AGENDA FOR THE
PENSION REFORM COMMITTEE
MEETING OF
August 10, 2004
3:00 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 3:00 PM AT 401 B STREET, 4TH FLOOR

THE OPINIONS AND VIEWS OF THE COMMITTEE OR ITS MEMBERS, AND PRESENTATIONS MADE AND DOCUMENTS PROVIDED TO THE COMMITTEE OR ITS MEMBERS, MAY CONTAIN PROJECTIONS, FORECASTS, ASSUMPTIONS, EXPRESSIONS OF OPINIONS, ESTIMATES AND OTHER BACKWARD-LOOKING RECONSTRUCTIONS OR FORWARD-LOOKING STATEMENTS, ARE NOT TO BE CONSTRUED AS REPRESENTATIONS OF FACT, AND ARE QUALIFIED IN THEIR ENTIRETY BY THIS CAUTIONARY STATEMENT. ONLY STATEMENTS MADE BY THE CITY IN AN OFFICIAL RELEASE OR SUBSEQUENT NOTICE OR ANNUAL REPORT, PUBLISHED IN A FINANCIAL NEWSPAPER OF GENERAL CIRCULATION AND/OR FILED WITH THE MSRB OR THE NRMSIRs ARE AUTHORIZED BYTHE CITY. THE CITY SHALL NOT BE RESPONSIBLE FOR THE ACCURACY, COMPLETENESS OR FAIRNESS OF UNAUTHORIZED STATEMENTS.

Item 1: Call to Order

Item 2: Roll Call

Members Present	Members Absent	Staff Present
April Boling	Dick Vortmann	Mary Braunwarth
Robert Butterfield	Tim Considine	Chris Morris
Kathleen Walsh-Rotto	Steve Austin	Larry Grissom, SDCERS Staff
Judith Italiano		Pam Holmberg
William Sheffler		
Stanley Elmore		

Item 3: Approval of Minutes

Mr. Sheffler noted that item 7 should be amended to reflect the date of the next meeting as August 10, not August 13. There was a motion for approval of the amended minutes for the July 27, 2004 Pension Reform Committee (Committee) meeting from Mr. Sheffler. The motion was seconded by Ms. Walsh-Rotto and passed unanimously.

Item 5: Discussion on Final Report

The Committee reviewed the July 28 draft final report. There were discussions on both content and structure. Ms. Boling asked Larry Grissom whether the Committee's recommendation pertaining to the treatment of contingent benefits was clear. The recommendation is that an amount equal to the value of the contingent benefits paid for from the Plan earnings should be replaced by the City annually based on an estimate calculated at the beginning of the fiscal year for that fiscal year. After discussing the recommendation, it was decided that Ms. Boling will re-write it to provide further clarification.

Committee members agreed to provide additional information and clarification on certain sections of the draft report. Bill Sheffler will edit the Background section and provide a glossary. Kathleen Walsh-Rotto will add the complete list of possible benefit changes to the Committee's recommendations. Rob Butterfield provided an expanded section on defined benefit plans vs. defined contribution. This section will be included in the revised draft of the final report.

Ms. Boling asked the Committee if they had any comments on Dick Vortmann's proposed additions/changes to the draft report. Stan Elmore said he preferred the current draft. Ms. Boling also asked for feedback on the e-mail provided by Rosie Wiseman. She asked that Mary Braunwarth make the grammatical changes outlined in Ms. Wiseman's e-mail.

Ms. Boling asked the Committee members to have all contributions to the final report delivered to Ms. Braunwarth by the close of business on Thursday, August 12. The comments will be incorporated and a revised draft will be distributed to the Committee on August 13 for review. The Committee will meet at 3:00 PM on August 17 for what they hope will be one last review of the report.

Item 6: New Business

There was no new business.

Item 7: Comments by Committee Chairperson

There were no comments.

Item 8: Comments by Committee Members

Mr. Butterfield asked if the Committee should take a position on the ballot measure concerning the composition of the Retirement Board, and Ms. Walsh-Rotto asked if the Committee should adopt the board composition language from the ballot measure in the final report. Ms. Boling asked that an item be added to next week's agenda to discuss and vote on these issues.

Item 9: Non-Agenda Public Comment

There were no requests to speak.

Item 10: **Adjournment**

The meeting was adjourned at 4:20 PM.

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FINAL REPORT FROM THE CITY OF SAN DIEGO

PENSION REFORM COMMITTEE

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Executive Summary/PowerPoint

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Committee Members

In September 2003, the Mayor nominated and the City Council approved appointment of a nine person Pension Reform Committee (the Committee) to address the growing public concern over the financial status of the City's pension system (the System). The Committee was to include a City retiree with pension experience, a City employee with union pension experience, a member of the Retirement Board, a taxpayer advocate and five citizens with experience in defined benefit pension plans.

