COUNCIL AGENDA: 01/25/11
ITEM:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: **SEE BELOW**

DATE: January 11, 2011

COUNCIL DISTRICT: City-Wide
SNI AREA: N/A

SUBJECT: RECOMMENDATIONS FOR LABOR NEGOTIATIONS DIRECTION ON 2ND TIER RETIREMENT BENEFITS FOR NEW EMPLOYEES

RECOMMENDATION

Accept staff report and provide direction to the City Manager on recommendations for labor negotiations direction on 2nd Tier retirement benefits for new employees.

OUTCOME

This report will provide the City Council with recommendations for labor negotiations direction on 2nd Tier retirement benefits for new employees.

EXECUTIVE SUMMARY

Retirement benefit costs, both pension and retiree healthcare, have increased significantly and are projected to continue to increase in the next several years. These costs are unsustainable in that they are growing at a rate and are of a magnitude that they are requiring an ever increasing share of the City's overall revenue stream, regardless of source of funds. Retirement reform is needed for the long-term sustainability of the retirement plans and in order to continue to provide even the most basic municipal services to the public.

The City of San Jose is not alone. Public entities across the nation are faced with significant retirement cost obligations, while revenues are not keeping pace with expenditure growth. These rising costs are consequently diverting limited resources from direct service delivery to our communities.

Recent reports published emphasize the need for retirement reform, including the following:

- Santa Clara County Grand Jury: Cities Must Rein In Unsustainable Employee Costs
- City Auditor: Pension Sustainability Rising Pension Costs Threaten The City's Ability to Maintain Service Levels – Alternatives For A Sustainable Future
- Santa Clara and San Mateo County City Managers' Associations: Policy Statement on Local Government Retirement Benefits

In addition, the vast majority of the voters of San Jose passed Measure W in November 2010, which provides the ability to exclude future City officers and employees from any existing retirement plans or benefits.

The City Council has already directed the City Manager to achieve retirement reform. Retirement reform is to include 2nd Tier pension and retiree healthcare benefits for new employees, options for current employees, changes to/elimination of the Supplemental Retiree Benefit Reserve (SRBR) or "13th Check", and Workers' Compensation Offset in the Police and Fire Department Retirement Plan.

In order to implement the City Council direction, the City will be commencing negotiations with all eleven bargaining units on retirement reform in 2011.[1] There are many alternatives for 2nd Tier retirement benefits. Ideas for a 2nd Tier have been generated from many sources including staff research, the City Auditor's report, and the General Fund Structural Deficit Elimination Plan Stakeholder Group**.** Options include a defined benefit plan, a defined contribution plan, a hybrid that includes characteristics of a defined benefit plan and a defined contribution plan, or participation in Social Security.

In carrying out the City Council's direction to negotiate 2nd Tier retirement benefits (pension and retiree healthcare) for new employees, these alternatives will be considered. Since a 2nd Tier is being pursued because of the high cost of the current retirement benefits, a very significant factor will be the total cost of the retirement benefits of a 2nd Tier compared to the cost of the current retirement benefits and the cost sharing between the City and employees.

As a point of comparison, the cost to the City and employees for participation in Social Security instead of having a separate pension plan is 12.4% of pensionable payroll. The City would pay 6.2% and the employees would pay 6.2%.[2] It is important to note that even with a 2nd Tier retirement benefit, the existing unfunded liability is **not** reduced and that very significant cost must continue to be paid to the City's retirement plans. In evaluating the 2nd Tier, this means that the City must consider not only the cost of the 2nd Tier benefit, but also the cost of the benefits for current employees and retirees.

[1] Retirement benefits for Firefighters will be subject to the upcoming binding interest arbitration under City Charter Section 1111.
[2] The City does participate in Medicare for employees hired on or after March 31, 1986, with the City and employees each paying 1.45% of covered payroll.

The following are the Administration's recommendations for the key cost factors that will guide the City's negotiators:

- Total cost of the benefits to both the City and employees of 2nd Tier retirement benefits, with cost estimates based upon realistic actuarial assumptions
- Cost sharing structure, including sharing of future unfunded liabilities
- Cost to the City and employees of 2nd Tier retirement benefits compared to cost to the City and employees of Social Security benefits
- Continuing cost of the benefits and unfunded liabilities for current employees and retirees

If the 2nd Tier includes a defined benefit component, the following are the Administration's recommendations for key elements that should be included in the benefit structure of a 2nd Tier compared to the existing benefits:

- Increased minimum retirement age and/or reduced pension for early retirement
- Reduced benefit formula, reduced maximum benefit, and revised vesting schedule for both pension and retiree healthcare benefits
- Cost of living adjustment (COLA) that is tied to the Consumer Price Index (CPI) with a maximum that is less than the current 3% fixed annual increase with consideration to the funded status of each plan when providing a COLA
- Increased time period for calculation of final compensation
- Revised survivorship benefits

Since the primary reason that the City is seeking 2nd Tier retirement benefits is to reduce costs, the Administration recommends the following goals to guide the negotiations and the exploration of alternatives:

