU system. The bill urges the UC system to adopt this policy; (2) exempts from these provisions (a) state employees whose salaries are governed by a memoranda of understanding pursuant to a collective bargaining agreement, (b) employees who occupy a classification that is deemed necessary to public safety and security by the governor through an executive order, (c) a person whose salary is set by the State Constitution, and (d) employees of trial courts; and (3) authorizes the controller to reject a request for a disbursement of funds that violates these provisions.

AB 53—Portantino (Died in Assembly, 2009) freezes any state employee's salary whose base salary is $150,000 or higher until January 1, 2012 and prohibits those employees from receiving payment for overtime work. Exempts 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. In addition, urges the Regents of the University of California and the Board of Directors of the Hastings College of the Law to adopt the policy for individuals employed by those entities.

PROGRAM BACKGROUND

In order to permit the Teachers' Retirement Board to exercise its fiduciary responsibility pursuant to Section 17 of Article XVI of the California Constitution, the Department of Personnel Administration established certain senior executive positions and investment management positions at both state retirement systems that were exempt from civil service, and subsequently delegated authority to the board to establish additional exempt positions and determine the compensation paid to those employees pursuant to compensation policies established by the respective boards.

Chapter 856, Statutes of 2003 (SB 269-Soto) authorized the board to set compensation for the chief executive officer, system actuary, 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 provided CalSTRS with a larger candidate pool and has enabled them to retain well-qualified staff in these positions. Subsequently, Chapter 333, Statutes of 2007 (AB 1317-Mullin) expanded the boards authority to also include the general counsel.

The express purpose of these two statutes was to enable the board to attract and retain key personnel by empowering the board to establish both appropriate classifications within the civil service for its senior executive and investment management employees and the compensation paid to those employees, competitive with the compensation paid to employees in other retirement and financial service entities, consistent with the holding of Westly v. Board of Administration, and notwithstanding the provisions of the Government Code that provide the State Personnel Board and the Department of Personnel Administration that authority. This bill is directly contrary to the expressed intent of the Legislature to provide CalSTRS this authority with respect to these specific positions.

The 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.

In keeping with best practices and in order to satisfy CalSTRS' 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 reflecting a mix of public and private sector markets.

FISCAL IMPACT

<u>Program Cost</u> – Potential loss of hundreds of millions in annual investment earnings.

<u>Administrative Costs/Savings</u> – There may be a potential savings of $500,000 to $1 million per year as a result of prohibiting CalSTRS employee salaries from exceeding the annual salary authorized by the Governor; however, this would more than likely be offset by the increased costs of hiring external managers to manage the investment program.

In addition, there may be an inability to provide reasonable and competitive compensation for the CEO, CIO, investment managers and other key staff, which may result in their departure from CalSTRS and potential operational deficiencies should the positions remain vacant for an extended period of time due to recruitment and retention problems. This could result in increased use of external fund managers, at greater cost to CalSTRS.

SUPPORT

Howard Jarvis Taxpayers Association (HJTA)
National Tax Limitation Committee

OPPOSITION

California State Teacher Retirement System (CalSTRS)

California Association of Professional Scientists (CAPS)
California Correctional Peace Officers Association (CCPOA)
California Correctional Supervisors Organization (CCSO)
California State University (CSU)
Professional Engineers in California Government (PEG)
University of California (UC)

ARGUMENTS

Pro: There may be potential short term savings of $500,000 to $1 million per year as a result of prohibiting CalSTRS employee salaries from exceeding the annual salary authorized by the Governor.

Con: Potential loss of hundreds of millions in investment earnings.

Increased difficulty recruiting and retaining experienced and highly qualified executive management and investment staff which could result in higher investment staff vacancy rates, and higher recruitment costs.

Increased costs for an externally managed investment program.

Raises legal concerns associated with reducing employee salaries.

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