Task Force Member	***Professional Background***
Ms. April Boling (Chairperson)	San Diego County Taxpayers Association (Taxpayer Advocate)
Mr. Stephen Austin	Swenson Advisors, LLP (Pension Plan Experience)
Mr. Robert Butterfield	Butterfield Schechter LLP (Pension Plan Experience)
Mr. Timothy Considine	Considine & Considine (Pension Plan Experience)
Mr. Stanley Elmore	City of San Diego Retiree with pension experience
Ms. Judith Italiano	San Diego Municipal Employees Association (City Employee/Union member with pension experience)
Mr. William Sheffler	Sheffler Consulting Actuaries, Inc. (Pension Plan Experience)
Mr. Richard Vortmann	San Diego City Employee Retirement System Board member/National Steel and Shipbuilding Company, NASSCO (Retirement Board Member)
Ms. Kathleen Walsh-Rotto	Principal Financial Group (Pension Plan Experience)

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* Biographies available in **Appendix A**

Objectives of the Committee

1. Report back to the City Council no later than 120 days from the date appointments are confirmed.
2. After reviewing and considering the scope and depth of audit activity currently being conducted by CERS, conduct any additional or supplemental independent audits, studies, or investigations deemed necessary and appropriate.
3. Provide recommendations to address any unfunded liability problems of the system.
4. Examine how the existing pension system has performed compared to other similar systems, including examination of actions other systems have taken to address funding shortfall problems, such as issuance of pension obligation bonds.
5. Examine whether changes should be made to the existing pension system. Examine whether the make-up and representative constitution of the Retirement Board should be restructured.
6. Examine whether the system should be changed from a defined benefit plan to a defined contribution plan for new employees.
7. Examine whether the City should join the California Public Employees Retirement System or any other retirement system.
8. Make any other recommendations as appropriate.

Introduction

The Committee has met weekly since early October. The City Council received a report **(Appendix B)** from the Committee on January 22, 2004. Additional information was provided to the Council on April 19, 2004 **(Appendix C).**

Certain recommendations made by the Committee required changes to the City Charter. While the Committee would have preferred to make these recommendations in the context of the total report, time constraints surrounding the placing of changes to the Charter on the ballot required that these proposals be brought forward ahead of the body of the report. The Committee presented proposed Charter changes to the Council=s Rules Committee and the City Council and actions have been taken by the Council on those proposals.

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Since early October, the Committee has gathered data, interviewed staff and other knowledgeable individuals related to the plan, and analyzed the information presented. The extent of the problem was identified and various corrective actions were evaluated. This report summarizes the analysis the Committee performed and presents the Committee=s corrective recommendations and the rationale therefore. The recommendations contained herein relate only to the City of San Diego's portion of the System.

I. BACKGROUND

Under a defined benefit pension plan, current employees and the pension plan sponsor (in this case, the City of San Diego) make annual contributions to the pension plan which is a trust. The theory is that these annual contributions, combined with the investment earnings of the pension plan, will ultimately provide sufficient funds to pay retirement benefits to all of the pension plan's participants who retire.

The annual contribution to the City of San Diego's pension plan (Plan) is computed by an actuary based upon the characteristics of the retirement commitment (e.g. age of retirement, percentage of replacement of base pay, etc.) and a variety of assumptions (e.g. rate of investment return, rate of inflation, mortality, etc.) This annual contribution is typically expressed as a percentage of payroll.

When actual experience does not exactly match the assumptions used by the Plan's actuary, it is possible to have either more or less assets in the Plan than needed to meet the projected liabilities. The shortfall or the surplus is spread (amortized) over a period of time and annual payments are made or credits are allowed to ultimately make-up the difference.

It should be noted that when there is a deficit, it means that those assets are not in the Plan's investment pool where they would be generating investment earnings. As a result, the payoff of the deficit must also account for the forgone earnings. This is analogous to principal and interest on a mortgage.

Because actual experience never perfectly matches the actuarial assumptions, the total annual contribution to any defined benefit plan will have two components: one is the cost of benefits earned during the year, and the other is the payment to close the deficit or surplus.

The City Manager recommends and the City Council approves the Plan benefits. Employees bargain for those benefits through the "Meet and Confer" process. In the opinion of the City Attorney's office, an employee becomes vested in the characteristics of the Plan as of the date he or she is hired. It is not possible, therefore, to change Plan benefits for either retirees or any current employee.

The San Diego City Employees' Retirement System (SDCERS) Trustees (the Retirement Board)

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administer the Plan. That includes managing the Plan's investment portfolio as well as ensuring the timely delivery of retirement benefits to the Plan's beneficiaries. The Trustee's primary fiduciary duty is to the beneficiaries of the Plan. Administration of the Plan includes approval of actuarial assumptions to be used in determining the annual contribution by the employees and the City. The composition of the Retirement Board is set by the City Charter.

II. THE CURRENT FUNDED STATUS OF THE SYSTEM

A critical task of the Committee was to determine the amount of the deficits present in the SDCERS system.

The Pension Plan

The most recent formal Actuarial Valuation of the Plan was as of June 30, 2003. In that valuation, the UAAL was calculated at $1.157 Billion and the Plan was determined to be 67.2% funded.

It is important to understand that the Plan assets are not valued at Fair Market Value (FMV) for purposes of the Actuarial Valuation. As with other pension plans, unrealized gains and losses are smoothed over a period of time to mitigate the effects of dramatic swings in the stock market. In the SDCERS Valuation, a smoothing period of five years is used. At June 30, 2003 the FMV of Plan assets was $2.464 Billion, while the Actuarial Value was $2.510 Billion. The difference of $46 Million will be recognized over future periods.

The annual valuation does not consider the present value of the Plan's contingent benefits. Contingent benefits (Corbett settlement, 13th check, COLA etc.) paid to the beneficiaries out of Plan earnings, thereby reducing the amount of earnings that stay with the Plan to fund its future commitments to retirees. Because these costs are considered contingent, they are not part of Normal Costs and, therefore, are not included in the calculation of the City's annual payment to the Plan. The net result is that even if the investment earnings exactly match the actuarial assumption, the UAAL increases each year by the amount of the contingent benefits.

Further, the current method and period being used for amortization of the UAAL does not generate a required payment that is high enough to cover even the forgone investment earnings, much less pay down any of the underlying UAAL.

