



Office of the City Auditor

Report to the City Council
City of San José

**PENSION SUSTAINABILITY:
RISING PENSION COSTS
THREATEN THE CITY'S
ABILITY TO MAINTAIN
SERVICE LEVELS –
ALTERNATIVES FOR A
SUSTAINABLE FUTURE**

Report 10-10
September 2010



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September 29, 2010

Honorable Mayor and Members
of the City Council
200 East Santa Clara Street
San Jose, CA 95113

Pension Sustainability: Rising Pension Costs Threaten the City's Ability to Maintain Service Levels – Alternatives for a Sustainable Future

The City of San Jose provides two defined benefit retirement plans for City employees: the Police and Fire Department Retirement Plan (Police and Fire) for sworn employees, and the Federated City Employees' Retirement System (Federated) for all other benefited City employees. In addition, the City offers a voluntary 457 deferred compensation plan for employees to supplement their savings. City employees do not participate in the Federal Social Security program.

The purpose of this audit was to assess the long-term sustainability of the City's pension benefits and the potential impact of increases in pension costs on City operations, and provide background on pension reform alternatives being pursued by other retirement systems.

This audit focuses on pension benefits. Chapter I of the report provides background information about the City's pension benefits. The City also faces considerable challenges with regard its obligations for retiree healthcare.

Pension benefit increases had dramatic impacts on costs even before recent market losses. Chapter 2 describes how, over time, the City's two retirement plans have changed significantly. New and enhanced benefits have been added since voters approved minimum benefit levels in 1965. Over the past 20 years, total annual pension benefits paid out of the retirement funds have grown seven fold. The City's annual contributions into the retirement funds to pay for pension benefits doubled from FY 1998-99 to FY 2009-10 and pension contribution rates as a percentage of payroll have grown sharply.

As of June 30, 2009, the City's estimated liability for pension benefits totaled \$5.4 billion. As a result of losses suffered during the 2007-09 economic downturn, the market value of assets as of June 30, 2009 totaled just \$3.4 billion and the City had an estimated unfunded pension liability of \$2 billion based on the market value of assets. Because of the actuarial method of smoothing gains and losses over time, recent market gains and losses have not been fully recognized for actuarial purposes (e.g. the actuarial value of assets as of June 30, 2009 was \$4.3 billion) nor reflected in the actuarially determined

contribution rates to date. In spite of recent strong investment returns (the market value of assets total \$3.8 billion as of June 30, 2010), previous losses are expected to push contribution rates higher as they are recognized in the coming years. Furthermore, the declining ratios of employees to retirees and beneficiaries creates a risk of higher contribution rates. As of June 30, 2009, the City also had a \$1.4 billion unfunded liability for its other post employment benefits (OPEB) based on the market value of assets.

Rising pension costs threaten the City's ability to maintain service levels. Chapter 3 addresses the question of sustainability. Personnel costs account for about two-thirds of General Fund expenditures and an increasing portion is attributable to retirement contributions. By FY 2014-15, annual pension and other post-employment benefit (OPEB) contributions are projected to reach 25 percent of total General Fund expenditures, up from 17 percent in FY 2010-11 and 6 percent in fiscal year 2000-01. Recent budget deficits required cuts to services, layoffs, and concessions from employee bargaining groups. Projected future deficits, in part due to rising pension costs, will require similar considerations.

The City's unfunded pension liability has grown dramatically in recent years. As of June 30, 2009, the City's unfunded pension liability was \$2 billion on a market value basis. Chapter 4 describes the reasons for the rise in the unfunded liability. One reason, of course, was investment losses totaling about \$978.8 million which were incurred from 2007-2009. In spite of recent investment gains of \$512 million, those losses will continue to affect the City's *unfunded liability* over the next few years because of the actuarial method of recognizing or *smoothing* gains and losses.

Another reason for the growth in the unfunded liability was the granting of retroactive benefit enhancements. Because San Jose residents are ultimately responsible for pension costs and retroactive benefit enhancements can create unfunded liabilities, we recommend the City Council explore prohibiting (1) pension benefit enhancements without voter approval and (2) retroactive pension benefit enhancements that create unfunded liabilities.

Another significant reason for the rise in the unfunded liability is that the assumptions used by the plans' actuaries to calculate pension liabilities and contribution rates did not hold true. This resulted in about \$750 million being added to the unfunded liability between June 30, 2007 and June 30, 2009. Actuarial assumptions represent expectations about future events such as investment returns, member mortality and retirement rates, and salary increases, among others. Actuaries use those assumptions to calculate pension liabilities and contribution rates. To ensure the reasonableness of the methods and assumptions used in the plans' actuarial valuations, we recommend the City Council amend the Municipal Code to require an actuarial audit of such valuations every five years if the actuary conducting the valuation has not changed in that time.

Individual components of the City's pension plans have different impacts on overall costs. Chapter 5 provides information about the major cost drivers of the City's pension costs. Two major drivers of those costs are the age at which members are eligible to receive benefits (50 for Police and Fire and 55 for Federated) and the plans' guaranteed annual 3 percent cost-of-living adjustment (COLA). Other provisions also have varying impacts on overall cost.

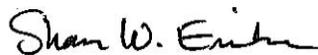
There are alternatives for a sustainable future. The City has limited legal maneuverability in how it could change its pension plans for current employees. Nonetheless, it is important that the City move aggressively to rein in pension costs that threaten the stability of the General Fund and the services it provides to the residents of San Jose. It is important to start somewhere, and it is important to start now. Chapter 6 briefly outlines some alternatives and our recommendation that the City Council pursue at least one or a combination of pension cost-containment strategies, including: (1) additional cost sharing by employees, (2) eliminating or at least prohibiting transfers in and distribution of

supplemental benefits when the plans are underfunded, (3) prospective changes in the plans for existing employees, (4) a second tier pension for new hires, and/or (5) joining CalPERS.

The City will continue to face considerable financial risks from rising pension costs for years to come. There is a risk that even if the City implements the recommendations in this audit, pension costs may still be unsustainable. Because of the risks of rising pension costs to the City's financial and budgetary future, in Chapter 7 we recommend that the Retirement Services Department (1) provide an annual report to the City Council that includes updates on the financial status of the plans, forecasts of pension costs, and sensitivity analyses showing best and worst case scenarios, and (2) provide an annual summary report to plan members that includes summary financial and actuarial data in an easily accessible format.

I will present this report at the October 21, 2010 meeting of the Public Safety, Finance, and Strategic Support Committee. We are releasing this report well advance of the Committee meeting so that the report can also help inform the work of the General Fund Structural Deficit Elimination Plan Stakeholder Group. The Administration has reviewed the information in this report and their response is shown on the yellow pages.

Respectfully submitted,



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Table of Contents

Cover Letter	i
Glossary	iv
Chapter 1 Introduction	1
Background	1
Audit Objective, Scope, and Methodology	8
Chapter 2 Pension Benefit Increases Had Dramatic Impacts on Costs Even Before Recent Market Losses	11
New and Enhanced Benefits Have Been Granted Since the Voters Approved Benefit Minimum Levels in 1965.....	12
Pension Benefit Payments to Retirees and Beneficiaries Have Grown Seven Fold Over the Past Twenty Years	16
The City’s Annual Contributions Into the Retirement Funds Doubled Over the Past Decade	18
The City’s Contribution Rates Have Risen Sharply in Recent Years and Are Projected to Rise Even Further in the Near Future.....	19
The Retirement Plans’ Unfunded Liabilities Play a Major Role in Rising Contribution Rates.....	21
The Declining Ratio of Employees to Retirees and Beneficiaries Creates a Risk of Even Higher Future Contribution Rates.....	24
At Current Contribution Rates, Estimates Show the Amount Owed in Pension Liabilities Will Continue to Grow at a Much Faster Rate Than Available Plan Assets.....	25
Chapter 3 Rising Pension Costs Threaten the City’s Ability to Maintain Service Levels	27
Fiscal Sustainability Should Be a Consideration For Any Decision on Whether the City Has Overcommitted on Pension Promises	27
About One Quarter of All General Fund Expenditure are Expected to Go Toward Retirement and OPEB Contributions by FY 2014-15	28
The City Has Seen Recent Budget Deficits and Projects More in the Future – Pension Costs Are a Major Factor.....	30
Chapter 4 The City’s Unfunded Pension Liability Has Grown Dramatically in Recent Years	33
As of June 30, 2009, the City Had a \$2 Billion Unfunded Pension Liability	34
Retirement Plans Have Experienced Large Market Losses in Recent Years, Increasing the Unfunded Pension Liability.....	35

Retroactive Benefit Enhancements Have Also Increased the Unfunded Pension Liability.....	36
Recommended Best Practice: Actuarial Audits	43
Chapter 5 Individual Components of the City’s Pension Plans Have Different Impacts on Overall Costs	45
Retirement Age and the Guaranteed 3 Percent COLA Are Major Cost Drivers of the City’s Pension Plans	45
Other Cost Elements	50
Chapter 6 Alternatives for a Sustainable Future.....	51
Maneuverability to Change Plans for Current Employees is Limited Under Current Law	51
The City May be Able to Reduce Costs Through Negotiations with Employee Bargaining Groups.....	52
The City Should Explore a Second Tier for New Employees	55
There is a High Cost to Self-Administer a Pension Plan	58
Pension Obligation Bonds.....	59
Moving Towards Sustainability	60
Additional Actuarial Review of Changes Before Approval Should Ensure Complete Understanding of Their Long-Term Impacts	61
Chapter 7 The City Will Continue to Face Considerable Financial Risks From Rising Pension Costs for Years to Come.....	63
The City Council Should Receive Annual Updates on the Retirement Plan’s Performance, Impact of Reforms, and Forecasted Pension Costs	63
The City Can Improve its Communication with Plan Members Regarding the Plans’ Performance and Financial Health.....	64
Conclusion.....	67
Administration Response	69

Table of Exhibits

Exhibit 1: Current Base Pension Formulas for the City's Retirement Plans.....	2
Exhibit 2: Retirement and Other Post-Employment Benefit Payments for Combined Plans, FY 1990-91 through FY 2009-10.....	3
Exhibit 3: Annual Pension Payments to Police and Fire Retirees and Beneficiaries as of June 30, 2009	4
Exhibit 4: Annual Pension Payments to Federated Retirees and Beneficiaries as of June 30, 2009	5
Exhibit 5: City and Employee Contribution Rates for FY 2010-11	6
Exhibit 6: Example of a City Employee Paystub.....	7
Exhibit 7: Impact of Pension Benefit Formula Changes on a Sample of Police and Fire Retirees.....	15
Exhibit 8: Impact of Pension Benefit Formula Changes on a Sample of Federated Retirees.....	16
Exhibit 9: Growth in Pension Benefit Payments and Total Retirees and Beneficiaries, FY 1990-91 Through FY 2009-10.....	17
Exhibit 10: Growth in the Average Annual Pension Benefit Paid Adjusted for Inflation (2009 dollars)	18
Exhibit 11: Annual Contributions for Pension Benefits Doubled Between FY 1998-99 Through FY 2009-10.....	19
Exhibit 12: The City's Retirement Contribution Rates as a Percent of Payroll, FY 1990-91 Through FY 2010-11	20
Exhibit 13: The City's Retirement Contribution Rates for Pension and Retiree Health Benefits, FY 1980-81 Through FY 2014-15 (projected).....	21
Exhibit 14: Market and Actuarial Values of Plan Assets Compared to Pension Liabilities, FY 1998-99 Through FY 2008-09.....	22
Exhibit 15: Pension Funded Ratios, June 30, 2009	23
Exhibit 16: Retirement Plans' Funded Ratios based on Actuarial Value of Assets, FY 1981-82 Through FY 2008-09	24
Exhibit 17: Decline in the Ratio of Employees to Retirees and Beneficiaries, FY 1980-81 Through FY 2009-10	25
Exhibit 18: Pension Benefit Payments Have Exceeded Contributions Since 2001	26
Exhibit 19: Retirement and OPEB Contributions Compared to All Other General Fund Expenditures, FYs 2000-01, 2010-11, and 2014-15 (projected)	29

Exhibit 20: The City’s Share of Current and Future Estimated Contribution Rates as a Percent of Payroll.....	30
Exhibit 21: Retirement Plans’ Funded Status (Unfunded Actuarial Accrued Liability), FY1990-91 Through FY 2008-09	34
Exhibit 22: Retirement Plans’ Investment Gains and Losses, FY 1996-97 Through FY 2009-10	36
Exhibit 23: Example of How Retroactive Benefit Enhancements Would Affect a Fire Employee Retiring in 2010 After 30 Years of Service	37
Exhibit 24: Police and Fire Retirement Plan Assumed and Actual Net Investment Returns, FY 1980-81 Through FY 2009-10.....	40
Exhibit 25: Federated City Employees’ Retirement System Assumed and Actual Net Investment Returns, FY 1980-81 Through FY 2009-10	40
Exhibit 26: Components of the Growth in the Actuarial Unfunded Liability from June 30, 2007 to June 30, 2009 (\$millions)	42
Exhibit 27: Estimated Percentage of Current Plan Costs Attributable to Charter Minimums and Other Selected Provisions	46
Exhibit 28: Estimated Costs Attributable to Various Benefit Levels – Police and Fire	47
Exhibit 29: Estimated Costs Attributable to Various Benefit Levels – Federated	47
Exhibit 30: Potential Lifetime Savings Using Highest Three-Year Average as Final Compensation	49
Exhibit 31: Selected Increased Cost Sharing Agreements, Other Governments and Bargaining Groups	53
Exhibit 32: Advantages and Disadvantages of Alternate Plan Designs	57

Glossary

(Glossary items italicized in text of audit)

Actuarial Assumptions: Assumptions representing expectations about future events (e.g. expected investment returns on plan assets, member retirement and mortality rates, future salary increases, or inflation) which are used by actuaries to calculate pension liabilities and contribution rates. *Unfunded liabilities* (see below) can grow when actuarial assumptions do not hold true.

Actuarial Valuation: Technical reports conducted by actuaries that measure retirement plans' assets and liabilities to determine funding progress. They also measure current costs and contribution requirements to determine how much employers and employees should contribute to maintain appropriate benefit funding progress.

Actuary: Professionals who analyze the financial consequences of risk by using mathematics, statistics, and financial theory to study uncertain future events, particularly those of concern to insurance and pension programs. Pension actuaries analyze probabilities related to the demographics of the members in a pension plan (e.g., the likelihood of retirement, disability, and death) and economic factors that may affect the value of benefits or the value of assets held in a pension plan's trust (e.g., investment return rate, inflation rate, rate of salary increases).

Actuarial Accrued Liability (or Pension Liability): The value today of all past *normal costs* (see below). Retired employees are no longer accruing benefits, so their actuarial accrued liability is the entire value of their benefit. The liability represents the value of benefits promised to employees and retirees for services already provided. This concept applies to both the pension liability and retiree health care liabilities.

Annual Required Contribution (ARC): The amount of money that actuaries calculate the employer needs to contribute to the retirement plan during the current year for benefits to be fully funded over time.

Experience Gains/Losses: Gains or losses that arise from the difference between actuarial assumptions about the future and actual outcomes in an organization's pension plan.

Market Gains/Losses: Gains or losses that arise from an increase or decrease in the market value of a plan's assets, including stock, real property, and investments.

Normal Cost: The portion of the total present value of benefits that actuaries allocate to each year of service. It can be thought of as the annual premium that the employer must contribute to fund the benefit. It is part of the ARC (see *above*).

Smoothing of Gains/Losses: Actuarial method of spreading, or smoothing, market gains and losses over a period of time (five years for both the Police and Fire and Federated plans). The purpose of smoothing is to minimize short-term, year-to-year contribution rate fluctuations which may result from market swings. The smoothed asset value is also known as the actuarial value of assets.

Unfunded Liability: This is the unfunded pension obligation for prior service costs, measured as the difference between the accrued liability and plan assets. When using the actuarial value of plan assets, it is also referred to as the Unfunded Actuarial Accrued Liability.

Chapter I Introduction

In accordance with the City Auditor's 2010-11 Work Plan, we have completed an audit of the sustainability of the City's pension systems. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We limited our work to those areas specified in the Audit Objective, Scope, and Methodology section of this report.

The City Auditor's Office thanks the Retirement Services Department, the Board members of the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan, and the Office of Employee Relations for giving their time, information, insight, and cooperation during the audit process.

Background

The City of San José (City) provides two retirement plans for City employees: the Police and Fire Department Retirement Plan (Police and Fire) for sworn employees and the Federated City Employees' Retirement System (Federated) for all other benefited City employees.

City employees **do not participate** in the federal Social Security program. This means that most City employees do not contribute to Social Security or earn quarters towards Social Security benefits while employed by the City of San José. Furthermore, any Social Security benefits they receive as a result of their employment elsewhere may be reduced based on the level of benefit they receive from the City's retirement plans. City employees hired after March 31, 1986 pay mandatory Medicare withholdings.

Other Plans

Members of the City Council and the Mayor are not members of the City's retirement plans. The City Council and the Mayor are given the option to participate in the California Public Employees Retirement System (CalPERS) or the City's Part-time, Temporary, Contract (PTC) 457 Deferred Compensation Plan. Councilmembers make retirement contributions into CalPERS or the PTC plan through bi-weekly payroll deductions, and the City makes its contributions on a bi-weekly basis.

A few Redevelopment Agency (RDA) staff who are benefited City employees are members of the Federated Retirement System. RDA staff who are not employed by the City participate in a defined contribution 401(a) plan to which the RDA contributes 9 percent of base salary and employees contribute 3 percent of base salary. In addition, the RDA and its employees pay into the Social Security program.

In accordance with federal regulations, the City also provides a retirement plan (the PTC 457 Deferred Compensation Plan) to its part-time, temporary, and contract employees who do not qualify to be members of the Police and Fire or Federated plans. Participants are required to contribute 3.75 percent of gross earnings which is matched by the City. This plan is in-lieu of Social Security, of which the City is not a participant, as noted previously.

In addition, the City offers a voluntary 457 Deferred Compensation Plan for employees to supplement their retirement savings. As of September 30, 2009, 72 percent of City employees participated in the 457 plan.

Pension Formulas and Benefits

Both Police and Fire and Federated Plans are **defined benefit plans**, meaning that the City provides a stable benefit based on a retirees’ years of service with the City and their final compensation.¹ This is in contrast to a **defined contribution plan** such as a 401(k) Plan, whereby retirement benefits are solely determined by the amount of assets that are available in the funds which had been accumulated over time by employer and employee contributions and investment earnings.

The City Charter (Charter) spells out the minimum pension benefits the City provides for employees. The Charter allows the City Council, at its discretion, to grant greater or additional benefits. Sworn employees may also be awarded additional benefits through binding arbitration.²

Exhibit I shows the current base pension formulas for the two plans.