- The total normal cost[3] of 2nd Tier retirement benefits should be equal to or less than 12.4% of pensionable payroll, with the City and employees sharing the cost equally
- Future unfunded liabilities in a 2nd Tier shall be shared equally between the City and employees

BACKGROUND

On November 18, 2010, as part of the 2011-2012 Organizational and Budget Planning Special City Council Meeting during which staff projected a $70 million General Fund shortfall[4] given information available at the time, the City Council approved staff recommendations for direction

[3] Normal Cost: The cost of funding the retirement benefit for each year of service. The normal cost does not include unfunded liabilities.
[4] At the time of issuance of this memorandum, the General Fund shortfall for 2011-2012 is projected to be at least $90 million. The final projection for the 2011-2012 General Fund shortfall will be issued late February as part of the 2011-2012 City Manager's Budget Request and 2012-2016 Five-Year Forecast and Revenue Projections.

in labor negotiations. This direction included continuing the prior direction of March 2010, of achieving a 10% reduction in total compensation for Fiscal Year 2010-2011, with modifications that the entire 10% be an ongoing reduction in total compensation, roll back any general wage increases received in Fiscal Year 2010-2011, include the City Auditor's recommendations for healthcare cost containment, and achieve reform in the areas of sick leave payout, compensation structure (eliminate automatic step increases, modify step structure and modify overtime eligibility), and retirement. Guiding principles were also approved for the upcoming labor negotiations.

In addition, the City Council directed Staff to continue analyzing options for a 2nd Tier retirement program and return to the City Council with recommendations. Options were to include the input from the General Fund Structural Deficit Elimination Plan (GFSDEP) Stakeholder Group and the City Auditor's recommendations that were already approved by the City Council. Staff was also directed to explore options as they relate to potential retirement savings for current employees.

This memorandum is intended to provide additional background on retirement reform efforts made by the City and provides recommended labor negotiations direction on 2nd Tier retirement benefits for new employees, which will commence in January 2011. This memo does not focus on potential changes for current employees since there are legal issues that require further research.

Additional background information regarding retirement benefits can be found on the City's internet site:

http://www.sanjoseca.gov/employeeRelations/RetirementBenefits.asp

http://www.sjretirement.com/

Personnel Costs

Public entities throughout the state have experienced significant increases in personnel costs, while revenues have not kept pace with expenditures, resulting in significant cuts to services to the community. In May 2010, the Santa Clara County Civil Grand Jury issued a report entitled, "Cities Must Rein in Unsustainable Employee Costs." The report states, "The overall costs to cities are not sustainable. Cities need to negotiate, approve and implement considerable cost containment measures so that employee financial obligations do not continue to escalate."

The Grand Jury report can be viewed at:
http://www.sccsuperiorcourt.org/jury/GJreports/2010/CitiesMustReinInUnsustainableEmployeeCosts.pdf

As a service driven organization, the majority of the City's costs are for the employees who provide those services. Over the last several years, the City has experienced a significant increase in those costs. It is projected that increases in personnel costs will continue. From Fiscal Year 2000-2001 to Fiscal Year 2011-2012[5], the average cost per employee is projected to increase by 90.14% from $73,581 in Fiscal Year 2000-2001 to $139,905 in Fiscal Year 2011-2012. During that same timeframe, the City's workforce has been reduced from 7,013 to 5,669. The chart below shows the difference in budgeted costs of base payroll, retirement benefits, healthcare benefits and other benefits from Fiscal Year 2000-2001 to the projected costs for Fiscal Year 2011-2012.

Citywide Salary & Benefits[6] [7]			
	2000-2001	**2011-2012**	**Difference**
BASE PAYROLL	$416,010,420	$520,021,634	25.00%
RETIREMENT CONTRIBUTIONS	**$ 63,054,083**	$194,359,828	208.24%
Federated Retirement	$39,409,193	$85,892,178	117.95%
Police/Fire Retirement	$23,644,890	$108,467,650	358.74%
HEALTH/DENTAL BENEFITS	**$30,317,792**	$64,592,359	113.05%
OTHER BENEFITS (Unemployment & Other Miscellaneous Benefits)	**$ 6,608,312**	$14,162,992	114.32%
TOTAL (ALL BENEFITS)	**$ 99,980,187**	**$273,115,179**	173.17%
GRAND TOTAL	**$ 515,990,607**	**$793,136,813**	53.71%
Average Total Cost Per FTE	**$ 73,581**	**$139,905**	90.14%
TOTAL FTE	**7,013**	**5,669**	-19.16%

The retirement benefit is the most expensive benefit provided to City employees. As noted in the chart above, it is projected that there will be a 359% increase in the costs for Police and Fire retirement benefits and a 118% increase in the Federated plan covering other City employees. Further, the City's retirement contribution rates are expected to continue to increase significantly in both retirement plans.

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[5] **Source:** City of San Jose Salary and Fringe Benefit Costs by Bargaining Unit & Fund for 2000-2001 through 2011-2012 Base Budget as of November 2010. These calculations do not reflect any actions taken by the retirement boards after the October retirement board meetings.

