Office of the City Auditor

City of San Diego

Performance Audit of the San Diego City Employees' Retirement System

SDCERS' Unique Environment Increases Operating Expense, but Cost-Cutting Opportunities Exist

Presentation to the Audit Committee

December 5, 2011

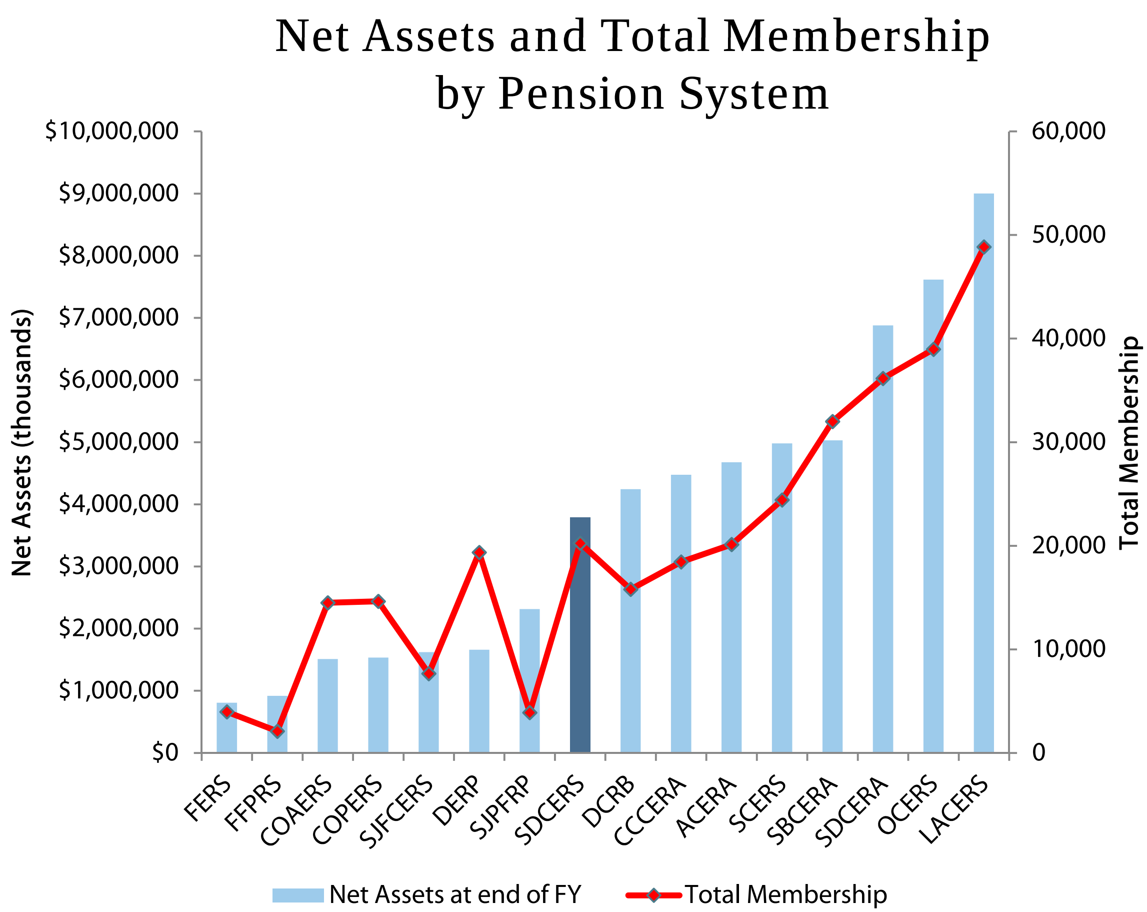
Independent · Objective · Accurate

Key Audit Objectives

- Determine whether SDCERS' expenses and actuarial assumptions are comparable to other retirement systems and identify reasons for anomalies.
- Identify potential reductions to administrative costs and investment management fees.
- Determine the effectiveness of SDCERS' disability pension approval process.

Peer Selection Methodology

- Selected 15 city and county pension systems in California and other states.
- California county systems were most similar in size.
- Considered asset and membership size, location in a metropolitan area, and availability of financial information.