Exhibit I: Current Base Pension Formulas for the City’s Retirement Plans

	Police and Fire	Federated
Eligibility	Age 50 with 25 years of service, 55 with 20 years or any age with 30 years	Age 55 with 5 years of service or any age with 30 years
Benefit Formula	<u>Police members</u> 2.5% of final compensation for each of the first 20 years of service, plus 4% per year of service in excess of 20 years of service <u>Fire members</u> 2.5% of final compensation for each of the first 20 years of service; 3% per year of service if 20 or more years of service	2.5% of final compensation for each year of service
Maximum allowable benefit	90% of final compensation	75% of final compensation

Source: San José Municipal Code

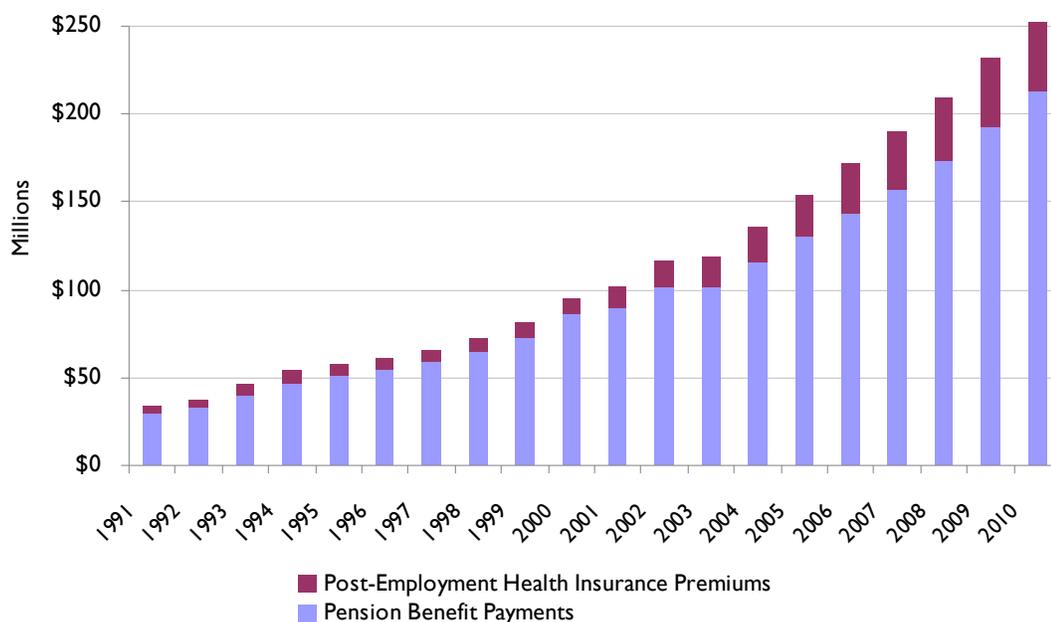
¹ Final compensation is determined as the average base pay of an employee’s highest 12 consecutive month period with the City. In general, this does not include overtime or special pay.

² The binding interest arbitration process occurs when the City and the police or fire unions are unable to reach an agreement on a successor memorandum of agreement (MOA) during labor contract negotiations and after the impasse resolution procedures have been completed.

In addition to the base pension formulas, other pension benefits include disability and survivor benefits, annual cost-of-living adjustments (COLAs), and supplemental benefits through the plans' Supplemental Retiree Benefit Reserves (SRBR). Besides those pension benefits, the City provides other post-employment benefits (OPEB) such as retiree medical and dental coverage for retirees who meet the minimum service requirements.

Exhibit 2 shows the growth in pension and post-employment benefit payments for both the Police and Fire and Federated Retirement Plans since 1991.

Exhibit 2: Retirement and Other Post-Employment Benefit Payments for Combined Plans, FY 1990-91 through FY 2009-10



Source: *Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1990-91 through 2008-09, Draft Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10*

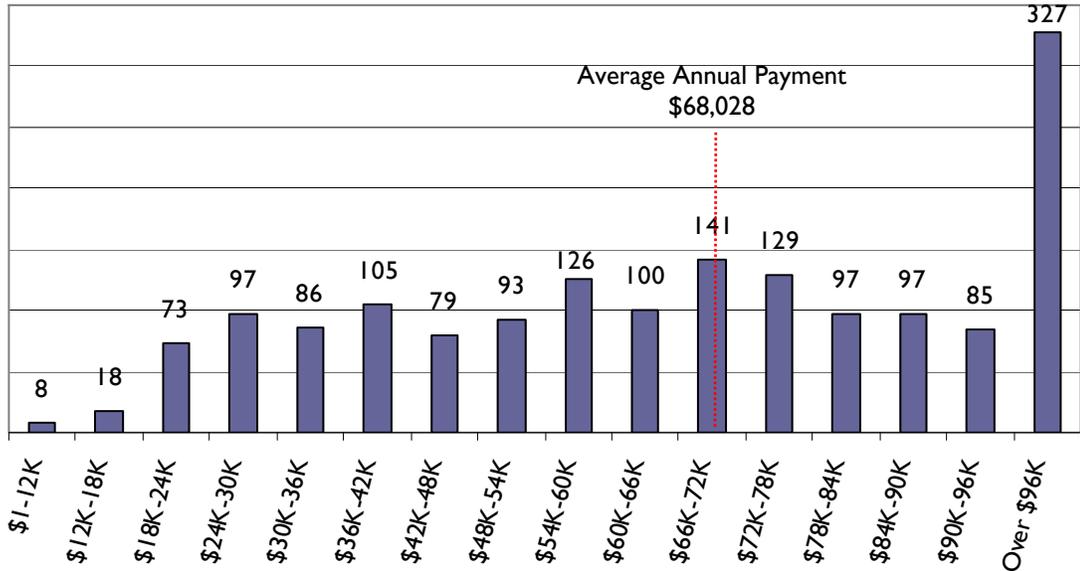
This audit focuses on pension benefits. The City also faces considerable challenges in funding its OPEB benefits. For more information on the City's significant OPEB obligations (including retiree medical and dental coverage) see <http://www.sanjoseca.gov/retireehealthcare/>.

Pension Payments

As of June 30, 2009, there were 1,661 retirees and other beneficiaries in the Police and Fire plan and 2,997 for the Federated plan.³ The median retirement age for Police and Fire retirees was 54 years of age and the median length of time they had been receiving retirement benefits was 12 years. The median retirement age for Federated retirees was 56 and they had been receiving retirement benefits on average for 9 years.

As of June 30, 2009 the average annual pension benefit paid to retirees and beneficiaries was about \$68,000 and \$34,500 for Police and Fire and Federated, respectively.⁴ Exhibits 3 and 4 provide a stratification of the annual pension benefits paid to retirees and beneficiaries for each plan. As seen in Exhibit 3, there were 327 Police and Fire retirees and beneficiaries (about one-fifth of the total) receiving annual pension benefit payments over \$96,000. Of these, 90 percent retired after 2000.⁵

Exhibit 3: Annual Pension Payments to Police and Fire Retirees and Beneficiaries as of June 30, 2009



Note: Does not include OPEB costs. Figures include 201 survivors of active or retired employees, and may include multiple payees per retiree.

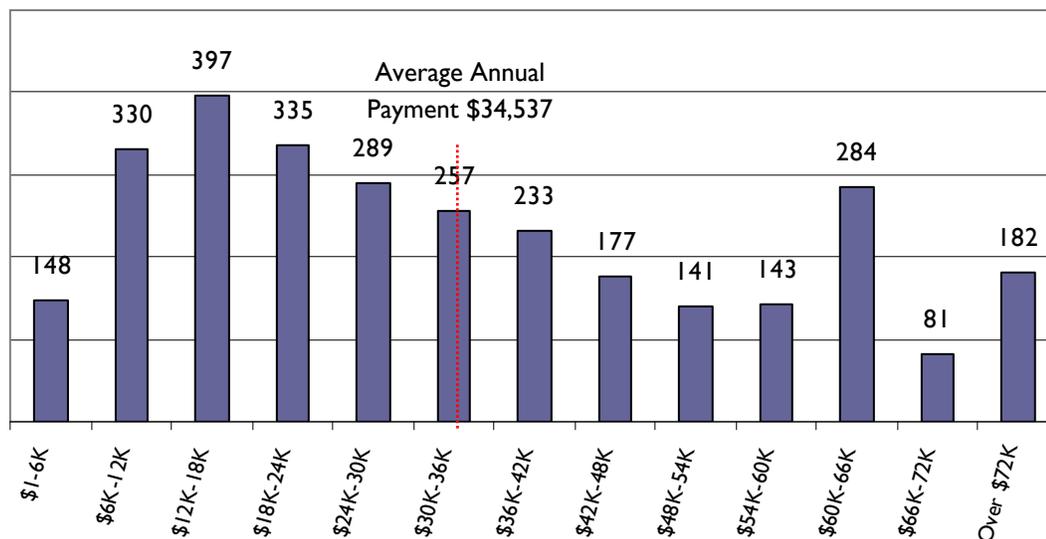
Source: Police and Fire Department Retirement Plan Comprehensive Annual Financial Report for the year ended June 30, 2009

³ Source: City of San José Comprehensive Annual Financial Report (CAFR) for Fiscal Year Ended June 30, 2009. Copies of the City’s and Retirement plans’ CAFRs for the fiscal year ended June 30, 2009 are online at <http://www.sanjoseca.gov/auditor/External.asp>. CAFRs for the retirement systems can also be found online at <http://www.sjretirement.com/>.

⁴ Actuarial Valuations, Police and Fire Department Retirement Plan and Federated City Employees’ Retirement System, June 30, 2009.

⁵ In 2000, the Police and Fire maximum pension benefit was raised from 80 to 85 percent. It subsequently was raised to 90 percent in later years. These and other benefit enhancements are discussed more fully in Chapter 2.

Exhibit 4: Annual Pension Payments to Federated Retirees and Beneficiaries as of June 30, 2009



Note: Does not include OPEB costs. Figures include 419 survivors of active or retired employees, and may include multiple payees per retiree.

Source: Federated City Employees' Retirement System Comprehensive Annual Financial Report for the year ended June 30, 2009

Funding of Pensions for the Police and Fire and Federated Plans

Police and Fire and Federated pensions are paid out of retirement funds administered by the Retirement Services Department. Both plans are designed to prefund pension benefits, meaning annual contributions made over the course of an employee's career (by both the City and the employee) along with investment earnings are expected to pay all of the employee's future pension benefits. It is generally assumed that over time, the majority of retirement plan assets will be generated from investment earnings. Even with the large market losses of recent years, investment earnings accounted for more than half of the additions to the retirement funds over the decade ending June 30, 2009.

Contributions

The City Charter provides that contributions for retirement benefits allocated to an employee's current year of service are required to be shared by the City with the employee in a ratio that is at least 8:3 ratio (i.e. the City must pay at least eight dollars for every three dollars the employee contributes).⁶ This cost is called the *normal cost* of pension benefits.

⁶ On the November 2010 ballot there is a measure to amend the City Charter that would, among other things, allow the City Council to provide a retirement plan or plans to new employees that are not subject to the Charter's minimum requirements, including the 8:3 contribution ratio.

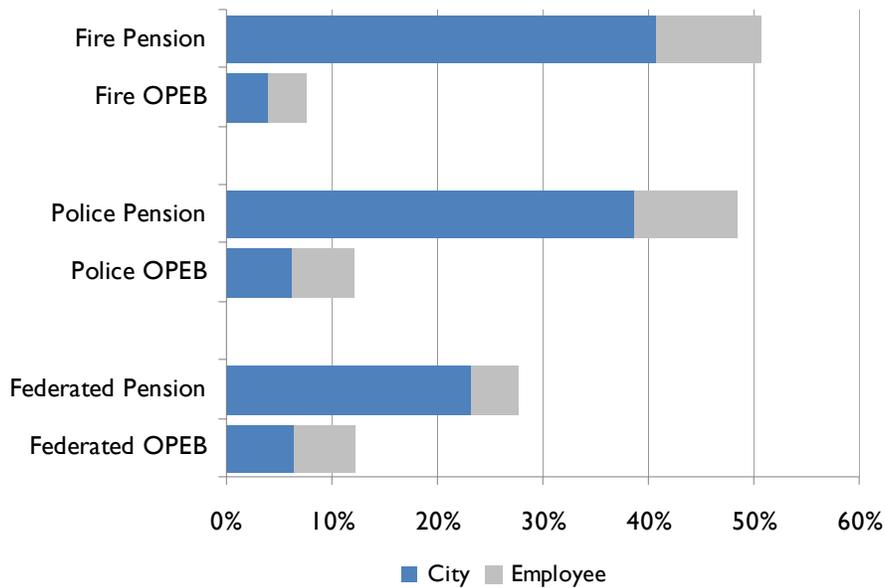
In addition, payment of prior service costs may be necessary because market losses or other circumstances may cause the plans to become underfunded. Under the San José Municipal Code (Municipal Code), 100 percent of the payments to make up for any underfunding have been the responsibility of the City.⁷

Contribution rates are set by the two Retirement Boards based on recommendations by outside *actuaries*. *Actuaries* are contracted by both plans to prepare *actuarial valuations*, the purposes of which are to provide information on the value of the plans' assets and liabilities and to set contribution rates to fully fund plan liabilities.

Funding for OPEB costs is outlined in the San José Municipal Code. The Federated retiree health plan is funded by employer and employee contributions on a 1:1 ratio for medical benefits and an 8:3 ratio for dental benefits. The Police and Fire retiree health plan is funded by employer and employee contributions in a 1:1 ratio for medical benefits and 3:1 ratio for dental benefits.

Contribution rates are set as a percentage of payroll. Exhibit 5 shows the base City and employee contribution rates for FY 2010-11.

Exhibit 5: City and Employee Contribution Rates for FY 2010-11



Note: These rates do not reflect adjustments to the contribution rates as a result of recent negotiations whereby some employee bargaining units agreed to pick up a portion of the City's annual payment to offset the City's contribution rate.

Source: Actuarial Valuations, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, June 30, 2009

⁷ As a result of negotiations with bargaining units and Municipal Code amendments related to the City Council's adoption of the FY 2010-11 Budget, some employee bargaining units will pay a portion of their prior service costs to offset the City's costs. This does not reduce the unfunded liability as there will be no additional contributions made (as discussed more fully later).

More information on projected contribution rates is shown in Exhibit 20.

Payroll Deductions

Exhibit 6 shows an example of a Federated employee’s paycheck and highlights the retirement contribution deductions and how they are broken out between pension costs and retirement health costs. Retirement contributions to the retirement system are mandatory and are deducted biweekly on a pre-tax basis from employee pay. This particular paycheck is from a pay period prior to FY 2010-II and does not reflect current contribution rates.

Exhibit 6: Example of a City Employee Paystub

Hours and Earnings					Taxes		
Description	Current		YTD		Description	Current	YTD
	Hours	Earnings	Hours	Earnings			
Regular	80	3,000.00	80	3,000.00	Fed Withholding	300.00	300.00
					Fed Med/EE	43.50	43.50
Total Gross Pay	80	\$ 3,000.00	80	\$ 3,000.00	Total	\$ 343.50	\$ 343.50
Before Tax Deductions			After Tax Deductions		Employer Paid Benefits		
Description	Current	YTD			Description	Current	YTD
Blue Shield Health	45.91	45.91			Unemployment Insurance	0.27	0.27
CSJ Vision Plan	6.34	6.34			Blue Shield Health	200.52	200.52
Retirement Contribution	227.40	227.40			DeltaCare/HMO	25.05	25.05
					Benefits Administration Fee	4.76	4.76
					Employee Assistance Program	2.91	2.91
					Retirement Contribution	659.40	659.40
Total	\$ 279.65	\$ 279.65			Total	\$ 892.91	892.91
Net Pay	\$ 2,376.85						

Employee Portion (7.58%) 4.26% Pension Cost 3.32% Retiree Healthcare Cost City Portion (21.98%) 18.16% Pension Cost 3.82% Retiree Healthcare Cost <hr/> 29.56% Total Retirement Contributions

Source: Auditor analysis of a random employee pay stub from PeopleSoft

Retirement Plan Responsibilities

Retirement Boards

Per the San José Municipal Code, the Police and Fire and Federated plans are managed, administered, and controlled by their respective Boards of Administration (Boards). Currently, each seven-member Board is composed of a combination of plan members, retirees, Councilmembers, and Civil Service Commission members. The Police and Fire Board also includes a member of the City Administration and the Federated Board includes a public member. Board members are appointed to four-year terms by the City Council.

On August 10, 2010, the City Council adopted an ordinance to establish a new plan for Retirement Board Governance that will replace the City Councilmembers and the Civil Service Commission and City Administration members with public members who meet certain experience requirements. The Police and Fire Board was also expanded to nine members by including one additional retiree and one additional public member.

The Boards hold sole fiduciary responsibility over the assets of the plans, including the responsibility of investment of moneys and the administration of the plans. To ensure that the plans remain actuarially sound, the Boards:

- Contract for actuarial investigations and valuations of the plans
- Review and adopt the *actuarial assumptions* used in the valuations (e.g. member mortality, service, and other tables and the assumed rate of return on plan assets)
- Establish contribution rates for the City and employees

It should be noted that the City Administration representative and the retirees and plan members on the Police and Fire and Federated boards are members of the respective plans which they are charged with managing and administering.

Retirement Services Department

The Retirement Services Department's core service is to *Administer Retirement Plans*. Key services include supervising the investment of plan assets; administering retirement benefits; and analyzing, developing and recommending policy for the Boards. The Department's operating budget for FY 2010-11 is \$4.4 million with 33.5 authorized full-time equivalent staff. Retirement Services employees are members of the Federated City Employees' Retirement System.

City Manager's Office of Employee Relations

The Office of Employee Relations (OER) is responsible for negotiating on behalf of the City with representatives of the eleven bargaining units representing City employees regarding wages, hours, and other terms and conditions of employment, including retirement benefits. OER employees are members of the Federated City Employees' Retirement System.

Audit Objective, Scope, and Methodology

The objectives of our audit were to assess the long-term sustainability of the City's pension benefits and the potential impact of increases in pension costs on City operations, and provide background on pension reform alternatives.

To achieve our audit objectives we performed the following:

1. To obtain a history of the City's retirement plans we obtained and reviewed the following documents for each plan:
 - *Actuarial valuation* reports, experience studies, annual reports, and/or comprehensive annual financial reports for the years 1981 through 2009
 - Memoranda from Retirement Services staff, outside actuaries, and investment professionals to the Retirement Boards about *actuarial assumptions* and methods, investments, and other relevant subjects
 - City Council and staff memoranda related to pension costs and budget considerations
 - Retirement Board minutes surrounding discussions of *actuarial assumptions* and methods

We also reviewed the City's 2000-01 through 2009-10 Operating Budgets, draft Police & Fire and Federated Retirement Plan Financial Statements for 2009-10, the City Manager's *2011-15 Five-Year Economic Forecast and Revenue Projections*, the City Charter, the Municipal Code, Memoranda of Agreement with employee bargaining groups, and relevant pension laws and regulations.

In addition, we interviewed staff from the Retirement Services Department, the City Manager's Budget Office, the Office of Employee Relations, and members of both the Federated and Police and Fire Retirement Boards.

2. To evaluate the *actuarial assumptions* and methods used by the two plans, we reviewed the City's retirement plans' current and historical *actuarial assumptions* and methodologies. We also reviewed *Actuarial Standards of Practice* and other documents to obtain an understanding of the *actuary's* role in preparing valuations and recommendations on plan assumptions and contribution rates.
3. To review other public retirement systems and alternative pension reform options, we evaluated *actuarial valuation* reports, comprehensive annual financial reports, and other information related to other public retirement plans, such as the California Public Employees' Retirement System (CalPERS), federal employee retirement plans, plans for other California local governments, and plans outside of California.

We also reviewed *Developing a Policy for Retirement Plan Design Options (1999, 2007)*, *Essential Design Elements of Defined Benefit Retirement Plans (2008)*, and *Sustainable Funding Practices of Defined Benefit Pension Plans (1994, 2005, 2008 and 2009)* published by the Government Finance Officers Association.

At our request, to determine the major cost drivers of the City's retirement plans, Retirement Services staff assessed the costs of various components of the City's pension plans as a proportion of the overall system costs.

4. To assess the accuracy and reliability of pension data, we examined a sample of retirees from the Federated and Police and Fire Retirement Systems and reconciled retiree pension information to actuarial data files, the PensionGold pension administration system, and, where applicable, PeopleSoft.⁸

In addition, to obtain an understanding of the overall current pension environment we reviewed various reports and documents related to public and private pension systems and other pension-related literature. Further, we reviewed the Governmental Accounting Standards Board (GASB) Proposed Changes to Accounting Rules Under Statements 25, 27, 43 and 45, titled *Postemployment Benefit Accounting and Financial Reporting*. We should note that as City employees, the Auditor's Office staff are members of the Federated City Employees' Retirement System.⁹

Previous Audit of Pensionable Earnings and Time Reporting

During FY 2009-10 we conducted an [Audit of Pensionable Earnings and Time Reporting](#), which identified payroll and retirement errors resulting in higher pension to retirees, unclear and duplicative time reporting codes, and retirees benefiting from the City's definitions of highest year and earnable income. The report included 15 recommendations that were accepted by the City Council and are in the process of being implemented. This included recommendations to correct the errors that resulted in higher pensions, and recommendations to consider amending the Municipal Code to (1) calculate final compensation as the highest base salary received (rather than base salary earnable), (2) credit one year of federated city service for 2,080 hours of service rendered in a calendar year (rather than 1,739 hours), and (3) return to using a three year average in calculating pension benefits (rather than the highest salary received in any twelve month period). The City will be in negotiations with the majority of bargaining groups in 2011 and will be considering these issues as part of the retirement reform discussions.¹⁰

Additional information

Additional information about the City's retirement benefits can be found on the Retirement Services website at <http://www.sjretirement.com/> and the OER website at <http://www.sanjoseca.gov/employeeRelations/RetirementBenefits.asp>.