[6] **Source:** City of San Jose Salary and Fringe Benefit Costs by Bargaining Unit & Fund for 2000-2001 through 2011-2012 Base Budget as of November 2010. These calculations do not reflect any actions taken by the retirement boards after the October retirement board meetings.

[7] **Note:** Does not include worker's compensation cost or overtime. The figures above are budgeted costs and include the cost of providing paid time off, such as vacation, holidays, personal/executive leave, and sick leave, to the extent that paid leave is taken during the fiscal year. The actual salary and benefit costs of individual employees vary.

On September 29, 2010, the City Auditor issued an audit entitled, "Pension Sustainability: Rising Pension Costs Threaten the City's Ability to Maintain Service Levels – Alternatives for a Sustainable Future." The audit focused on the rising costs of City retirement benefits, identifying the major cost drivers and recommendations to achieve more sustainable retirement costs for the future. One of the findings in the City Auditor's report is that rising pension costs threaten the City's ability to maintain service levels. On October 26, 2010, the City Council took action to accept the City Auditor's recommendations. The Pension Sustainability Audit can be viewed at: http://www.sanjoseca.gov/auditor/AuditReports/1010/1010.pdf.

Current Retirement Benefits in San Jose

The City's two retirement systems provide defined retirement benefits to eligible employees. Both retirement plans use investment income and employer and employee contributions to provide eligible retirees with pensions and retiree healthcare benefits. The following charts summarize the current pension and retiree healthcare benefits currently provided.

Current Pension Benefits			
	Federated	**Fire**	**Police**
Eligibility	55 w/ 5 years of service 30 years at any age	50 w/ 25 years of service 55 w/20 years of service 30 years at any age	50 w/ 25 years of service 55 w/20 years of service 30 years at any age
Vesting	5 Years of Service	10 Years of Service only if 20 years have lapsed from date of membership	10 Years of Service only if 20 years have lapsed from date of membership
Maximum Benefit[8]	75%	90%	90%
Formula Based on Highest 12 Months Salary	2.5% per year of service	Years 0-20: 2.5% per year of service At 20 years of service: 3.0% per year	Years 0-20: 2.5% per year of service Years 21-30: 4.0% per year of service
Annual Cost of Living Adjustment (COLA)	3% Fixed (compounded)	3% Fixed (compounded)	3% Fixed (compounded)

[8] Includes base pay and any premiums that are pensionable.

Current Retiree Healthcare Benefits			
	Federated	**Fire**	**Police**
Eligibility	Medical: 15 years of service Dental: 5 years of service	Medical and Dental: 15 years of service or 20 years for those who leave prior to retirement	Medical and Dental: 15 years of service or 20 years for those who leave prior to retirement
Benefit	100% of lowest priced plan for single or family	100% of lowest priced plan for single or family	100% of lowest priced plan for single or family

In addition, the plans also provide survivor benefits, permanent disability benefits to eligible members and beneficiaries, reciprocity with other pension programs, and a Supplemental Retiree Benefit Reserve (SRBR) that provides a supplemental "13th check" benefit under certain conditions.[9] Police and Fire members of the retirement plan are also eligible to receive their full pension without any offset for workers' compensation benefits they may also be receiving.

Both the City and employees make contributions for pension and retiree healthcare benefits which have been calculated as a percentage of payroll. The City will contribute approximately $156 million into the two retirement plans in Fiscal Year 2010-2011, $89 million for the Police & Fire Plan and $67 million for the Federated Plan.

Retirement costs (pension and retiree healthcare) alone are significant cost drivers to the City's budget. To ensure long-term sustainability of retirement benefits for City employees and to maintain the City's ability to provide services, retirement reform is needed. The City has made significant progress in retirement reform and will continue these efforts in 2011.

Retirement Reform Efforts

In light of the City's fiscal situation and the significant increased costs in retirement contributions, there have been a number of efforts that have been undertaken to address this issue. However, additional retirement reform is still needed to ensure long-term sustainability of retirement benefits for City employees and to maintain the City's ability to provide services.

Retiree Healthcare Pre-Funding

The level and eligibility for retiree healthcare benefits for City employees are defined in the Municipal Code. Contributions from both the City and current employees provide the funding for these benefits. Prior to 2008, the City and employees were partially pre-funding the Annual Required Contribution (ARC) for retiree healthcare. Unfortunately, over time, this has resulted in a significant unfunded liability for the City and employees.

[9] Payments from the SRBR program have been suspended for Fiscal Year 2010-2011.

In July 2007, the City Council directed staff to develop options to achieve full pre-funding of the ARC for retiree healthcare and to develop options to reduce the retiree healthcare liability. The City was successful in achieving a five-year phase-in approach to fully pre-fund retiree healthcare benefits with the majority of the employee units.[10]

Achieving the full funding strategy is consistent with the principle that benefits costs should be paid for as they accrue. In addition, by setting aside sufficient funds to pay for future benefits combined with the higher rate of return on investments of those funds, it can serve to reduce the long-term cost of providing future benefits for current City employees. This is the same strategy used to fund the pension benefits.

