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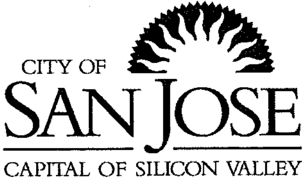

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: **Retirement Information Request**

DATE: December 3, 2009

INFORMATION

On November 5, 2009, the City Council held a Budget Planning Meeting to begin early engagement and planning for the Fiscal Year 2010-2011 General Fund Budget. Several retirement related inquiries were made by Councilmembers and the following provides a response to these inquiries. The information in this memorandum has been coordinated with the Department of Retirement Services.

Given the immense City deficit, what is the effect of delaying full funding until better financial times?

"Full funding" would indicate the two retirement plans are 100% funded. In other words, the market value of assets is equal to the actuarial accrued liability. The shortfall between the market value of assets and the actuarial accrued liability is the unfunded actuarial accrued liability (UAAL). The combined projected shortfall, including investment losses yet to be smoothed, on the pension benefit is approximately $2 billion. The plans do not make up for the shortfall in required assets immediately but instead use amortization schedules to pay for the UAAL over time. The Federated City Employees' Retirement System annual required pension contribution is the actuarially determined normal cost plus an amount equal to amortize the UAAL over a rolling 30-year period as a level percent of payroll. This is the smallest payment to the plan required under Governmental Accounting Standards Board rules.

The Police & Fire Department Retirement Plan annual required pension contribution is the actuarially determined normal cost plus an amount equal to amortize the UAAL over a period not greater than 16 years as a level percent of payroll.

Even with the payment of the annual required contributions, both plans are expected to take generations to reach full funding. If the City fails to make the annual required contributions, the City would be required to account for and report the additional unfunded liability in its annual financial report, which could potentially have a negative financial impact. It is very important that the City continue to make the annual required contributions to avoid further deferral of the costs of retirement benefits to future generations of taxpayers.

How can the use of one-time funds help to address the current shortage in funding for the retirement accounts?

The City has the option of making additional payments towards the unfunded actuarial accrued liability at any time. Any funds paid into the trust can only be used for future benefit payments and must remain in the trust. Projections based on the most recent actuarial valuations as of June 30, 2007, indicate unfunded actuarial accrued liabilities (UAAL) of $425 million for the Federated City Employees' Retirement System and $328 million for the Police and Fire Department Retirement Plan. The actual June 30, 2009, UAAL amounts will be known in early 2010 and can be reasonably expected to be higher than these amounts due to negative plan experience compared to current demographic and other assumptions.

The Federated Plan uses a 30-year rolling amortization period for the UAAL. For example, a one time lump sum payment of $10 million dollars would reduce the employer contribution rate for the Federated Plan by approximately 0.2%.

The Police and Fire Plan uses a layered amortization approach whereby actuarial gains/losses are amortized over a fixed and declining period of 16 years. Over time, the net amortization period for the Police and Fire Plan is a weighted average of the combined layers. A one time lump sum payment of $10 million dollars would reduce the employer contribution rate for the Police and Fire Plan by approximately 0.3% assuming the payment is amortized over a 16 year period.

What strategies are other cities, counties and experts discussing to address retirement funding issues?

It is important for the Retirement Boards to ensure the long range actuarial assumptions for the plans will be the best estimates of future experience. Deviations from expectations over time will result in contribution rate volatility. The interest rate assumption is arguably the most important assumption in determining future contribution rates required to fund the plan. Pension plan costs and liabilities are extremely sensitive to the interest assumption because of the long time-lapse between benefit accrual and benefit payment.

Failure of the plan to realize the net actuarial return assumption over the long run will lead to increasing employer contribution rates and under funded plan status.

Both the Federated Plan and the Police and Fire Plan have net actuarial rate of return assumptions of 8.25% and 8.00% respectively. Both of these are higher than median rates of return given the current portfolio asset allocations. By way of comparison, both the City of San Diego and City of San Francisco have set their actuarial rate of return assumption to 7.5%.

All California public sector pension plans are facing significant increases in required contributions due to recent investment losses. All of these retirement systems use smoothing methods in an attempt to stabilize contribution rates and minimize volatility in rates from year to year. There are essentially three elements of smoothing methodologies that plan sponsors have examined: the length of the smoothing period, the market value corridor and the amortization period for paying off the unfunded actuarial accrued liability (UAAL).

Currently, both of the City retirement plans use a 5-year smoothing period in recognizing investment gains/losses relative to the actuarially assumed rate of return. Within the California public sector plans, 5 years is the most common period with the shortest being 3 years and the longest 15 years. The City of San Diego uses a 4-year smoothing period and the City of San Francisco uses a 5-year smoothing period.