Put another way, when one considers the drain on Plan earnings caused by payment of the retiree health costs and contingent benefits coupled with the fact that the UAAL amortization is applying nothing to the actual principal portion of the liability, it becomes clear that Afull actuarial funding@ is a misleading term at best.

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In the spring of this year, the Committee requested and received an updated calculation of the UAAL from the Plan=s actuary. The Committee was aware that there had been positive movement in the market but was also aware that there would be additional losses recognized from earlier periods due to asset smoothing. The update was as of January 31, 2004. Rather than $1.157 Billion as was identified at June 30, 2003, the UAAL had increased to $1.167 Billion. The funded ratio, however, had increased slightly to 68.7%.

Based on an assumption that the UAAL would still be at $1.167 Billion as of June 30, 2004 (meaning no further variances from the actuarial assumptions) and that there would also be no variances from the actuarial assumptions for FY05 (the year ended June, 2005), the Committee calculated the amount of contribution that would need to be transferred into the Plan during FY05 to keep the UAAL from growing as follows (in millions):

Normal Cost	$76.01
Contingent Benefits	20.30
Retiree Medical Benefits (current year premium only)	13.00
Interest (foregone earnings) on the UAAL	93.36
Total	$202.67*

* Excludes the unfunded liability for medical costs discussed in paragraph B below

In FY04, the City=s contribution to the Plan was $85 Million. Assuming the current lawsuit brought by the system=s retirees is settled, the agreed-upon payment for FY05 is $130 Million, ramping up to $177.5 Million in FY08. These numbers make it abundantly clear that, absent a stock market miracle, the UAAL will continue to grow.

Retiree Health Care

The second deficit in the SDCERS system relates to retiree health care. Currently, the City itself is not making any payments on the liability. Current retirees= health care is being paid from a special reserve within the Plan. The reserve is funded by Asiphoning off@ earnings from the Plan as discussed above, thereby increasing the UAAL.

The larger problem, however, is that this is a Apay as you go@ system, meaning that there is no recognition of the long-term liability for the medical premiums of retirees in future years nor is there recognition that the City is also incurring a liability every year for the existing employees= right to a health benefit when they eventually retire.

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In the opinion of the City Attorney, various groups of employees and retirees have different levels of vesting related to health care. Based on the assumption that current and future retirees will continue to receive this benefit at the same level as enjoyed currently, the Pension Reform Committee requested and received an analysis of the current liability associated with this commitment. Based upon a 5% annual Amedflation@ rate, the liability is estimated at $545 million. This is in addition to the $1.167 Billion UAAL identified above. The payment required to cover the Normal Cost associated with retiree health care and to eliminate the unfunded liability of $545 over 15 years is calculated as (in millions):

Normal Cost	$26.08
Amortization of Liability	$58.96
Total:	$85.04

This payment is required in addition to any payment needed to fund the the Plan itself.

III. HOW DID THIS HAPPEN?

In attempting to describe how we believe the current pension and retiree health problems came to be, the Pension Reform Committee=s purpose is not to find fault or allocate blame. Rather it is to ensure a full understanding of the interrelated causes of the problem as a means to ensure they are not repeated in the future. In this section we will address causes. In subsequent sections we will address corrective recommendations.

Quantification of Causes

The Pension Reform Committee requested and received an analysis of the components of the increase in the Unfunded Actuarial Accrued Liability (UAAL) from July 1, 1996 to June 30, 2003. This analysis, prepared by the Plan=s actuary, provided the following allocation:

Investment performance	6%	
Under funding by City	10%	
Use of Plan earnings for contingent benefits	12%	
Net Actuarial losses	31%	(back-out pay raise portion)
Benefit improvements	41%	(back-out Corbett benefits)

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100%

It should be noted that the Retirement Board commissioned a similar study that resulted in a significantly different allocation resulting from the interdependence of the various factors. The variance is currently being analyzed by the Retirement Board. The most insignificant variance, however, was in investment performance where the Retirement Board=s study indicates an allocation factor of 7% rather than 6%.

Description of Causes

<u>Investment performance</u>

While this is the least significant factor mathematically, it warrants discussion because the market Abubble@ of the late 1990s masked the other factors, providing an unwarranted sense of well-being by the Retirement Board and the City.

As discussed in the initial section, the City=s annual contribution is calculated using a variety of actuarial assumptions. One of those assumptions is an 8% average rate of return on investment. Looking back over ten years, the experience has, in fact, been 8% <u>on average</u>. The problem is that the average includes a peak followed by a trough. It is highly likely that if the 8% average had been realized with the trough preceding the peak, we (and many other retirement plans) would not be as under-funded as we are.

During the late 1990s, the City felt comfortable not only increasing benefits but also making lower contributions than it should have. When the market adjusted back to the investment rate of return originally anticipated in the actuarial assumptions, the fiscal impact of decisions made during the bubble became evident. As a result, there was an inclination to blame the declining funded status of the Plan on the decreasing market rather than acknowledging that the stabilization of the market was simply baring the results of ill-advised decisions.

<u>Under-funding by the City</u>

As previously discussed, the term “full actuarial funding” is misleading given the City’s method of implementation. It implies that a Plan sponsor is paying an amount sufficient to cover not only current costs but also to pay an amortized portion of any unfunded liability. In the case of the City’s Plan, the unfunded liability increases due to the drain on Plan earnings resulting from payments into the reserve for retiree medical benefits or any of the contingent liabilities. Additionally, because of the amortization

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method and schedule used to retire the deficit, the deficit actually grows.