Retirement Board Governance

In 2009, the City retained Cortex Applied Research ("Cortex") to review the fiduciary governance models of both of the City's retirement plans. The scope of the review was limited to the governance models of the City's retirement systems including the composition of the retirement boards, the authority of the boards and of the City, and the necessary skills and experience of board members.

Based on their review of relevant documentation, interviews with stakeholders, and research into industry best practices, Cortex concluded that the current governance models of the retirement plans did not support the long-term effective management of the plans and therefore did not effectively serve the interests of the plan stakeholders, i.e. members, retirees, and taxpayers. The Cortex report, which can be found at http://www.sanjoseca.gov/pdf/Attachment%203.pdf, included several recommendations.

In light of the main issues identified by Cortex, the City Administration reviewed and sought input from various stakeholders on the recommendations. In February 2010, the City Administration subsequently recommended, and the City Council approved, changes in the board governance of both retirement plans. These changes included adding retirement board members that are members of the public and independent of the City, and that possess relevant education and experience that would be beneficial in managing the retirement funds.

The Municipal Code has since been amended to incorporate the changes to the board governance structure. On December 16, 2010, the City Council interviewed and appointed the majority of the new public board members to each retirement plan.

General Fund Structural Deficit Elimination Plan (GFSDEP) Stakeholder Group

The GFSDEP Stakeholder Group was reconstituted at the direction of the City Council to develop guiding principles for retirement reform. The stakeholder group, comprised of City employees, bargaining unit representatives, public members and San Jose business owners had

[10] No agreement has yet been reached with the San Jose Fire Fighters, Local 230 to phase-in to fully pre-fund retiree healthcare. This will be a subject in the upcoming binding interest arbitration.

four meetings and focused on identifying major considerations and concerns with the existing retirement system and priority elements for reform.

On November 18, 2010, the City Council accepted the staff report that summarized the top five high-level ideas for potential changes to the current retirement benefit systems:

- Create a second-tier pension system for new employees
- Increase the retirement age
- Change automatic 3% COLA to link increases to the CPI or to the increase given to Social Security recipients
- Change to a defined contribution plan, like a 401(k)—could be a hybrid, could be an option, consider which group of employees the City wants to incent to stay due to training investment
- No City pension holiday; always pay full normal cost

Pension Reform ("Measure W")

Article 15 of the Charter sets forth the minimum requirements of employee retirement benefits. The Charter details the minimum monthly service and disability retirement allowance after completing a certain number of service years, and establishes the 8:3 cost sharing between the City and the employees for the normal cost.

On August 3, 2010, the City Council approved to proceed with a ballot measure to amend the City Charter related to pensions. On November 2, 2010, the ballot measure was passed by an overwhelming margin by the San Jose voters. The Measure allows 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.

Summary

The City has made significant strides in addressing retirement reform; however, these efforts alone are not enough. Changes to pension and retiree healthcare benefits must be made for new employees to ensure long-term sustainability of the plans and to preserve the City's ability to provide services to the community.

ANALYSIS

Fiscal Year 2010-2011 Retirement Contribution Rates

The City's current retirement benefits are the most expensive employee benefit, and costs are projected to increase significantly in the future. This fiscal year alone, the City paid approximately $156 million into both retirement plans. The retirement contributions for Fiscal Year 2010-2011 approved by the Retirement Boards for the City and employees are listed below.

Fiscal Year 2010-2011 Retirement Contributions[11]						
	Federated		**Police**		**Fire**	
	City	Employee	City	Employee	City	Employee
Pension	23.18%	4.54%	38.32%	9.81%	40.24%	10.09%
Health	6.41%	5.76%	6.26%	5.76%	3.92%	3.61%
TOTAL	**29.59%**	**10.30%**	**44.58%**	**15.57%**	**44.16%**	**13.70%**

Unfunded Liabilities

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.

The current unfunded liability under both calculations is detailed in the charts below.

Pension Unfunded Liability As of June 30, 2010			
	Federated	**Police and Fire**	**Total**
Market Value	$1.0 billion	$1.0 billion	$2.0 billion
Actuarial Value	$0.78 billion	$0.65 billion	$1.43 billion

Retiree Healthcare (OPEB) Unfunded Liability As of June 30, 2010			
	Federated	**Police and Fire[12]**	**Total**
Market Value	$0.82 billion	TBD	TBD
Actuarial Value	$0.82 billion	TBD	TBD

The San Jose Municipal Code provides that the City, and ultimately the taxpayers, are responsible for 100% of the unfunded liability for the pension benefit. The retiree medical liability, however, is shared 50/50 between the City and employees.

The Federated Plan amortizes the existing unfunded liability over 30 years, and any additional actuarial gains or losses over 20 years. The Police and Fire Plan amortizes the existing unfunded pension liability over 16 years.