Background

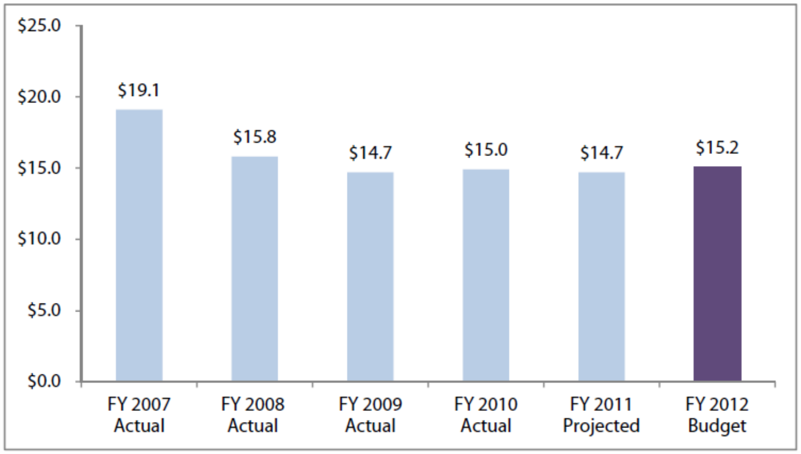
San Diego City Employees' Retirement System

- SDCERS is a defined-benefit system providing retirement, disability, and healthcare benefits to retirees from the City of San Diego, the Unified Port District, and the San Diego Regional Airport Authority.
- SDCERS is governed by a 13-member Board of Administration with "plenary authority and fiduciary responsibility" to invest plan assets and administer the system. The Board appoints a CEO who oversees all operations.
- At the end of fiscal year 2010, SDCERS had 20,244 members and $3.8 billion in net assets.
- The City's fiscal year 2012 ARC payment is $231 million. In fiscal year 2011, the ARC payment comprised 16% of the General Fund budget.

Background

Overview of Administrative Expenses

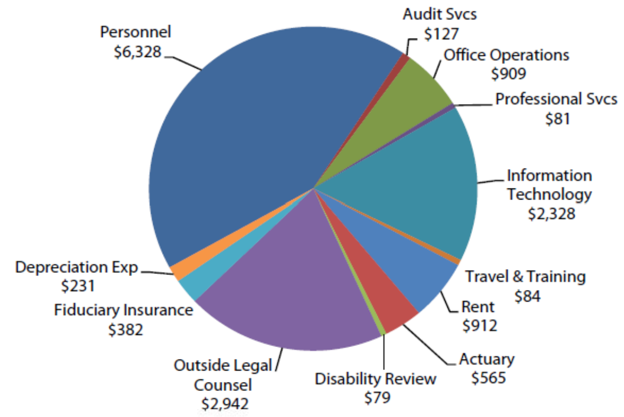
SDCERS' Administrative Expenses, Fiscal Year 2007 through Fiscal Year 2012 (in millions)



Source: Auditor generated from SDCERS' Comprehensive Annual Financial Reports (CAFR) and budget documents.

The largest administrative cost for SDCERS include personnel, information technology, outside legal counsel, and fiduciary insurance.

Breakdown of SDCERS' Fiscal Year 2010 Administrative Expenses (in thousands)



Source: Auditor generated from SDCERS' fiscal year 2010 Comprehensive Annual Financial Report (CAFR).

