

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Retirement Stakeholder
Solutions Working Group

**SUBJECT: RETIREMENT STAKEHOLDER
SOLUTIONS WORKING GROUP
FINAL REPORT**

DATE: Month Day, Year

Approved

Date

INFORMATION

Retirement Stakeholder Solutions Working Group Final Report

INTRODUCTION

In the March 2019 Mayor's Budget Message, the Mayor recommended convening stakeholders to address retirement fund resilience based on the serious challenges that the City may face from increasing retirement costs. A review of the City's annual contributions to the pension and retiree healthcare plans showed that the contribution rates were growing faster than the City's revenue growth, and that these contribution rates were competing with our City services and program for money in the General Fund. The Mayor recommended asking key stakeholders to explore options to address the increasing costs in a public setting to promote a shared understanding of challenges ahead and evaluations of any ideas that the stakeholders may bring forward. The Retirement Stakeholder Solutions Working Group began meeting in November 2019. The members included

- Mayor Sam Liccardo
- Councilmember Raul Peralez
- Councilmember Dev Davis
- Councilmember Pam Foley
- Tim Bussey, Silicon Valley Organization
- Jay Castellano, Federated Retirement Board
- Julia Cooper, Finance Director
- Susan Devencenzi, San Jose Retired Employees' Association
- Julie Jennings, CAMP
- Sean Kaldor, IAFF Local 230
- Paul Kelly, Police Officers Association
- Drew Lanza, Police and Fire Retirement Board
- Elaine Orr, Federated Retirement Board

- Roberto Pena, Director of the Office of Retirement Services/CEO
- Prabhu Palani, Assistant Director of the Office of Retirement Services/CIO
- Jim Shannon, Budget Director
- Ray Storms, Association of Retired Police and Fire Personnel
- Vince Sunzeri, Police and Fire Retirement Board
- John Tucker, MEF
- Pat Waite, Citizens for Fiscal Responsibility

The Retirement Stakeholder Solutions Working Group (RSSWG) met eight times over the course of 2019, 2020, and 2021. Please see Appendix A for links to meeting agendas and resources. Due to the COVID-19 pandemic, the RSSWG took a hiatus from meeting to prioritize the City’s emergency response and resumed meeting in October 2020. The RSSWG explored the various avenues to reduce the City’s unfunded pension liability. The RSSWG consulted outside experts, reviewed the [2019 Civil Grand Jury Report](#), and examined previous discussions by the Retirement Boards and the City Council on these topics.

The Retirement Boards and the City Council have had thorough and significant discussions over the last several years regarding investment allocation and the impact that investment allocation will have on returns. These discussions took place on the following dates:

Date	Meeting
May 15, 2018	Joint Meeting of the City Council and Retirement Boards
April 30, 2019	Joint Meeting of the City Council and Retirement Boards
October 16, 2020	Joint Meeting of the City Council and Retirement Boards

After a review of the options, it was determined that several options would not be feasible and did not warrant a further analysis by the group at this time. These included:

- **Reduction of Retirement Benefits** – The City and the City’s bargaining units are currently under a ten-year retirement memorandum of agreement. Any changes or reductions to retirement benefits could not take place until at least 2025 and would require significant negotiations with the City’s bargaining units and may require voter approval.
- **Exploring the actions of the Federal Reserve Bank** – The City and Retirement Boards receive regular updates regarding how the decisions of the Federal Reserve Bank may impact pensions.
- **Exploring Bridge Loans to increase Liquidity** – Liquidity of funds is not currently an issue for the pension systems.
- **Securitizing Public Assets** – The City currently has limited public assets which could be used for this.
- **Establishing a Stabilization Fund** – In order to create a stabilization fund, the City would need to have excess funds in which to create this fund. The City is not currently in a budgetary position where this would be feasible.