[11] Retirement Board adopted rates. They do not include the discount for the City because of the annual prepayment of the retirement contributions. In addition, it should be noted that several employee units have agreed to pay a portion of the City's retirement contributions.
[12] The June 30, 2010, OPEB (retiree healthcare) valuation has not been completed. It is anticipated that the report, including the contributions will be available in February.

As the City considers alternative retirement benefits for new employees, any changes for new employees will **not** reduce the unfunded liability that already exists. The City is ultimately responsible for 100% of the existing unfunded liability for the pension benefit.

Funding Ratios

When a retirement plan is considered "fully" or "100%" funded, it means that the assets are equal to the liabilities. As a result of the significant unfunded liability, funding ratios for both plans have fallen significantly. The current funding ratios for both retirement plans are detailed in the following chart:

Retirement Funding Ratios As of June 30, 2010		
Pension	**Federated**	**Police and Fire**
Market Value of Assets	60%	69.1%
Actuarial Value of Assets	69%	79.8%
Retiree Healthcare (OPEB) Plans	**Federated**	**Police and Fire**[13]
Market Value of Assets	12%	TBD
Actuarial Value of Assets	12%	TBD

Changes to Actuarial Assumptions and Methodologies

The City's contributions to the retirement plan are established by the retirement boards, based on annual actuarial reports, and are based on many factors, including the cost-sharing arrangement between the City and employees and the level of benefits provided. Increases in the City's contribution rates can occur for various reasons, including retirement benefit enhancements.

To project the cost and liabilities of the plans, assumptions are made, and each year actual experience is compared against the projected experience. If assumptions are changed, contribution requirements are adjusted to take into account a change in the projected experience in future years.

It is important that realistic actuarial assumptions are used. The Boards need to adhere to funding policies that are based on sound actuarial methods to avoid intergenerational transfers of benefit costs. In the report dated November 22, 2010, prepared by The Segal Company, the Police and Fire Department Retirement Board's actuary states:

> *"The use of realistic actuarial assumptions is important to maintain adequate funding, while fulfilling benefit commitments to participants already retired and to those near retirement. The actuarial assumptions do not determine the "actual cost" of the plan.*

[13] The June 30, 2010, OPEB (retiree healthcare) valuation has not been completed. It is anticipated that the report, which will include the funding ratios will be available in February.

> *The actual cost is determined solely by the benefits and administrative expenses paid out, offset by investment income received.* ***However, it is desirable to estimate as closely as possible what the actual cost will be so as to permit an orderly method for setting aside contributions today to provide benefits in the future, and to maintain equity among generations of participants and taxpayers."*** *(Emphasis added.)*

In order to address this objective, both retirement boards have made revisions to actuarial assumptions and methodologies for the pension valuations that will be used to establish the City and employee retirement contributions for Fiscal Year 2011-2012.

In analyzing the potential cost savings of a 2nd Tier of retirement benefits for new employees, it will be important to utilize realistic actuarial assumptions since overly optimistic assumptions may overstate the potential cost savings.

Earnings Assumption (Investment Rate of Return)

The investment rate of return is the estimated average future net rate of return on current and future assets of the retirement plan as of the valuation date. This rate is used to discount the actuarial liability for each plan, and is one of the most important assumptions.

The Federated City Employees' Retirement System Board recently approved changing its decision to phase-in the earnings assumption from a five-year period to a three-year period which now ends with the June 30, 2011, valuation. The earnings assumption will be 7.95% for the 2010 valuation, which is used to establish the retirement contribution rates for Fiscal Year 2011-2012 and 7.75% for the 2011 valuation, which will be used to establish the retirement contribution rates for Fiscal Year 2012-2013.

The Police & Fire Department Retirement Board also recently lowered the current earnings assumption from 8.0% to 7.75% for the 2010 valuation, which is used to establish the retirement contribution rates for Fiscal Year 2011-2012. The Police and Fire Department Retirement Board has also decided to lower the earnings assumption to 7.50% for the 2011 valuation, which would be used to establish the retirement contribution rates for Fiscal Year 2012-2013.

In addition, because assets are smoothed and the full investment losses from the 2008-2009 market downturn have not been recognized yet, the contribution rates are expected to increase for the next several years assuming investment returns meet the assumed rate of return and all other actuarial assumptions are met.

The earnings assumption actuarial change was made to each plan to more closely align expected rates of return to actual investment rates of return. This new change will result in the City experiencing an increase in retirement contributions for Fiscal Year 2011-2012. Based upon the actuarial reports, the boards may be making further changes to the earnings assumptions. For example, in its November 22, 2010 report, The Segal Company's model produces a net investment return of 6.93%, which is significantly lower than the current assumption.

If the investments do not result in earnings that are at least as much as the assumptions set by the Boards, it results in an unfunded pension liability that must be entirely paid by the City, and ultimately the taxpayers. For example, the Police and Fire Department Retirement Board will now assume that the plan will earn a net rate of return of 7.75% on investments and the Federated City Employees' Retirement System Board will assume a net rate of return of 7.95%. The City is 100% responsible for any pension unfunded liability for pension benefits that are created when investments result in earnings less than the assumptions. There is no investment risk to employees or retirees for the pension benefits they receive. Ultimately, taxpayers bear 100% of the risk.