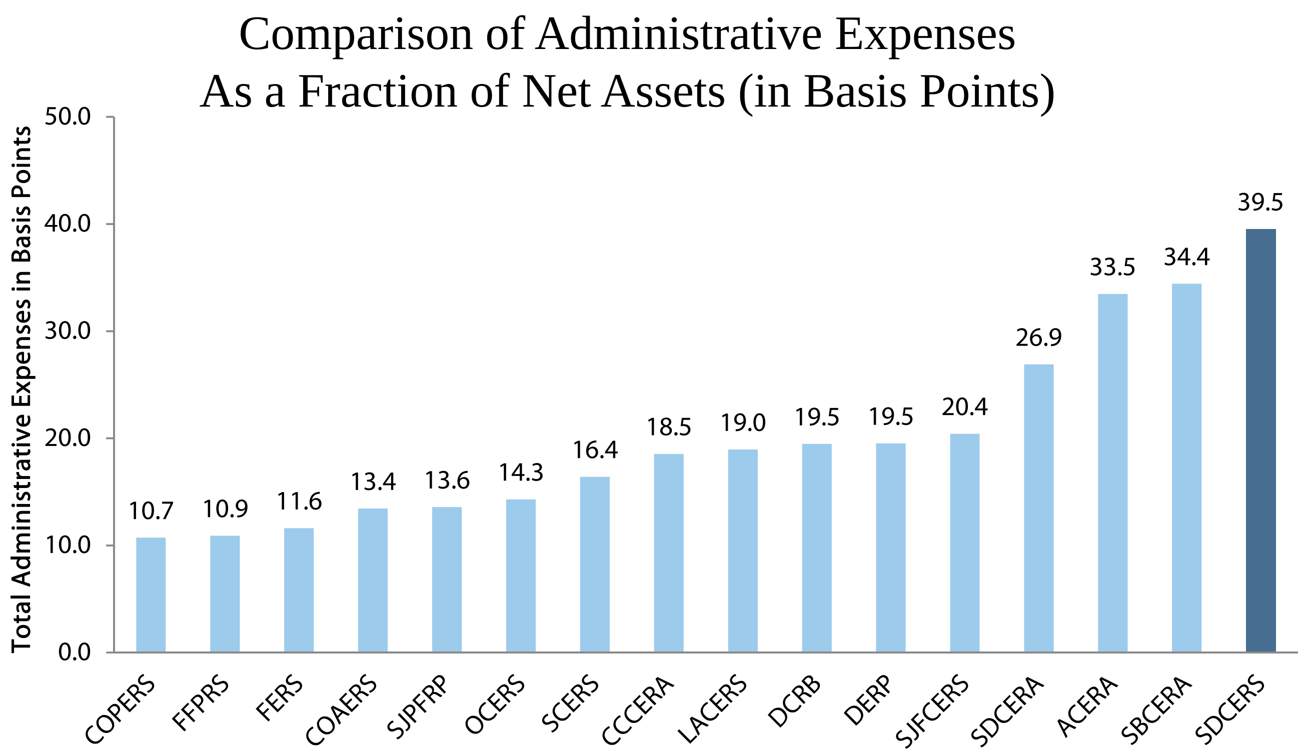
SDCERS' administrative expenses fell significantly between fiscal years 2007 and 2009 in large part due to the completion of IT projects.

Summary of Findings

- When compared to peers, SDCERS' administrative and investment expenses are higher, plan funding is lower, and actuarial assumptions are more conservative.
- While this is largely due to the unique operating environment that has resulted from the history between SDCERS and the City, opportunities exist to reduce expenses.
- The audit also identified potential savings for the City if it changed policies related to Medicare Part B reimbursements and Industrial Disability Retirements.

Administrative Expenses - Key Findings

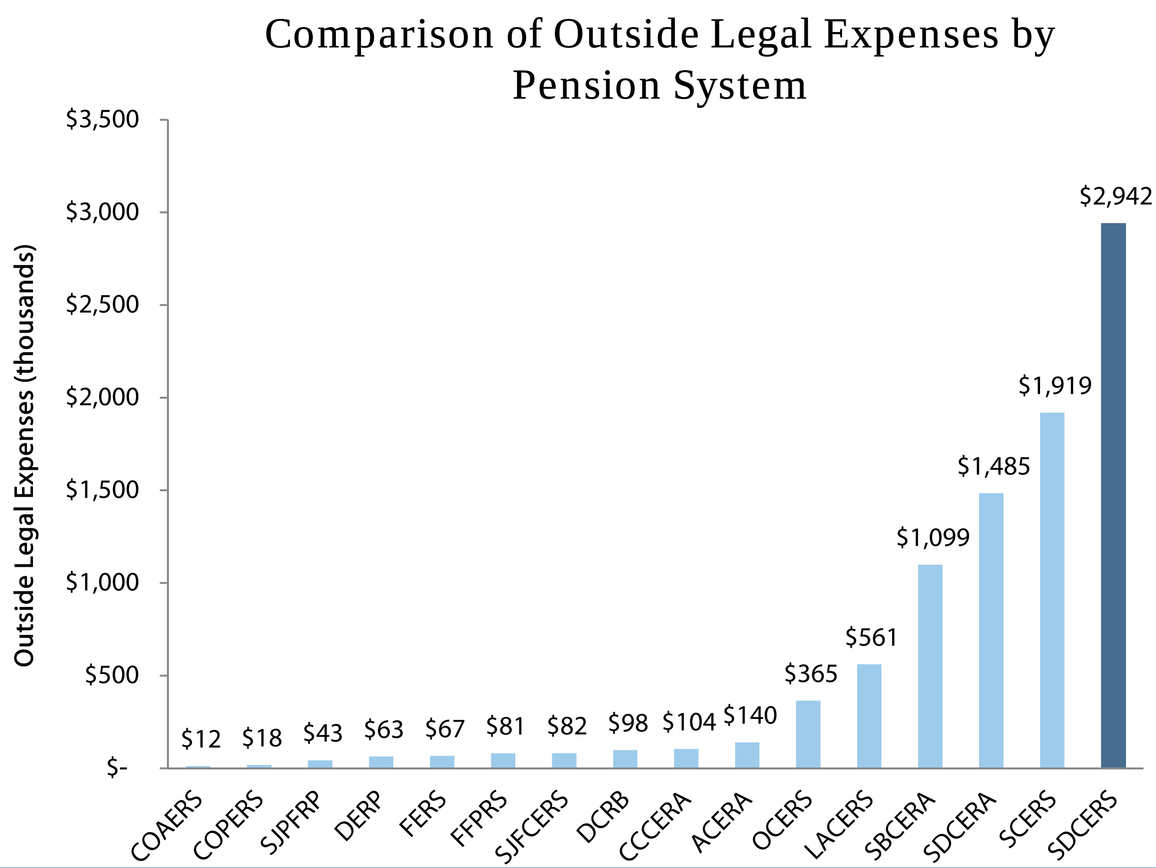
Administrative Expenses are Higher than Peers



