PersWatch

Enhancing Benefits Through
Increased Accountability

<u>REVISED 3/17/09</u> Testimony of James McRitchie to CalPERS Performance and Compensation Committee – March 16, 2009 Agenda Items 4, 5, and 6

Why Issue Raised

Several on my PERSWatch mailing list complained of "outrageous" staff bonuses totaling $3.5 million and "trickery" last summer when the CalPERS real estate portfolio reportedly gained in value, while the value of homes and our economy plummeted. That's not good for public relations. Upon further examination, I think our bonus system can be improved.

Public Pensions Under Attack

Former Assemblyman Keith Richman and the Howard Jarvis Taxpayers Association are busy again. Paul McCauley is circulating a petition to allow vested pensions to be renegotiated. The State faces a $48.2 billion unfunded obligation for retired state employee health benefits. Investment management firm SEI reports that nearly half of U.S. pension plan sponsors are likely to end their defined benefit pension plans this year. (http://www.complianceweek.com/blog/whitehouse/category/pensions)

Bonuses Under Attack

The public is up in arms about bonuses being paid out to AIG. But the public isn't just outraged at companies getting bailouts. Here's a headline from Boston: "Pension fund chief has bonus after loss." Despite losses to the state's pension fund of $1 billion, the CEO got a $64,000 bonus because the fund outperformed market indexes. The headline in Sacramento could be worse.

What Pension Plans Are Demanding of Private Sector

In response to the public and shareowner outcry, more than two-thirds of survey respondents to a Grant Thornton study of its US clients paid 2008 bonuses *below* targeted levels, while more than a quarter *eliminated* them altogether. Activist funds are pushing "say on pay" and clawbacks for unearned compensation. AFSCME is introducing "hold past retirement" resolutions, which ask that companies hold 75% of bonuses until after retirement, and "bonus banking" resolutions where bonuses are at least held for several years to ensure against spikes, earnings adjustments, etc. CalPERS Human Resources should review these resolutions with corporate governance staff in your Investment Office to determine what best practices should apply to staff and that it is aligned with corporate governance policies.

CalPERS Should Restructure Bonuses

CalPERS' bonus structure suffers, to some degree, from characteristics frequently criticized in the corporate sector. Like options grants to corporate executives, CalPERS bonuses are structured with no downside risk, only upside gain. Additionally, adjustments or "clawback" provisions are needed to recoup unearned bonuses.

Last year, as the market was tanking, CalPERS awarded $3.5 million in bonuses. A substantial portion was based on measures not directly connected to fund returns like leadership, selecting managers, maintaining policies, and staffing.

Points in these proposed plans are only awarded, not subtracted. So, managers could do poorly in factors that cost tens of millions but still get a bonus based on factors that yield only tens of thousands.

Because of the inclusion of factors like staff development, and because there are no negative points, only positive points, a scenario could occur where not only does the fund lose money and the fund manager gets a bonuses, but the fund manager also doesn't beat any of their financial benchmarks, and still gets a bonus because of these softer performance measures.

Additionally, it is my understanding that CalPERS annual bonuses are weighted (1 year performance counts 10%, 3 year 40%, and 5 year 50%) and that adjustments to fund valuation aren't applied retroactively. If there is no mark-to-market accounting, staff might be getting performance bonuses based on a bubble. While the 1, 3, and 5-year bases give greater weight to long-term performance, since negative points aren't considered, there is really no penalty for artificially spiking performance.

CalPERS should award negative points *for under-performance and should subtract these from positive basis points. Payments should also be delayed to ensure performance reflects market, rather than book, value. This is especially important for real estate, alternative investment and other managers where value isn't measured minute by minute, as it is with most equities.*

Think about paying on a one or two year delay. Spread payout even more or scale it back if CalPERS is in a down cycle or the employee quits. In fact, if they quit, perhaps they should forgo their final year of performance pay. These reforms would not only better align pay with performance, they would decrease staff turnover and guard against a possible public relations nightmare.