Payment of Annual Required Contribution (ARC)

Currently, the Boards' actuaries perform annual valuations and calculate retirement contribution rates (this calculation is based on estimated payroll data). The Boards adopt the retirement contribution rates to be effective the following fiscal year and the City and employees are notified of the new retirement contribution rates.

For example, the calculation for the City and employee retirement contribution rates for the current fiscal year were based on estimated payroll from Fiscal Year 2008-2009. The estimated payroll for the current fiscal year, however, is quite different due to the elimination of over 350 positions in all funds from the 2008-2009 Adopted Budget to the 2009-2010 Adopted Budget and close to 800 positions in all funds from the 2009-2010 Adopted Budget to the 2010-2011 Adopted Budget. Since the estimated payroll is significantly different from the actual payroll currently experienced and since the retirement contributions are based on a percentage, during times of organizational contraction, the actual contribution to the retirement plans is less than anticipated by the plan's actuaries.

The Federated Board adopted a policy setting the ARC to be the greater of the dollar amount reported in the actuarial valuation (adjusted for interest based on the time of the contributions) or the dollar amount determined by applying the percent of payroll contribution reported in the actuarial valuation to the actual payroll for the fiscal year. This policy will be effective for the Fiscal Year 2011-2012 contributions to the plan, subject to amendments to the Municipal Code.

Due to the contraction in City positions, with this newly adopted contribution methodology, the City would be required to pay a minimum dollar amount regardless of actual payroll experienced to ensure that the plans are funded in accordance with the annual actuarial valuation. Please note that this policy does not affect the employee contributions to the plan, which creates an increase of the unfunded liability.

The Federated Board's Actuary, Cheiron, indicated in its December 2010, report that:

> *"[t]he decision to characterize the ARC as a dollar amount, but not less than the floor amount will lead to a sounder funding of the plan as this approach:*

- *Ensures that the UAL amortization payment will be made whenever actual payroll is lower than anticipated, and*
- *Avoids potential underfunding of the plan when reductions in force take place that increase the normal cost rate, and*
- *Ensures that the normal cost payment will be made whenever actual payroll is greater than anticipated."*

The adoption of this revised funding policy will require the City to plan its budget accordingly for Fiscal Year 2011-2012 and future years.

The Police and Fire Department Retirement Board made a similar change in methodology at its January 2011 Board meeting.

2011-2012 Retirement Contribution Rates[14]

The following chart provides the contribution rates that were recently approved by the Boards for each plan.[15] It should be noted that five employee units have agreed to continue to pay a portion of the City's pension unfunded liability contributions on an ongoing basis.

Federated City Employees' Retirement System			
Pension	City	Employees	Total
Normal Cost	12.76%	4.68%	17.44%
Unfunded Liability – Prior Service Cost	15.58%	0%	15.58%
Subtotal	**28.34%**[16]	**4.68%**	**33.02%**
Medical and Dental	7.16%	6.51%	13.67%
Total	**35.50%**	**11.19%**	**46.69%**

Police and Fire Department Retirement Plan (Police)			
Pension	City	Employees	Total
Normal Cost	27.69%	10.38%	38.07%
Unfunded Liability – Prior Service Cost	22.09%	0.08%	22.17%
Subtotal	**49.78%**[17]	**10.46%**	**60.24%**
Medical and Dental[18]	6.26%	5.76%	12.02%
Total	**56.04%**	**16.22%**	**72.26%**

[14] The June 30, 2010 OBEB (retiree healthcare) valuation for the Police and Fire Department Retirement Plan has not been completed. It is anticipated that the report, including the contributions will be available in February. The rates in the charts do not include the discount rate that would be applied if the City prepays the retirement contributions.
[15] These rates do not include the discount rate for the City because of the prepayment of retirement contributions.
[16] Before applying the charge to reduce the contribution rate by 0.49% of pay for 2011-2012 only.
[17] Before applying the charge to reduce the contribution rate by 0.49% of pay for 2011-2012 only.
[18] Medical and Dental rates for the City and Employees are for Fiscal Year 2010-2011. It is anticipated that the Fiscal Year 2011-2012 rates will be available in February.

Police and Fire Department Retirement Plan (Fire)			
Pension	City	Employees	Total
Normal Cost	28.53%	10.70%	39.23%
Unfunded Liability – Prior Service Cost	23.01%	0.06%	23.07%
Subtotal	**51.54%**	**10.76%**	**62.30%**
Medical and Dental	3.92%	3.61%	7.53%
Total	**55.46%**	**14.37%**	**69.83%**

It is also important to note that the City will need to plan for the recent change adopted by the Boards discussed above that may require a dollar amount contribution that is higher than the contribution rates. It is projected that the retirement contributions will continue to increase beyond those that have been approved for Fiscal Year 2011-2012.