⁸ We reviewed a random sample of four Federated retirees from a population of 2,578 Federated retirees; and a sample of six Police and Fire retirees from a population of 1,455 Police and Fire retirees.

⁹ Government Auditing Standards state that auditors are not precluded from auditing pension plans that they participate in if (1) the auditor has no control over the investment strategy, benefits, or other management issues associated with the pension plan and (2) the auditor belongs to such pension plan as part of his/her employment with the audit organization, provided that the plan is normally offered to all employees in equivalent employment positions.

¹⁰ The report is online at www.sanjoseca.gov/auditor.

Chapter 2 Pension Benefit Increases Had Dramatic Impacts on Costs Even Before Recent Market Losses

SUMMARY

Over time, the City's two retirement plans have changed significantly. New and enhanced benefits have been added since voters approved minimum benefit levels in 1965. As a result of plan changes, current pensions are higher than what employees would have received under previous benefit levels. Over the past 20 years, total annual pension benefit payments to retiree and beneficiaries have grown seven fold, in part because the average benefit has grown and in part because the beneficiary population is two and a half times larger than it was in FY 1990-91. The City's annual contributions into the retirement funds to pay future pension benefits doubled from FY 1998-99 to FY 2009-10, and contribution rates (expressed as a percentage of payroll and inclusive of contributions for OPEB costs) have grown sharply in recent years. They are projected to reach more than 75 percent of payroll for Police and Fire and 45 percent for Federated by FY 2014-15.

As of June 30, 2009, the City's pension liabilities totaled \$5.4 billion, compared to \$2.1 billion ten years earlier. This liability represents the amount promised to employees and retirees for pension benefits for services already provided. By comparison, as a result of losses suffered during the recent economic downturn, the market value of assets totaled just \$3.4 billion. As of June 30, 2009, the City had a \$2 billion unfunded pension liability based on that market value. Because of the actuarial method of *smoothing* gains and losses over time, the actuarial value of assets totaled \$4.3 billion; the effect of this is that the impact of recent market gains and losses have not been fully reflected in the City's retirement contribution rates. As of June 30, 2009, the City also had a \$1.4 billion unfunded liability for retiree healthcare based on the market value of assets. Furthermore, the declining ratio of employees to retirees and beneficiaries creates a risk of higher contribution rates in the future. At current contribution rates, estimates show that the amount owed in pension liabilities will continue to grow at a much faster rate than available plan assets.

New and Enhanced Benefits Have Been Granted Since the Voters Approved Benefit Minimum Levels in 1965

The City has provided pension benefits to its employees for decades. The Charter spells out the minimum benefits the City's two retirement plans must provide for members. According to the City Attorney's Office, the current minimum benefits were approved by San José voters in 1965. The Charter minimum benefit for Police and Fire members is 50% of final compensation at age 55 upon completion of 20 years of service, final compensation defined as average compensation in the final three years of service. The Charter minimum benefit for Federated members is 2% of final compensation per year of service for first 25 years of service plus 1% for each year beyond 25 at age 55 subject to an 85% maximum; or at age 70 regardless of years of service.¹¹

The City Council has the authority to grant benefits greater than the minimum benefits spelled out in the City Charter, and has granted benefit enhancements pursuant to negotiations with employee bargaining groups. Police and Fire members may also be awarded benefits through binding interest arbitration. Recent plan changes have been modified to provide benefits similar to those made by other California local governments, which followed benefit enhancements awarded at the state level during the dot-com boom.

Both retirement plans have changed over time, in some ways significantly. Since 1965, the formula for calculating Police and Fire pensions has changed more than five times and for Federated twice. Police and Fire had a retirement age of 55, but now members can retire at 50. The Municipal Code has been amended to modify the computation of final average compensation from a three-year average to the highest average of 12 consecutive months for both plans. In addition, the Municipal Code has been amended to provide survivorship benefits, a guaranteed 3 percent COLA, and the establishment of the Supplemental Retiree Benefit Reserves (SRBR) have also been granted to both retirement plans.

Following are selected changes to each plan over time for service retirements.¹²

Police and Fire (current plan established 1961)

1961 Retirement age was 55 with 20 years of service or age 65 regardless of years of service. Benefit was 50% of final compensation. Final compensation was defined as highest average during three consecutive years of service.

¹¹ On the November 2010 ballot there is a measure to amend the City Charter that would, among other things, allow the City Council to provide a retirement plan or plans to new employees that are not subject to the Charter's minimum requirements, including the 8:3 contribution ratio.

¹² Not all retirement changes or benefit enhancements are included in the histories listed.

- 1968 Retirement age reduced from 55 with at least 20 years of service to 50 or older with at least 20 years of service or at any age with 30 years of service. Benefit formula increased for members who were at least 55 at time of retirement increased to 50% of final compensation plus 1.66% per year of service in excess of 20; maximum benefit set at 66.66% of final compensation. For members who retired before age 55, benefit stayed at 50% of final compensation.
- 1970 Benefit formula changed for members who were at least 55 at time of retirement or had 30 years of service to 50% of final compensation plus 2.5% of final compensation per year of service in excess of 20; maximum benefit raised to 75% of final compensation. Definition of final compensation changed to highest one year, not to exceed 108% of the 12 months preceding final 12 months of service. COLA introduced at CPI not exceed 3%.
- 1984 City Council grants medical benefits to members of the Police and Fire Plan.
- 1986 City Council adds dental benefits to the Police and Fire Plan.
- 1994 Reciprocity with CalPERS established (which potentially can affect the years of service¹³ and final compensation determinations)
- 1998 Benefit formula changed (retroactive to February 1996 for members who were at least 55 at time of retirement or had 30 years of service) to 2.5% of final compensation for each of first 20 years of service, plus 3% per year of service in excess of 20; maximum benefit raised from 75% to 80% of final compensation as awarded through binding interest arbitration.
- 2000 Benefit formula changed for members who were at least 55 at time of retirement or had 30 years of service to 4% of final compensation for years in excess of 25. Maximum benefit raised from 80% to 85% of final compensation.
- 2002 COLA changed to a guaranteed 3% annual adjustment. Police and Fire Supplemental Retiree Benefit Reserve (SRBR) established in 2001, commenced distributions. SRBR provides up to one additional pension payment per year in an amount that depends on investment earnings, compensation, years of service, and time retired.
- 2006 Benefit formula for Police members who were at least 55 at time of retirement or had 30 years of service changed to 2.5% of final compensation per year of service for first 20 years plus 4% of final compensation per year beyond 20; maximum benefit for Police members raised to 90% of final compensation.
- 2008 Benefit formula for Fire members who were at least 55 at time of service or had 30 years of service changed to 2.5% of final compensation per year of service for up to 20 years; if 20 or more years of service, 3% of final compensation; maximum benefit for Fire members raised to 90% of final salary as awarded through binding interest arbitration.

¹³ Reciprocity can affect the years of service for the purpose of establishing entitlement to a pension, but does not affect the years of service for the pension benefit calculation or entitlement to health benefits.

Federated (current plan established 1975)

- 1975 Retirement at age 55 or older with 5 years of service or any age with 30 years of service. Benefit formula set at 2.5% of final compensation for each year of service (previously set at 2% for each year of service for first 20 years with additional 1.0 to 1.3% for additional years), subject to a maximum benefit of 75% of final compensation. Final compensation defined as highest annual average earnable during any 3 years consecutive years of service. COLA set at CPI not to exceed 3%.
- 1984 City Council grants medical benefits to members of the Federated Plan.
- 1986 Federated SRBR established. SRBR provides up to one additional pension payment per year in an amount that depends on investment earnings, compensation years of service and time retired. City Council adds dental benefits to the Federated Plan.
- 1994 Reciprocity with CalPERS established. (same impact as noted earlier)
- 2001 Final compensation defined as average compensation earnable for highest consecutive 12 months.
- 2006 COLA changed to a guaranteed 3% annual adjustment.

As a Result of Plan Changes, Current Pensions Are Higher Than What Employees Would Have Received Under Previous Benefit Levels

To illustrate the impact of formula changes on calculated benefits, we drew a sample of retirees and compared their actual base pension to benefit levels calculated using past pension formulas. Exhibit 7 shows a sample of Police and Fire retirees' actual base pension benefit and a comparison with calculated benefits under previous pension formulas.

All sample retirees included in Exhibit 7 started service with the City after 1970 and retired after January 1, 2005.¹⁴ The maximum retirement benefit allowed at the time each commenced service with the City was 75 percent of final average compensation. On average, the Police and Fire retirees in our sample are receiving about 8 percent more than the formula in place when they started City service (or about \$11,000 on average), not including cost of living adjustments or SRBR distributions.

¹⁴ We selected a random sample of six Police and Fire retirees from a population of 1,455 Police and Fire retirees.

For example, employee #3 retired in 2007 with a current annual pension of \$125,752, or nearly \$15,000 more than their pension would have been under the formula in place when he or she began employment. If the retiree receives a pension for 20 years, total benefits paid out of the retirement fund (including the guaranteed annual COLA, but not including any SRBR distributions) will be nearly \$500,000 more than if the benefit formula had not been enhanced over time.

Exhibit 7: Impact of Pension Benefit Formula Changes on a Sample of Police and Fire Retirees

Sample Retiree	Base Pension Amount
#1 (Fire) Retirement date: 1/27/07 Years of service: 25.4 Final compensation: \$146,340	(1) Calculated under pre-1996 formula: \$92,925 (2) Calculated under 1996-2000 formula: \$96,877 (3) Actual base pension: \$97,503 Difference: \$4,578 per year
#2 (Fire) Retirement date: 1/29/05 Years of service: 32.3 Final compensation: \$172,704	(1) Calculated under pre-1996 formula: \$129,528 (2) Calculated under 1996-2000 formula: \$138,163 (3) Actual base pension: \$146,799 Difference: \$17,271 per year
#3 (Fire) Retirement date: 7/3/07 Years of service: 32.4 Final compensation: \$147,948	(1) Calculated under pre-1996 formula: \$110,958 (2) Calculated under 1996-2000 formula: \$118,355 (3) Actual base pension: \$125,752 Difference: \$14,794 per year
#4 (Fire) Retirement date: 6/27/09 Years of service: 28.0 Final compensation: \$173,016	(1) Calculated under pre-1996 formula: \$121,242 (2) Calculated under 1996-2000 formula: \$128,189 (3) Calculated under 2000-2008 formula: \$133,431 (4) Actual base pension: \$145,491 Difference: \$24,249 per year
#5 (Police) Retirement date: 6/18/05 Years of service: 27.3 Final compensation: \$110,796	(1) Calculated under pre-1996 formula: \$75,675 (2) Calculated under 1996-2000 formula: \$79,731 (3) Actual base pension: \$82,303 Difference: \$6,628 per year
#6 (Police) Retirement date: 1/28/06 Years of services: 20.1 Final compensation: \$111,444	(1) Calculated under pre-1996 formula: \$55,882 (2) Calculated under 1996-2000 formula: \$55,914 (3) Actual base pension: \$55,914 Difference: \$32 per year

Source: Auditor analysis based on information obtained from Pension Gold, San José City Charter and Municipal Code

Notes to accompany Exhibit 7 (calculations for illustrative purposes only; do not include COLA or SRBR):

- All pensions are stated as actual base in first year of retirement.
- Pre-1996 pension formula calculated as 2.5% per year of service, maximum = 75% of final compensation
- 1996-2000 pension formula was 2.5% per year of service for first 20 years of service, 3% per year over 20, maximum of 80% of final compensation
- 2000-2006 (Police) and 2000-2008 (Fire) pension formula was 2.5% per year of service for first 20 years, 3% for next 5, 4% over 25; maximum of 85% of final compensation
- 2006-Current Police formula is 2.5% per year of service for first 20 years, and 4% for each year thereafter; maximum is 90% of final compensation
- 2008-Current Fire formula is 2.5% per year if less than 20 years of service; if more than 20 years of service, 3% per year; maximum is 90% of final compensation

As shown in Exhibit 8, we conducted a similar analysis for a sample of Federated retirees.¹⁵ For the employees in our sample, current pension benefits are about 11 percent higher than they would have been calculated under the formula that was in effect prior to the most recent change. For example, sample employee #1 retired in 2008 with a current annual pension of \$116,070 compared to an estimated \$104,579 benefit under the formula in place prior to 1975.

Exhibit 8: Impact of Pension Benefit Formula Changes on a Sample of Federated Retirees

Sample Retiree	Base Pension Amount
<u>Retiree #1</u> Retirement date: 6/28/08 Years of service: 24.1 Final compensation: \$192,861	(1) Calculated under 1975 formula: \$104,579 (2) Actual base pension: \$116,070 Difference: \$11,491 per year
<u>Retiree #2</u> Retirement date: 3/10/07 Years of service: 21.3 Final compensation: \$47,227	(1) Calculated under 1975 formula: \$22,634 (2) Actual base pension: \$25,174 Difference: \$2,540 per year
<u>Retiree #3</u> Retirement date: 7/3/04 Years of service: 15.4 Final compensation: \$62,185	(1) Calculated under 1975 formula: \$21,547 (2) Actual base pension: \$23,903 Difference: \$2,356 per year
<u>Retiree #4</u> Retirement date: 1/6/01 Years of service: 27.5 Final compensation: \$43,659	(1) Calculated under 1975 formula: \$27,014 (2) Actual base pension: \$29,970 Difference: \$2,956 per year

Source: Auditor analysis based on information obtained from Pension Gold, PeopleSoft, San José City Charter and Municipal Code

Notes to accompany Exhibit 8 (calculations for illustration purposes only; do not include COLA or SRBR):

- 1975 pension formula was 2.5% per year of service, maximum benefit 75% of final compensation (highest year average). Calculation assumes highest three year average is 90% of highest one year average compensation.
- Current pension formula is 2.5% per year of service, maximum benefit is 75% of final compensation; final compensation is highest one year average.

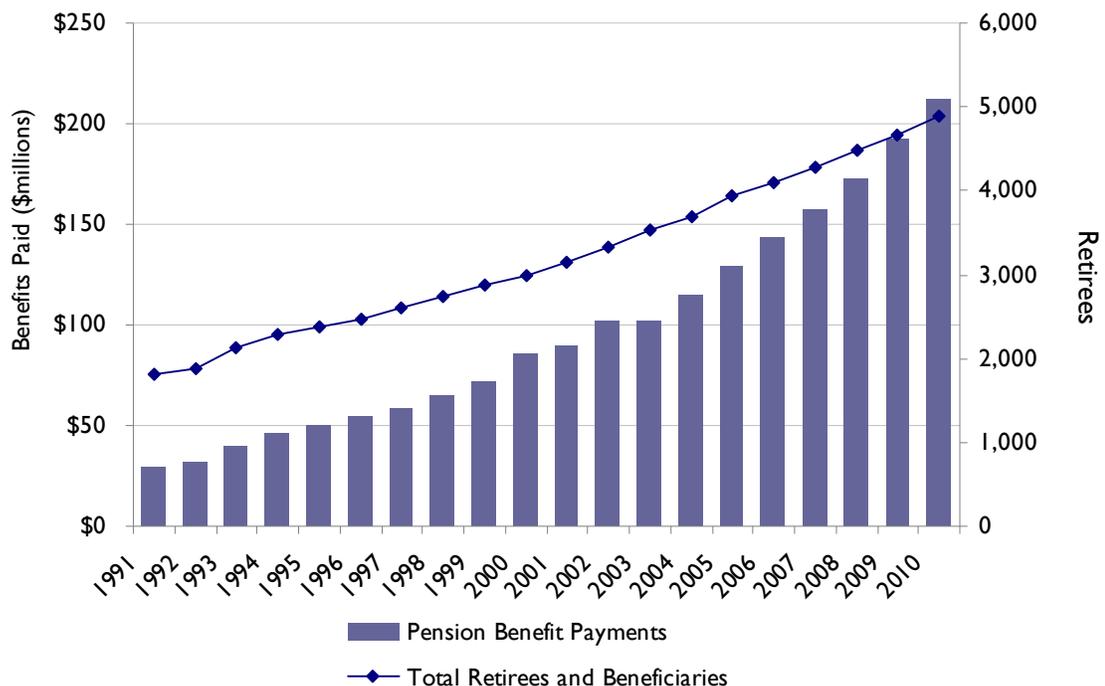
Pension Benefit Payments to Retirees and Beneficiaries Have Grown Seven Fold Over the Past Twenty Years

Over the past 20 years total pension benefits paid out of the retirement funds have grown seven fold, in part because the average annual pension benefit increased by about 175 percent for Police and Fire and 150 percent for Federated, and in part because the number of beneficiaries is two and a half times larger than it was in FY 1990-91.

¹⁵ We selected a sample of four Federated retirees on a random basis from a population of 2,578 Federated retirees.

Exhibit 9 shows the growth in pension benefits paid out of the City's retirement funds and the growth in the total retiree and beneficiary population from FY 1990-91 through FY 2009-10. In FY 2009-10, the retirement plans paid out more than \$210 million in pension benefits, compared to \$72 million in FY 1998-99 and \$30 million in FY 1990-91.¹⁶ Over that same time, the number of retirees and beneficiaries grew from 1,816 to 4,891. These trends are likely to continue into the future as about 30 percent of the City's workforce was within five years of retirement eligibility as of October 2009.

Exhibit 9: Growth in Pension Benefit Payments and Total Retirees and Beneficiaries, FY 1990-91 Through FY 2009-10



Sources: Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1990-91 through 2008-09, Draft Police and Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

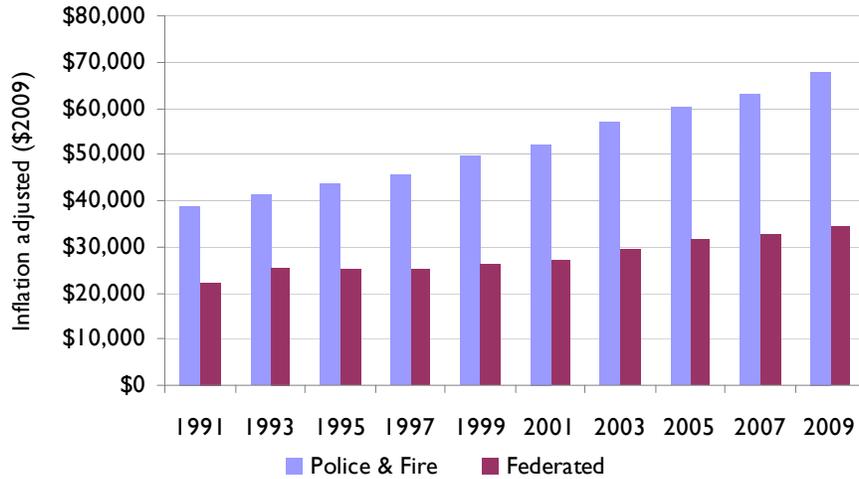
Growth in Average Annual Pension Benefit Paid

Exhibit 10 shows the growth in the average annual pension benefit paid to retirees and beneficiaries from FY 1990-91 through FY 2008-09 for both plans (adjusted for inflation). The increase in the average annual pension benefit paid is partly due to a rise in average salaries. Over this same period, average salaries increased by 135 percent for Police and Fire members and 106 percent for

¹⁶ These figures are unadjusted for inflation and do not include payments for other post-employment benefits such as the cost for retiree health and dental benefits. In FY 2008-09, the Retirement Plans paid nearly \$40 million for post-employment health insurance premiums.

Federated members. Even after adjusting for inflation, the average annual pension benefit has increased over this period by about 75 percent for Police and Fire and 54 percent for Federated.