About half of the California public sector plans use a market value corridor when determining the actuarial value of assets used for rate setting purposes. The corridor sets limits on the amount of deferred gains or losses that are recognized. The Police and Fire Plan employs an 80-120% corridor which is the most commonly used. The Federated Retirement Plan has no corridor. Some California plans have either eliminated or expanded the corridor to reduce the short term increase in contribution rates. Whereas this reduces rate increases in the near term, it does not change the long term cost of the plan. The necessary contributions to fund the plan will have to be made in future years and only the timing of contributions is affected. Of the cities mentioned above for comparison, both continue to use an 80-120% corridor.

Using a longer amortization period to pay off the UAAL would reduce the employer contribution rate. However, the lower contribution rate comes at the expense of the additional length of time needed to pay off the debt and the additional interest costs on the balance due. Amortization periods of between 15 to 20 years are commonly used among the California plans. The Police and Fire plan uses a 16-year declining period to pay off actuarial gains/losses as they are realized. The Federated Plan uses a rolling 30-year period which is the longest allowed under government accounting standards. Under the 30-year rolling amortization, the UAAL is never fully amortized and the balance owed continues to increase unless offset by future actuarial gains. The City of San Diego has a 20-year amortization (19 years left) to pay down the June 30, 2007, UAAL.

Apart from funding methodologies, cities and counties are also considering revising pension benefits. Some agencies, such as the City of San Jose, are limited in the retirement benefit changes that can be achieved to the extent that the retirement benefits are vested. For that reason, agencies are exploring alternative retirement benefits for new employees. However, it should be noted that changing benefits for new employees does not reduce the existing unfunded liability. Benefits for new employees would reduce costs, beginning gradually.

Some agencies have already implemented a second tier of retirement benefits for new hires. For example, the City of Palo Alto recently implemented a different retirement formula for several employee units. The benefit for new hires is the PERS 2%@60 formula.

<u>What are the benefits of moving to annual pension and retiree healthcare valuations?</u>

Annual actuarial valuations would reduce the volatility in employer and employee contribution rates. In the rate setting process, the actuary factors in the plan experience between valuation dates. This experience includes investment performance, demographic experience, and changes to plan assumptions and benefits. The longer the period between valuation dates, the greater the potential for significant adjustments in contribution rates.

Currently, the City and employee contribution rates are adjusted every two years. The last couple of years have seen particularly high levels of volatility in the investment markets and large investment losses. These losses have driven the steep increases in required contributions to the plans. Annual valuations will allow the contribution rates to adjust more quickly and potentially smooth these changes over time. However, the total cost of the plan does not change; only the timing of the contributions will be altered.

<u>Explain the new asset allocation methodology that has been adopted by both retirement boards.</u>

The Police and Fire Retirement Plan Board adopted a new asset allocation as of October 1, 2009, based on the results of an asset liability modeling (ALM) study performed by the Board's investment consultant NEPC. One objective of the ALM study was to develop a long-term asset allocation strategy including recommendations on which asset classes should be represented in the portfolio and long term target percentages to be allocated to each of these classes. This asset allocation was determined with due consideration given to the expected plan liabilities and cash flow needs, as well as future potential economic conditions.

The newly adopted target asset allocation delivers a higher expected long term rate of return with lower expected risk than the prior asset allocation. Under the newly adopted asset allocation, the long term return increases to 7.3% from 7.2%. The standard deviation of the portfolio, which is a measure of the volatility in the return, is reduced from 10.4% to 9.0%. Rather than a reduced return expectation, the new allocation improves return while at the same time reducing risk through a more diversified portfolio. Specifically, the new allocation reduces the exposure of the portfolio to equities while increasing exposure to alternative assets. The alternative asset allocation will include investments in private equity, real estate, real assets such as commodities, absolute return strategies such as hedge funds and opportunistic strategies based on market conditions. The increased diversification of the portfolio serves to reduce volatility in returns and improves expected return.

While the new asset allocation improves the expected portfolio return the median net return for the Police & Fire Department Retirement Board portfolio is still less than the actuarial assumed return of 8%. Retirement Services Staff has calculated that the probability of achieving an annual net rate of return of 8% or greater over the next 30 years with the new allocation is less than 20%. Consequently, it is extremely unlikely that investment returns in the future will make up the losses that the plan has experienced in the last couple of years.

The Federated Retirement System Board has not adopted a change to the plan's asset allocation since January 2008. The Board's investment consultant in combination with the plan's actuary and Retirement Services staff are currently working on an ALM study which may result in recommendations to change the current asset allocation.

Next Steps

The two retirement board actuaries are preparing the actuarial valuations that will be used to determine the contribution rates for the City and the employees for Fiscal Year 2010-2011. This includes potential changes to actuarial assumptions and methodologies.

At the November 5, 2009, Special Council Meeting, the City Council directed Staff to start negotiations to change retirement benefits for new employees to allow the City to control future retirement costs. Analysis and more information regarding a second tier of retirement benefits will be provided to the City Council in the next several months.

Given the significant impact of the City's retirement contributions to the budget, the City Administration will continue to provide the City Council updates as information becomes available.

DEBRA FIGONE
City Manager