Full actuarial funding as currently defined did not and does not result in a required payment large enough to keep the Plan's deficit from growing.

It is clear that this and previous Mayors and Councils did not understand this phenomenon and it is probable that many, if not most, of the Retirement Board trustees did not understand it either. As a result, when the City Manager approached the Retirement Board in 1996 asking that it agree to contributions of less than Afull actuarial funding@, it did so. This action was perpetuated by a similar agreement entered into in 2002. Even at Afull actuarial funding@, the City would have been increasing its liability. By paying less than that, the problem was exacerbated. *(KWR will add impacts of Managers I & II)*

Use of Plan earnings for contingent benefits

When determining the annual contribution, the actuary uses an 8% earnings assumption. The Plan is, in fact, experiencing 8% earnings on its assets. It does not, however, retain those earnings in order to pay future retirement benefits. Instead, a portion is siphoned off to pay contingent benefits. The most widely discussed of these contingent benefits are (described in layman=s terms):

a. 13th Check - In the early years of the Plan, the Plan's investments were doing well. In 1985 the Andrews case required the City to share the unexpected investment return with the employees. There were times when the additional checks were sizeable. Time passed and the extra payments came to be expected. Some years later, the City Council decided to curtail the practice. A suit was brought by an employee to require that the practice continue. The resolution was that the Retirement Board must make an additional payment to the employees in years where the Plan has earnings (the definition is complex and not particularly relevant), however those payments are capped at (with some variation) $30 per year of service. Thus, a retiree with thirty years of service will typically receive $900. In years where there are no earnings, the check is not payable and, in fact, cannot be paid. Each year stands on its own, and there is no forward accumulation if there are not earnings in a particular year. As this payment is made to all retirees, it is an expanding population. Currently, these payments are about $4 Million per year.

b. Corbett Settlement - In another California jurisdiction, a question arose as to whether or not retirement benefits had been calculated using all pertinent elements of salary A lawsuit was brought and it was determined that they had not. Similar suits were brought in other

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jurisdictions including San Diego. A decision was made to settle the lawsuit. As a result, the City changed its methodology. In addition, it is now bound to make additional payments to a specific group of retirees. Those payments are made out of the Plan=s earnings (again the complex definition). Unlike the 13th check, these payments accumulate. If a payment is not made in one year due to the Plan=s earnings level, that payment is payable in the next year when there are earnings. The payment does not, however, accrue interest. Because these payments are made to a specific group of retirees, this is a decreasing population. These payments are currently about $5.5 Million per year. There was also a one-time retroactive payment of approximately $20 Million.

c. Other - There are other smaller contingent benefits including a reserve for the supplemental COLA.

Actuarial Gains and Losses

These represent deviations from the actuarial assumptions. Based upon the Plan actuary=s analysis, these are:

- Extremely low employee turnover
- Significant service purchase subsidies
- Pay increases above those assumed
- Retirement/DROP incidence

Benefit Improvements

When a new or improved benefit is granted to existing employees with retroactive applicability for all prior years of service, not only does the ANormal Cost@ of the Plan increase, but a Apast service liability@ is also created. This is most easily understood through the following example:

Joe has worked for the City for 25 years. During those 25 years, the Plan called for retirement based on 2.5% benefit for every year of service. Joe was expecting to retire at 75% of base pay if he stayed for 30 years (30 years X 2.5% per year = 75% of base pay). The actuary also expected the same thing and the contribution into the plan was based upon that 75% assumption. But during Joe=s 26th year of service, there was a plan improvement. Instead of receiving 2.5% for each year of service, he will now receive 3.0% for each year. An option would have been to have Joe receive 2.5% for his first 25 years of service and 3.0% for the future 5 years, but that was not the way the benefit was granted. Because of the "retroactive

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element," Joe now will retire at a 90% of base pay (30 years X 3%). The actuary will adjust Normal Cost for the upcoming years to reflect the increase, but the shortfall related to Joe's first 25 years of service becomes a Apast service liability@.

A variety of such benefits was granted during the period when the stock market was at its peak. The past service element of these benefits has caused a significant portion of the increase to the Plan=s UAAL.

IV. REDUCING/ELIMINATING THE UAAL

When assessing solutions to the Plan=s under-funded status, there are two discreet components of the issue: 1) recommendations with respect to reduction or elimination of the Unfunded Actuarial Accrued Liability (UAAL), and 2) recommendations regarding the ongoing annual costs of the basic plan and the contingent benefits. This section deals with the first of these two items.

An ongoing theme among Pension Reform Committee members was concern that the UAAL is not treated as a real obligation of the City. It is referred to publicly as Asoft debt@ because it is not required to be disclosed as debt on the financial statements of the City. Since it is not included in the City=s debt, it is (and this is subject to considerable debate) not considered by lenders when decisions are made as to other City bonded indebtedness including bonding capacity. One of the underlying goals of the Committee is to bring this debt onto the books of the City so that the full obligation is acknowledged and dealt with.

One strategy for reduction of the UAAL is to do nothing and hope that the market simply takes care of the problem. This is a naive and unrealistic strategy given that the actuarial expectation is an 8% investment return. For the UAAL to be permanently relieved through the market, the Plan would need to achieve (over many years) a consistent return of more than 8%. Further, since the $1.157 Billion in assets (the amount of the UAAL) is not in the Plan currently, the Plan now loses the benefit of any earnings those funds might realize.

The only real option is an infusion of assets into the Plan coupled with a ramp-up of annual contributions.