Administrative Expenses - Key Findings

Legal Expenses are Significantly Higher

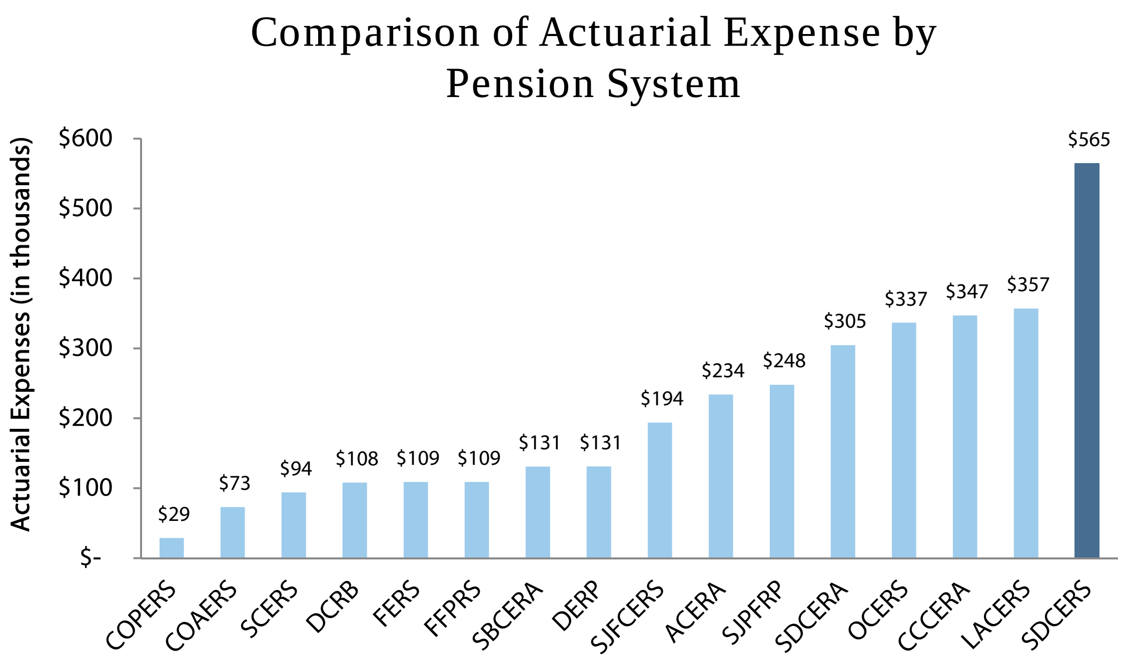
- SDCERS has been embroiled in lawsuits for years due, in part, to the actions of prior trustees and City officials.
- In each lawsuit, SDCERS hires outside legal counsel for representation. In FY 2010, SDCERS was involved in seven lawsuits, including six as the defendant.
- Other systems do not have the litigation workload of SDCERS.