Due to the significant cost to the City, alternatives for creating sustainable retirement benefits are necessary. The current retirement benefits are not fiscally sustainable, and as the City Auditor concluded, rising pension costs threaten the City's ability to maintain service levels. The costs are diverting limited resources from direct service delivery to the community. Any new system or 2nd Tier should be sustainable for taxpayers and the City.

Alternatives for 2nd Tier Retirement Benefits for New Employees

Alternatives for 2nd Tier retirement benefits for new employees can include any one of the following:

Defined Contribution Plan: This type of plan provides an individual account for each participant. The benefits are based on the amount contributed into the plan and are also affected by income, expenses, gains, and losses. There are no promises of a set monthly benefit at retirement. Some examples of defined contribution plans include 457 plans, 401(k) plans, 403(b) plans, employee stock ownership plans, and profit sharing plans.

Defined Benefit Plan: This type of plan guarantees the participant a specific monthly benefit at retirement. Monthly benefits may be a specific amount or may be calculated through a formula that considers a participant's salary and service. Unlike defined contribution plans, the participant is not required to make investment decisions and has no investment risk.

Hybrid: This type of plan may include characteristics of both a defined contribution plan and a defined benefit plan.

Social Security: Employers are mandated to be in Social Security unless they are in a qualified public retirement system. The City does not participate in Social Security, but would be required to do so if the City did not participate in a qualified public retirement system. For new employees, the City could consider participating in Social Security in lieu of a qualified public retirement system.

According to information found on the Social Security website, http://www.socialsecurity.gov/pubs/10035.html#retirement, approximately 96 percent of U.S. workers are covered under Social Security. Therefore, Social Security is part of the retirement plan of almost every American worker. The current retirement age to receive full Social Security benefits is 67. However, individuals are eligible to receive Social Security retirement benefits as early as age 62, but if an individual retires before full retirement age, the benefits will be reduced based on age.

Currently, employers and employees participating in Social Security each contribute 6.2% into Social Security through payroll deductions, for a total of 12.4%.[19] For 2011, the maximum taxable earnings amount for Social Security is $106,800.[20] The maximum benefit depends on the age a worker chooses to retire. For a worker retiring at age 66 in 2010, the monthly maximum amount is $2,346 ($28,152 annually).

In addition to Social Security, individuals age 65 or older are eligible for Medicare.[21] Medicare is financed by a portion of the payroll taxes paid by workers and employers. Medicare has four parts: Hospital Insurance (Part A), Medical Insurance (Part B), Medicare Advantage (Part C), and Prescription Drug Coverage (Part D). Information on Medicare benefits can be found at: http://www.ssa.gov/pubs/10043.html#part1. Medicare's Hospital Insurance Program has no limitation on taxable earnings. Tax rates under the Medicare program are 1.45% each for employees and employers.

Recommendations for 2nd Tier Retirement Benefits for New Employees

It is recommended that the City Council direct the City Manager to achieve 2nd Tier pension and retiree healthcare benefits that consider the alternatives noted above, but do not exceed a normal cost to the City and employees of 12.4% of pensionable pay for new employees, equivalent to the Social Security contribution.

If a defined benefit plan or hybrid plan is considered, the following factors should be considered:

Cost Sharing – Pension Unfunded Liability

The pension cost sharing between the City and employees should be re-evaluated, so that the City and taxpayers are not responsible for paying 100% of any unfunded liability which may develop in the future. Future unfunded liabilities in a 2nd Tier should be shared equally between the City and employees.

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[19] As part of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, there will be a temporary one year cut in employee payroll taxes. The current rate is 6.2%, which will be 4.2% of wages paid in 2011.
[20] Source: http://ssa-custhelp.ssa.gov/app/answers/detail/a_id/240/kw/employer%20contribution%20to%20social%20security
[21] The City does participate in Medicare for employees hired on or after March 31, 1986, with the City and employees each paying 1.45%.

Cost of Living Adjustment (COLA)

The current benefit is a 3% COLA that is guaranteed to all retirees in the plans ever year, regardless of the actual change in the consumer price index.

Any new COLA should be tied to the consumer price index with a maximum of less than 3% and consideration should be given to the funding ratios of each plan when providing a COLA.

Retirement Age

In the Auditor's Report on Pension Sustainability, the report identified the City's retirement age to be one of the largest cost drivers. The current Social Security retirement age to receive the maximum benefit is 67; however Social Security allows individuals to retiree at the age of 62 with a reduced benefit. The City should consider increasing the retirement age for full benefits for each plan or require an actuarial reduction in benefits paid prior to full retirement age.

Pension Formula

The pension formula determines how the actual benefit is calculated. Federated plan members are eligible to receive a maximum benefit of 75% of final compensation. Police and Fire plan members are eligible to receive a maximum benefit of 90% of final compensation.

Any new benefit that considers a defined benefit plan should provide a reduced maximum benefit that is more affordable and provides long-term sustainability.