Pension Obligation Bonds (POBs) as an Option

Assuming that the City has adequate bonding capacity and can borrow at interest rates below the Plan=s

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investment rate of return (currently an 8% assumption), there is the potential benefit of interest arbitrage (i.e. borrow at 6.5% and invest at 8%) . The cash provided by the POB is contributed to the Plan to reduce the deficit thereby increasing the funded status of the plan. Such bonds are taxable and are generally looked upon more favorably by investors if they are part of an overall plan to reduce the deficit and control costs.

Using City Real Estate as a Funding Mechanism

It was recognized that there may be limits to the City=s debt capacity or other pressing City needs for that capacity that would make the extensive use of POBs either not possible or not attractive. The City owns a considerable amount of real estate that could be used, in a variety of forms, to provide the needed cash infusion. The most straight-forward option would be for the City to sell City-owned real estate and transfer the cash into the plan. Another possibility would be to borrow against the real estate, using it as collateral.

The third possibility would be to transfer specific real estate into the Plan. The concern about this option was that this would put the Plan in the position of becoming an unintentional landlord and might also expose the Plan to any liabilities associated with the property. Assuming the Plan was willing to hold the real estate, the Council-adopted policies related to percentages of Plan assets invested in certain types of investments (in this case, real property) would need to be changed.

A fourth possibility would be to allow the Plan to hold a fully amortizing note carrying the actuarially assumed interest rate of 8% secured by specific City real estate. This would have the benefit of assuring the actuarial rate of return without the City losing the use of the real estate or its potential gain in value. As with the third possibility discussed above, this would require a change to the Council approved investment policy. While it was determined that this is a viable possibility, it is clear that the Plan=s investment advisors would prefer to have the City borrow against the real estate and place the cash into to the Plan.

<u>Recommendation #1</u>

$600 Million in assets should be infused into the plan over the next three fiscal years. Of that amount, no less than $200 Million should be placed in the plan during FY 05 (preferably by December 31, 2004) and that amount should be attained through the issuance of Pension Obligation Bonds. Subsequent infusions, bringing the total to $600 Million can be through POBs, or some form of real estate secured transaction.

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Implementation of this proposal should bring the Plan back to an 85% funded status by FY07.

Increased Annual Contributions

As discussed previously, the UAAL has been growing, in part, as a result of the use of a payment calculation mechanism that results in the unfunded balance increasing in the early years of the amortization schedule.

Under the current methodology (widely used in public pension plans), the payment is calculated as a fixed percentage of inflation adjusted payroll based upon a 30-year amortization schedule. Thus, rather than the payment remaining constant as with a home mortgage, the payment amount increases each year as payroll increases due to inflation. **(Appendix F)** Since the interest rate on the unpaid balance remains constant at 8%, the net result is a payment in the early years of the schedule that does not cover the interest. The unpaid interest is then added to the principal. In other words, a $1 Billion debt would increase to approximately $1.16 Billion before it would start decreasing.

While it is true that such a method will result in full payment of the UAAL by the end of year 30, the common practice among public plans is to start over on the amortization plan as soon as the ever-increasing payment level becomes uncomfortable.

The Pension Reform Committee does not support the idea of negative interest amortization and believes that the payment against the UAAL should always be set at a level that actually decreases the debt rather than adding to it. While there is certainly more than one way to eliminate negative amortization, the Pension Reform Committee sees no reason to believe that the Retirement Board will choose an amortization method other than the fixed percentage of inflation adjusted payroll. Assuming use of that method, the longest amortization period that will not result in negative amortization is fifteen years.

Conversely, the Committee was concerned that if there is a surplus, that surplus could be amortized over a one-year period, resulting in a contribution Aholiday@. Because actuarial methods consistently strive for the smoothest possible (within reason) payment schedule, the Committee believes that a period no shorter than five years should be used for the amortization of a surplus.

Recommendation #2

The City Charter should be amended to require that, when amortizing net actuarial gains or

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losses, a period of no longer than 15 years be used for the amortization of losses and that a period of no shorter than 5 years be used for the amortization of a surplus. This change should be effective for FY08 contributions.

As previously discussed, the retroactive granting of new or improved benefits to existing employees creates a past service element/cost. While this form of benefit enhancement is certainly the prerogative of the Mayor and Council, the Pension Reform Committee believes that the past service cost should be dealt with over a reasonably short period of time so that a more

accurate comparison can be made between the impact of a current compensation enhancement (e.g. pay raise) and the current impact of a retroactive pension benefit increase.

Recommendation #3

The City Charter should be amended to require that for all new pension benefit improvements to the currently existing plan, SDCERS will, when setting actuarial assumptions and methodologies for funding purposes, use an amortization period no greater than straight -line 5 years fixed for any past service liability for each new benefit improvement. This change should be effective immediatey.

V. TREATMENT OF CONTINGENT BENEFITS

As previously discussed, contingent benefits and retiree health care premiums are paid from Plan earnings. Because they are not considered in the calculation of ANormal Cost@, the net result is that the UAAL grows each year by the amount of the contingent benefits paid and the amount of the addition to the Plan=s health care reserve.

To make matters worse, the payment for any given fiscal year is paid in the subsequent year (usually November). For example, there are sufficient earnings in FY04 to trigger payment of the 13th check. Currently, that liability is not reflected in the June 30, 2004 actuarial valuation nor is there a reserve established for it at June 30, 2004 even though the fact of the liability is known. The payment is made in FY05 and because it was not considered in Normal Cost, adds to the UAAL at 6/30/05. The UAAL for 6/30/05 is quantified during FY06 and amortization of that liability begins in FY07.