- **Monthly Employer Contributions** – The City already makes employer contributions. For 2020-2021, Tier 1 pension costs were paid at the beginning of the fiscal year; Tier 2 pension costs and OPEB contributions are made on a monthly basis to the retirement system through payroll.
- **Exploring Plan Consolidation** – This was recommended by the 2019 Civil Grand Jury report. The group did not entertain a lengthy discussion on this option due, in part, to considerations of the different types of memberships and requirements of each retirement plan. If the Council and/or Retirement Boards are interested in this option, a more thorough discussion may be had at a later date.
- **Exploring Auto-Triggers** – Creating auto-triggers may result in a change or reduction to retirement benefits, therefore would need to be negotiated with the City’s bargaining units. As mentioned above, due to the City’s retirement memorandum of agreement, changes cannot be made until at least 2025.

The following topics were determined to be the most beneficial to discuss to stabilize and/or reduce retirement costs:

1. **Investment Fees**
2. **Pension Plan Amortization Schedules**
3. **Lump Sum Buyout**
4. **Pension Obligation Bonds**
5. **Dedicated Revenue Stream**

This report provides the RSSWG analysis of each topic discussed at the meetings with focus given to five lenses to describe the efficacy and achievability of the potential solutions. The five lenses include: feasibility, cost, risk, difficulty to achieve, and impact on the unfunded liability. Each section will include a brief introduction to the topic and a discussion of each of the five lenses.

The analysis of each option is summarized below:

Option	Feasibility	Cost	Risk	Difficulty	Impact on UAL
Investment Fees	Achievable	Neutral	Low	Low to Medium	Not significant
Amortization Schedules	Achievable	Determined over time	Low to Medium	Low	Significant
Lump Sum Buyout	Unlikely	Undetermined	No risk	High	Undetermined
Pension Obligation Bonds	Achievable	Determined over time	High	Moderate	Significant
Dedicated Revenue Stream	<i>New Tax:</i> Unlikely <i>Existing Revenue Stream:</i> Achievable	<i>New Tax:</i> Moderate <i>Existing Revenue Stream:</i> Low	<i>New Tax:</i> Low <i>Existing Revenue Stream:</i> Low	<i>New Tax:</i> High <i>Existing Revenue Stream:</i> High	<i>New Tax:</i> Unlikely <i>Existing Revenue Stream:</i> Significant

ANALYSIS

Investment Fees

Background: This topic was first addressed in the March 2019 Budget Message as “Investment Fee Drag”. During the February 2020 RSSWG meeting, Prabhu Palani, Chief Investment Officer of Retirement Services, gave a presentation on the difference between active investment management and passive investment management. Active investment managers typically have a higher cost than passive investment managers because the managers take a hands-on approach to be able to take advantage of opportunities that arise daily in the markets. The Retirement Boards and City Council have discussed the topic of “Investment Fee Drag” for several years and the Boards have made significant progress in reducing investment fees where possible.

Fees are as much a function of asset allocation as they are of the active vs passive decision. While the asset allocation adopted by the boards does include higher-fee private strategies, this has been determined to be the optimal approach to managing pension assets, in light of the plans’ discount rate, the extraordinarily low level of current interest rates, and the accompanying risk reduction afforded by managing a well-diversified portfolio. The rationale for the plans’ asset allocation has been discussed at several public meetings including the joint meetings of the City Council and Retirement Boards in the last few years, as noted above.

Topic of Discussion: The question arose as to whether the funds would save money on management fees if more passive investments and investment managers were utilized. The presentation included the active versus passive allocations for both plans.

