

**PENSION REFORM COMMITTEE
MEETING OF
Tuesday, November 18, 2003
4:00 PM – 6:00 PM Meeting**

**401 B Street
Conference Room, 4th Floor**

MINUTES

**THE REGULAR MEETINGS OF THE PENSION REFORM COMMITTEE ARE
SCHEDULED FOR EVERY TUESDAY AT 4:00 PM AT 401 B STREET, 4TH FLOOR**

Item 1: Call to Order

Item 2: Roll Call

<u>Members Present</u>	<u>Members Absent</u>	<u>Staff Present</u>
April Boling	Steve Austin	Patricia Frazier
Robert Butterfield	Richard Vortmann	Rick Duverney
Tim Considine		Mary Braunwarth
Stanley Elmore		Pam Holmberg
Judith Italiano		Larry Grissom – SDCERS staff
William Sheffler		Paul Barnett – SDCERS staff
Kathleen Walsh-Rotto		

Item 3: Approval of Minutes

A motion to approve the minutes from the November 4, 2003 meeting was made by Kathleen Walsh-Rotto. It was seconded by Judie Italiano. The motion was unanimously approved.

Item 5: Review of Meeting Schedule

Ms. Boling pointed out that there are currently meetings scheduled on December 23rd and December 30th. Because of their proximity to the holidays she would like to cancel those meetings. There were no objections from the Committee.

It is the Committee's policy to take non-agenda public testimony at the end of each meeting. Because of the structure of next week's meeting (November 25) the public comment will be taken at the beginning of that meeting.

Item 4: Actuarial Valuation

Rick Roeder of Gabriel, Roeder, Smith & Company, the actuary for the SDCERS system, provided an overview of actuarial analysis and how it applies to the SDCERS system, and answered questions on his presentation. Please see the attached presentation.

Item 8: Non-Agenda Public Comment

Bob Headland, a City Retiree, expressed his concerns with the Retirement System. He specifically noted the impact of the 13th check and Corbett settlement payments that haven't been paid to retirees with lower pensions. His biggest concern is how many years it will take to straighten all these problems out. He doesn't think it can be solved in the next 20 to 30 years unless there is a commitment from the City Council to straighten it out and finance the System.

Jim Gleason is a City retiree and one of the members of a class action suit against SDCERS and the City for under funding the system. He said this is friendly lawsuit. Their one and only objective is to have the System fully funded. They are not asking for anything more, no added benefits for any groups or individuals. He believes it is in the interest of retirees and in the interest of employees to create a more stable System. He said there is \$1 billion of debt that has been laid on the shoulders of future taxpayers. He believes the debt has been created through consciously under funding the System through City Manger's Plan 1 and City Manager's Plan 2 that came out of the meet and confer process. He said the City's problems have come about from under funding the System, investment losses, and benefits.

Michael Conger, is an attorney who represents several clients who are City retirees, addressed the Committee. He feels there are three major things which need to be fixed by the System. He feels the City has been under funding the System since 1991. The under funding of the Retirement System was identified in last year's Blue Ribbon Report as the City's second largest risk. He believes the second problem is the make up of the Board. He feels the third big problem is that the System needs to be simplified. There are to many bells and whistles. The staff of the City's System is 53 compared to 60 at the County for twice as many employees.

Item 6: Comments by Committee Chairperson

There were none.

Item 7: Comments by Committee Members

Ms. Walsh-Rotto asked Mr. Grissom if there would be any written dialogue between the Investment Committee and the portfolio managers in regards to some of the mutual funds with questionable situations going on. If there has been any, she would like it to be passed on to the Committee. Mr. Grissom said there had been some correspondence regarding Putnam Funds and he would pass it on to the Committee.

Mr. Butterfield asked was the status was of the Retirement Board's approval for the three proposed audit reports. Mr. Grissom reported it is on this Retirement Board's agenda this Friday and they will act on it.

Ms. Italiano asked that at the next meeting that the Committee discuss what has gotten the Committee here and where the Committee is going.

Ms. Boling said the next meeting would be a round table discussion of where the Committee is going, what reports may look like, a timeline, and the report back to Council in January.

Item 9: Adjournment

The meeting was adjourned at 6:00 PM

The next meeting will be on Tuesday, November 25 at 4:00 PM at the same location



ACTUARIAL 101 &

SDCERS

for

Pension Reform Commission

November 18, 2003



What Is It All About, Actuary?

In the realm of pension funding:

ANSWER: Calculate long-term contribution estimates that are designed not to produce intergenerational subsidies among taxpayers of different eras.



How do we do this?

ANSWER:

a) Estimate the value of benefits owed participants.

Then

b) Figure out a reasonable period of time to finance a).



You apply the above actuarial principles in your day-to-day life.

Suppose you want to take a European vacation. Since your Board has recently instituted a policy that prohibits international travel for due diligence, you find out that your out-of-pocket cost will be \$5,000.

You want to save for this trip in advance over the next year (roughly 50 weeks).

You calculate that $\$5,000 / 50 = \100 per week.

Now suppose that your job is really stressing you. You will commit hari kari if you wait a whole year for this vacation. You decide you must take this vacation in 6 months, but subject to your same advance funding constraint.

You recalculate $\$5,000 / 25 = \200 per week.

MORAL: You are all actuaries in training and did not realize it. For many of you, I realize that will be a depressing thought.

