

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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City Council Docket Date: March 5, 2007

Item Number: 203

Subject: Amendments to the San Diego Municipal Code Eliminating the “Waterfall”

OVERVIEW

This proposal asks the City Council to strike certain portions of the San Diego Municipal Code that, over the past two decades, have created unrecognized liabilities in the Retirement System and diverted assets from the SDCERS Trust Fund. The City Attorney’s Report presents a history of the development of the Waterfall and the concept of Surplus Earnings, including its flawed financial basis. This information has been public for some time and many parties, including the IBA, have called for analysis and action to eliminate this practice. The item before the Council at this time is intended to accomplish that goal.

FISCAL/POLICY DISCUSSION

The IBA strongly supports the elimination of the concept of Surplus Earnings and the Waterfall from the City’s Municipal Code. At the same time, it is critical that decision-makers understand the various potential impacts of striking out these sections as proposed.

§24.1502(a)(1) Employee and Employer Contribution Accounts

This section requires interest to be credited to such accounts in accordance with §24.0904 and Board rules. Since §24.0904 still stands with this action, it is our understanding that elimination of the Waterfall will not impact the SDCERS Board’s ability to credit interest as appropriate according to their legal and fiduciary duty.

§24.1502(a)(2) SDCERS Administrative Budget

Elimination of the Waterfall will mean that “Surplus Earnings” are no longer diverted to this purpose. However, SDCERS still must administer the Retirement System and an operating budget is required to do so. Based on our conversations with the City

Attorney's Office, we understand that SDCERS has the right to use plan assets for their administrative budget under the California Constitution, even if this provision of the Municipal Code is eliminated, and therefore there should be no impact to SDCERS. We would note briefly, however, that SDCERS has committed to administering the Retirement System consistent with the City's Municipal Code, which serve as the Plan Documents for the System, in accordance with IRS requirements. This would seem to indicate that the City should consider, as an extra measure, insert appropriate language to authorize expenses for the operating budget in another section of the Municipal Code, in accordance with guidance from the City Attorney.

§24.1502(a)(3) Any Reserves Established by Board

It is our understanding that this section applies to the DROP Reserves in place, but that there are no other reserves established under this section at this time. The SDCERS Board has taken action to formally recognize the DROP assets and liabilities and these appear in the recent valuation. In addition, the Board has established an ad-hoc committee to study the issue of crediting interest to DROP accounts, which is understood to be under their purview as fiduciaries. Elimination of this section is therefore not expected to impact benefits to members or the finances of the City or System.

§24.1502(a)(4) Credit Surplus Earnings to Other Plan Sponsors

Since the concept of Surplus Earnings will no longer exist, there will be no surplus earnings to distribute to the various Plan Sponsors. Without the concept of Surplus Earnings and diversion of those earnings to other purposes, this section is unnecessary. The Board will continue to ensure, with the advice of their actuary and counsel, that total earnings are appropriately distributed among Plan sponsors, in accordance with their duty as fiduciaries.

§24.1502(a)(5) Retiree Health

In 2005, the City took the responsibility of funding retiree health benefits from its own funds. In addition, the reserve originally established to fund this benefit was completely drawn down at that time, and no further funds exist in this reserve. It is appropriate to eliminate any reference to retiree health as a financial obligation of the SDCERS Trust in the City's Municipal Code.

§24.1502(a)(6) 13th Check

This benefit will still exist, as provided for in §24.1503. However, this section only establishes the benefit and eligibility for it, but does not specify when it is to be paid. We have consulted with the City Attorney's Office on this and it is our understanding that this shall be clarified as soon as possible. Additionally, we would note that this payment has been assumed by SDCERS in their valuation of June 30, 2006, wherein the liabilities for the 13th check were included with the assumption that the benefit will be paid 100% of the time. Therefore, the ARC the City pays each year will provide assets to cover

these liabilities and the elimination of this section should not have any further financial impact.

§24.1502(a)(7) Corbett Settlement

As with the 13th Check, this liability is now recognized in the total liabilities of SDCERS and is included in their valuation of June 30, 2006. The City's ARC now provides assets to cover this liability. It is our understanding that it is satisfactory to eliminate the reference to payment of this liability since the City already has an obligation to do so under the terms of the settlement, even if it is not codified anywhere in the Municipal Code. However, we would again note that SDCERS has committed to administering the Retirement System consistent with the City's Municipal Code, which serve as the Plan Documents for the System, in accordance with IRS requirements. As with the SDCERS administrative budget, the City Council may wish to explore inserting appropriate language to authorize expenses for this settlement in another section of the Municipal Code, in accordance with guidance from the City Attorney.

§24.1502(a)(8) Credit Interest to Supplemental COLA and Employee Contribution Reserve

The Employee Contribution Reserve has been fully exhausted, so it is appropriate to remove any reference to interest crediting for this account. The Supplemental COLA Reserve was valued at \$17,273,016 as of June 30, 2006. Municipal Code §24.1503(c)(3) provides for the annual crediting of interest, so the ability to credit interest is not eliminated. However, §24.1503(c)(3) states that interest shall be credited "if sufficient funds are available." The determination of what constitutes sufficient funds and on what authority is not further defined in the Municipal Code. We suggest that this should be clarified by the City Council with counsel from the City Attorney.

§24.1502(b) Surplus Earnings Credited to Employer Contribution Reserve to Reduce System Liability

Since the concept of Surplus Earnings will no longer exist, there will be no surplus earnings to distribute to the System's liabilities. However, since earnings will flow into System assets to reduce any unfunded liability, there is no fiscal impact with the elimination of this section. Without the concept of Surplus Earnings and diversion of those earnings to other purposes, this section is unnecessary.

The IBA also notes that references to Surplus Earnings and/or any sections above have also been eliminated throughout Municipal Code Chapter 2, Article 4, Division 15 in this proposed ordinance

Finally, the IBA notes that the City Attorney's Office has asserted that neither Meet and Confer nor a vote of the Retirement System Membership (pursuant to Charter Section 143.1(a)) is required to adopt this ordinance. This is because no benefits are impacted but the funding mechanism is changed, which is a management right.

CONCLUSION

The IBA supports this effort to remove the Waterfall from the City’s Municipal Code. In so doing, the faulty concept of Surplus Earnings will be eliminated from the City’s code and operations. As discussed in the above, the IBA encourages the City Council to engage the City Attorney’s counsel further on the following issues:

1. Shall the City Council insert authorizing language for payment of Corbett benefits and expenditure of funds for SDCERS operating budget elsewhere in the Municipal Code, to ensure that SDCERS may comply with IRS requirements to administer the System in accordance with Plan Documents?
2. Absent the qualifications in the Waterfall, what is the authority on when the 13th Check shall be paid out?
3. Regarding interest crediting to the Supplemental COLA Reserve, what constitutes “sufficient funds” and who is responsible for determining it?

With these minor clarifications in hand, the IBA supports this item in which the Waterfall and the concept of Surplus Earnings will be successfully removed from the City’s Municipal Code in compliance with the City’s Remediation Plan, the Internal Revenue Code, and the California Constitution, as referenced in the City Attorney’s report.

[SIGNED]

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