ATTACHMENT C

SDCERS
San Diego City Employees' Retirement System

Mark A. Hovey
Chief Executive Officer

August 17, 2010

Honorable Kevin A. Enright
Presiding Judge
Superior Court of the State of California
For the County of San Diego
Hall of Justice
220 West Broadway
San Diego, CA 92101

Re: Grand Jury Report of June 8, 2010

Dear Judge Enright:

The San Diego Grand Jury issued a report entitled "The City's Financial Crisis: Past, Present, and Future" on June 8, 2010, a copy of which is attached. Several of the Grand Jury's comments pertained to the San Diego City Employees' Retirement System (SDCERS). Also attached is a copy of SDCERS' response to the Grand Jury report.

Sincerely,

Mark A. Hovey
Chief Executive Officer

cc: SDCERS' Board of Administration
Honorable Mayor Jerry Sanders
San Diego City Council
Eduardo Luna, City Auditor
City Audit Committee
Victoria Stubblefield, Foreperson of the Grand Jury

Enclosures

SDCERS
San Diego City Employees' Retirement System

Fact/Finding/Recommendation	SDCERS Response
Fact – Set Two (Page 5)	
Fact: During that time, City Hall and SDCERS negotiated increased pension benefits for themselves and their employees.	Only the City negotiated with its bargaining units. SDCERS does not participate in the negotiation process (meet and confer) with the City or the City's bargaining units.
Fact: City employees, including elected officials and SDCERS staffers, were also granted retroactive increases in the rates at which their retirement allowance is calculated. Thus, there was an adjusted higher compensation for work for which retirees had already been paid.	The City negotiated the retroactive increase with its active employees, not retirees, to provide for increased benefits.
Fact: Some former SDCERS Board members were union leaders who also worked for the City. They voted for enhanced pension benefits for themselves and their constituencies without requiring increased contributions by the City to the pension fund. These actions put the retirement system in jeopardy by not ensuring its financial support and placing unsustainable burdens on the pension system. To date, no one has been held accountable in that regard.	Certain Board members in their capacity as union leaders negotiated with the City for enhanced benefits. As Board members, however, they did not vote for enhanced benefits. Rather, they voted to approve an agreement regarding the payment of the City's Annual Required Contribution ("ARC"). City employees and former Board members were indicted with an ultimate finding as to all members and employees, except Ronald Saathoff, that they did not commit a violation of law. (See, *Lexin v. Superior Court*, 47 Cal.4th 1050 (2010); *U.S. vs. Saathoff*, 2007 U.S. Dist. LEXIS 34779)
Fact: Today's pension underfunding is estimated at $2.2 billion.	The Unfunded Actuarial Liability at June 30, 2009 was $2.1 billion. This liability is comprised of several components, including the City's prior contribution underfunding. It also includes investment losses and actuarial experience losses.
Fact-Set Two (Page 6)	
Fact: Prior to 1996, most City employees were limited to pensions not exceeding 90% of their highest annual salary.	In fact, prior to 1996, there was no percentage limit on pensions relative to an employees' highest annual salary. However, based on the calculation factor in place at the time, it would have taken at

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	least 32 years of service to reach 90%. After 1996, most City employee pensions are limited to 90% of their highest annual salary. San Diego Municipal Code (SDMC) §§24.0402(g) and 24.0403(e)
Fact: Of its $42 million annual budget, SDCERS spends $28 million for investment advice, spread among twenty-six different firms. This money comes primarily from the City's General Fund.	All fees are paid out of the SDCERS portfolio, not the City's General Fund. Fees are a reflection of assets under management, and support over $300 million of annual investment earnings.
Fact: Article IX, §141 of the City Charter provides the authority for the City Council to establish a retirement system for City employees. Because City Charter §141 is permissive, the City Council may adopt an ordinance abolishing the SDCERS retirement system. As long as the City provides retirement benefits to its employees, there must be some sort of Retirement Board to invest the funds of the retirement system and to administer its benefits.	The City Council does not have authority to abolish the System by ordinance. Once the system has been established, the California Constitution and San Diego City Charter provide mandatory provisions as to the make-up of the System established to administer the benefits and any alterations of that System. There is no provision in the City Charter that would allow the City Council to outsource management of the System to any entity other than the State Retirement System (CALPERS) or the U.S. Government (Social Security).
Recommendation 10-126: Consider alternative methods of selecting investment advisors, including competitive bidding or reverse auction processes.	The recommendation will not be implemented because it is not warranted and is not reasonable. SDCERS actively negotiates competitive fee arrangements with all of its investment managers. A recent review of fees paid indicated that SDCERS fees are at or below the median fee paid as measured by the Callan Investments Institute. Fees are not a driver of investment manager selection. Rather, fees are the last step in the selection process and also reflect the manager skill needed to effectively manage a particular investment strategy. Reverse auctions and competitive bidding are usually used in industrial business-to-business procurement. This does not occur in

