OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Retirement Package Design and Options for Consideration

OVERVIEW

On March 4, 2008 the Mayor briefed the City Council in closed session and made public a proposal to restructure the retirement benefits package for non-safety City employees hired on or after January 1, 2009. In summary, the package scales back benefits, disincentivizes early retirement and reduces both costs and investment risks to the City. The Mayor's team is meeting and conferring with the appropriate labor unions on this one plan.

The Mayor's team, through a contract with Mercer Human Resource Consulting, has been provided with educational workshops and design strategies, including alternative plan designs, since early October 2007. From this effort, the Mayor identified one plan that he has proposed to the City Councilmembers. No other options have been presented. While we support pension reform efforts, we feel that this significant policy decision warrants a thoughtful discussion of objectives for a new City of San Diego retirement package and alternative plans that could meet those objectives.

For this reason, the IBA undertook to create some alternative plans to illustrate how various plan components could achieve similar goals to those in the Mayor's proposal. We have developed five different designs and added a sixth CalPERS design for valuation. We believe that providing options for discussion will result in a more deliberative process and ultimately a better end product for both employee and employer.

FISCAL/POLICY DISCUSSION

When preparing to design and implement a new retirement package, decision-makers must first set objectives to achieve through implementation, and then find a plan design that meets those objectives. A brief discussion of some of the objectives for consideration follows:

Allocation of Investment Risk

In many ways, the discussion of the allocation of investment risk between employee and employer compares a defined benefit plan (i.e. a traditional pension) to a defined contribution plan (i.e. a 401(k)). In the former, the employer retains all of the investment risk, because a promise has been made to provide a certain benefit in the future, regardless of how the investment performs. In a defined benefit program, the employer makes up any difference created by under-performing investments. In a defined contribution plan, the employee retains all of the risk, because the only commitment of the employer is to contribute a certain amount or percentage of pay. How that investment performs will be part of what determines the ultimate amount available for the employee's retirement, and the employee bears the risk of an under-performing investment that may provide a less than desirable retirement account balance.

Trends in the private sector, as well as with some public sector agencies, reflect a move toward defined contribution plans in order to limit risk of costs to the employer that they have limited control over. In the City, general employees actually have both a defined benefit and defined contribution plan, which enables the employee and employer to share the risk of investment to some degree.

On a related note, we remind the reader that transferring investment risk from employer to employee may actually reduce the investment potential, as well. Many studies have shown that defined contribution plans that are self-directed are invested with less success than defined benefit plans such as the San Diego City Employees' Retirement System, which has realized returns of nearly 10% in the last decade. Whether it is due to less education for the average investor, access to better investment vehicles and advisers, or other factors, if a reduction in risk to the employer is pursued, it is worthwhile to evaluate the advantages and disadvantages of different investment opportunities for defined contribution portions of the retirement package.

In designing a new retirement package, the City should gather information about a desirable level of investment risk allocation in order to enhance the probability of an adequate retirement for the employee and the most efficient and effective use of public funds.

Recruitment and Retention

Recruitment and retention of talented employees is a significant issue for state and local governments. The aging population will likely create significant burdens for public sector employment in the coming years. According to the Rockefeller Center for the Study of the States, approximately two-fifths of state and local government employees will be eligible for retirement over the next 5 to 10 years. The workforce population is growing at a slower rate than those eligible for retirement, which could further exacerbate an already tight labor market. As a result, recruiting younger employees to join the public sector could become more difficult in such a competitive environment.

One major incentive of public sector employment is the relative stability and security that is offered by a government position. Pension benefits are a key component of that security, producing an incentive that offsets monetary compensation incentives (such as year end bonuses or stock options) that may be offered in private sector employment.

Governor Schwarzenegger's Public Employee Post-Employment Benefits Commission (PEBC) recently released a comprehensive analysis of pension programs throughout the state, offering a plan to address public pension funding issues. The first principle guiding the Report's discussion and recommendations was:

> 1. A competitive, affordable benefits package serves the public good by enabling public employers to recruit and retain qualified public employees.

