
OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Information Related to Recommended Contracting Processes for Actuarial Services

OVERVIEW

At the Audit Committee meeting on October 6, 2008, Internal Auditor staff presented their review of internal control remediations that had been identified for the San Diego City Employees Retirement System (SDCERS). The issue of appropriate practices for contracting for actuarial services was discussed as it related to a Kroll Report recommendation for SDCERS. The Audit Committee requested that the IBA work with the Internal Auditor to research information related to best practices for contracting for actuarial services. This report provides the results of that research.

FISCAL/POLICY DISCUSSION

Recommendation from the Kroll Report and SDCERS Response

The Kroll Remediation Plan presented to the City on August 8, 2006 provided over 100 recommendations for improving financial reporting and control processes. Several of these recommendations pertained directly to SDCERS. The following recommendation can be found on page 260 of the Kroll Report:

“We also recommend that SDCERS rebid the contract for the performance of its actuarial valuation every five years and that the actuary not be engaged for more than two five-year terms. After an engagement for the maximum ten-year term, an actuary should be eligible to be considered for an engagement only after five years of no service to SDCERS.”

The Kroll Report does not cite a source or reference for this recommendation and the IBA was unable to reach the Kroll consultants for comment. Kroll noted in their report, however, that they believed former SDCERS actuary Rick Roeder (of Gabriel, Roeder, Smith & Company) “failed to provide the objective, critical advice that could have protected the SDCERS Trust from the City’s penchant for seeking to minimize its contributions to the System.” Mr. Roeder was the SDCERS actuary for a 12-year period from 1992 to 2004. The SDCERS Board hired Cheiron to serve as its actuary since 2004 and recently renewed their contract for another three-year term (with a five-year renewal option).

In responding to the Internal Auditor and the Audit Committee regarding the above referenced Kroll recommendation, SDCERS CFO Mark Hovey indicated that the SDCERS Board did not support a maximum ten-year limitation. Mr. Hovey indicated that it was the Board’s go-forward intention to vigorously rebid the actuarial contract every 5 years (his statement ties to a pending change to the SDCERS Board Rules for retaining service providers) and to always select the best qualified bidder. As noted by the Internal Auditor, the recently renewed contract with Cheiron has future renewal options that do not comply with Board’s go-forward policy intention or the Kroll recommendation.

Research Related to Recommended Contracting Processes for Actuarial Services

The IBA contacted several professional associations (Government Finance Officers Association, Society of Actuaries and the American Academy of Actuaries) and was unable to find a recommended best practice for hiring actuaries. The Audit Committee’s professional audit consultant (Jefferson Wells) and the City’s Independent Consultant (Stan Keller) were also asked if they knew of best practices for hiring actuaries. Mr. Keller consulted with McGladery & Pullen, his independent accounting consultant. These expert consultants were similarly unable to find or cite a best practice.

The IBA believes the absence of related best practices neither supports or refutes Kroll’s recommendation. It could be that professional guidelines have yet to be established in this regard. Alternatively, it may be an acceptable practice to renew a contract with the same actuary for more than ten years provided that other safeguards exist for periodically checking their work. In reviewing other literature and viewpoints on this topic, weaknesses associated with using one actuary over an extended period of time include:

- Alternative assumption and valuation viewpoints are not heard.
- Unbiased peer professionals do not check actuarial methods.
- Actuaries may be influenced by their hiring boards – this concern may be real or perceived.

Strengths associated with using one actuary over an extended period of time include:

- Continuity and consistency of actuarial work.
- A more comprehensive understanding of complex plan provisions and the evolution of those provisions.
- Lower fees attributable to plan familiarity.

In order to provide peer agency perspective, the IBA worked with the Internal Auditor to survey the actuarial hiring policies and practices of other large cities. The resulting information is provided in the table below.