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Fact/Finding/Recommendation	SDCERS Response
	the investment industry as buyers are not procuring commodities but rather paying for skill and results.
Recommendation 10-127: Investigate alternate retirement systems to determine whether the San Diego Employees' Retirement System (SDCERS) should be dissolved in favor of another system, a purely outsourced operation, or retention of the current system.	There is no provision in the City Charter that would allow the City Council to outsource management of the System to any entity other than the State Retirement System (CALPERS) or the U.S. Government (Social Security).
Fact – Set Three (page 7-8)	
Fact: With respect to the pension deficit of $2.2 billion, SDCERS now claims it can be amortized (spread) over thirty years.	Amortizing the City's UAL over 30 years is not a new claim. In recent years, the SDCERS Board has implemented shorter amortization schedules with the majority of the City's pension deficit being amortized over 20 years, with 18 years remaining as of the June 30, 2009 valuation. Nearly all of the remaining deficit is being amortized over 15 years. Only the UAL layer attributed to changed actuarial assumptions or methods (evaluated once every 3-5 years) may be amortized over 30 years.
Fact: In the first five years of the projected pay down, the General Fund contribution will amount to a total of $1.46 billion owed in the following fiscal years: • $232.4 million in 2011 • $258.8 million in 2012 • $282.9 million in 2013 • $305.3 million in 2014 • $326.5 million in 2015	The five annual amounts shown add to $1.41 billion, not $1.46 billion; the figures shown are before taking into account savings from new general and police plans for members hired after June 30, 2009, and the figures shown are not the General Fund amounts but the total Citywide payment, with the General Fund amounts approximately 20% less.

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FINDINGS	
Finding 06: All of the above pay-down projections are actuarial estimates based on an analysis of the pension fund's fiscal condition at the close of FY 2009. In projecting the financial reconciliation, various officials indicated this is a dynamic economic condition that the City and the pension fund are facing. If it is examined at a different point in time, the unfunded liability and the projected ARC payments may differ.	SDCERS agrees with this finding.
Finding 07: These pay-down projections are based partially on the assumption by SDCERS that its pension fund portfolio will earn at least 7.75% each and every year. Earnings over the past three years have been a negative 1.84%	SDCERS partially disagrees with this finding. The earnings assumption is exactly 7.75%, not "at least 7.75%," which implies the system will need to earn more than that to support the pay-down projections. Also, SDCERS does not expect earnings each and every year of exactly 7.75%, but rather that over our long term investment timeline, the fund will earn more than 7.75% in some years, and less in others averaging over time to 7.75%. Using a three-year return citation is misleading, insufficient and out of context with SDCERS' long-term strategy.
Finding 08: The supposition that pension underfunding can be paid down by amortizing the unfunded pension obligation of $2.2 billion over thirty years is unrealistic, according to top City officials.	SDCERS partially disagrees with this finding, in that the system is not using a thirty year amortization period for the $2.1 billion Unfunded Actuarial Liability (UAL). The UAL as of June 30, 2007 is being paid down over a closed period of 20 years, and each successive annual UAL layer, be it a net gain or net loss, is being amortized over 15 years.
Fact – Set Four (page 8)	
Fact: During 2008-2009, SDCERS experienced an unanticipated drop in the value of its $3.5 billion portfolio. Stocks fell to a twelve year low in early 2009. The Standard & Poor's 500 Index fell 42% from June 2008 through June 2009.	The June 30, 2009 Actuarial Valuation for the City of San Diego, on page 15, shows that market value of assets declined from $4.7 billion at June 30, 2008 to $3.7 billion at June 30, 2009, or $1.0 billion (21%). This change in asset values reflects the change in all cash flows,