The Pension Reform Committee believes that an amount equal to the value of the contingent benefits

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siphoned from the Plan earnings should be replaced by the City annually based on an estimate calculated at the beginning of the fiscal year for that fiscal year. For example, the amount of the 13th check related to FY06 should be calculated on the assumption that it will be paid. That amount should be added to the FY06 contribution for Normal Cost and the contribution for amortization of the UAAL. If, at the end of FY06, it is determined that there are not sufficient Plan earnings to trigger the 13th check, then additional City contribution to the Plan would become an actuarial gain.

In the case of the Corbett settlement, a reserve should be established for any amounts not paid due to lack of Plan earnings. The treatment is different because Corbett accumulates and the 13th check does not. Other contingent benefits should be replaced by the City in a similar manner to that discussed above.

It should be noted that the above funding mechanism affects only the calculation of the City's annual contribution to the The Plan and does not affect the way in which the contingent benefits themselves are calculated or paid.

Recommendation #4

The City=s annual required contribution to the Plan for a given year should be defined as the total of Normal Cost, UAAL amortization (including interest), and an amount equivalent to the estimated contingent liabilities related to that year.

VI. TREATMENT OF RETIREE HEALTH CARE BENEFITS

While the liability related to retiree health care benefits is discussed in a later section, elimination of the current method of payment is more appropriately addressed at this juncture as it is akin to the treatment of contingent benefits.

Recommendation #5

Payments for retiree health care benefits should no longer be funded via the retirement plan. SDMC 24.1502(a)(5) should be eliminated thereby removing health care benefits from the the Plan=s distributionAwaterfall@

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VII. REDUCTION OF NORMAL COST

The City=s pension benefits are generous by almost any standard applied and particularly when compared to the private sector. According to the latest actuarial valuation, the ANormal Cost@ of the plan is approximately 24% of payroll. This amount is split nearly equally (to be discussed further in a later section) between the employer (the City) and the employee.

One rationale presented to us was that the employees are entitled to generous pension benefits because they are paid at a lower rate than the private sector during their working career. Evidence to support his assertion was primarily anecdotal. Other evidence indicated that the non-safety employees have been well represented through the collective bargaining process and that areas of significant under-compensation have been surfaced and corrected. After two meetings on this topic, we concluded that there was insufficient evidence to conclude that City employees are paid either better or worse than their counterparts.

Another rationale presented to us was that the pension benefits are generous because City employees do not participate in Social Security. This means that neither the employer nor the employee pay 6.2% FICA. The fact, however, is that as an offset to the absence of a Social Security benefit, the City was required to provide General Member employees a Supplemental Pension Savings Plan (SPSP). Safety members are not entitled to SPSP but are entitled to a higher pension factor than General Members. SPSP is a defined contribution plan that is in addition to the defined benefit plan. The City pays 3.05% of the employee=s salary into this SPSP plan. The employee is required to contribute 3.05% also and can voluntarily contribute up to another 3% which the City will match. Thus, if the employee takes advantage of the full employer match, the City has to contribute up to 6.05% of the employee=s salary.

The Committee determined that there is nothing inherently wrong with a defined benefit plan and that eliminating the defined benefit plan in favor of a defined contribution plan would not necessarily result in an improved situation. This is particularly true in light of the City Attorney=s opinion that any Plan changes can only affect newly hired employees.

Furthermore, a conversion to a defined contribution plan for new hires could result in increased cost for all employees as a group. Applying the normal cost of the Plan of approximately 24% as a contribution percentage for the demographically younger group and new hires will have the actuarial effect of increasing the normal cost as a percentage of payroll for the group of employees remaining in the Plan.

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This is because the actual normal cost for younger employees is lower than the 24% average normal cost , and the actual normal cost for older than average employees is significantly more than the 24%. The newly hired, younger than average employees, under the current Plan in effect subsidize the older than average employees.

The Committee believes City employees overwhelmingly are seeking the long-term benefits of a defined benefit plan. The Committee believes, based on credible evidence, that the City would experience recruitment and retention difficulties in offering only a defined contribution plan in lieu of a defined benefit plan to its newly hired employees.

The Committee received credible evidence that the long-term investment performance of the existing Plan will significantly exceed the performance of individually directed contribution accounts, resulting in greater benefit for employees as a group per dollar of City/employee contribution. The Committee also recognized the difficulty of replicating current disability benefits without a defined benefit plan.

The Committee also concluded, based upon data obtained from the California Public Employees Retirement System (CalPERS), that it would not be fiscally prudent for the Plan to join CalPERS. There is no evidence to suggest that CalPERS is better managed than the City=s system, nor that its investments are performing at a superior rate of return.

The conclusion of the Pension Reform Committee was that the City should stay with a defined benefit plan but that benefits should be scaled back for new hires. We understand that these changes cannot be unilaterally dictated by the Mayor and Council, but will be negotiated through the Ameet and confer@ process. If, in the end, agreement cannot be reached, we believe the City will ultimately have no financial choice but to either require that the employees pay a larger share of the pension costs or else convert to a defined contribution plan. To this end, we are recommending a series of potential plan changes affecting new employees.

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<u>Recommendation #6</u>

The normal retirement age should be raised by seven years for all employees and the early retirement age should be set at a number of years that are five years less than the normal retirement age.

This will result in a savings of 1% of pay, or based on current payroll, $6,050,000

The above recommendation will result in the following normal retirement ages:

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General members	62
Fire and safety	57
Legislative	62

Early retirement ages would be:

General members	55
Fire and safety	52
Legislative	55

Recommendation #7

The annual accrual rate for the percentage of final base payroll to be used in calculating the pension benefit be reduced 20%.