Active vs. Passive Allocations as of 12/31/2018

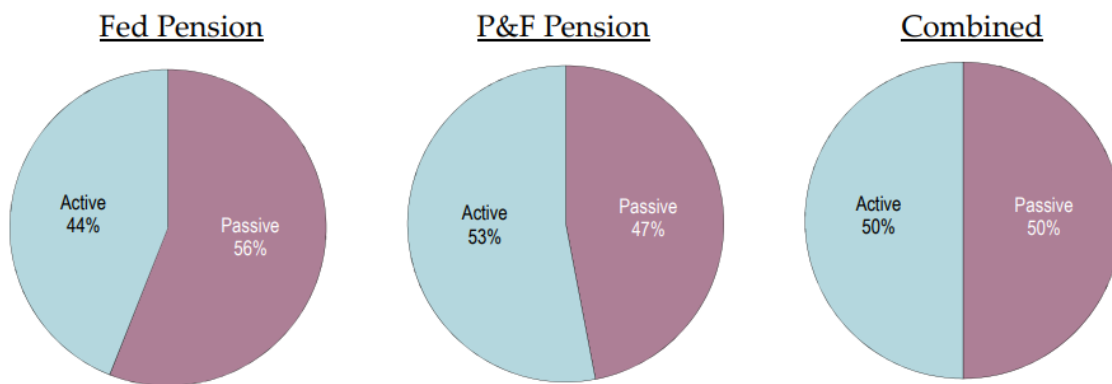


Figure 1. January 13, 2020 - Meketa Investment Group

Analysis:

I. Feasibility

The City’s two independent retirement systems have boards of administration (Boards) that have the fiduciary responsibility to administer the pension plans. As part of their fiduciary duty, the Boards make investment decisions on behalf of the pension beneficiaries.

If the Boards chose to change the direction of the current investment structure, they would be able to do so through the Investment Committees’ recommendations. As an aggregate 50% of the total investments are currently with active managers, there would be some logistical challenges of when and how to move the funds from the current active investment to passive investments. However, the investment asset allocation is routinely scrutinized for maximum efficiency, and it is plausible that the Boards could make the change to more passive investments on an incremental basis.

Determination: Achievable

II. Cost

The cost to change the investment allocation would depend on several factors related to market timing of making changes to the investment allocation. The active manager strategy allows the City’s retirement funds to be invested in several alternative strategies that require active management such as real estate and private equity. Losing access to those common alternative strategies may result in a loss of market returns. However, it would also result in reduced fees. In calendar year 2019, the total spent on investment fees was \$60.1 million.

The table below shows the what the plans’ total market values would have been if no active managers were used to achieve the target asset allocation in the prior ten-year period. The savings from the active managers’ fees would likely also result in a loss of returns.

What Total Market Value and Funded Ratio Could Have Been¹

	As of September 30, 2019	
	Federated	Police and Fire
Actual Portfolio Value	\$2,129,249,945	\$3,647,566,683
Actual Funded Ratio	50.7%	73.1%
10 - Year Investable Benchmark Portfolio Value	\$2,068,251,504	\$3,722,145,150
10 - Year Investable Benchmark Funded Ratio	49.2%	74.6%

Figure 2. January 13, 2020 - Meketa Investment Group

Cost savings: Neutral – reduction in investment fees may result in reduced market returns so there is no apparent advantage in an asset allocation of only passive managers.

III. Risk

The topic of risk is inherent when discussing information related to investments. When reviewing the risk related to investments fees and investment managers, the risk is associated with the cost of using active investment management services instead of passive management services, and in determining if the plans are not achieving their expected returns because of the choice to use more active management services. The analysis that was provided by the Office of Retirement Services investment team is that the City would have not seen as high of returns if only passive management had been used (Figure 2). Although the returns would have been lower, the difference is not significant. As such, it appears that using a different investment method would not result in significant differences in investment returns, and the risk of losing a large percentage of fund is low.

Determination: Low risk

IV. Difficulty

The implementation of this change would likely take several Board meetings, but it would be achievable if approved by each Board. The change to passive managers would also require the Boards to be thoughtful about the timing of placing money into different asset allocations in order to time the market.

Determination: Low to medium difficulty depending on Board approval and market timing.

V. Impact on Unfunded Liability

Total investment fees for the plans were \$67.6 million in calendar year 2017. The Retirement Boards' actuary, Cheiron, conducted an analysis of the calendar year 2017 investment fees and determined that for every \$1 million reduction in investment fees, the City contributions would decrease by approximately \$20,000. This would lead to an approximate decrease of \$1.2 million per year if investment fees were reduced to \$0. \$1.2 million is fairly insignificant in light of the City's total annual contribution of \$240 million toward the unfunded liability.

While the investment fees would be reduced with an asset allocation more heavily weighted toward passive investment management, the analysis shows that this change would not reduce the City's contribution to the retirement plans in a significant way.

Determination: Not significant.