Determination of Final Compensation

An employee's final compensation is a key factor in determining their monthly pension. The calculation of the final compensation is currently based on the highest 12-month average compensation. Reverting to the highest three-year average compensation should be considered, as it will reduce costs in the long-term and minimizes the potential for pension "spiking."

In addition, the Federated City Employees' Retirement System provides that a retiree's pension is based on the highest annual salary an employee could have earned, even if the employee did not actually earn the full year's salary. This provision should be revised so that pensions are calculated based on the salaries that are actually earned.

Retirement Service Credit

The Federated City Employees' Retirement System provides one year of retirement service credit after earning 1,739 pensionable hours. Full-time employees typically have 2,080 pensionable hours per year, and both the City and employees make retirement contributions on all 2,080 hours. This provision should be revised to provide one year of retirement service credit after earning 2,080 pensionable hours.

Minimum Service Requirements (Vesting)

A minimum of 5 years of service is required in the Federated plan in order to receive pension benefits. In the Police and Fire plan, active members need a minimum of 20 years in order to retire. Consideration should be given to revising the minimum service requirements.

Joint and Survivor Benefits

Spouses or domestic partners are eligible for survivorship benefits under the provisions of both retirement plans. Surviving children are also provided benefits if they are minors or students. This benefit should be evaluated to determine if there are any cost saving opportunities compared to the structure of the current benefits.

Retiree Healthcare Benefit

The level and eligibility for retiree healthcare benefits are contained in the San Jose Municipal Code as part of the retirement plans. Generally, employees are eligible for retiree medical insurance coverage at fifteen (15) years of service.

For eligible retirees, the benefit provides for 100% of the premium cost for the lowest priced plan available to active employees for either single or family coverage. This is a better benefit than is provided to active employees who pay a portion of the premium.

This is a significant cost that is paid by the employees and the City. A revised retiree healthcare benefit should be provided for new employees that is more cost effective and sustainable. Consideration should be given to amending the maximum benefit levels and eligibility requirements.

Cost Sharing – Retiree Healthcare

Contributions for retiree medical benefits are made by the City and the employees in the ratio of one-to-one (50/50 split). The current cost sharing for retiree healthcare unfunded liability should be maintained for new employees.

In addition, when retirees are Medicare eligible, they should be required to enroll in Medicare Part A and B at the time of eligibility.

The Police and Fire Department Retirement Plan reimburses retirees for Medicare Part A and B. This is a cost incurred by the retirement Plan. Consideration should be made to eliminate reimbursement of Medicare Part A and B.

Retiree Dental Benefit

The plans currently provide retiree dental benefits at the time of retirement. It is not common for public entities to provide retiree dental benefits. The City should revaluate this benefit, including the eligibility requirements.

Retroactive Disability Retirement Applications (Police and Fire Department Retirement Plan)

Currently, employees who file an application for a regular service retirement in the Police and Fire Department Retirement Plan are eligible to request a retroactive disability retirement if an application is filed within one year after retirement. For example, if an employee retires on a service retirement, the retiree can return within one year **after they retired** and change the status from a service retirement to a disability retirement. This requires a retroactive determination of the retiree's disability and their ability to continue to work. Consideration should be made to preclude future retirees from requesting a change in status from a service retirement to a disability retirement after an employee has retired.

Other Reforms

As approved by the City Council on November 18, 2010, retirement reform will also need to include:

- Options for current employees: The City will explore what can be changed in the existing retirement benefits (pension and retiree healthcare) for current employees and future retirees.

- Supplemental Retiree Benefit Reserve (SRBR) or "13th Check": The City will explore modifying and/or eliminating the SRBR program.

- Workers' Compensation Offset in the Police and Fire Retirement Plan: Police and Fire members of the retirement plan are eligible to receive their full pension, without any offset for workers' compensation benefits they may be receiving. The City should pursue a workers' compensation offset.

CONCLUSION

The fiscal health and cost of the current retirement plans is a very significant concern. Retirement reform is necessary for the long-term sustainability of the City's retirement plans. Providing reasonable retirement benefits that are cost effective and sustainable in the long term are important, but most importantly, retirement reform is needed to continue services to the community.

EVALUATION AND FOLLOW-UP

It is very important to remain mindful that any proposed changes must be discussed as part of the negotiation process with the City's bargaining unit representatives. When the negotiation processes have been concluded, any result will be brought to the City Council in open session for approval.

PUBLIC OUTREACH/INTEREST

- ☐ **Criteria 1**: Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**
- ☐ **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- ☐ **Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This item will be placed on the January 25, 2011, Council Agenda and the memorandum will be available to the public on the City's website.

COORDINATION

This memorandum was coordinated with the City Manager's Budget Office, the Department of Retirement Services and the City Attorney's Office.

In advance of the January 25, 2011, City Council meeting, copies of this memorandum will be provided to the bargaining unit representatives and members of the Executive Management (Unit 99) Forum.

CEQA

CEQA: Exempt.

Debra Figone
City Manager

For questions please contact Alex Gurza, Director of Employee Relations, at (408) 535-8150.