Exhibit 10: Growth in the Average Annual Pension Benefit Paid Adjusted for Inflation (2009 dollars)



Sources: Actuarial Valuations and Annual Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1990-91 through 2008-09; U.S. Department of Labor, Bureau of Labor Statistics

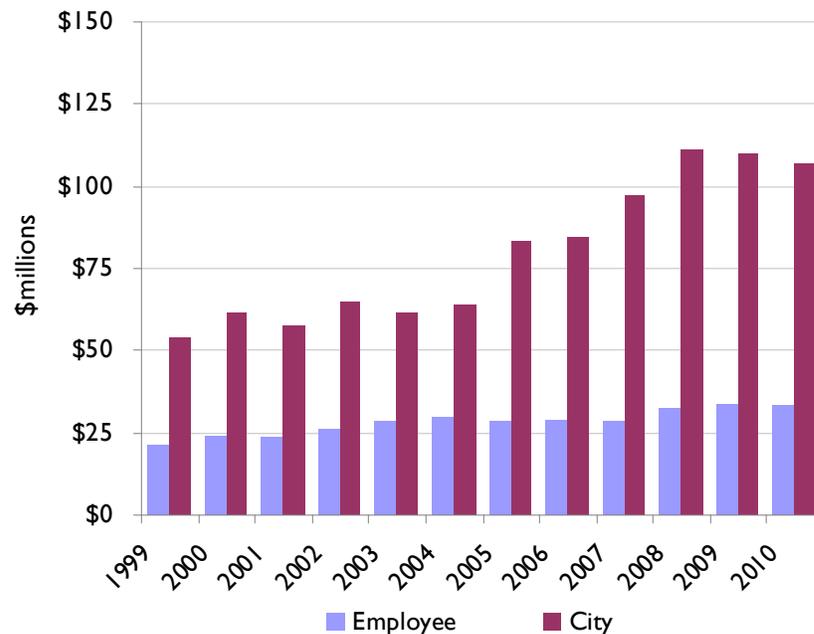
Note: Averages calculated based on number of retirees and beneficiaries. This includes survivors of active or retired employees, and may include multiple payees per retiree.

The City's Annual Contributions Into the Retirement Funds Doubled Over the Past Decade

The City has had to make increasingly larger annual contributions to its retirement plans to ensure there are enough assets to pay for future pension benefits. From FY 1998-99 to FY 2009-10, the City's annual contributions into the retirement funds doubled from about \$54 million to about \$107 million.

Exhibit 11 shows the total annual contributions to the retirement plans by both the City and employees from FY 1998-99 through FY 2009-10. Note that although total employee contributions have increased (from about \$21 million in FY 1998-99 to about \$33 million in FY 2009-10), they have not increased at nearly the same rate as the City's contributions.

Exhibit 11: Annual Contributions for Pension Benefits Doubled Between FY 1998-99 Through FY 2009-10



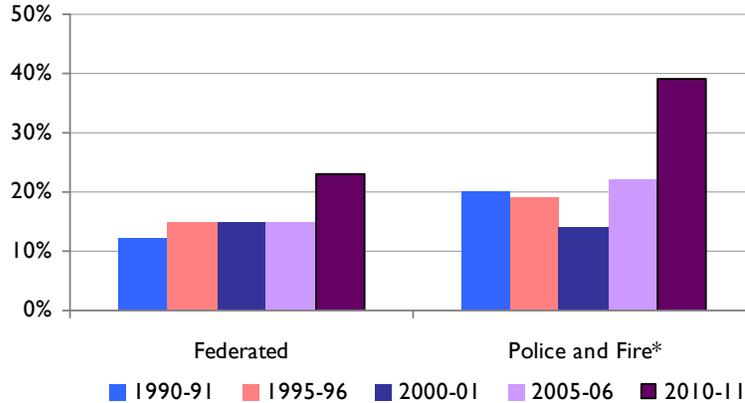
Sources: Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1998-99 through 2008-09, Draft Police and Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

Divided by the number of active employees shown in the retirement plans' Comprehensive Annual Financial Reports, the City's contributions per employee rose from about \$11,600 to about \$24,800 for Police and Fire (about 212 percent) and from about \$7,200 to about \$12,000 for Federated (about 165 percent) from FY 1998-99 through FY 2009-10.

The City's Contribution Rates Have Risen Sharply in Recent Years and Are Projected to Rise Even Further in the Near Future

Over the past 10 years, the City has experienced a profound increase in the percent of payroll that it pays to the retirement plans for future pension benefits. The City's contribution rates (expressed as a percent of payroll) have more than doubled since FY 1990-91, including significant growth in the last five years. Exhibit 12 shows the City's contribution rates at five-year intervals since FY 1990-91.

Exhibit 12: The City's Retirement Contribution Rates as a Percent of Payroll, FY 1990-91 Through FY 2010-11¹⁷



*Actual rate in FY 2010-11 for police members is 38%. For fire members, it is 40%
Sources: Retirement Plan Comprehensive Annual Financial Reports and Annual Reports, Fiscal Years 1990-91 through 2008-09

Projected Rate Increases Outstrip Anything Seen to Date

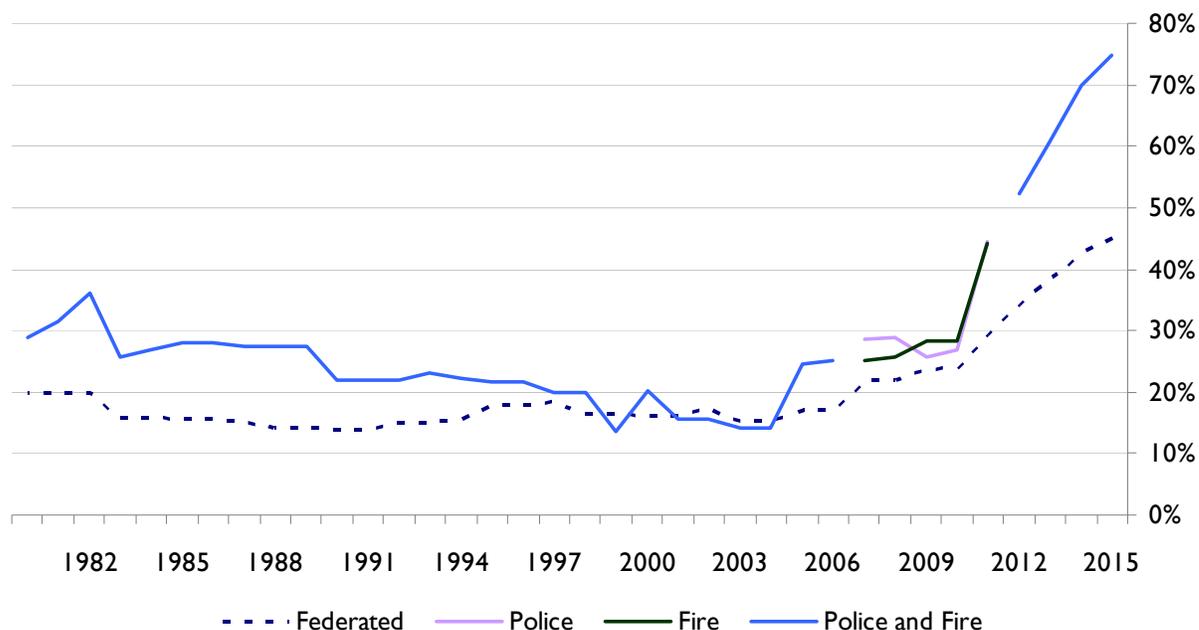
Exhibit 13 shows the change in contribution rates from FY 1980-81 to projected rates through FY 2014-15, inclusive of rates for retiree medical and dental benefits. Contribution rates for Police and Fire declined steadily from the early 1980's through about 2003 before rising rapidly to today's high rates. For Federated, rates remained below 20 percent for many years before recent increases.

According to the City Manager's Office's *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program*¹⁸ future rates are expected to rise to around 75 percent of payroll for Police and Fire and more than 45 percent for Federated, causing the projected annual retirement contribution paid out of the City's General Fund to be more than \$270 million in FY 2014-15. This is more than the entire FY 2010-11 Operating Budgets for the Fire Department, the Airport, and the City's libraries combined.

¹⁷ These figures do not reflect adjustments to the City's rates as a result of recent negotiations whereby some employee bargaining units agreed to pick up a portion of the City's annual payment to offset the City's contribution rate.

¹⁸ The forecast is online at see <http://www.sanjoseca.gov/budget/FY1011/FiveYearForecast.asp>

Exhibit 13: The City's Retirement Contribution Rates for Pension and Retiree Health Benefits, FY 1980-81 Through FY 2014-15 (projected)



Sources: *Comprehensive Annual Financial Reports and Annual Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1980-81 through 2008-09, Retirement Board May 2010 Rate Resolutions, and the City Manager's Budget Office*

More detail on the City's projected contribution rates going forward (and the breakdown between pension and OPEB contributions) is shown in Exhibit 20.

The Retirement Plans' Unfunded Liabilities Play a Major Role in Rising Contribution Rates

As of June 30, 2009, A \$5.4 Billion Pension Liability...

As the number of retirees has increased and as the City has enhanced benefits, the City's pension liability (that is, the amount of benefits promised to current employees and retirees) has grown dramatically. As of June 30, 2009, the City's estimated liability for pension benefits already earned was \$5.4 billion – or, put another way, the City had an estimated \$5.4 billion in *pension liabilities*. This compares to \$2.1 billion in pension liabilities ten years earlier.

...But Only \$3.4 Billion in Pension Assets

As a result of the 2007-09 economic downturn, the combined investment losses in the two plans for the fiscal years 2007-08 and 2008-09 totaled \$978.8 million. As of June 30, 2009, the market value of the plans' assets was \$3.4 billion, or \$2 billion less than the combined pension liabilities.

It is important to note that as of June 30, 2009, the actuarial value of the combined plan assets totaled \$4.3 billion, or about \$1 billion more than the market value of the plans' assets. This is because, for actuarial purposes, market gains and losses are not fully recognized by the plans in the year they occur. They are recognized (or smoothed) over five years to minimize the impact of market volatility on annual contribution rates. The effect of this is that the large market losses suffered in fiscal years 2007-08 and 2008-09 have not yet been fully recognized for actuarial purposes.

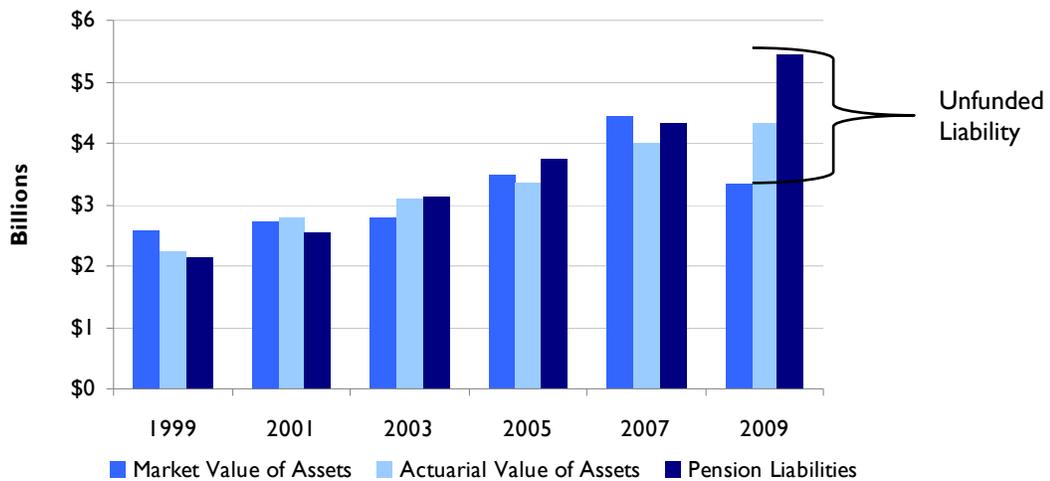
It is also important to note that during fiscal year 2009-10, the combined investment gains for the two plans totaled \$512 million.¹⁹ As of June 30, 2010, the market value of the plans' assets was \$3.8 billion. Nonetheless, as investment gains and losses are recognized over the next few years, it is expected that the City's contribution rates will rise.

As of June 30, 2009, the City Had a \$2 Billion Unfunded Pension Liability

The difference between the pension liability and the value of plan assets is called the *unfunded liability*. The *unfunded liability* is calculated two ways: (1) based on the market value of assets, and (2) based on the actuarial value of assets. Using the market value of assets, the City's combined *unfunded liability* for both pension plans totaled \$2 billion as of June 30, 2009. As described earlier, using the actuarial (or smoothed) value of assets, the City's unfunded pension liability is less – \$1.1 billion.

Exhibit 14 shows the market and actuarial values of the combined plan assets compared to pension liabilities from FY 1998-99 through FY 2008-09.

Exhibit 14: Market and Actuarial Values of Plan Assets Compared to Pension Liabilities, FY 1998-99 Through FY 2008-09



Source: Auditor analysis of retirement plan actuarial valuations, 1999 through 2009

¹⁹ Includes \$314 million for Police and Fire, and \$198 million for Federated.

As of June 30, 2009, the City Also Had a \$1.4 Billion Unfunded Retiree Healthcare Liability

The City also has an estimated \$1.4 billion in unfunded liabilities as a result of promised OPEB benefits. In addition to pension benefits, the City sponsors and administers the Federated and Police and Fire post-employment healthcare plans. As of the June 30, 2009 actuarial valuation dates, the estimated accrued liability for Police and Fire retiree healthcare (i.e. OPEB) benefits was about \$762 million, of which about \$719 million was unfunded; and the estimated liability for Federated OPEB benefits was about \$796 million, of which about \$711 million was unfunded.

In previous years, the City only partially pre-funded OPEB costs based on 10 or 15 year cash flow projections for the retirement plans. For FY 2009-10, the policy was changed to fully prefund the annual required contribution of OPEB costs after a five-year phase-in period for the majority of its employee units (with the exception of Fire Department plan members). The unfunded liability is being amortized, or paid down, over 30 years. This “pay down” is included as part of the annual contribution and will result in increases in contributions for the City and employees.

More information about the City’s retiree healthcare funding status can be found at <http://www.sanjoseca.gov/retireehealthcare/>.

Funded Ratios Have Fallen

The ratio of plan assets to plan liabilities determines the plan’s funded ratio. If plan assets are greater than liabilities, then the funded ratio will be over 100 percent. Alternatively, if plan liabilities exceed plan assets, the funded ratio will be less than 100 percent. Many experts, including the Government Finance Officers’ Association, consider a funded ratio of about 80 percent of market value or better to be sound for government pensions.

Comparing the market value of plan assets to the estimated pension liability, Police and Fire was 66 percent funded, and Federated was 55 percent funded as of June 30, 2009. Exhibit 15 shows both plans’ funded status for pension benefits using both the actuarial (or smoothed) value and the market value of plan assets. Exhibit 15 illustrates the effect that *smoothing* has on the actuarial value of assets, in this case by deferring the impact of market losses.

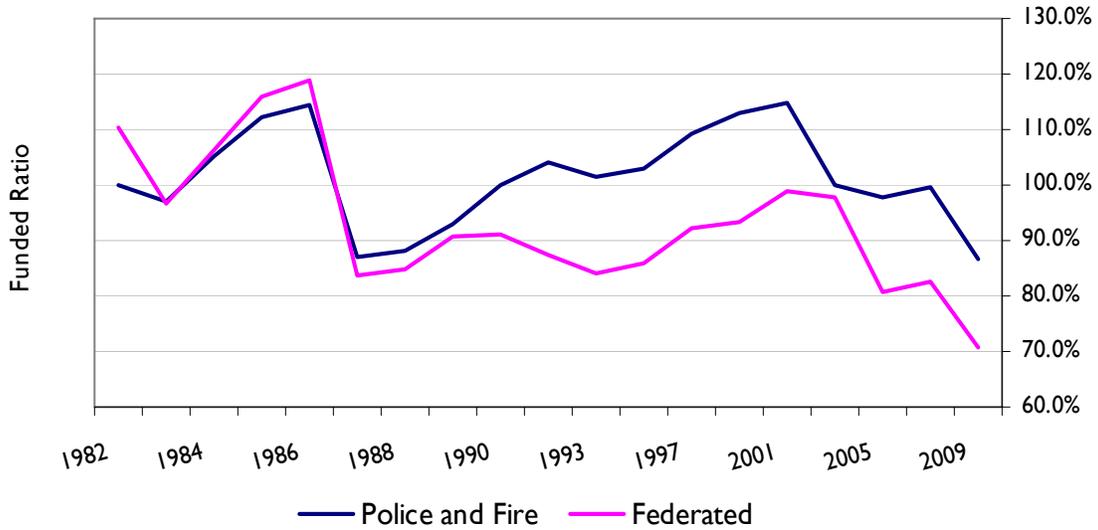
Exhibit 15: Pension Funded Ratios, June 30, 2009

	Police and Fire	Federated
Market Value	66%	54%
Actuarial value	87%	71%

Source: Auditor analysis of data from each retirement plan’s actuarial valuations as of June 30, 2009

As recently as June 30, 2007, the Police and Fire and Federated plans were considered 100 percent and 83 percent funded on an actuarial basis.²⁰ However, as shown in Exhibit 16, pension funded ratios as of 2008-09 are lower than at any actuarial valuation since 1981-82.

Exhibit 16: Retirement Plans' Funded Ratios based on Actuarial Value of Assets, FY 1981-82 Through FY 2008-09



Source: Actuarial Valuations and Annual Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1981-82 through 2008-09

Chapter 4 includes more information about the growth in the City's unfunded pension liability.

The Declining Ratio of Employees to Retirees and Beneficiaries Creates a Risk of Even Higher Future Contribution Rates

When a pension system is fully funded, the ratio of workers to retirees matters little, because the money for retirees is already in the bank. But when a plan is underfunded, making the payouts can become extremely burdensome...²¹

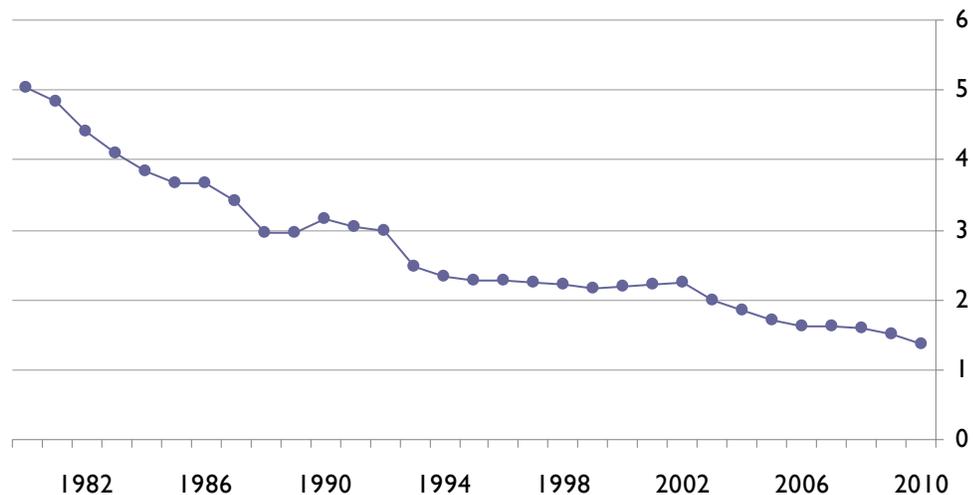
In FY 2009-10, there were 6,660 active employees compared to 4,891 beneficiaries, or roughly **1.4 employees to each beneficiary**. The employee to beneficiary ratio was roughly 3 to 1 in FY 1990-91 and 5 to 1 in FY 1979-80.

²⁰ At that time, the Police and Fire OPEB obligation was estimated to be 7 percent funded, and the Federated OPEB obligation was estimated to be 16 percent funded on an actuarial basis (June 30, 2007 valuations).

²¹ The Pew Center on the States, "Promises with a Price" (December 2007)

The result of a declining ratio is that with fewer active employees as a percentage of overall pension plan membership, the annual cost to pay down the *unfunded liability* (which is included in the City's annual contribution) is spread across the payroll of a declining pool of members. In that environment, pension contribution rates can become volatile when there are swings in asset values arising from investment gains and losses. Exhibit 17 shows the decline in the ratio of employees to retirees since the early 1980s.