Pension Plan Amortization Schedules

Background: The topic of amortization schedules was discussed during the January 2020 RSSWG meeting with an accompanying presentation by Bill Hallmark from Cheiron. Cheiron is

the Boards' actuary and each year they make actuarial determinations of the retirement plans' future liabilities and assets. The actuaries set the annual determined contribution needed to fund the retirement plans in the future. Based upon a set of assumptions, the actuary calculates if there is a difference between the expected growth of assets and the future liabilities (or future benefits) that will be paid out of the retirement system. The difference between the assets and liabilities is called the unfunded actuarial liability.

The amortization methods determine the amount, timing, and pattern of payment of the unfunded actuarial liability. They represent a payment plan for the retirement system to get to the funding target of 100% funded – meaning that the assets can cover expected future benefit payments. The Boards approve the amortization methods on an annual basis when approving the actuarial valuation. One of the decisions that can be made is the length of amortization period. The amortization period can be made shorter or longer. In the case of a shorter amortization period, the plan will generally remain closer to 100% funded because any deviations are made up over a shorter period. However, contributions will also be more volatile and higher when there is an unfunded liability. In the case of a longer amortization period, the plan may stray further from being 100% funded, but contributions will be more stable and lower payments will be required for an unfunded liability. These layers can be adjusted to stabilize the City's contributions. Smoothing of these layers was not fully discussed by the RSSWG and may be further discussed by Council if there is interest.

The City's two retirement plans currently use layered fixed period amortization periods. This means that there are closed amortizations for each year and that there are separate amortization periods for gains/losses, assumption changes, and benefit changes.

Topic of Discussion: The question arose as to whether the length and structure of the amortization periods should be changed to lessen the City's contributions to the retirement plans.

Analysis

I. Feasibility

The two Boards can make changes to the amortization periods during the annual actuarial valuation assumption approvals. In the recent past, the Boards have approved minor changes to the length of different amortization period for the gains/losses of the plans. For example, the Police and Fire Board approved a change to the 2005 amortization period to extend the amortization by one (1) year. This allowed for the costs of other assumption changes, such as lowering the discount rate, to be mitigated through the smoothing of the future payments related to the gains/losses and benefit changes of 2005.

Determination: Achievable

II. Cost

While there are no upfront cash costs to changing the amortization schedule of a retirement plan, the costs come in the form of changes to the City's annual contributions.

- Shorter Amortization Period – As discussed above, shortening the length of an amortization period can increase costs in the short-term because the payments are due more quickly. For example, if an amortization period was 30 years, but then it is changed to 15 years, the payments are bigger to accommodate the new timeframe. This allows costs to be reduced in the years after the end of the amortization period. However, shorter amortization periods may cause heightened volatility in City contributions.
- Longer Amortization Period – As discussed above, increasing the length of an amortization period can decrease the annual contribution amount in the short-term because the retirement plans would then have a longer time to achieve their funding targets. However, increasing the amortization period increases the total contributions needed due to interest charges over a longer period of time.

Cost savings: Determined over time. Cost savings can only be determined over length of time of the chosen amortization schedule.

III. Risk

The risk associated with changing amortization periods also depends on the length of the amortization period, and in this case, the risk is tied to the plan sponsor's ability to pay its actuarially determined contribution. There is more risk associated with a shorter amortization period because large actuarial losses can result high costs that the plan sponsor has a shorter time to repay. Whereas a longer amortization period allows for actuarial losses to be spread out over several years, so increased costs are spread over a longer period.

If the plan sponsor can afford to pay increased costs over a shorter period, there is less risk associated with the amortization methodology change. Additionally, this change can result in less unfunded liability associated with the plan.

Determination: Low to medium, depending on the plan sponsor's ability to pay the associated costs

IV. Difficulty

The Boards have the fiduciary responsibility to approve the assumptions for the annual actuarial valuations. The amortization periods can be adjusted with the approval of the Board of each retirement plan. As these decisions typically occur on an annual basis, it would only take a majority vote of each Board to make amortization changes.

Determination: Low difficulty based on Board approval.

V. Impact on Unfunded Liability

The degree of success of lowering the unfunded actuarial liability will depend on the type of amortization period change that would be approved by the Boards.