This will result in a savings of 1% of pay, or based on current payroll, $6,050,000.

The above recommendation will result in the following accrual rate percentages:

General members	2.0%
Fire and safety	2.4%
Legislative	2.8%

Recommendation #8

The final base payroll should be based on an average of the employee=s highest three years= salary rather than on the highest one year of salary.

This will result in a savings of 1.06% of pay, or based on current payroll, $6,413,000 annually.

Recommendation #9

The final base payroll should exclude salary differentials such as second shift differential, bilingual differential, etc.

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This will result in a savings of 1% of pay, or based on current payroll, $6,050,000.

Recommendation #10

Eliminate specific programs that permit DROP and purchase of years of service credit, except those that are federally protected.

This will result in a savings of .1% of pay, or based on current payroll, $605,000 annually for DROP. Based on current employment levels, total losses of $22,000,000 to $25,000,000 would be avoided due to elimination of service purchase.

It is not possible to add all of the savings identified above to arrive at a total savings if all recommendations are adopted. Because of the interaction between the components, the total savings which could be achieved if all recommendations are adopted is 3.74% of pay, or based on current payroll, $22,636,000 annually.

These savings will emerge over time as more of the participants are covered by the new benefits, and current participants retire. However, had this structure been in place for the current workforce, the Plan's unfunded accrued actuarial liability would have been reduced by $633,000,000., and the annual savings on amortization payments would amount to $68,475,000.

VIII. RETIREE MEDICAL BENEFITS

The unfunded liability related to the City=s retiree medical benefit commitment is arguably an even worse problem than the pension liability. This is not necessarily related to its size ($748Million vs. $1.157Billion for the pension) but is related to the fact that it is hidden and is being deferred out to future years= taxpayers.

As was discussed under the funded status of the system, these benefits are currently being covered by a pay-as-you go basis out of earnings of the Plan. In a previous recommendation we have indicated that such a practice should stop.

Recommendation #11

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The City should establish either a separate trust or a separate accounting within the pension trust to account for the assets and liabilities of the retiree medical benefit plan. Retiree Medical Plan assets may be comingled with Retirement Plan assets for investment purposes, but be accounted for separately for all other purposes. Annual contributions to the Retiree Medical Plan should be separately identified in the City budget and in no way be confused or comingled with Retirement Plan contributions.

The liability for the Retiree Medical Plan should be clearly stated on the books of the City. The Governmental Accounting Standards Board (GASB) has acknowledged the problem that is being created nationally by lack of accounting for the liabilities associated with these plans. This year it issued Statement 43 Financial Reporting for Post employment Benefit Plans Other Than Pension Plans. Other post employment benefits (OPEB) include healthcare and other non-pension benefits provided to employees as part of their compensation for services. In its news release of May 11, 2004, Karl Johnson, the GASB project manager states:

> AStatement 43 provides a framework for transparent financial reporting by governmental entities that have fiduciary responsibility for OPEB plan assets regarding their stewardship of plan assets, the funded status and funding progress of the plan, and employer contributions to the plan.@

While GASB #43 is not yet effective and the City is therefore not yet required to comply, the Pension Reform Committee urges its early adoption.

Recommendation #12

Adopt GASB #43 effective July 1, 2005

The above recommendations deal with the accounting for the benefits, they do not address the ability or inability of the City to fund this already-existing liability.

While an in-depth review of the retiree medical benefits is outside the Acharter@ of the Pension Reform Committee, we suggest that the City should conclude, as soon as possible, whether the current employees have a vested right to retiree health care. If the answer is no, the employees should be given that information. If the answer is yes, a plan for payment of the liability should be immediately developed.

Recommendation #13

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When amortizing the unfunded liability for retiree medical benefits, a method should be used that does not create negative amortization of the liability.

IX. GOVERNANCE

The Pension Reform Committee discussed the basic component of governance of the pension system. The city ostensibly has created an independent Board, separate from the City, to manage the pension. However, the City Charter dictates the composition of the 13 member Board of Trustees as follows:

3 representatives from City management
2 representatives elected by police and fire members
3 representatives elected by General Members
1 representative elected by retired members
4 independent citizens nominated by the Mayor and appointed by the City Council

While contributions to the Plan are made by both the employees and the City, only the City acts as the final guarantor of all benefits paid by the Plan. This ultimate guarantee of the Plan=s ability to pay the agreed-upon benefits means that the primary, if not the sole, stakeholder in the operation of the Plan itself are the citizens of the City of the San Diego.

At the heart of the concern is that, of the thirteen members of the Retirement Board, eight members can clearly benefit by enabling the City to fund its current operating budget at the expense of the retirement plan as long as the ramifications to the Plan are not severe over the short term. The notion that the Board is simply administrative, as some would argue, is countered by the fact that the intentional underfunding of the plan requested by the City Manager in both 1996 and 2002 had to be approved by the Board before it could even be heard by the City Council.

The second significant problem is the technical skill required to understand the complex issues that are present in the administration of the Plan. The combination of the highly technical rules for pension administration and the need to understand the use of arcane actuarial science in the measurement of present and future Plan liabilities requires an experienced and trained Board member to effectively govern the Plan. While some may argue that the purpose of the Board member is to set policy and that technical aspects are handled by trained professionals, lack of understanding of the finer points of

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administration means that a Board member may be unable to ask meaningful questions.