Exhibit 17: Decline in the Ratio of Employees to Retirees and Beneficiaries, FY 1980-81 Through FY 2009-10

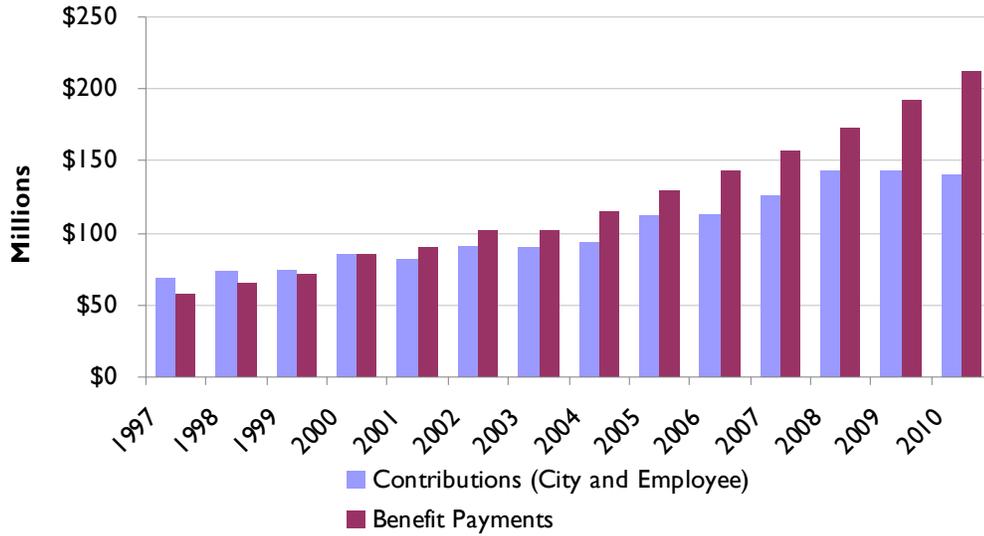


Source: Auditor analysis of data from Retirement Plan Comprehensive Annual Financial Reports, Annual Reports and actuarial reviews, Fiscal Years 1980-81 through 2008-09, Draft Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

At Current Contribution Rates, Estimates Show the Amount Owed in Pension Liabilities Will Continue to Grow at a Much Faster Rate Than Available Plan Assets

Pension payments to retirees are paid out of accumulated assets in the funds. As shown in Exhibit 18, current payments out of the pension funds have exceeded contributions for some time. This is to be expected in systems that are pre-funded and rely on investment returns to fund much of the future benefits.

Exhibit 18: Pension Benefit Payments Have Exceeded Contributions Since 2001



Sources: Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 2006-07 through 2008-09, Draft Police and Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

However, San José's plans are currently underfunded, and if contribution rates were frozen indefinitely at today's rates, even if investments yielded expected returns, Retirement Services staff estimate that the amount owed in pension obligations would continue to grow at a much faster rate than available plan assets, leading to ever increasing unfunded liabilities over the foreseeable future.

It is important to note that San José may be in better shape than some other retirement plan sponsors. According to Joshua Rauh of the Kellogg School of Management at Northwestern University, assuming states make contributions at recent rates and assuming they do earn 8 percent, 20 state funds will run out of cash by 2025; the first, will run dry in 2018.

Chapter 3 **Rising Pension Costs Threaten the City's Ability to Maintain Service Levels**

SUMMARY

Fiscal sustainability refers to whether the City can maintain current service levels without compromising service levels for future generations and whether the City can meet future obligations.

Currently, personnel costs such as salaries and compensation, employee benefits and retirement benefits account for about two-thirds of General Fund expenditures. The amount of personnel costs attributable to retirement contributions has increased over time. By FY 2014-15, annual pension and OPEB contributions are projected to reach 25 percent of total General Fund expenditures, up from 17 percent in FY 2010-11 and 6 percent in FY 2000-01.

Recent budget deficits required cuts to services, layoffs, and concessions from employee bargaining groups. Projected future deficits, in part because of rising pension costs, will require similar considerations. Continuing this trend of layoffs and pay and benefit reductions may make it difficult for the City to provide services and to retain and attract a quality workforce in the future.

Fiscal Sustainability Should Be a Consideration For Any Decision on Whether the City Has Overcommitted on Pension Promises

For many years, sustainability referred to the intersection between society's economic and environmental goals. According to the U.S. Environmental Protection Agency, "sustainability calls for policies and strategies that meet society's present needs without compromising the ability of future generations to meet their own needs."

More recently, the idea of sustainability has begun to inform decision making and reporting in other areas, including the fiscal sustainability of government entities. The Government Accounting Standards Board (GASB) began a research project in 2006 to identify the information needed by users of financial reports to assess a government's economic condition. Included in GASB's deliberation on the subject is the concept of fiscal sustainability. GASB wrote:

At a very high level, long-term fiscal sustainability reporting involves an assessment of the extent to which service delivery can be maintained at existing levels, and the extent to which governmental obligations to

citizens, under existing legal frameworks, can be met from predicted inflows over a predetermined future period.

Fiscal sustainability is a key concept the City should consider as it determines whether it has overcommitted on pension promises. Specific questions to answer should be:

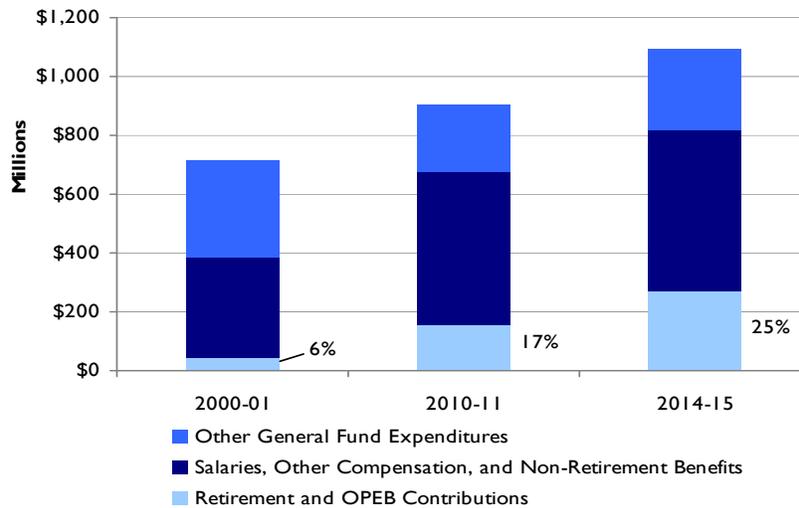
- Can the City maintain existing service levels without compromising service levels for future generations?
- Can the City meet its future obligations?

About One Quarter of All General Fund Expenditure are Expected to Go Toward Retirement and OPEB Contributions by FY 2014-15

Of the City's FY 2010-11 General Fund budgeted expenditures, about two-thirds are for personnel costs, including salaries, other compensation, and employee benefits. A growing portion of that personnel cost was funding for pension and OPEB costs.

According to the City Manager's economic forecasts, retirement and OPEB contributions are expected to be about 25 percent of total General Fund expenditures by FY 2014-15 (totaling about \$270 million). By comparison, they accounted for 17 percent of total General Fund expenditures in FY 2010-11 and 6 percent in FY 2000-01. Exhibit 19 shows the proportion of personnel costs, retirement and OPEB contributions, and other expenditures in the General Fund.

Exhibit 19: Retirement and OPEB Contributions Compared to All Other General Fund Expenditures, FYs 2000-01, 2010-11, and 2014-15 (projected)²²



Source: Auditor analysis of data provided by the City Manager's Budget Office and from the 2011-2015 Five-Year Economic Forecast and Revenue Projections, February 2010

Expected Growth in City Contribution Rates

The increasing costs are a result of the expected growth in the City's contribution rates, which are shown in Exhibit 20.

²² In the FY 2010-11 proposed budget, the budgeted amount of pension and OPEB contributions from all funds totaled about \$197.3 million. These figures are before reductions to the City's required contributions resulting from additional contributions offered by employee bargaining groups.

Exhibit 20: The City's Share of Current and Future Estimated Contribution Rates as a Percent of Payroll

	2010-11	2011-12 (est.)	2012-13 (est.)	2013-14 (est.)	2014-15 (est.)
Federated members:					
Pension	23.2%	27.1%	30.5%	34.0%	36.4%
OPEB	6.4%	7.2%	7.9%	8.7%	8.7%
Total	29.6%	34.3%	38.4%	42.7%	45.1%
Police members:					
Pension	38.3%	44.4%	51.3%	59.3%	64.3%
OPEB	6.3%	7.9%	9.3%	10.6%	10.6%
Total	44.6%	52.3%	60.6%	69.9%	74.9%
Fire members:					
Pension	40.2%	44.5%	51.3%	59.3%	64.3%
OPEB	3.9%	7.9%	9.3%	10.6%	10.7%
Total	44.1%	52.4%	60.6%	69.9%	75.0%

Note: these rates are before any negotiated employee pickup of a portion of the City's contribution rate. The above rates do not include the pre-payment discount rate.²³

Source: Retirement Services Department and City Manager's Budget Office

As a comparison to these rates, the current combined cost for the employer and employee portions of Social Security and Medicare is 15.3 percent of pay.

The City Has Seen Recent Budget Deficits and Projects More in the Future – Pension Costs Are a Major Factor

In early 2010, San José's City Council was required to close a projected \$118.5 million deficit in the City's General Fund for FY 2010-11. Approximately \$52 million of that was attributable to higher than expected pension costs. To close the deficit, the Council was forced to cut services, lay off employees, and seek pay and other concessions from the City's employee bargaining units.

As part of its consideration of the FY 2010-11 Budget, the City Council directed the City Manager to begin discussions with employee bargaining groups to achieve a 10 percent reduction in total employee compensation. Total compensation includes base pay and benefits, including retirement contributions. Many employee bargaining groups agreed to reduce total compensation to save jobs and avoid service cuts.

²³ The pre-pay discount refers to a discount the City achieves by paying the full *annual required contribution* at the beginning of the year rather than throughout the year as the liability is accrued. The discount is a result of achieving the full year's investment earnings on contributions.

Some examples of actions taken included:

- Members of five unions, representing over 1,400 Federated members, agreed to increase their contributions into the retirement system towards the unfunded liability from 10.30 percent to 21.13 percent of their pay (or from \$10.30 for every \$100 of pay, to \$21.13 for every \$100 of pay). In comparison, Social Security contributions are set at 6.2 percent of pay.
- Police members agreed to increase their retirement contributions by 5.25 percent. This saved 70 police officer positions that had been designated for elimination. Total pension contributions by police members now equal 15.06 percent of pay.
- Many other employees had their base pay reduced, saw their medical and dental benefits reduced, and/or are being asked to take unpaid furlough days.

However, even with these concessions, 713 full-time equivalent positions were eliminated (leading to 191 full- or part-time employees being laid off) and services were reduced across the City. According to the City Manager's Budget Office, because one-time funds were used to continue many services in FY 2010-11, the full associated impact of some service cuts will not become effective until July 2011-12. This includes 217 positions to be eliminated at an annual net cost of \$22.2 million.²⁴

As of August 31, 2010, the forecasted General Fund deficit for FY 2011-12 is \$41 million and continued deficits are forecast through FY 2014-15. To close projected budget deficits, the City Council will need to make decisions about cutting services, laying off employees, and negotiating with bargaining units, including retirement reform.

Continuing this trend of layoffs or reducing pay or benefits may make it difficult for the City to retain and attract a quality workforce in the future. Moreover, years of successive budget reductions are cutting City services to the core.

²⁴ For more information see *2010-2011 Adopted Budget in Brief* at <http://www.sanjoseca.gov/budget/FY1011/2010-2011AdoptedBudgetinBriefFINAL.pdf>.

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Chapter 4 The City's Unfunded Pension Liability Has Grown Dramatically in Recent Years

SUMMARY

As of June 30, 2009, the City's pension liability was \$5.4 billion. That is, the City had promised to pay an estimated \$5.4 billion in retirement benefits to current employees and retirees. However, the City did not have enough in the two retirement funds to meet its promises and was \$2 billion short (on a market value basis) of the amount it should have set aside to meet those expectations.

One reason for the rise in the *unfunded pension liability* was investment losses of about \$978.8 million incurred from 2007-2009. In spite of recent investment gains of \$512 million, those losses will continue to affect the City's *unfunded liability* over the next few years because of the actuarial method of recognizing or *smoothing* gains and losses over five years to minimize the effect that market swings have on contribution rates

Another reason for the rise in the *unfunded pension liability* was the retroactive application of benefit enhancements, such as in 2006 and 2008 when retroactive benefit enhancements for Police and Fire members created more than \$70 million in *unfunded liabilities*. Because San José residents are ultimately responsible for pension costs and the fact that *unfunded liabilities* can result from retroactive benefit enhancements, we recommend the City Council consider prohibiting:

1. Pension benefit enhancements without voter approval
2. Retroactive pension benefit enhancements that create *unfunded liabilities*

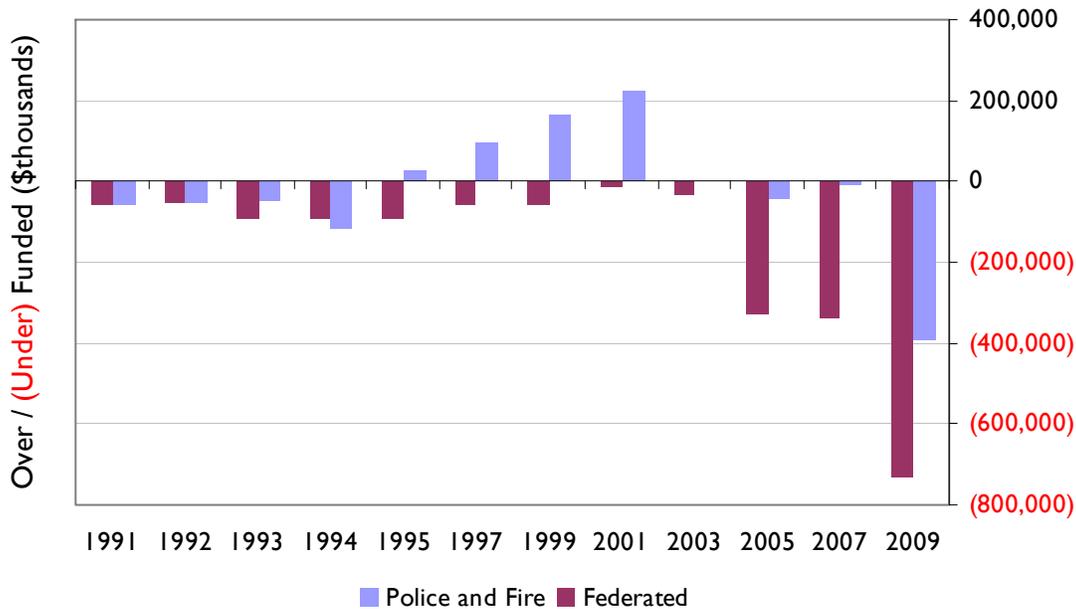
However, another significant reason for the rise in the *unfunded liability* is that *actuarial assumptions* used to calculate the City's *pension liabilities* did not hold true. These assumptions represent expectations about future events and include such things as the plans' investment returns, member mortality and retirement rates, and salary increases. Because the plans' *actuarial assumptions* did not hold true and certain assumptions were adjusted based on past experience, the *unfunded liability* increased by about \$750 million between June 30, 2007 and June 30, 2009.

To ensure the reasonableness of the methods and assumptions used in the retirement plans' *actuarial valuations*, we recommend that the City Council amend the Municipal Code to require an actuarial audit of such valuations every five years if the *actuary* conducting the valuation has not changed in that time.

As of June 30, 2009, the City Had a \$2 Billion Unfunded Pension Liability

As shown in Exhibit 21, the Retirement Plans' funded status has deteriorated significantly since 1990-91.

Exhibit 21: Retirement Plans' Funded Status (Unfunded Actuarial Accrued Liability), FY1990-91 Through FY 2008-09



Source: Actuarial Valuations and Annual Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1990-91 through 2008-09

By June 30, 2009, the City's *unfunded pension liability* totaled about \$2 billion based on market value.²⁵ On an actuarial basis, the unfunded liability was about \$1.1 billion. However, because only a portion of the recent market losses have been recognized for actuarial purposes (as a result of smoothing market gains and losses over time), these costs will rise further in the coming years when the remaining losses are recognized. For 2010-11, the annual cost to pay this down added roughly:

- 13 to 14 percent of payroll to the City's annual contribution for Police and Fire members (or about \$34 million)
- 11 percent of payroll to the City's annual contribution for Federated members (or about \$35 million)

Unfunded liabilities in government pensions arise for a number of reasons, primarily because (1) the government did not fund benefits earned by employees

²⁵ In addition to the pension plans' unfunded liability, the City also has \$1.4 billion in unfunded liabilities (on a market value basis) as a result of promised OPEB benefits as described in Chapter 2.

each year, (2) new benefits are added, or (3) *actuarial assumptions*, or expectations, about key economic and demographic factors which determine contribution rates (e.g. investment returns, rates of member retirement or mortality) do not match actual outcomes. In San José, the City saw both (2) and (3) occur.

The Importance of Fully Funding the Annual Required Contribution for Pension Benefits

Unlike some jurisdictions, the City **has** generally been fully funding its *annual required contributions* for pension benefits. The plans have had *actuarial valuations* completed on a regular biennial schedule and, with the exception of two years in the 1990s, has consistently made its *annual required contribution* (ARC).²⁶ The plans recently changed to having annual valuations. Furthermore, the City is moving towards fully funding the ARC for retiree healthcare.

Recent newspaper articles are replete with stories of other jurisdictions that have not funded their annual required pension contributions and who have made little effort to fund their OPEB liabilities. As a result, current and future taxpayers will be on the hook to pay those costs.

Fully funding the annual required contribution for pension benefits is not just an important budgetary choice; it also addresses the concept of inter-generational or inter-period equity. As discussed later, intergenerational equity is the concept that current-year costs should be recognized and paid in the current year, and not shifted off to future taxpayers.

Retirement Plans Have Experienced Large Market Losses in Recent Years, Increasing the Unfunded Pension Liability

There is, of course, no guarantee that even a fully funded pension plan will stay that way. As a result of the recent economic downturn, the combined investment losses of both plans totaled more than \$765 million in FY 2008-09. This is in addition to \$214 million in losses from the previous year. In FY 2009-10 the combined investment gains of both plans totaled \$512 million. Because they are generally assumed to generate the majority of assets over time, investment earnings are an extremely important component of a pension plan's viability. Exhibit 22 shows the investment gains and losses between FY 1996-97 through FY 2009-10.

²⁶ In those two years, the City made 92 percent and 96 percent of the total ARC for the Federated Plan. The reasons were that (1) the City opted to phase in a recommended contribution rate increase and (2) the City elected to defer funding for the reciprocity benefit provided in 1994 as the actuaries were unable to adequately value the liability because a lack of reliable data.

Exhibit 22: Retirement Plans' Investment Gains and Losses, FY 1996-97 Through FY 2009-10



Sources: Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1996-97 through 2008-09, Draft Police and Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

Even Strong Returns May Not be Able to Make Up for Recent Losses

During FY 2009-10, each plan saw strong net investment returns, 15.3 percent for Federated and 13.7 percent for Police and Fire. However, because of the nature of compounded interest, even strong returns such as these may not fully offset past losses. Following is an example to highlight this. If a \$100 investment loses 20 percent of its value in year one, the balance is \$80. If in year two the investment earns a 20 percent return the value of the investment is only \$96, not \$100. To get back to even, the investment would need to earn a 25 percent return on investment in the second year (\$20 divided by \$80).

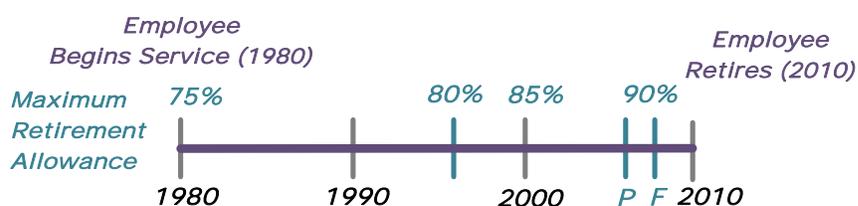
Retroactive Benefit Enhancements Have Also Increased the Unfunded Pension Liability

Another reason for the increase in the unfunded liability is that each plan has had benefits enhanced over time, often retroactively over current members' entire careers. Retroactive benefit enhancements create a liability for pension obligations which had not been previously funded through prior years' contributions.