- Shorter Amortization Period – The City would be able to pay down the unfunded actuarial liability faster, but the change would cause a significant impact to the City’s General Fund. This would limit the different programs and services offered by the City as a trade off to paying down the unfunded actuarial liability faster. If any of the assumptions are not met, the cost could significantly increase.
- Longer Amortization Period – By increasing the length of the amortization period, the City would be increasing the unfunded actuarial liability as more interest gets added to the retirement plan the longer the principal is not paid off. While this does decrease the annual retirement contributions, it increases cost over the life of the plan. This can cause intergenerational transfers of debt.

Determination: May be significant but requires a balance of available funds and risk tolerance.

Lump Sum Buyout

Background: During the February 2020 RSSWG meeting, the topic of lump sum buyouts was discussed. A lump sum buyout is a program that is designed to pay a retired or deferred vested employee an actuarially determined amount in lieu of that retired individual receiving a monthly pension or retiree healthcare benefits. The lump sum can be for the entire pension benefit or a portion of the pension benefit. For example, there are jurisdictions who provided a lump sum in lieu of retired individuals receiving the guaranteed annual Cost-of-Living Adjustment (COLA). There is typically a set election period for the opt-in to the program to take place, and the individuals can take the amount as a lump sum or rollover into an eligible retirement savings plan. This idea was discussed based on two different case studies of state pension systems: Illinois and Missouri.

In Missouri, the State Legislature passed legislation to allow former employees to make a one-time election to receive a lump sum payment equal to a percentage of the present value of the former employee’s deferred pension benefit. Members had to be a deferred vested former employee of the Missouri State Pension System. The buyout payment was equal to sixty percent (60%) of the present value of the member’s deferred normal retirement annuity. In total 25.7% of the eligible vested former state employees elected to buyout. This resulted in a \$41 million reduction in the actuarial liability.

In Illinois, two voluntary buyout plans were available to retirees and deferred vested members. The first was an automatic annual increase buyout, in which a retiring Tier 1 member could trade the 3% compounded COLA for 1.5% increases on the base pension amount and 70% of the

difference between the value of the two COLAs. The second buyout was for inactive deferred members in their Tier 1 and Tier 2. These members could elect 60% of the current value of their pensions as a lump sum payout. The buyouts only delivered 3% of projected savings, with General Fund saving of \$13.1 million. Most of those savings were based on the COLA buyout.

Topic of Discussion: The question arose as to whether a pension lump sum buyout would work in the City of San Jose and if it would effectively reduce costs.

Analysis

I. Feasibility

Changes in retirement benefits, including buyouts, must be negotiated with City bargaining units before implementation. The City currently has 11 bargaining units that represent City employees, and negotiations would need to take place with each unit should this change be applicable to the Police and Fire Retirement Plan and the Federated City Employees Retirement System. In 2015, the bargaining units agreed to a ten-year retirement Memorandum of Agreement known as the Alternative Pension Reform Frameworks (“Frameworks”), therefore the City will be unable to negotiate any additional changes to benefits until at least 2025. Based on those recent retirement reform negotiations, these discussions would likely be complex and lengthy. The buyout producing savings if less than 100% of the actuarial value of benefits is offered, so members must be willing to agree to take less than they would have received over the lifetime of their pension. Since it would be a negotiated benefit, even if a low number of members would opt-in to the program, it must be implemented. This raises a question if the savings would be worth the effort and cost put into creating the lump sum buyout program.

Determination: Unlikely to achieve

II. Cost

The cost of a lump sum buyout is determined by the structure of the program and the number of eligible members who opt-in. For example, the COLA buyout is likely less expensive than the pension benefit buyout and depends on who takes the benefit.

Retirement costs would be reduced from an annual retirement contribution perspective because the actuarial liability of those who choose to opt-in would be decreased. If enough members take the lump sum, there could be a significant reduction in the unfunded actuarial liability.

In order to fund the buyout, agencies have used funds that are already in pension trusts or pension obligation bonds.