ACTUARIAL JARGON

Present Value: The amount of funds currently required to provide a payment or series of payments in the future.

Normal Cost: The actuarial present value of system benefits allocated to the current year of service for active members.

Accrued Liability: The difference between the present value of benefits and the present value of future normal costs.

Funding Method: A mathematical budgeting process for allocating the present value of benefits between future normal costs and accrued liability.

PUTTING JARGON INTO ACTION: A SIMPLE EXAMPLE

Imagine a uniform world of no diversity and no ability to invest fund money to yield any type of positive return.

- A 35-year old enters the work force.
- Nobody dies or terminates employment prior to retirement.
- The worker will retire at 65 with an annual pension of \$30,000.
- The worker will live until age 85.
- For simplicity, no COLA is assumed.
- The Present Value is $\$600,000 = \$30,000 * (85 - 65)$
- The Normal Cost is $\$20,000 = \$600,000 / (65 - 35)$

When the worker attains age 40, what is the accrued liability?

$\$600,000 * (5/30) = \$100,000$. The worker has completed five years of their 30-year career.

DIFFERENT FUNDING METHODS

Entry Age Normal – Used by majority of public funds.

Projected Unit Credit – Funded ratio (Actuarial Value of Assets divided by Actuarial Value of Liabilities) will often be about 10% higher than if Entry Age Normal had been used. In other words, the accrued liabilities under Entry Age Normal will often be about 10% higher than under PUC.

Aggregate – One funding method which does not differentiate between Normal Cost and Amortization of Unfunded Liability.

Corridor – Pegged contribution rate stays the same as long as funded ratio stays within a predetermined range.

Policy Issue: What to do if the actuarial value of assets exceeds the actuarial value of liabilities? Is there a credit against Normal Cost and, if so, how much?

ACTUARIAL VALUE OF ASSETS

Market Value – Usually deemed inappropriate due to the short-term vagaries of the market.

Book Value – Inappropriate for any entity that has significant equity allocation.

Blended Value – Best to spread both recognized and unrecognized gains and losses over a period of years (usually 3 or 5).

Excludable Assets – Some systems exercise discretion as to assets included in actuarial value or have policies regarding “excess” investment returns.

NEED FOR LONG-TERM PERSPECTIVE

A newly-hired 20-year old may be receiving a pension check in 2070.

Long-term view argues against annual assumption changes.

Trustees should look at various indices over 5-10 years to help draw reasonable conclusions (contribution rates, funded ratio, unfounded liability, actuarial gains (losses)).

For example, returns of the past three years would not be a good barometer. Nor would returns of 1995-99 in isolation.

ACTUARIAL ASSUMPTIONS

Economic

Rate of Inflation

Real Rate of Investment Return

Rate of Assumed Growth in Member Payroll

The Nominal Assumed Investment Rate of Return =

Assumed Rate of Inflation plus Assumed Real Rate of Return

(4.25% for SDCERS)

(3.75% for SDCERS)

Actuarial Myth: The higher the assumed investment rate of return, the less conservative the assumptions are:

Case Study:	CALPERS	Entity B
Inflation:	3.50%	4.5%
Real:	<u>4.75%</u>	<u>4%</u>
Nominal Return:	8.25%	8.5%

Contrary to first blush, CALPERS' assumptions are more conservative.

Real rate of return is more important than the nominal assumed return. Hence, the slogan, **"Let's Get Real"**.

Changing the assumed rate of inflation has partly offsetting impact.

Actuarial Myth: Changing the assumed rate of inflation will not have an actuarial impact because of the offsetting nature of the investment and pay increase assumptions. This is untrue because inflation impacts the value of benefits in pay status. Assumed pay changes only have an impact during an active member's working career.

Some have mistakenly assumed that a constant "spread" between the nominal investment assumption and the pay assumption will result in unchanged contribution rates. This is a variation on the above myth.

Investment Myth: A plan's current funded ratio should have an impact on investment policy. This is a fallacy because funded ratios can change materially over several years without undermining a sound asset allocation and investment policy. Most systems are well enough funded that cash flow issues for benefit payout purposes is usually not a central issue.

Non-Economic Assumptions

- Merit and seniority of pay increases to individuals
- Expected retirement ages for service retirement
- Rates of employee turnover (reciprocity considered)
- Rates of disability retirement (duty versus non-duty)
- Rates of mortality
- Retirees with qualified spouses

Many would overestimate the impact of mortality improvements and underestimate the impact of assumed employee turnover.

Funded Ratios

- Defined as Actuarial Value of Assets divided by Actuarial Value of Liabilities.
- Have all the permanence of castles in the sand. Both bear and bull markets tend to operate in long cycles. SDCERS' funded ratio has dropped from 105% to 77% in two years. In absence of benefit increases and contingent benefits, it is possible for this ratio to sharply rise in a strong bull market.
- SDCERS' funded ratio was very stable in the 1990's.
- Many assumed that a funded ratio of 100+% or 110+% means long-term contribution relief. This is the biggest lesson the recent bear market can impart.
- Many assume that a fund is always better off with a higher funded ratio. From a vantage point of negotiating extra benefit increases, this is



Projected Unit Credit

SDCERS Funding Method

Entry Age Normal is most
commonly used

EAN Funded Ratio of 70%