For example, in 2006 and 2008, the maximum allowable benefit for Police and Fire members was increased from 85 percent of final compensation to 90 percent and this was applied retroactively to all active members. This enhancement added about \$70 million to the Police and Fire *unfunded liability* (or about \$26,000 per Police member and \$47,000 per Fire member). It should be noted that the 2008 increased benefit for Fire members was granted by an Arbitration Board through the Charter's binding interest arbitration procedures.

The following example illustrates how a retroactive benefit enhancement creates *unfunded liabilities*. Exhibit 23 shows a timeline for a sworn Fire employee who began working with the City in 1980 and retired in 2010 with a final compensation equaling \$100,000. Because this individual worked for 30 years, they receive the maximum allowable benefit of 90 percent of final compensation (or a pension equal to \$90,000).

Exhibit 23: Example of How Retroactive Benefit Enhancements Would Affect a Fire Employee Retiring in 2010 After 30 Years of Service



Source: Auditor analysis of the San José Municipal Code

During the employee's service, the maximum benefit level was changed three times:

- 1996 – maximum benefit was raised from 75% of final compensation to 80%
- 2000 – maximum was raised from 80% to 85%
- 2008 – maximum was raised from 85% to 90%

For most of this employee's career, both employee and City contributions were made to fund a lesser level of benefits. When the maximum allowable pension was increased in 2008 and applied retroactively, it created an *unfunded liability* equaling the difference between the level of assets required for an annual \$90,000 pension and that required to fund a \$75,000 or \$85,000 pension. Historically, the unfunded liability for these types of retroactive benefit enhancements has been the sole responsibility of the City.

Benefit enhancements can be granted by the City Council or, in the case of Police and Fire members, through the binding arbitration process. Because taxpayers are ultimately responsible for future pension benefits, jurisdictions such as San Francisco and San Diego only allow benefit enhancements to occur through voter approval.

The state of Maine has a clause in its constitution stating that *unfunded liabilities* in its state retirement system may not be created except those resulting from *experience losses* (see next section for discussion of *experience losses*). The effect of this is that retroactive benefit enhancements cannot be granted if they create any *unfunded liability*.

Recommendation #1: We recommend the City Council explore prohibiting:

- 1. Pension benefit enhancements without voter approval**
- 2. Retroactive pension benefit enhancements that create unfunded liabilities**

The Unfunded Liability for Pensions Increased by About \$750 Million Because Actuarial Assumptions That Had Been Used to Cost the Plans Did Not Hold True

A key objective of retirement planning is to strive for prefunded benefits, meaning contributions are made during the course of an employee's career such that those contributions (along with investment earnings) pay for the entire cost of the employee's pension benefits. As discussed earlier, this prefunding is important for inter-period equity, i.e. the concept of paying for current services and not shifting the burden onto future taxpayers.

The Role of Actuarial Assumptions in Calculating Pension Liabilities and Contribution Rates

When actuaries conduct valuations to calculate *pension liabilities* and contribution rates, they make assumptions about future events that affect the amount and timing of benefits to be paid and assets required to be accumulated. These assumptions relate to such variables as:

- Future investment returns on plan assets
- Member mortality rates
- Member retirement rates
- Expected salary increases by members
- Additional variables such as disability rates, termination rates, and other factors which can impact future benefit calculations

When *actuarial assumptions* do not hold true, a plan's *unfunded liability* may grow. For example, if a beneficiary lives longer than expected, they will receive more benefits than predicted. The costs of these unexpected benefits will result in a higher pension liability. When conducting an *actuarial valuation*, actuaries recognize *experience gains or losses*, depending on whether actual outcomes as compared to the assumptions result in a lower or higher calculated liability.

Actuaries may also change assumptions to reflect changing expectations of the future. Changing assumptions also result in adjustments to the pension liability as they impact projected experience in all future years (as such, they also affect the plan's *normal costs*).

The Unfunded Liability Increased by More Than \$220 Million Because Investment Returns Fell Below Expectations

The current assumption for net investment return is 8.0 percent for Police and Fire. Federated's prior assumption of 8.25 percent is being stepped down to 7.75 percent over the next 5 years. When investment returns do not meet these expectations, the plans' must recognize *experience losses*. These *experience losses* are distinguished from the market losses discussed earlier. *Experience losses* are the difference between actual investment returns and what is expected to occur as represented by the actuarial assumption.

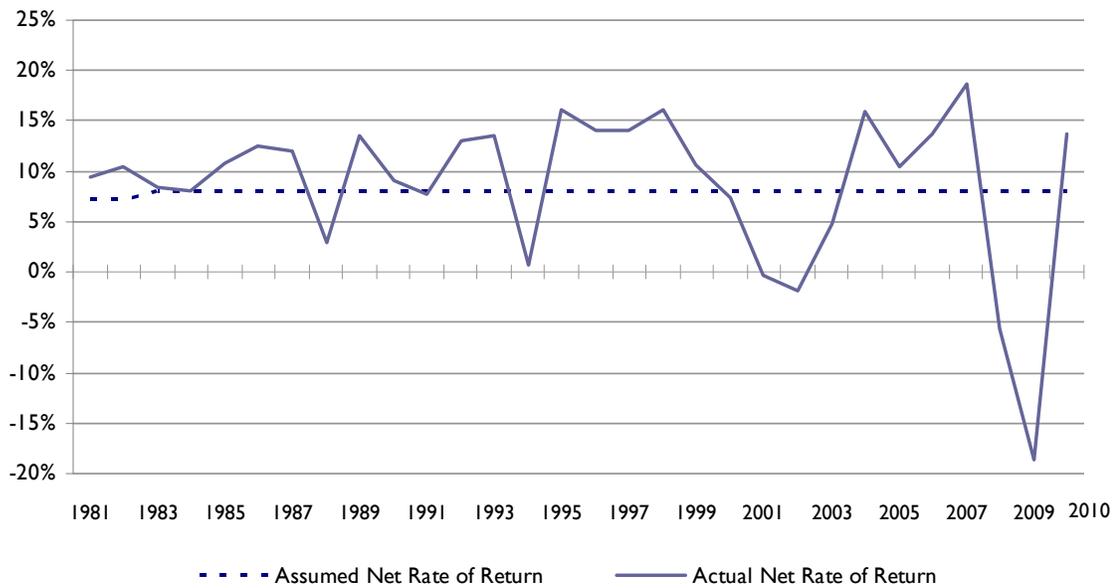
It is important to compare the actual investment return to the assumed return because, as was reported by the Pew Center on the States in *The Trillion Dollar Gap*, if a plan suffered a one-time, 24 percent loss in value:

... the fund would have to make 16 percent in annual investment returns for the next five years to accumulate as much as would have been accrued if they had consistently received the historically anticipated 8 percent rate of return over the same period of time.²⁷

Exhibits 24 and 25 show the assumed investment returns and estimated actual net returns from FY 1980-81 through FY 2009-10 for each plan.

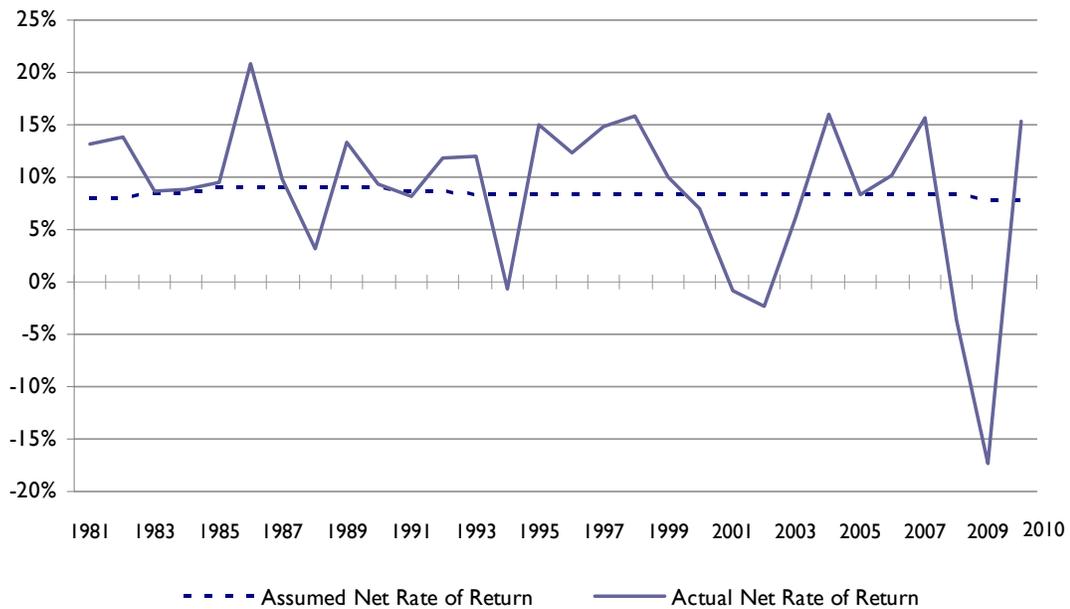
²⁷ The Pew Center on the States, "The Trillion Dollar Gap" (February 2010)

Exhibit 24: Police and Fire Retirement Plan Assumed and Actual Net Investment Returns, FY 1980-81 Through FY 2009-10



Sources: Comprehensive Annual Financial Reports, Annual Reports and actuarial valuations, Police and Fire Department Retirement Plan, Fiscal Years 1980-81 through 2008-09, Draft Police and Fire Department Retirement Plan Financial Statements Fiscal Year 2009-10

Exhibit 25: Federated City Employees' Retirement System Assumed and Actual Net Investment Returns, FY 1980-81 Through FY 2009-10



Sources: Comprehensive Annual Financial Reports, Annual Reports and actuarial valuations, Federated City Employees' Retirement System, Fiscal Years 1980-81 through 2008-09, Draft Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

Through FY 2009-10, each plan had met its assumed net investment return in 22 of the past 30 years. However, in each case the plans failed to meet the assumed return in 5 of the previous 10 years. Over the last thirty years, the long-term compound growth rates for both plans were about 7.5 percent.

Between June 30, 2007 and June 30, 2009, actuarial *experience losses* from investment returns added about \$138 million to the Police and Fire *unfunded liability* and \$86 million to the Federated *unfunded liability* (about \$36,000 per Police and Fire member and \$11,000 per Federated member²⁸).²⁹

The Unfunded Liability Increased by More Than \$160 Million Because Other Demographic and Economic Assumptions Did Not Hold True

According to experience analyses prepared by the plans' actuaries in 2009, other demographic and economic assumptions did not hold true.

- Police and Fire – the plan experienced earlier retirements and higher salary increases among active members than expected.³⁰
- Federated – the plan experienced more retirements, more terminations and withdrawals, and fewer salary increases than expected.

As a result, the contribution rates had been set too low, and the plans fell further behind. Experience losses associated with these assumptions for the two years ending June 30, 2009 added about \$105 million to the Police and Fire unfunded liability and \$62 million to the Federated unfunded liability (about \$27,500 per Police and Fire member and \$8,000 per Federated member).

The Unfunded Liability Increased by More Than \$370 Million Because Some Mortality Rate, Retirement Rate, Salary Increase, and Investment Rate Assumptions Were Adjusted Based on Past Experience

Changing assumptions can have a large impact on the calculation of *pension liabilities*. As a result of the experience analyses and Retirement Services staff advocating for more realistic assumptions, the actuaries for each plan recommended, and the Boards' approved, changes to key plan assumptions for the June 30, 2009 valuations.³¹ These changes added about \$145 million and \$229 million to the Police and Fire and Federated unfunded liabilities respectively (about \$38,000 per Police and Fire member and \$29,000 per Federated member).

²⁸ Member includes retired members, survivors, and active employees.

²⁹ As noted earlier, because of the actuarial method of smoothing gains and losses, recent market losses have not been fully recognized for actuarial purposes.

³⁰ The assumption was for annual salary increases to range from 5% to 9% depending upon years of service. Actual average salary increases over the 4-year study period ranged from 7.3% to 11.6%.

³¹ In recent years, Retirement Services has hired two actuaries for its staff.

Specific changes included:

- Police and Fire Plan – (1) mortality rate was changed to reflect longer expected lives of plan members, (2) retirement rate for Police members was adjusted to reflect earlier retirements, and (3) salary increase assumption was changed to reflect higher salary increases.
- Federated Plan – (1) begin phase-in for reduction in long-term investment rate of return assumption from 8.25 percent to 7.75 percent and (2) mortality rate assumption was changed to reflect longer lives.

Because recent market losses have not been fully recognized for actuarial purposes, the actuarial unfunded liability totaled \$1.1 billion at June 30, 2009 (or about \$1 billion less than the market value of the unfunded liability). Even with the deferral of market losses, however, the City’s actuarial unfunded liability grew by \$778 million between 2007 and 2009 as a result of experience losses and assumption changes.

Exhibit 26 shows the components of the growth in the two plans’ actuarial unfunded liabilities from June 30, 2007 to June 30, 2009 along with the amount of deferred losses to be recognized in the future.

Exhibit 26: Components of the Growth in the Actuarial Unfunded Liability from June 30, 2007 to June 30, 2009 (\$millions)

	Police & Fire	Federated	Total
Actuarial Unfunded liability, June 30, 2007	\$ 6.6	\$ 338.1	\$ 344.7
Investment <i>experience losses</i> (actual return less than assumed return—as opposed to market losses which have <i>not</i> been fully recognized for actuarial purposes)	138.4	86.5	224.9
Other outcomes differing from assumptions (e.g. member mortality and retirement rates, salary increases)	105.1	62.2	167.3
Change in investment return assumption	-0-	141.5	141.5
Changes in other assumptions: Police and Fire – mortality and retirement rates, salary increases Federated – mortality rate	145.4	87.3	232.7
Amortization of previous unfunded liability	(1.6)	-0-	(1.6)
Interest costs and other	-0-	14.0	14.0
Actuarial Unfunded liability, June 30, 2009	393.9	729.6	1,123.5
Deferred losses	600.4	399.9	1,000.3
Unfunded liability (market value), June 30, 2009	\$ 994.3	\$ 1,129.5	\$ 2,123.8

Source: Auditor analysis of June 30, 2009 Actuarial Valuations for San José’s two retirement systems

Recommended Best Practice: Actuarial Audits

According to the Police and Fire actuary, The Segal Company, the use of realistic *actuarial assumptions* is important to maintain adequate funding, as estimating as closely as possible to the actual cost “will permit an orderly method for setting aside contributions today to provide benefits in the future, and to maintain equity among generations of taxpayers and participants.”

As is evident from recent history, when *actuarial assumptions* do not hold true, unfunded liabilities and contribution rates can increase dramatically. The Government Finance Officers Association’s (GFOA) recommends that retirement plans have an independent *actuary* conduct an audit of the plan’s *actuarial valuations* at least once every five to eight years. The purpose of the actuarial audit is “to provide an independent critique of the reasonableness of the actuarial methods and assumptions in use and the validity of the resulting actuarially computed contributions and liabilities.”

Other jurisdictions, including the states of Washington and Missouri, have specific policies which require regular, periodic actuarial audits. In San José, only when the retirement plans change actuaries are the *actuarial valuations* subjected to such peer-level scrutiny.

Recommendation #2: To ensure the reasonableness of the methods and assumptions used in the retirement plans’ actuarial valuations, we recommend that the City Council amend the Municipal Code to require an actuarial audit of such valuations every five years if the actuary conducting the valuation has not changed in that time.

GASB Project Plan: Postemployment Benefit Accounting and Financial Reporting

In 2006, GASB launched a research project to gather information regarding how effective the standards established for pension accounting and financial reporting—Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*—have been in improving accountability and providing decision-useful information.

GASB has issued its preliminary views and proposed changes on pension accounting and financial reporting. Retirement Services staff have already conducted a preliminary analysis of how the proposed changes would impact the City’s financial reporting and accounting of post-employment benefits:

- The unfunded liability would be recognized as a liability on the City's balance sheet. The liability would be defined as the difference between the *actuarial accrued liability* and the net *market* value of assets.
- Because the City's annual expense calculation may be calculated differently than the current annual required pension contribution, the changes could potentially add volatility and introduce a disconnect between the two.

However, it should be noted that new standards regarding pension accounting have not yet been issued by GASB and are probably years away from implementation.

Chapter 5 Individual Components of the City's Pension Plans Have Different Impacts on Overall Costs

SUMMARY

Each component of a pension plan has an impact on the overall cost of the system. In addition to the pension formulas (expressed as a set percentage multiplied by a member's years of service), two major drivers of the City's pension costs are:

- Age at which members are eligible to receive retirement benefits (50 for Police and Fire and 55 for Federated)
- Each plan's guaranteed annual 3 percent cost-of-living adjustment (COLA).

Other cost drivers with varying degrees of impact include the determination of final average salary using the highest one-year average, joint and survivor benefits, the maximum pension levels (90 percent for Police and Fire and 75 percent for Federated), the plans' reciprocity provisions, and the Supplemental Retiree Benefit Reserves.

Retirement Age and the Guaranteed 3 Percent COLA Are Major Cost Drivers of the City's Pension Plans

Each component of a pension plan has an impact on the overall cost of the system. In conjunction with our review, we asked Retirement Services staff to assess the relative costs of various components of the City's pension plans as a proportion of the overall cost. The following are not designed as specific proposals for change; they are meant to give a general picture of what plan provisions are driving pension costs. Specific elements of the current plans' designs included in the analysis were:

- Retirement age
- Pension formulas, including maximum allowable benefit
- COLA
- Final compensation

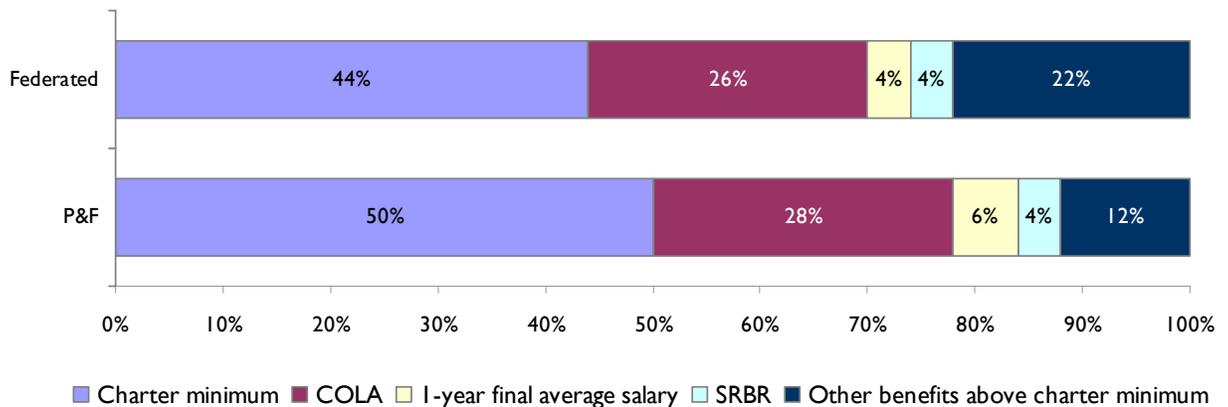
- Standard allowance to surviving spouse/domestic partner or children (“joint and survivor benefits”)

Estimated Cost of Charter Minimum and Other Selected Provisions

For Police and Fire, the Charter minimum benefit equals 50 percent of final compensation; the Federated minimum benefit equals 2 percent of final compensation for the first 25 years of service plus 1 percent for each year beyond 25 (with a maximum benefit of 85 percent of final compensation). For each plan, the Charter defines final compensation as the average salary in the three years immediately preceding the member’s retirement.