Cost Savings: Undetermined. Significant retirement costs reductions would require a high number of employees to opt-in to the buyout in order for the unfunded actuarial liability to decrease. This would require the City to have significant cash on hand to pay the lump sums.

III. Risk

Lump sum buyout programs are designed to de-risk a pension plan by transferring the defined benefit obligations into upfront cash payments. The plan participant then assumes the risk that they will have sufficient funds to cover the length of their retirement. Even if less people opt-in to the lump sum program than initially expected, the retirement plan does not incur any negative actuarial losses from individuals leaving the plan. In fact, the plan would likely see a small actuarial gain from individuals foregoing a lifelong annuity.

Determination: No risk

IV. Difficulty

The lump sum buyout program depends on several factors being successful for the program to conclude with significant savings to the unfunded actuarial liability. The program would have to be carefully structured to incentivize participation and elicit approval from the bargaining units. There are no guarantees of who would opt-in to the program so there would need to be educational programs included in the implementation. The reality of “self-selection bias” is also to be considered as it could defeat the potential cost savings of this option. Individual plan members are better able to anticipate their situations. For instance, an individual who will retire young, relatively healthy, and with a long family life expectancy is not likely to take a buyout as it is not likely to be financially prudent for the individual. Alternatively, an individual who plans to retire later in life with underlying medical conditions may choose the buyout and may receive more than if the individual chose to receive monthly annuity payments.

Determination: High difficulty based on each factor requiring success.

V. Impact on Unfunded Liability

As mentioned above, the likelihood of a lump sum buyout decreasing the unfunded actuarial liability would depend on the number of people who opt-in to the program and the impact to the actuarial liability. A high number of members would need to opt-in to create a significant change, and the lump sum would have to be high enough to incentivize members to give up a lifelong annuity but less than 100% of the actuarial value.

Determination: Undetermined. Only significant if a high number of members opt-in and the value of the lump sum is less than 100% of the actuarial value of the benefit.

Pension Obligation Bonds

Background: Pension Obligation Bonds are bonds issued by a government sponsor of retirement systems to pay for its obligation to the pension system in which its employees are members. Over the last ten years, approximately \$6.3 billion has been issued in Pension Obligation Bonds nationally and over half were California issuers. Pension Obligation Bonds can potentially save

money for the City by replacing the unfunded liability with lower cost debt owed to bond holders. Pension Obligation Bonds were first explored by the City in 2010 at the direction of then Mayor Chuck Reed to address the rising retirement costs and budget shortfall. At the time, it was concluded that Pension Obligation Bonds were not a viable tool under any scenario to address the City's 2010-2011 budget shortfall. There were a number of risks identified, including a belief at the time that general stock market conditions were not favorable for the issuance of such a bond and there were significant potential financial risks to the City over the long term. The City determined that further exploration of Pension Obligation Bonds would need to occur in the context of a comprehensive look at pension system cost mitigation.

Topic of Discussion: During the October 2020 meeting of the RSSWG, Julia H. Cooper, Director of Finance, and Nikolai J. Sklaroff, Deputy Director of Finance presented an overview of Pension Obligation Bonds. Cheiron also presented information regarding Pension Obligation Bonds. The group discussed the option of preparing Pension Obligation Bond documents for validation in preparation for a possible future bond issuance. During the December 1, 2020 City Council meeting, Council voted to accept the recommendation of the Council's Rules and Open Government Committee to "(a) Initiate the process for possible issuance of pension bond obligation to fund unfunded actuarial liability of the Federated and Police and Fire Retirement Plans" and "(b) Conduct other preparatory work that will enable the Council in 2021 to make a fully informed decision about the merits and risks of this option as a means of reducing our multi-billion-dollar unfunded actuarial liability with an arbitrage strategy in a very low interest rate environment." The City staff has tentatively scheduled this discussion of Pension Obligation Bonds at an April 2021 City Council Study Session and "If Council offers a favorable response after that study session, develop the required documentation for City Council to consider proceeding with the validation and subsequent authorization for the issuance of pension obligation bonds." In accepting the report and approving the recommendation, Council also directed staff to include an analysis of how this has worked in other jurisdictions.