Administrative Expenses - Key Findings

Actuary Costs are Driven-Up by Litigation

- SDCERS' actuary analyzes the actuarial impact of any plan changes that may result from litigation.
- SDCERS' actuary completes three unique valuations – one for each plan sponsor.



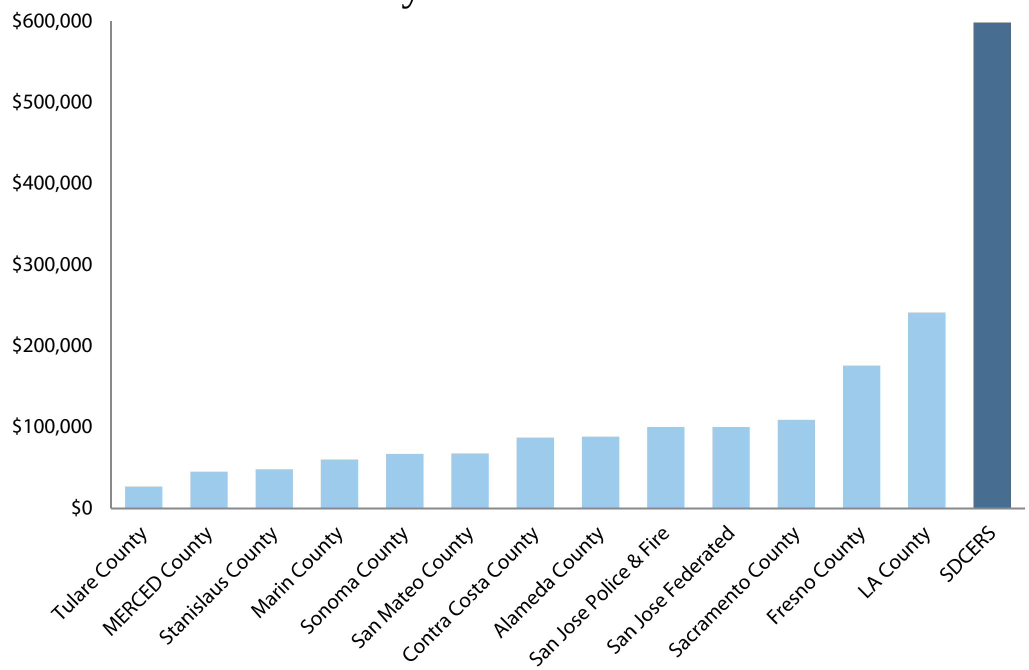
➢ ***Recommendation: SDCERS should consider its high actuary costs when evaluating responses to its Fall 2011 RFP for actuarial services.***

Administrative Expense - Key Findings

Fiduciary Insurance Premium is Significantly Higher

- SDCERS purchases annual fiduciary liability insurance to protect its trustees from being personally liable in a lawsuit resulting from their official duties.
- SDCERS has the highest annual premium, likely due to its high coverage level, $0 deductible, and litigious history.
- The insurance is meant to protect trustees personal assets, but current coverage does not fully provide this assurance.

Comparison of California Retirement Systems' Fiduciary Insurance Premiums



➢ ***Recommendation: SDCERS' management and trustees should work with its legal counsel to identify alternatives to fiduciary insurance and cancel the current policy when a more suitable and cost-effective alternative is identified.***

Administrative Expenses - Key Findings

Certain Operational Inefficiencies Exist due to SDCERS' Current Pension Administration Information System

- The current pension administration system does not adequately support the Benefit Administration function.
- An outside consultant hired in 2009 made a number of recommendations for SDCERS to address through process improvements and implementation of a new pension administration system.
- SDCERS has selected a new pension administration system for implementation in January 2014 that could reduce Benefits Administration staff needs by up to 5 FTEs.