Fact/Finding/Recommendation	SDCERS Response
SDCERS pension assets fell $1.3 billion or 30% during that same period. (SDCERS June 20, 2009 Actuarial Valuation for City of San Diego, p. 19)	including contribution in and benefit payments out, as well as investment performance. Page 19 of the valuation deals with changes in liabilities, not assets.
FINDINGS	
Finding 09: SDCERS indicated that investment losses in FY 2009 were approximately 19.2% of its portfolio while the average for investment losses in the United States was 25%-30%.	SDCERS agrees with the finding.
Finding 10: For every year SDCERS does not reach an investment return of 7.75%, the City is required to increase its contribution to the retirement fund.	SDCERS partially agrees with this finding, although it fails to acknowledge that returns above 7.75% will reduce the City's contributions.
RECOMMENDATIONS	
Recommendation 10-130: Consider taking the steps necessary to declare an immediate moratorium on all new DROP entrants pending the completion of the cost neutrality analysis.	Neither the City nor SDCERS should implement this recommendation, because "a moratorium" on new DROP entrants, absent an amendment to the plan, would violate the Plan document and risk plan disqualification by the IRS with adverse tax consequences to the City and SDCERS' members.
Recommendation 10-131: Consider taking steps necessary to discontinue DROP for all new entrants should the actuarial analysis demonstrate that it is not cost neutral.	If the City decides to implement this recommendation, it should do so in a manner that does not violate the vested rights of Members and does not violate SDMC §24.1004(k) or Internal Revenue Code Section 411(e). The City passed an ordinance that discontinues the DROP option for all new hires effective July 1, 2005.
Fact (pages 10-11)	

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Fact: SDCERS indicates that should its annual stock portfolio returns exceed 7.75%, retirees receive a "13th check" (not to exceed $900 per year).	There is no limitation on the total amount of a Retiree's 13th Check. Generally, each recipient receives $30 per year of qualifying service, so if a Retiree had 30 years of service credit their 13th check would be $900. If a Retiree had 35 years of service credit they would receive $1,050.
Fact: (13th check). As this payment is made to all retirees, it is an expanding population.	The eligible 13th check population is a closed group of active and retired members. The 13th check benefit has been eliminated for employees hired after July 1, 2005.
Fact: According to the SDCERS actuarial report for FY 2009, the City's elected officials pay 9.06% of salary as their pension contribution, while the City picks up 30.53%.	The Elected Official's normal cost rate is 9.06%, of which the City offsets (pays on the official's behalf) 5.89%, leaving a net contribution by the Elected Official of 3.17%. The 30.53% is the City's normal cost contribution plus a portion of the UAL attributed to past City underfunding, investment losses and actuarial experience losses.
FINDINGS	
Finding 15: For FY 2011, the City's contribution is more than three times the contributions of City elected officials.	SDCERS partially disagrees with this finding. As noted in the fact directly above, including the offset paid by the City, their contribution for Elected Officials is 36.42%, which is more than 11 times the Elected Official net contribution.
Finding 16: The concept of "substantially equal" contributions, shared by the City and its employees, to date has not been applied when determining responsibility for increased ARC payments resulting from SDCERS investment losses. For example, for FY 2011, the City's ARC payment includes over $70 million it alone is paying to make up for SDCERS investment losses in FY 2009.	SDCERS disagrees with this finding, to the extent that it implies that the investment losses should be shared equally between the City and its employees. SDCERS has undertaken a comprehensive study of the issue through its General Counsel, Fiduciary Counsel and Actuary and has determined that the substantially equal requirement does not apply to investment losses and gains.
Fact (page 12): On August 14, 2007, SDCERS actuarial consultants reported a $146 million actual cash loss to the	SDCERS disagrees with this fact to the extent it is misleading. The SDCERS actuary did not report "an actual cash loss." In its August 14,

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Purchase Service Credit Program because the liability created by those purchases from 2000 to 2006 was based on an incorrect rate structure that did not cover the actual cost that should have been charged to City employees.	2007 letter, Cheiron stated the net actuarial deficiency for pre-2000 Purchase of Service Credit (PSC) contracts through October 31, 2003 was $146 million. The rate structure for PSC contracts has since been revised.

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