Analysis

I. Feasibility

The bond attorneys rendering legal opinions on such bonds (known as "Bond Counsel") have been requiring that Pension Obligation Bond documents are "validated" in Superior Court, an action that takes approximately 45-60 days from the date of filing. Following this judicial validation, bond rating agencies issue bond ratings and the City can issue the bonds after the end of the 30-day appeal period; there is no expiration of the court validation. Validation by the Superior Court does not obligate the City to issue bonds. The City is very experienced at the bond issuance process.

Determination: Achievable

II. Cost

There are initial consulting costs associated with the court validation process and development of bond documents that the City can be reimbursed for at the issuance of the bonds. If the average actual earning on the invested proceeds exceeds the average borrowing rate on the low interest rate of the bonds, Pension Obligation Bonds will have a positive impact; however, while the borrowing cost is fixed at the time the bonds are sold, the earnings in the pension plans are not.

Cost savings: Determined over time. Cost savings would only be determined after the full maturation of the bond.

III. Risk

While Pension Obligation Bonds can provide significant savings, the issuance of Pension Obligation Bonds may create additional risk for the plan sponsor. The borrowing rate on the bonds will be fixed at the time the bonds are sold and although the City would only want to borrow when borrowing interest rates are lower than the expected return on a pension plan's investments, the earnings will be depend on many factors over the life of the bonds. As with any contribution to the retirement systems, funds contributed by the Pension Obligation Bonds are subject to investment risk and that risk may be more concentrated due to the lump sum investment of bond proceeds.

A Pension Obligation Bond can provide an economic benefit to the plan sponsor and the retirement fund if the actual investment performance of the retirement plan over the life of the bonds exceeds the costs of issuing the bonds. If the funds invested from Pension Obligation Bond proceeds fail to earn more than the interest rate owed over the term of the Pension Obligation Bond, this can result in increased liabilities for the plan sponsor. The City currently makes its actuarially determined payments based on the discount rates determined by the Boards which may be adjusted over time; the interest rate on Pension Obligation Bonds would not have the flexibility of similar rate adjustments.

Depending on when they issued their bonds compared to market performance cycles, some agencies have issued Pension Obligation Bonds only to see sharp declines in the stock market. In these cases, the plan sponsor had to pay back debt service requirements on the Pension Obligation Bond while still dealing with the increased unfunded actuarial liabilities.

Issuing a Pension Obligation Bond is a complex financial decision that can have significant consequences if the invested proceeds do not meet the necessary rate of return over the life of the bond. Although the Federal Reserve has set low interest rates, there is always the possibility of a market recession or economic downturn. In those circumstances, it may be difficult to achieve positive investment returns.

The City has engaged expert advisors to help it study and present these risks to the City Council during the planned Study Session.

Determination: High risk

IV. Difficulty

Pension Obligation Bonds take a significant investment of time to prepare for a successful validation and preparation of the market disclosure and rating agency materials required in order to issue the bonds, but the City is very experienced in bond issuance. Additionally, this would require City Council approval.

Determination: Moderate difficulty assuming Council approval

V. Impact on Unfunded Liability

The success of the Pension Obligation Bond issuance is potentially great provided that bonds are timed well with the market and are issued in an amount sufficient to make an impact on the current unfunded pension liability. Naturally the size of the impact is a matter of choice by the City as well, depending on the size of the bond issue the City chooses to issue. Typically, a government sponsor would not borrow for the full amount of its unfunded liability and the amount of borrowing would be the product of multiple considerations including, among others, the actuarial funding target selected, investor demand for bonds, and decisions on how to limit investment risk by incrementally issuing bonds.

Determination: Significant

Dedicated Revenue Stream

Background: A large portion of the City's General Fund, approximately 20.7% in 2020-2021, is used to pay for retirement costs. Of the \$320.6 million that the City will pay toward retirement costs in 2020-2021, approximately \$204.2 million will be used to pay for the unfunded actuarial liability. On December 14, 2020, the RSSWG explored the idea of identifying dedicated revenue streams to make payments on the City's unfunded pension liability.