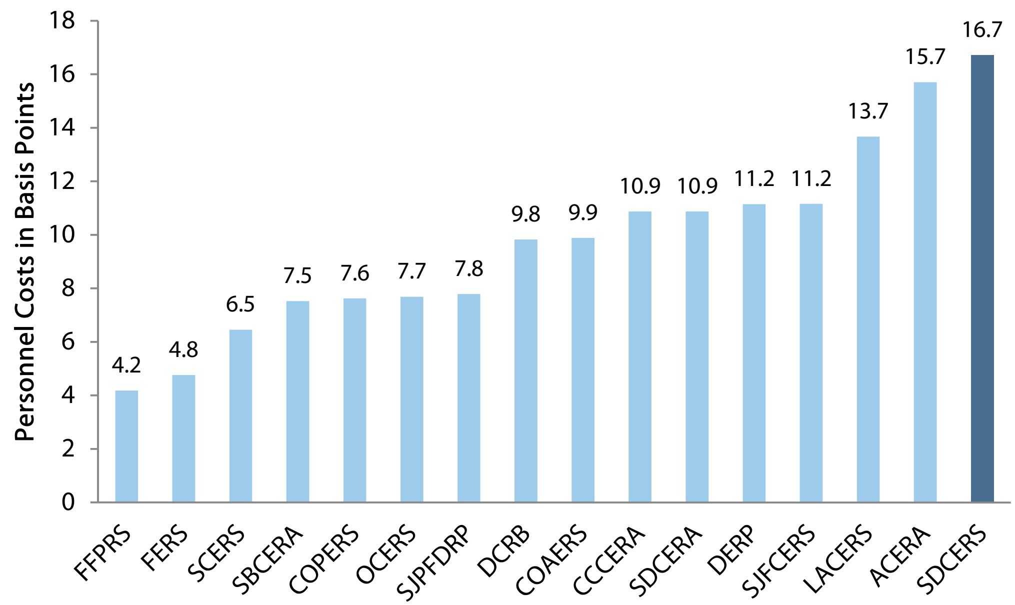
➢ ***Recommendation: SDCERS should designate an individual to ensure the business process recommendations made by its consultant are implemented.***

Administrative Expenses - Key Findings

While Difficult to Accurately Compare, SDCERS' Personnel Costs Appear on the High-End of Peer Systems

- Different systems report personnel expenses in different expenditure categories.
- Some systems share staff resources with their plan sponsors.
- Implementation of the new system in January 2014 may reduce staff costs.

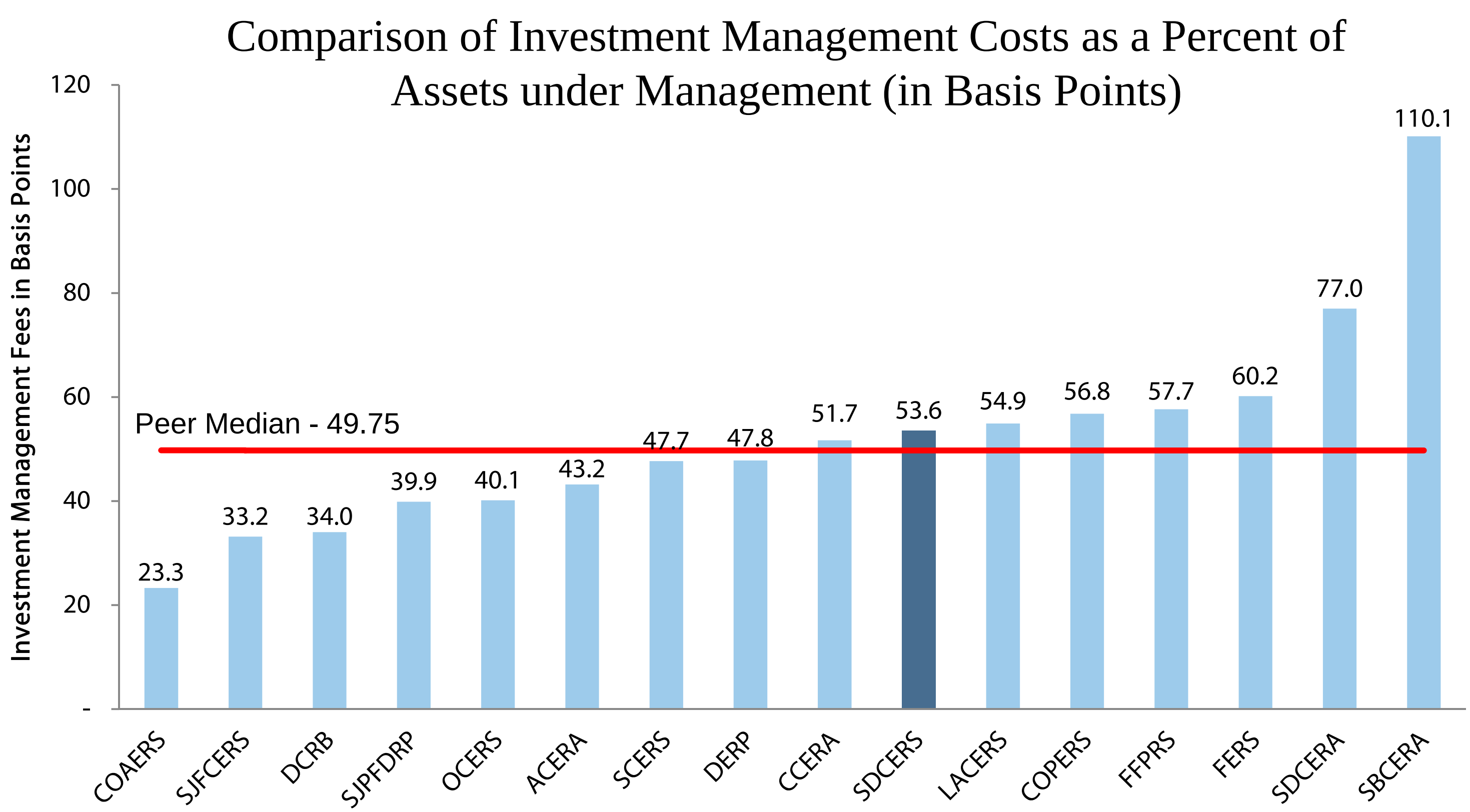
Personnel Costs as a Fraction of Net Assets (in Basis Points)