Finally, there is an issue in communication between the City Council and the Retirement Board. The City Council seems to view the Board as its eyes and ears in the retirement system. Councilmembers have repeatedly commented that if there are any problems in the retirement system, they depend on the Board to let them know. This includes any actions the Council might consider taking that could be potentially harmful, even in a minor way, to the Plan. The Board, on the other hand, views itself as strictly administrative and does not seem to feel that advisory input to the Council is appropriate.

For all of these reasons, the Pension Reform Committee believes that the Plan, the beneficiaries, and the City would be better served by a Board composed of qualified professionals who have no vested interest in the Plan.

Recommendation #14

Change the composition of the Retirement Board to seven members appointed by the City Council. These members will serve with staggered terms of four years each, with a two consecutive term maximum. Such appointees will have the professional qualifications of a college degree and/or relevant professional certifications, fifteen years experience in pension administration, pension actuarial practices, investment management (including real estate), banking, or certified public accounting. Such appointees will be U.S. Citizens and residents of the City of San Diego but cannot be City employees, participants (direct or indirectly through a direct family member) of the SDCERS, nor a union representative of employees or participants, nor can such appointees have any other personal interests which would be, or create the appearance of, a conflict of interest with the duties of a Trustee.

Another governance issue that was addressed related to applications for disability retirement. Currently, when an application is submitted for disability retirement, it is first reviewed by SDCERS staff. If the application is recommended for approval, it moves directly to the Board for action. If the application is not recommended for approval, it is forwarded to an outside adjudicator who hears from both parties, reviews documents, and renders a finding. That finding then returns to the Board where, more often than not, the whole application is heard again, though not under oath.

Again due to the possible conflicts of interest present when a Board member is asked to make these types of findings related to another employee who either was or is in the same bargaining unit, this process places Board members in an extraordinarily awkward position. The Pension Reform Committee felt it would be in the best interest of everyone concerned to create a process whereby

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applications forwarded to an adjudicator would not be returned to the Board. Instead, the finding of the adjudicator would be final.

<u>Recommendation #15</u>

An additional provision should be made to the City Charter that would codify the current disability retirement determination process as it is now except that the hearing officer=s decision would be final rather than a recommendation to the Board for approval.

X. OTHER RECOMMENDATIONS

A. Study disability retirement application process and system

In grappling with the issues surrounding the cost of the City=s Plan, the Pension Reform Committee found that the complexities and nuances of the portion of the system related to disability retirement appear to have resulted not only in inconsistent treatment among employee groups but have created a system that appears ripe for abuse.

At one point the Committee attempted to recommend application of the Social Security definition to the City system, but determined that it could create unintended consequences. This area clearly needs additional study and should be reviewed by a team of individuals who have appropriate H.R. and/or legal experience.

<u>Recommendation #16</u>

The City should establish a committee to review the entire disability retirement system. Representatives on this committee should include knowledgeable employees of both the City and SDCERS as well as outside professionals with experience in this area.

Employee/Employer Sharing of Pension Costs

Section 143 of the City Charter states:

> "The City shall contribute annually an amount substantially equal to that required of the employees for normal retirement allowances, as certified by the actuary, but shall not

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> be required to contribute in excess of that amount, except in the case of financial liabilities accruing under any new retirement plan or revised retirement plan because of past service of the employees."

This section of the Charter has apparently been loosely interpreted to mean that the employees bear 50% of Normal Cost and that all other costs are borne by the City. Another reading would be that past service costs (discussed earlier) are the sole responsibility of the City, but that any other costs should be split 50/50. Even if one agrees that the 50/50 split applies to Normal Cost only, then it appears that the Charter may not be being followed.

The Pension Reform Committee attempted to get a full explanation of these issues, but was not able to do so. This issue was identified fairly late in the process and it appears that it will take a significant amount of investigation and possible legal interpretation.

Even if it is determined that the employees have not been paying an amount consistent with the intent of the Charter, a question remains as to what can be done about that either retroactively or prospectively. It is our understanding that the Retirement Board is now investigating this matter.

Recommendation #17

The City Council Rules Committee should require a report (with recommendations) from SDCERS on the issue of the 50/50 employer/employee cost split by the end of the calendar year.

Actuarial Assumptions

The Plan=s actuary has recommended several changes to the actuarial assumptions used to determine the employer and employee contribution rates. Recently the Retirement Board engaged a second firm to audit the June 30, 2003 actuarial valuation and to evaluate the assumptions being used and/or recommended.

The Committee supports the recommended changes to assumptions with the exception of the recommendation regarding investment return.
As discussed extensively in earlier sections, the Plan=s assets generate investment earnings and increase in value due to both inflation and market forces. The problem is that a portion of those earnings are siphoned off to pay for other commitments such as retiree medical benefits and contingent benefits. The

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Committee has addressed this by recommending a change to the computation of the City=s annual contribution that would require replacement of those Alost@ earnings.

Both the Plan=s actuary and the auditor chosen by the Retirement Board have recognized this same phenomenon and attempted to compensate for it by reducing the assumed investment return to acknowledge the fact that the entire investment return is not applied to Plan growth.

The Plan=s assumed investment rate of return is 8%. The Plan has been experiencing 8%. Therefore the Committee believes that it is simply more straightforward to deal with the dilution of Plan assets annually rather than artificially adjusting the investment rate of return to compensate.

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XI. Appendices

A. Biographies

B. Interim Report of Pension Reform Committee to Mayor and City Council January 22, 2004

C. Additional Information to City Council April 19, 2004

D. Amortization/Fixed Percentage of Salary/Inflation Adjusted Schedule

E. Memorandum from Mayor Dick Murphy September 24, 2003

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F. Unfunded Actuarial Accrued Liability (UAAL)

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