City	Actuarial Contract Policy	Practice	Notes
Los Angeles	No	Adhere to city-wide policy which stipulates any contract longer than three years must be approved by Council	No limits on continuous service
San Francisco	No	Adhere to city-wide policy stipulates service agreements be reviewed every five years	No limits on continuous service - past 17 years Towers Perrin, Cheiron since 7/1/08
Phoenix	Yes	Board appoints the actuary and at its discretion, may solicit bids periodically for service	No limits on continuous service
Portland	No	No formal policy for hiring or retaining the actuary. Recently solicited bids and hired a new actuary	No limits on continuous service
San Jose	Yes	Board policy requires rebids every 8 years	No limits on continuous service
Seattle	No	No formal policy for hiring or retaining the actuary. Recently solicited bids and hired a new actuary	New firm has 4-year contract.
Kansas City	No	No formal policy for hiring or retaining the actuary. New firm hired in 2006	Has used same firm for over 20 years

Although the above is a limited sampling of other major cities, it should be noted that there are no limitations on continuous service for actuaries at these agencies.

Actuarial Audits

An actuarial audit is the scrutiny of one actuary's work by another actuary to ensure that actuarial valuations are performed correctly and that the methods and assumptions used are reasonable. Considering the financial objectives of the plan, an actuarial audit includes a critique of the plan actuary's judgment concerning the plan's exposure to risk.

The primary purpose of an actuarial audit is to verify that the actuarial work is accurate and the advice given is sound.

In light of Kroll's recommendation and the stated position of the SDCERS Board, the IBA believes that a comprehensive actuarial audit every five years would significantly address the concern behind the Kroll recommendation and be in keeping with the Board's preference not to have a continuous service limitation. The Government Finance Officers Association recommends actuarial audits at least once every ten years. Many larger plans have a policy of having an actuarial audit every five years, and a few have actuarial audits more frequently. SDCERS officials indicate that the pension plan has yet to commission an actuarial audit.

An actuarial audit would be different than the actuarial work currently being performed by City actuary Joseph Esuchanko. Mr. Esuchanko is performing specialized reviews at the request of different City departments as opposed to performing a prescribed actuarial audit that is regularly commissioned by the SDCERS Board.

Legislative Body Oversight of Pension Administration

Analysis performed by the SDCERS actuary clearly has budget planning implications for the City Council as the estimated value of pension plan assets and liabilities determines the expected level of the City's contribution to the plan in future years. Despite this important connection, the ability of a legislative body to direct the activities of a retirement board appears to be limited. The IBA has performed a limited review of Article 16 (Section 17) of the California Constitution. This section provides that retirement boards have "sole and exclusive fiduciary responsibility" to administer plans and to manage plan assets in a manner that safeguards benefits/services for plan participants and their beneficiaries. The IBA recommends that the Office of the City Attorney be asked to corroborate this understanding or to further clarify the influence that a legislative body may have over plan administration activities that are overseen by a retirement board.

CONCLUSION

Given the City's pension system history and noting some of the potential weaknesses associated with using one actuary over an extended period of time (cited above), the IBA understands the Kroll recommendation to limit continuous service for a particular actuary at ten years. We also appreciate SDCERS stated intention to rebid the actuarial work every five years and always select the best-qualified actuary for the plan. We have also noted that the California Constitution provides retirement boards with plenary authority and fiduciary responsibility to administer their retirement plans.

The IBA believes that SDCERS can satisfy the general intention of the Kroll recommendation and perhaps satisfy Audit Committee concerns by amending their Board Rules to 1) rebid actuary/service provider contracts every five years, 2) honor their fiduciary responsibility to select the best qualified actuary irrespective of existing

consultant relationships, and 3) require a comprehensive actuarial audit be performed every five years by a qualified and competitively selected actuarial firm.

The IBA has shared the above recommendation with the City's Internal Auditor and Jefferson Wells, the Committee's independent audit consultant. Both agree that this action by the SDCERS Board would satisfy the general intention of the Kroll recommendation. The IBA offers this recommendation for the Audit Committee and SDCERS Board to consider.

[SIGNED]

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