➢ ***Recommendation: SDCERS should reassess its staffing level once the new pension administration system is implemented.***

Investment Expenses - Key Findings

SDCERS' Investment Expenses were Slightly Higher than the Peer Median



Investment Expenses - Key Findings

- Investment expenses are primarily a function of total assets under management, allocation of the investment portfolio, and a system's ability to negotiate investment fees.

- SDCERS' investment FY 2010 investment expenses were higher than the peer median largely because its investment portfolio was almost entirely actively managed, which carries higher investment fees.

- SDCERS recently began moving a portion of its portfolio to passive investment strategies with the goal of reducing fees and mitigating risk without significant reductions to returns.

➢ ***Recommendation: SDCERS should periodically assess its asset allocation, rate of return, and investment costs to determine the appropriate mix of passive and active investments.***

Potential City Cost Savings - OPEB Health Care and Disability Benefits Policy Changes

The City spends almost $100,000 a year to reimburse high-income retirees' Medicare Part B IRMAA premiums—a benefit not explicitly outlined in the City's Municipal Code.

- ***Recommendation: The Risk Management Department should request the City Attorney's Office to determine the City's obligation in reimbursing IRMMA payments and review the retiree healthcare tentative agreement to determine if IRMAA payments are eligible for reimbursement.***

Potential City Cost Savings - OPEB Health Care and Disability Benefits Policy Changes

Industrial Disability Retirement Benefit Payouts are not Offset by Income Received from Outside Employment or Workers' Compensation

- Other local governments offset IDR benefits by income from outside employment or Workers' Compensation awards through either a dollar-for-dollar benefit reduction (Option 1) or a one dollar benefit reduction for each dollar where combined income exceeds the retiree's salary as an employee (Option 2).
- From fiscal year 2006 through 2010, Option 1 could have reduced the IDR benefit payout by $880,000 to $1.3 million, and Option 2 could have saved the City between $54,000 and $313,000.

➢ ***Recommendation: The Risk Management Department should request the City Attorney's Office to determine if IDR benefits can be offset and, if so, identify steps for implementation of offsets.***

Actuarial Assumptions

SDCERS Changed Actuarial Assumptions and Methodology to be in line with Industry Standards and Peers, but Are More Conservative

- Adopted the Entry Age Normal (EAN) actuarial funding method.
- Adopted more conservative UAL amortization periods.
  - 20 years for UAL as of June 30, 2007
  - 15 years for annual gains and losses incurred after 2007 (most systems amortize over 16 years or more).
  - 30 years for any changes in actuarial methods or assumptions.
- Changed the asset smoothing method to expected value of assets (approximately 4 year period).
- Prohibited negative amortization so the amortization pay-off period decreases with each year.

Recommendations

- We made a total of **12 recommendations,** 10 directed at SDCERS and 2 directed at the City's Risk Management Department.

- SDCERS agreed with 9 recommendations and partially agreed with 1 recommendation. Risk Management agreed with 1 recommendation and partially agreed with the other.