In 2005, the League of California Cities issued a report addressing public sector pension reform. In it, they offered the following recommendation:

> Pension benefits should be viewed in the context of an overall compensation structure whose goal is the recruitment and retention of employees in public sector jobs. In recognition of competitive market forces, any change in the structure of retirement benefits must be evaluated in concert with other adjustments in compensation necessary to continue to attract and retain an experienced and qualified workforce.

In addressing pension reform, the League of California Cities concluded:

> Defined benefit plans should be retained as the central component of public pension systems in California.

Income Replacement

Inasmuch as the successful recruitment and retention of employees depends largely on the compensation package offered, the income replacement provided through the City's retirement package must be a key component of any plan design. Studies suggest that an individual will require an income replacement ratio of 75-90% if retiring at age 65. When considering the establishment of a new retirement package, an employer should engage an actuary to provide estimates of the income replacement ratio that would be provided under the plan at the targeted retirement age. For a defined benefit plan, this includes a calculation of benefits as specified by the plan formula. For a defined contribution plan, this includes assumptions as to contribution behavior (if voluntary contributions are available) and investment returns, among other factors. Later in this report, we will look at income replacement ratios under a variety of sample packages.

Retirement Age & Accrual Rates

In providing a retirement package, it is important to consider the retirement behavior that is being incentivized through the structure of the benefits. Two plans that may be intended to provide the same benefits at a given age may have a very different accrual pattern. For instance, defined benefit plans are generally known to backload the accrual of benefits, such that the majority of benefits at retirement age were accrued in the later years of the employee's career. In contrast, defined contribution plans are generally known to accrue benefits more quickly, or earlier in an employee's career.

Similarly, two defined benefit plans may provide the same benefits (i.e. 2% at age 65) but one may accrue more benefits earlier (i.e. 1.00% at age 55 vs. 0.76% at age 55). These factors may result in differing retirement decisions for employees and will create differing cost structures for the employer.

As a result, it is critical that an employer considering new retirement plan designs first make a reasoned decision on a fair and appropriate retirement age for targeted benefits, considering also the retirement behavior to be incentivized and an affordable cost structure for the employer. Once a target age is defined, a plan may be designed to meet that target. For consideration, age 65 has often been cited as a traditional retirement age, while full Social Security benefits are available at age 67 for those born 1960 and later. In the Final Report of the City's Pension Reform Committee (PRC) in 2004, the Committee recommended increasing the General and Legislative standard retirement age to 62. This recommendation has not been brought forward for consideration, but the Kroll report advised the City to review these and other PRC recommendations as part of the remediation plan.

Employer Costs

An essential consideration in designing a retirement package is the cost to the employer. Particularly in a public agency, there is a duty to utilize taxpayer funds as efficiently and effectively as possible. As referenced above, the Governor's PEBC made their first principle both a competitive and affordable benefits package. In addition, in August 2006, Kroll recommended in their report that the City should develop a retirement plan that could attract and retain talented employees as well as be affordable to the City. The plans to be considered in this report all provide an estimate of the employer contribution rate, enabling the City Council to understand the costs of providing different types and levels of benefits.

The Mayor's proposal would achieve several objectives as compared to the City's current retirement package. Most notably, it is expected that it would do much to disincentivize early retirement, control costs and risk for the City, and provide income replacement that is in-line with industry recommendations. Similarly, the IBA has developed several alternative plans that were designed to meet a variety of these objectives, and to different degrees. To model these plans, as well as to compare them to the Mayor's proposal and the City's current package, we enlisted the assistance of the City's contracted actuary, Mr. Joseph Esuchanko, Actuarial Service Company, P.C. His analysis and valuation of the various plan designs are attached to this report.

For purposes of this discussion, we will be referring to the Actuary's Exhibit 3, which utilizes final compensation based on the average of final three years salary and results are based on 35 years of service at age 65. In addition, we note the assumptions used for all designs, found on p. 3 of the Actuary's report, as follows:

- Investment return on SPSP: 6%
- Inflation factor: 3%
- Annuity rate of return: 6%

Three of the seven alternatives are described briefly below**. The full detail can be found in the attached Actuary's report, pp. 2-3 and Exhibit 3.**

Design One:
Defined Benefit Plan: 2% at 65 formula.
Defined Contribution Plan: 3% mandatory contribution and match. No voluntary contribution or match.
Results: This plan scales back benefits and also incentivizes later retirement as compared to the current plan. The defined benefit plan is emphasized and still comprises the majority of the retirement benefits. **Design Two** provides a similar structure that achieve these same objectives.