Exhibit 27 highlights the cost components of the current plans. As shown in Exhibit 27 the minimum benefits spelled out in the Charter account for an estimated 44 to 50 percent of the total cost of each plan. The guaranteed 3 percent COLA, which is not part of the Charter minimum benefit, accounts for an additional 26 to 28 percent of the cost of each plan. The one-year final compensation for determining pension benefits accounts for 4 to 6 percent of cost, and the SRBR accounts for an estimated 4 percent of each plan’s cost.

Exhibit 27: Estimated Percentage of Current Plan Costs Attributable to Charter Minimums and Other Selected Provisions

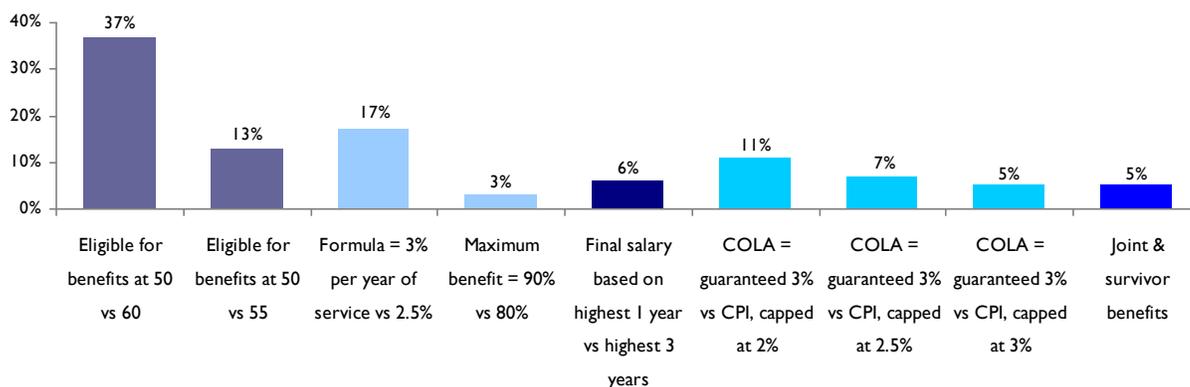


Source: Retirement Services Department
 Note: Costs are estimated based on current active membership and actuarial assumptions used for the June 30, 2009 valuations.

Estimated Cost of Various Benefit Levels

Exhibits 28 and 29 show estimated costs attributable to various benefit levels, including the retirement age, the COLA, pension formulas, joint and survivor benefits, and the highest one-year average final salary versus the highest three-year average.

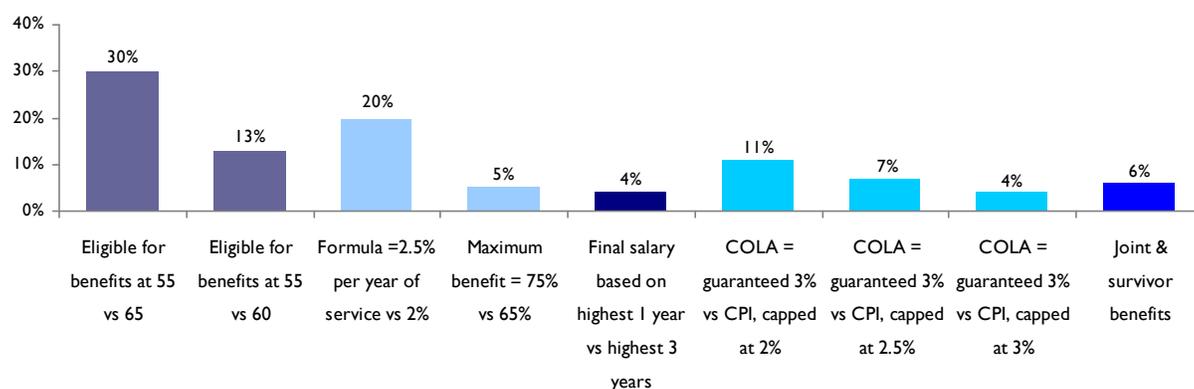
Exhibit 28: Estimated Costs Attributable to Various Benefit Levels – Police and Fire



Source: Retirement Services Department

Note: Costs are estimated based on current active membership and actuarial assumptions used for the June 30, 2009 valuations. CPI-capped COLA costs were estimated using annual CPI over the last 50 years assuming no COLA banks.

Exhibit 29: Estimated Costs Attributable to Various Benefit Levels – Federated



Source: Retirement Services Department

Note: Costs are estimated based on current active membership and actuarial assumptions used for the June 30, 2009 valuations. CPI-capped COLA costs were estimated using annual CPI over the last 50 years assuming no COLA banks.

These cost components are described in more detail below:

Retirement Age

As is shown in Exhibits 28 and 29, one of the largest cost drivers is the age at which retirees are eligible to receive benefits – **more than 30 percent** of total cost comes from the eligibility to retire at 50 and 55 years of age versus 60 and 65 year of age for Police and Fire and Federated, respectively.

The Police and Fire retirement age was decreased from age 55 to age 50 in 1968. The Federated retirement age of 55 or older with 5 years of service, or any age with 30 years of service, has been in place since 1975. Eligibility to retire at 50 versus 60 years of age increases Police and Fire costs by about **37 percent**. Eligibility to retire at 55 versus 65 years of age increases Federated costs by about **30 percent**.

Increasing or reducing the retirement age has the effect of changing both the number of years a retiree receives benefits and the number of years that they contribute into the system prior to retirement. Among retirees as of June 30, 2009 the median retirement age for Police and Fire retirees was 54 and the median retirement age for Federated was 56. By comparison, eligibility for Social Security benefits begins at age 65 (or 62 for a reduced, early benefit) or 67 for individuals born after 1960.

Locally and across the country, consideration is being given to increasing retirement ages. For example, in 1983, the Federal government approved phasing in increased Social Security retirement ages in an effort to shore up the Social Security Trust Fund.

Pension Formulas, Including Maximum Allowable Pension

Pension formulas determine how the actual benefit is calculated. The maximum allowable benefit provides a ceiling on the level of benefit that is allowable (before the application of any COLA). As shown in Exhibit 29, Retirement staff estimate that pensioning employees at 2.5 percent instead of, say, 2 percent increases Federated costs by about **20 percent**, and that pensioning Police and Fire employees at 3 percent rather than 2.5 percent increases costs by about **17 percent**. On the other hand, reducing the maximum benefit to, say 65 percent of final salary rather than 75 percent could reduce Federated costs by about **5 percent**.

Guaranteed Annual Increases (a.k.a. COLAs)

San José's pension plans provide guaranteed annual cost-of-living increases, even in the first year of members' retirement. The current system provides that all pensions in effect as of February 1st (Police and Fire) and April 1st (Federated) receive an automatic 3 percent increase. As a result, a Police and Fire member can retire on January 31st at 90 percent of salary and receive a 3 percent increase the next day, resulting in a pension of 92.7% of final salary.

This fixed COLA was negotiated in 2002 and 2006 for Police and Fire and Federated respectively, and replaced a previous benefit that was tied to the Consumer Price Index (CPI) and capped at 3 percent. In years that the CPI was greater than 3 percent, the excess was banked to offset years in which the CPI was lower than that mark.

As shown above in Exhibit 27, Retirement staff estimate the guaranteed COLA accounts for about **28 percent** of the total cost of the Police and Fire plan, and **26 percent** of the total cost of the Federated plan. As shown in Exhibits 28 and 29, the guaranteed 3 percent COLAs cost an estimated 11 percent of pay more than would a COLA based on the CPI and capped at 2 percent.

Determination of Final Compensation

Both plans have changed their determination of final compensation from highest three-year average compensation to highest 12-month average compensation. Although the highest one-year provision took effect in 1970 for Police and Fire, the Federated benefit was changed more recently, in 2001.

Exhibit 30 shows a recalculation of what three sample Federated retirees' pension would be using a three-year average when computing final average salary compared to the actual current benefit calculation.

Exhibit 30: Potential Lifetime Savings Using Highest Three-Year Average as Final Compensation

Sample Federated Retiree	Current Monthly Pension	Monthly Pension Using Highest Three-Year Average	Potential Life Savings Using Three-Year Average (w/COLA)
Retiree #1	\$9,673	\$9,300	\$247,958
Retiree #2	\$2,098	\$2,047	\$44,224
Retiree #3	\$1,992	\$1,874	\$58,071
Total Potential Life Savings			\$350,253

Source: Auditor analysis based on information obtained from Pension Gold and PeopleSoft.

As shown earlier in Exhibits 27, Retirement Services staff estimates the cost of determining final salary from the highest one-year average salary versus the highest three-year average salary costs about **6 percent** and **4 percent** for Police and Fire and Federated respectively.³²

Standard Joint and Survivor Benefits

Both plans have standard joint and survivor benefits that increase estimated pension plan liabilities by about **5 to 6 percent** (see Exhibits 28 and 29). For each plan, spouses or domestic partners are eligible for up to 50 percent of a member's pension after the member's post-retirement death. Surviving children are also provided benefits if they are minors or students up to the age of 22.³³

³² As noted in the *Audit Objective, Scope, and Methodology* section of this report, the City Auditor's Office has previously recommended the City return to using a three year average in pension calculations rather than the highest compensation earnable in any twelve month period.

³³ Note that retirees may choose an optional settlement at retirement that reduces their pension benefit to provide a higher survivorship allowance to a designated beneficiary or their spouse/domestic partner.

Other Cost Elements

Two other elements of the City's retirement plans also add costs to the pension systems:

Reciprocity

In 1994, the City entered into an agreement with CalPERS that extends reciprocal benefits to plan members. Reciprocity allows members to combine their service with the City with reciprocal CalPERS systems to determine total years of service and final compensation. In FY 2010-11, reciprocity added 0.45 percent of payroll to the current Federated contribution rate (adding about \$1.5 million per year to the City's *annual required contribution*).

Supplemental Retiree Benefit Reserves (SRBR)

The SRBRs allow for supplemental benefits to retirees which are derived from plan "excess" earnings. When the plans actual investment returns exceed the expected returns, then a portion is transferred into the SRBR for later distribution as a supplemental benefit. This is expected to take place even when the plan is underfunded. The Federated SRBR was established in 1986; the Police and Fire SRBR was established in 2002. Each plan had a funded ratio greater than 100 percent the year their respective SRBRs were established.³⁴

Retirement Services staff estimates that the cost to the Retirement Funds to transfer "excess" earnings to the SRBR is about 0.3 percent of earnings. That is, if the plan is normally expected to earn 8.0 percent in investment earnings in the long term, it will need to actually earn about 8.3 percent to account for SRBR transfers for the years when the plan exceeded 8.0 percent. As was shown in Exhibit 27, the SRBRs account for about **4 percent** of the total costs of each plan.

For FY 2009-10, each plan had net investment earnings in excess of the expected returns. Retirement Services staff estimates that there may be "excess" earnings for Federated, meaning there may be a transfer of income into the SRBR even though the plan has a significant underfunded liability. As of August 31, 2010, there had not been a determination of whether there would be a distribution to Federated retirees however. For Police and Fire, the calculation of excess earnings is slightly different and Retirement Services staff does not believe that there will be "excess" earnings for FY 2009-10.

³⁴ The parameters for when each plan makes a distribution to retirees differ and distributions are not made every year. In general, when distributions are made, the amount per retiree depends on years of service and years retired. As of June 30, 2010, the balance in the SRBR for Police and Fire is \$32.3 and for Federated is \$21.3 million.

Chapter 6 Alternatives for a Sustainable Future

SUMMARY

The City has limited maneuverability in how it could change its pension plans for current employees. Nonetheless, the City may be able to or may have to reduce its pension costs to preserve the system. Other jurisdictions have reduced their costs through (1) additional cost sharing by employees, (2) prospective changes in plans for existing employees, and (3) establishing a second tier pension for new hires. We recommend the City pursue one or a combination of these cost-containment strategies, and that the City consider eliminating the SRBRs or at least prohibiting transfers into the SRBRs and distribution of supplemental benefits when the plans are underfunded, and also consider joining CalPERS in order to reduce administrative costs.

Finally, because of rising pension costs and their threat to the City's General Fund, we recommend that the City Manager should propose an annual ongoing budget for actuarial services to ensure that any cost projections for negotiations with bargaining groups are actuarially sound and to assess the long-term sustainability of any proposed plan revisions.

Maneuverability to Change Plans for Current Employees is Limited Under Current Law

There is considerable discussion about how limited the City or other local governments are in changing certain benefits for active members of retirement plans. The City's maneuverability to change its pension plans for active employees may be restricted as it could be deemed an impairment of an existing contract.³⁵ In this situation, San José is not unique. According to a recent New York Times article:

There is, of course, no argument for canceling a pension already earned. But public employees benefit from a unique notion that, once they have worked a single day, their pension arrangement going forward can never be altered. No other Americans enjoy such protections. Private companies often negotiate (or force upon their workers) pension adjustments.³⁶

However, not every benefit was authorized or "promised" in the same way, and some things can be more easily modified than others (e.g. employee contribution

³⁵ The vested rights doctrine may have different application to retiree medical benefits for current employees than pension benefits for current employees.

³⁶ Roger Lowenstein, *The Next Crisis: Public Pension Funds* (June 2010)

rates) and additional analysis will be required. There are currently lawsuits challenging the assertion that current pension benefits cannot be changed, including:

- Orange County, California sued to repeal the awarding of previously granted retroactive benefits. The case was dismissed by a Los Angeles County Superior Court judge in 2009. The County has appealed that decision.
- The states of Colorado and Minnesota each changed the formula for calculating COLAs in their pension systems. Subsequently, lawsuits were filed by retirees challenging the legality of the changes. As of August 30, 2010, there had not been rulings in the Colorado or Minnesota cases.

In May 2008, the City of Vallejo, California filed for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code. Under the filing, Vallejo listed the two largest unsecured claims against the city as retiree health benefits and unfunded pension obligations.³⁷ As part of the bankruptcy workout plan adopted by Vallejo's City Council in December 2009, the City sought to reduce retiree health care benefits but left existing pension benefits alone.³⁸

The City May be Able to Reduce Costs Through Negotiations with Employee Bargaining Groups

As discussed earlier, the retirement funds have substantial assets set aside to fund future pension benefits, but not enough to avoid significant outlays in the future to reach full funding.

In combination with future budget and service reductions, the City will most probably seek to reduce pension costs through negotiations. This is what occurred during the FY 2010-11 budget process. To reduce costs, the City proposed a variety of concessions from employee bargaining units that would reduce the City's pension costs, including:

- Additional retirement contributions to help offset the City's annual contributions towards the plans' unfunded liabilities
- Reductions in employee base pay (upon which future benefits are based)

³⁷ Vallejo's unfunded retiree health benefit obligations totaled \$135 million and unfunded pension obligations totaled \$84 million. By comparison, Vallejo's total General Fund revenues in its FY 2008-09 Proposed Budget were about \$80 million.

³⁸ In March 2010, Vallejo approved a new contract with its firefighters that reduced benefits for new hires but did not touch benefits of existing employees.

Increased Cost Sharing Between the City and Employees

As has already been seen, one alternative is increased cost sharing. Negotiations between the state of California and some employee bargaining groups led to increases in the amount employees would contribute for their pensions. Similarly, other local governments have negotiated with employee bargaining groups and increased employee contribution rates. Exhibit 3I shows selected cities and one state employee bargaining group who have raised employee contribution levels (note: similar to San José employees, these groups do not contribute to Social Security).

Exhibit 3I: Selected Increased Cost Sharing Agreements, Other Governments and Bargaining Groups³⁹

	Change in Employee Contribution Rate
City of Palo Alto miscellaneous employees	Raised from 2% to 8%
City of Oakland Police (subject to approval of parcel tax by Oakland voters)	Raised from 0% to 9% over three years
City of San Francisco public safety (new employees)	Raised from 7.5% to 9%
California Highway Patrol	Raised from 8% to 10%

Source: City Auditor analysis of information from Memoranda of Understanding, Election Results, and news articles

It should be noted for comparison that San José current employee contribution rates including OPEB are already 15.57% for Police members, 13.7% for Fire members, and 10.3% for Federated members.⁴⁰

San José employees share in the *normal cost* of their pensions, on an 8:3 ratio specified in the Charter. On the November 2010 ballot there is a measure to amend the City Charter that would, among other things, allow the City Council to provide a retirement plan or plans to new employees that are not subject to the Charter's minimum requirements, including the 8:3 contribution ratio.

The Charter does not specify how the cost of the *unfunded liability* is to be shared. Currently, employees share in the current year or estimated *normal cost* of benefits, but historically the City has borne the full burden of paying for any *unfunded liabilities*. Beginning in 2010, some bargaining groups will be picking up a negotiated share of that burden, offsetting the City's payments towards the unfunded liability. It should be noted that these agreements do not result in any additional contributions towards the unfunded liability; only a redistribution of who pays.

³⁹ Each of these agreements were part of larger pension reform measures which also reduced benefits or changed the calculation of final compensation for new hires.

⁴⁰ These rates are before any negotiated employee pickup of a portion of the City's contribution as a result of negotiations with bargaining units for the FY 2010-11 Budget as described in Chapter 3.

Consideration Should be Given to Eliminating the SRBRs or at Least Prohibiting Transfers of “Excess Earnings” and Distribution of Supplemental Benefits When the Plans Are Underfunded

As described in Chapter 5, the SRBRs provide supplemental benefits to retirees which are derived from plan “excess” earnings. This can take place even when the plans are underfunded. As was seen in Exhibit 27, the SRBRs account for about 4 percent of the total costs of each plan. The Federated SRBR was established in 1986. The Police and Fire SRBR was established in 2001 and commenced distribution in 2002. In our opinion, elimination of this practice is necessary to preserve and protect the retirement plans.

Prospective Changes to Retirement Plans Are Allowable in Exchange for Commensurate Benefits

An exception to the perceived rule against changing certain benefits of active members can occur if, in exchange for a benefit reduction, a commensurate benefit is provided. In 2010, this occurred in Vermont where state teachers agreed to a later retirement age in exchange for an increase in the maximum allowable benefit.

As noted previously, as a result of recent budget deficits, many City employees’ base pay and employee benefits have been reduced, others are paying more than 20 percent of their wages and salaries in pension contributions, and 191 employees were laid off. At the same time, regular employee contribution rates for retirement and OPEB costs have increased as well. As budget deficits are forecast into the future, City employees may find the combined impacts from the annual budget process, negotiations related to concessions, and rising contribution rates overly costly and personally unsustainable.

For example, faced with negotiating based on their total compensation (where retirement benefits are included along with base pay and other benefits), some employees may prefer any reductions to their total compensation be balanced between income and benefits. For example, reducing base pay and increasing retirement contributions each have the effect of reducing an employees’ take-home pay. Faced with difficult choices, employees may choose to agree to things that do not affect net pay to cover other needs such as saving to purchase a home.

The willingness and ability of bargaining units to agree to a particular concession can be dependent upon where the employees they represent are in their careers and what they expect or prefer in a pension. For example, an individual nearing retirement may be less interested in changes to their plan than an individual just beginning their career. For this reason, the agreement in Vermont to raise the retirement age did not affect teachers who were within five years of retirement.

Some employees, particularly those with only a few years in the system and/or who may not view a 30-year career with the City as a likelihood, may put more value on a plan that allows more portability and self-direction than the current system. As was the case in Vermont, some employees may prefer a later retirement age in exchange for something else. In San José, that could mean reduced current contributions into the system, increased portability, or some other consideration.

The City Should Explore a Second Tier for New Employees

The Charter provides for the minimum pension benefits the City must provide for employees. On the November 2, 2010 ballot there is a measure to amend the pension provisions in the City Charter. If approved, the City Council would have the ability to establish second tier retirement plans for new employees that are not subject to the Charter's minimum requirements. Other jurisdictions already have multiple tiers within their pension systems.⁴¹

The City Manager's Associations of Santa Clara and San Mateo County have recommended that cities in the region implement a second tier of benefits for new employees. CalPERS and some local jurisdictions (e.g. San Francisco, Oakland, Palo Alto, San Carlos, South San Francisco, and Campbell) already have created second tiers for new hires.⁴² Some of the changes in benefits include:

- Raising the retirement age from 50 to 55 for public safety employees and 55 to 60 for miscellaneous employees
- Reducing the benefit formula to 2 percent of final compensation times years of service
- Changing the definition of final compensation to the average of the highest three years rather than highest one year

Some jurisdictions have implemented 401(k) style defined contribution plans⁴³ (e.g. Alaska) or hybrid systems with both defined benefit and defined contribution plans (e.g. Washington, Utah, and Michigan). When these types of plans are implemented, current employees are often allowed to opt into them.