Design Four:
Defined Benefit Plan: 1.75% at 65 formula.
Defined Contribution Plan: Partial matches for voluntary and mandatory contributions.
Results: Similar to the Mayor's proposal and private sector trends, this provides a significant shift in emphasis from defined benefit to defined contribution, although the defined benefit plan is still the primary source of retirement benefits. **Designs Five and Six** represent a middle ground approach between Designs One and Four, wherein the defined contribution portion is emphasized but the defined benefit portion is not reduced as significantly as seen here.

CalPERS Design:
Defined Benefit Plan: Utilizes CalPERS' 2% at 60 formula.
Defined Contribution Plan: None specified at this time.
Results: Benefits are moderately scaled back, but consistent with other public agencies in that approximately 2,500 employers contract with CalPERS for this or one of their other defined benefit plans. Any type of defined contribution plan could be paired with this plan if desired, but the emphasis would remain on the defined benefit portion for the provision of benefits. **Design Three** provides a variation which is closely related to this approach.

The following chart compares the City's current package with the Mayor's proposal and this selection of IBA alternative packages on the key objectives described above:

	Design One	Design Four	CalPERS Design	Current Plan	Mayor's Proposal
Allocation of Investment Risk (Ratio)	3.8-to-1 City to Employee	1.7-to-1 City to Employee	Variable*	2.7-to-1 City to Employee	1.9-to-1 City to Employee
Income Replacement (Age 65)	84.65%	94.06%	80.85%*	133.85%	82.24%
Within recommended range?	Yes	Yes	Yes	No	Yes
Retirement Age Target	65	65	60	55	65
Employer Costs (percent of pay)	9%	9.4%	7.62%*	15.94%	9.6%
Estimated City Savings (final)	$23.6M	$21.9M	$7.9M*	N/A	$22.3M

* does not include effect of a defined contribution plan, if any

While it is difficult to assign a value to a plan in terms of whether it will recruit and retain top talent in the City's employee ranks, it may help to compare the City to other nearby jurisdictions with which the City competes for employees. As we've discussed above, comparisons should include the full compensation packages offered by the jurisdictions. While that is beyond the scope of this report, we believe it is valuable to know how the current and prospective retirement packages compare, as a first step in understanding how a change may impact the City's success in this area. Here are some notes on retirement packages provided by the County and other cities in San Diego County.

- ✓ Similar to the City, 14 other cities do not participate in Social Security
- ✓ Only two other cities provide a 401(k) defined contribution plan to employees, similar to the City's SPSP program
- ✓ The County and at least 16 of the cities provide an optional 457 deferred compensation plan, as does the City
- ✓ All 17 other cities contract with CalPERS for some or all of their defined benefit plan administration
    - 9 contract for the 3.0% at 60
    - 3 contract for the 2.7% at 55
    - 3 contract for the 2.5% at 55
    - 2 contract for the 2.0% at 55

- ✓ The County of San Diego uses a 3% at 60 formula through the San Diego County Employees' Retirement Association

While the Mayor's proposal is expected to achieve many of the objectives listed, the IBA does note that its stronger shift to the defined contribution plan is a significant departure from retirement packages provided by other public agencies, and that the benefits offered may be lower for the employee than in other sample plans, while not achieving significantly more savings for the City. The IBA also suggests that the sample plans provided may be more straightforward in that a prospective employee could easily understand the benefits offered and how that compares to other local employers. Coupled with better benefits for the same projected cost, these plans may provide for more success in recruitment and retention. Based on this review, the IBA finds many reasons to more thoroughly develop plan objectives with decision-makers and explore alternatives to ensure the implementation of the most beneficial package to both employer and employee.

CONCLUSION

The IBA is not recommending a particular plan design at this time, though we support the broad principles the Mayor has sought to achieve, including: controlling costs and investment risk for the City; disincentivizing early retirement; and providing an adequate replacement income for employees that will also enable the City to attract and retain a talented workforce. As shown in this analysis, we believe there are many plans that can achieve these goals and to different degrees. We are available to assist the Council as further discussions and analysis are conducted during this time.

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Attachment