Local governments are only exempt from having their full time employees participate in the Social Security system if they provide a plan that meets certain minimum standards. In addition, in order for employee contributions to be made

⁴¹ For simplicity, when we refer to second tier benefits, we are referring to a plan's most recent tier which includes a reduced level of benefits than previous tiers.

⁴² Oakland's second tier is contingent upon voter approval of a parcel tax ballot measure in November 2010.

⁴³ We are using the term "401(k) style defined contribution plans" because 401(k) plans, in particular, cannot be implemented by governmental agencies that did not have them in place in 1986.

into a retirement plan on a pre-tax basis, the plan must meet Internal Revenue Code requirements, including the requirement that it provide a “definitely determinable benefit” to employees.

As a result, a straight 401(k) style defined contribution plan is **not** an option for the City; but Social Security could be. The City could opt to participate in Social Security and pay 6.2 percent of payroll into the Social Security Trust Fund (potentially supplemented with a defined contribution plan). As was noted in Chapter 1, Redevelopment Agency staff who are not City employees participate in a defined contribution 401(a) plan in which the Redevelopment Agency contributes 9 percent of base salary and makes payments into Social Security, and employees contribute 3 percent of base salary and also make payments into Social Security.

Considerations for Second Tier Benefits

In developing a policy for second tier retirement benefits, the City will need to consider a number of factors, including:

- Purpose of plan:
 - City’s perspective – attract and retain a quality workforce
 - Employee perspective – future replacement income (Money magazine cites a retirement income target (from all sources) of 70 percent of pre-retirement income to live comfortably in retirement)
- Affordability of the plan
- Are employees covered by Social Security or offered other supplemental savings plans?
- Portability of retirement assets and/or reciprocity with other California public pension systems
- Who bears the risk (i.e. investment risk or the risk of not meeting other assumptions)?

Workforce Development Concerns in Designing a Second Tier

The City’s defined benefit plan is designed to reward longevity and promise a fixed benefit for life in retirement. It encourages retention because the benefit becomes more valuable as the employee ages and stays more years with the City. As a retirement plan task force in Maine recently reported:

A major consideration for... evaluating a second tier plan is who is it designed to benefit and why? If the goal is to solely to encourage employee longevity, the traditional defined benefit plan is the answer. If the goal is to attract and hire younger employees, a defined contribution plan is a likely option. If the goal is to create portability of benefits so that

mobile employees can build a retirement income, then Social Security with a supplemental defined contribution plan, or to a lesser extent, a defined benefit plan may fit the need.⁴⁴

The large number of anticipated baby boomer retirements, and the significant replacement hiring that may occur to backfill those positions, requires that the City has a system that will continue to be attractive to incoming talent – even as the City attempts to reduce costs. According to some observers, a new generation of employees may have different desires and expectations of career paths and compensation tradeoffs. While the need for cost reduction may be what is driving the change, a desirable result should also be a revised system that aligns to employer and employee needs into the future.

Alternate Plan Designs

Exhibit 32 lists some commonly understood advantages and disadvantages of alternate plan designs. The important consideration of plan affordability would depend upon the specifics of the plan.

Exhibit 32: Advantages and Disadvantages of Alternate Plan Designs

	Advantages	Disadvantages
Defined benefit plan	<ul style="list-style-type: none"> - Guaranteed lifetime benefit to employees - Motivates employees to continue in service - Generally more expensive overall, but more efficient than defined contribution plans at providing benefits on a per dollar of benefit paid basis⁴⁵ 	<ul style="list-style-type: none"> - Employer bears all of the risk - Limited portability of benefits - Cost of plan can fluctuate from year to year as a result of actuarial projections
401(k) style defined contribution plan (in combination with Social Security)	<ul style="list-style-type: none"> - Employer costs are limited - Annual contribution amount is easily determined - More portable than defined benefit plan 	<ul style="list-style-type: none"> - Employee bears risk of outliving accumulated assets and market returns - Does not provide same motivation to continue service as defined benefit plan
Hybrid plan (with defined benefit and defined contribution characteristics)	<ul style="list-style-type: none"> - Depends on plan design - Flexibility in sharing risk associated with pension obligations 	<ul style="list-style-type: none"> - Depends on plan design

Source: Auditor analysis

⁴⁴ Maine Unified Retirement Plan Task Force, *Task Force Study and Report Maine State Employee and Teacher Unified Retirement Plan* (March 2010).

⁴⁵ According to Gabriel, Roeder, Smith & Company, the Federated plan's actuary, this is because individuals in defined contribution plans need to invest more conservatively as they grow older and accumulate assets to finance benefits. Defined benefit plans do not have to alter their investment mix over time and can spread the risks of mortality over their members' lifetimes.

Potential Cost Savings From Establishing a Second Tier May be Minimal in the Short-Term

Because second tiers generally apply only to new hires, cost savings may be minimal in the near term but grow in future years because of employee turnover. This is because the normal cost and the continued amortization of the unfunded liability for the first tier must still be paid. Nonetheless, as an estimate of how quickly savings could be achieved, about 20-25 percent of employees would be included in the second tier in five years if San José's employee turnover in the future is the same as in recent history.

Allowing current employees to opt into the second tier could further reduce pension costs. Opting-in could benefit current employees in the form of lower pension contributions – particularly if it had been negotiated that first-tier employees would share in the cost of the unfunded liability. Under those circumstances, employees might want the option to take a lower future benefit in exchange for more income now.

Potential Impact on Contribution Rates

Although a second tier would reduce pension costs, it could have an adverse impact to contribution **rates** for remaining first tier members. This could occur if the annual cost to pay down the unfunded liability was spread across a diminishing number of employees. Ironically, the same thing happens with layoffs. Layoffs reduce the salary base, potentially increasing the required contribution rates for the remaining employees.

There is a High Cost to Self-Administer a Pension Plan

Self administering a pension plan is costly for local jurisdictions. San José is one of only a handful of California cities that administer their own pension system. The majority of the state's cities and counties are members of CalPERS.

In FY 2008-09 the combined administrative expenses of the Police and Fire and Federated plans totaled about \$5 million, or about 2.6 percent of total contributions. In comparison, the administrative expenses of the Sacramento County Employees' Retirement System and the San Bernardino Employees' Retirement Association were about 2.6 percent and 3.0 percent of total contributions, respectively.

Comparatively, because CalPERS is able to spread its costs across a larger pool of participants, the City would have been charged about \$1.4 million in

administrative fees (or 1 percent of total contributions) if it was a member of CalPERS.⁴⁶

CalPERS offers multiple benefit packages from which local governments can choose; the packages are generally comparable to the City's current benefit structure. CalPERS offers separate packages for two categories of employees: public safety and miscellaneous.

If a city with an existing pension plan opted to join CalPERS, they could either transfer all of their active and retired members with all prior service costs, or transfer all active members going forward (with the city continuing to administer the benefits for costs associated with past service). A city could also transfer just one of the categories of employees but not the other (e.g. a city could opt to have CalPERS administer its pension plan for public safety employees but not for its miscellaneous employees).

There are challenges associated with joining CalPERS and achieving potential cost savings, including:

- To fully achieve cost savings, the Retirement Boards would need to transfer all prior service costs (i.e. costs already earned) to CalPERS. This would require a 2/3 majority vote of all retirement plan members. If all prior service costs were not transferred, and only a portion of employees moved to CalPERS, the City would end up paying CalPERS administrative fees **and** incurring its own expenses administering the prior service costs.
- Employee and employer contributions would be set by CalPERS.⁴⁷
- The City would rely on CalPERS to invest plan assets.
- The City might be required to continue to administer medical and dental benefits for some time.
- Upfront costs of transferring prior service costs would be about \$300,000 (\$25 per member).

Pension Obligation Bonds

Pension Obligation Bonds (POB) are taxable bonds other California jurisdictions have issued to finance some or all of their unfunded liabilities. POBs can lead to

⁴⁶ As annual contributions are projected to rise in the future, administrative fees that CalPERS would charge would rise. Similarly, as the City's personnel costs rise, the City's retirement plans' administrative costs would also rise. The differential between the CalPERS costs and self-administering the plans would vary accordingly.

⁴⁷ The contract with CalPERS would not impact the City Charter mandated 8:3 contribution ratio nor the City or employee bargaining groups ability to negotiate contribution rates within the Charter parameters.

cost savings **if** the interest paid on the POBs is less than the rate of return earned on retirement fund assets.

The GFOA recommends that local governments use caution when issuing POBs as they present risks.⁴⁸ Principal among these is investment risk (i.e. if the pension plan earns less than the interest paid on the POBs, then they become a net cost to the issuer).

In May 2010, the City Manager reported to the Council that (1) it was imperative that they understand the market risks of POBs and (2) they were not a viable tool to address the FY 2010-11 budget deficit. We agree with this assessment.

Moving Towards Sustainability

The City has recognized that retirement reform is essential to the long-term sustainability and availability of retirement benefits for City employees. In our opinion, it is important that the City move aggressively to rein in pension costs that threaten the stability of the General Fund and the services it provides to the residents of San José. It is important to start somewhere, and it is important to start now.

Recommendation #3: We recommend the City Administration pursue at least one or a combination of pension cost-containment strategies, including:

- a) Additional cost sharing between the City and employees
- b) Eliminating the Supplemental Retirement Benefit Reserves (SRBRs) or at least prohibiting transfers in and distribution of “excess earnings” when the plans are underfunded
- c) Negotiating with employee bargaining groups for changes to plan benefits for existing employees
- d) Establishing a second tier pension benefit for new employees
- e) Considering whether to join the California Public Employees Retirement System in order to reduce administrative costs

The Administration should work with the Office of Employee Relations on potential meet-and-confer issues that such changes would present.

⁴⁸ For more information, see the GFOA’s advisories “Evaluation the Use of Pension Obligation Bonds (1997 and 2005) and “Need for Considerable Caution in Regard to OPEB Bonds” (2007) available at www.gfoa.org. A GFOA advisory identifies specific policies and procedures necessary **to minimize** a government’s exposure to potential loss in connection with its financial management activities, and should **not** to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Additional Actuarial Review of Changes Before Approval Should Ensure Complete Understanding of Their Long-Term Impacts

The question of what is acceptable and what is affordable will require detailed analysis. The GFOA advises that benefit enhancements should be actuarially valued before they can be approved in order to ensure a complete understanding of their long-term financial impacts. We agree with this policy should be followed for all benefit changes to existing plans, including options for second tiers.

OER is responsible for negotiating on behalf of the City with employee bargaining units regarding wages and other terms of employment. Currently, OER contracts with actuaries to cost out employee benefits as necessary (e.g. during negotiations with employee bargaining groups). However, OER does not currently have an ongoing budget for actuarial services. Because of rising pensions costs and their threat to the General Fund, we believe that OER should have a dedicated budget for actuarial services so that it can have available such services when the City begins negotiations with the bargaining units regarding retirement benefits.

In our opinion, this type of expert advice will be critical to ensure that the City is fully aware of the potential risks and liabilities such changes represent. Furthermore, independent review and advice will help the City and all stakeholders assess the potential impact of changes in actuarial assumptions and the sustainability of benefit changes. This will facilitate the City Council, on behalf of taxpayers, taking a more active role as the plan sponsor and guarantor of the City's pension plans.

Recommendation #4: To obtain independent, expert advice on pension risks and liabilities, the City Manager should propose an annual ongoing budget for actuarial services.

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Chapter 7 **The City Will Continue to Face Considerable Financial Risks From Rising Pension Costs for Years to Come**

SUMMARY

There is a risk that even if the City implements the previous recommendations, pension costs may still be unsustainable. Because of the risks of rising pension costs to the City's financial and budgetary future, we recommend that the Retirement Services Department provide an annual report to the City Council that includes updates on the financial status of the plans, forecasts of pension costs, and sensitivity analyses showing best and worst case scenarios. This should be a supplement to the City Manager's Budget Office's *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program*. In addition, the Retirement Services Department should ensure that each City Councilmember receive both plans' Comprehensive Annual Financial Reports (CAFRs).

The City can also improve its communications with plan members regarding the plans' performance and financial health. In addition to the CAFR, some local governments prepare annual summary reports which provide financial and actuarial data found in the CAFRs in an easily accessible format. We recommend that the Retirement Services Department prepare an annual summary report to be distributed to all plan members and posted on the Department's website.

The City Council Should Receive Annual Updates on the Retirement Plan's Performance, Impact of Reforms, and Forecasted Pension Costs

There is a risk that even if the previous recommendations are implemented, pension costs may still be unsustainable. As of June 30, 2009, the unfunded liability of the plans calculated using the market value of assets totaled \$2 billion, or about \$1 billion more than that using the actuarial value of assets. The future is also unpredictable, and lower than expected investment returns and other outcomes differing from actuarial assumptions could add to the unfunded liability as they did in the past.

Because of the risks posed to the City's financial and budgetary future from rising pension costs, we believe it is important that Council receive periodic updates on the retirement systems performance so that they can take further action as necessary.

Beginning in 2010, the Retirement Services Department has provided a quarterly investment report of the pension systems to the City Council's Public Safety, Finance, and Strategic Support Committee. Additional reporting from the Retirement Services Department to the Council would build on that work to ensure that Councilmembers are fully aware of the costs, risks, and performance of the City's retirement systems. The contents of such reporting should include an update on the financial status of the plans and forecasts of future pension costs, as well as a sensitivity analyses showing best and worst case scenarios.

The City's Budget Office prepares the *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program* as part of the yearly budget process. This report includes information on projected pension costs. Given the significance of the City's pension systems, we believe that supplemental and more detailed information from the Retirement Services Department is warranted.

Recommendation #5: To ensure the Council is fully informed on the retirement plans' performance, the impact of reforms, and pension costs, the Retirement Services Department should:

- 1. Ensure that each City Councilmember receive both plans' Comprehensive Annual Financial Report**
- 2. Provide an annual report to the City Council that includes updates on the financial status of the plans, forecasts of pension costs, and sensitivity analyses showing best and worst case scenarios. This should be a supplement to the City Manager's Budget Office's *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program*.**

The City Can Improve its Communication with Plan Members Regarding the Plans' Performance and Financial Health

The City's Retirement Services website contains both plans' CAFRs which contain a wealth of information about the financial health of the plans, investment returns, and other information. The OER website contains the most recent *actuarial valuations* and other information. Although the CAFRs and the *actuarial valuations* contain much information on the retirement plans, it is not presented in a format that is easily accessible to all plan members.

In addition to recommending that local officials prepare and widely distribute their CAFRs, the Government Finance Officer's Association also recommends distributing summary information to all plan participants. According to one such report, the "goal of the Summary Report is to provide an easy to read format that allows members and others to quickly assess the financial status of the retirement system."

The summary reports include such data as:

- Plan assets and changes
- Historical data such as funding ratios, contribution rates, and plan membership for the previous decade
- Asset allocations
- Information about current plan membership with average ages, years of service, and other information of both active and retired members

These reports are posted on the plans' websites and often distributed by e-mail or mail to active and retired members.

Recommendation #6: To improve communication and understanding of the financial health of the retirement systems, the Retirement Services Department should prepare an annual summary report containing current and historical financial and actuarial information to be distributed to all plan members and posted on the Retirement Services Department website.

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Conclusion

Pension benefit increases had dramatic impacts on costs even before recent market losses. Now, rising pension costs threaten the City's ability to maintain service levels. As of June 30, 2009, the City's estimated liability for pension benefits totaled \$5.4 billion--\$2 billion of that (on a market value basis) was unfunded. In addition, the City and its employees face a \$1.4 billion unfunded liability for OPEB benefits. The City's unfunded pension liability has grown dramatically in recent years, and the City will continue to face considerable financial risks from rising pension costs for years to come. Understanding how we got to this place, identifying the major cost drivers of the City's pension plans, and assessing alternatives for a sustainable future, are only first steps towards solving the problem. As we said earlier, it is important to do something about rising pension costs, and it is important to start now.

RECOMMENDATIONS

Recommendation #1: We recommend the City Council explore prohibiting:

1. Pension benefit enhancements without voter approval
2. Retroactive pension benefit enhancements that create unfunded liabilities

Recommendation #2: To ensure the reasonableness of the methods and assumptions used in the retirement plans' actuarial valuations, we recommend that the City Council amend the Municipal Code to require an actuarial audit of such valuations every five years if the actuary conducting the valuation has not changed in that time.

Recommendation #3: We recommend the City Administration pursue at least one or a combination of pension cost-containment strategies, including:

- Additional cost sharing between the City and employees
- Eliminating the Supplemental Retirement Benefit Reserves (SRBRs) or at least prohibiting transfers in and distribution of "excess earnings" when the plans are underfunded
- Negotiating with employee bargaining groups for changes to plan benefits for existing employees
- Establishing a second tier pension benefit for new employees
- Considering whether to join the California Public Employees Retirement System in order to reduce administrative costs

The Administration should work with the Office of Employee Relations on potential meet-and-confer issues that such changes would present.

Recommendation #4: To ensure that pension cost projections for negotiations with employee bargaining groups are actuarially sound, the Administration should provide the Office of Employee Relations an ongoing budget for actuarial services.

Recommendation #5: To ensure the Council is fully informed on the retirement plans' performance, the impact of reforms, and pension costs, the Retirement Services Department should:

1. Ensure that each City Councilmember receive both plans' Comprehensive Annual Financial Report
2. Provide an annual report to the City Council that includes updates on the financial status of the plans, forecasts of pension costs, and sensitivity analyses showing best and worst case scenarios. This should be a supplement to the City Manager's Budget Office's *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program*.

Recommendation #6: To improve communication and understanding of the financial health of the retirement systems, the Retirement Services Department should prepare an annual summary report containing current and historical financial and actuarial information to be distributed to all plan members and posted on the Retirement Services Department website.

Memorandum

TO: SHARON ERICKSON
CITY AUDITOR

FROM: Alex Gurza

**SUBJECT: RESPONSE TO THE AUDIT OF
"PENSION SUSTAINABILITY"**

DATE: October 6, 2010

Approved



Date

10/6/10

The Administration has reviewed the audit of the sustainability of the City's pension systems and is in general agreement with the recommendations identified in the report.

Public agencies throughout the state are experiencing similar dramatic increases in costs for retirement benefits. The City and employees have experienced a significant increase in contributions from Fiscal Year 2009-2010 to Fiscal Year 2010-2011. Given recent actuarial reports, the City expects contribution rates to rise dramatically in the upcoming years. It is projected that the City's contribution rates will be approximately 45% for the Federated City Employees' Retirement System and approximately 75% for the Police and Fire Department Retirement Plan by Fiscal Year 2014-2015.

There will be significant focus on retirement reform efforts in Fiscal year 2010-2011. To initiate this effort, the City has reconvened the General Fund Structural Deficit Elimination Stakeholder Group in order for stakeholders to have input on the goals for retirement reform. In addition, the stakeholder process will provide an opportunity for education on why retirement reform is necessary. The reconvening will commence on September 29, 2010, and the work completed by the Stakeholder Group will be reported to Council in November 2010.

In addition, there is a ballot measure included in the November 2010, election that if passed would allow the City Council to adopt an ordinance to exclude future City officers and employees from any existing retirement plans or benefits and to establish retirement plans for future employees that do not provide for the current minimum requirements in the City Charter.

In January 2011, the City will be entering into negotiations with virtually all the City's bargaining units. The information provided in the audit report will be information considered by the Council when providing direction to the City Manager regarding retirement reform. Discussions regarding retirement reform may include the audit recommendations such as second tier pension benefit for new employees, increasing retirement age, the calculation of the pension benefit and additional cost sharing between the City and employees.

The City Manager's Office thanks the City Auditor's Office for its comprehensive and informative review of the City's pension systems that will serve as another source of valuable information for the City's retirement reform efforts.



Alex Gurza
Director of Employee Relations

***For additional information on this report, contact Alex Gurza,
Director of Employee Relations, at 535-8150.***