Topic of Discussion: During the December 14, 2020 meeting, the City's Budget Director, Jim Shannon presented two options of different sources of revenue that could be dedicated for this purpose: new taxes and the allocation of an existing revenue source, each of which is analyzed below.

Analysis

New Taxes

I. Feasibility

In order to implement a new tax for dedicated purposes, voters must approve the tax by a 2/3 vote. Establishing a new tax or raising taxes solely to fund pension obligations is generally unpopular with voters and therefore, it would be very difficult to achieve a 2/3 vote to implement a new tax for the purpose of paying down the City's unfunded pension liability.

Determination: Unlikely to be achieved

II. Cost

Implementation of a new tax for this purpose would require a ballot measure. While the direct cost to the City is substantial as a one-time expenditure of approximately \$600,000, the cost is moderate in comparison with the City's total budget. If achieved, the amount of money available to pay off the unfunded pension liability would be dependent upon the amount of the tax and the strength of the economy.

Cost: Moderate

III. Risk

The direct risk involved with proposing new taxes through a ballot initiative is if the ballot initiative does not pass with the required approval rate. The direct risk to the plan sponsor is low if the ballot measure does not pass as the City would be in the same circumstance as before. However, a tax measure typically requires significant commitment from political and community leaders to pass.

Determination: Low risk

IV. Difficulty

To implement a new tax, the City would need to place it before voters and a garner a 2/3 vote.

Determination: Highly difficult

V. Impact on Unfunded Liability

As noted above, a new tax requires a 2/3 vote which is a difficult threshold to meet generally, and particularly difficult for funding uses that lack broad advocacy or constituencies.

Determination: Unlikely

Allocation of an Existing Revenue Source

I. Feasibility

The alternative is to identify an existing revenue source that could be dedicated to paying the unfunded pension liability. Existing revenue sources are already accounted for in the general fund base budget. Possible new revenue sources discussed by the group would be taxes in excess of current projections that could be dedicated to the additional paydown of the UAL, such as any additional revenue from any new cannabis businesses and/or the additional revenue associated with the recently increased cardroom tax. The current downturn in the economy due to the Covid-19 pandemic makes this difficult to implement immediately but could potentially provide dedicated revenues when the economy is stronger in the future.

Determination: Achievable

II. Cost

The cost to dedicate the additional increment of an existing revenue source to paying the City's unfunded pension liability is comparatively low, as it would be implemented during the City's existing budget process.

Cost: Low

III. Risk

The incremental increase of funding would need to be incorporated in the retirement plans' investment allocations, but the additional funds would take on the existing risk of the investment plans. Further, increasing the plan sponsor's required payment could cause a decrease in future payments owed to the pension plan. This can decrease the overall risk of the plan.

Determination: Low risk

IV. Difficulty

The allocation of any increased revenue sources to the City is analyzed as part of the City's budget process. There are many competing priorities for City funds to be used for programs and services for the community. While an accelerated paydown of the UAL would yield net savings, the City would need to carefully consider the tradeoff of otherwise allocating those funds to restore services or address budgetary shortfalls. Therefore, it could be difficult to earmark new revenue to pay down the City's unfunded pension liability.

Determination: Highly difficult

V. Impact on Unfunded Liability

The impact of allocating additional revenue from an existing funding source to pay down the UAL could have significant impacts depending on the level of increased contributions. Even given the City's large current annual Tier 1 UAL payment of \$290 million, total UAL is approximately \$3.5 billion¹, an accelerated pay down of the UAL for a period of time could yield substantial longer term savings. Based on a request by the RSSWG to understand how much a dedicated revenue stream would need to be in order to make a significant change to the unfunded pension liability, the Boards' actuary produced several scenarios over 5 and 10 years to demonstrate the range of possibilities for the Federated Retirement System as shown in Appendix B. In the scenarios shown, the average annual savings over a 25-year period ranged from \$7 million to \$14 million.

Determination: Significant depending on the value of the dedicated revenue stream

SUMMARY

The intent of this report is to provide City Council with a summary of the options discussed during these meetings and the likely success of each one based on a number of factors.

For questions, please contact Cheryl Parkman, Assistant to the City Manager, at (408) 535-8152.

SAM LICCARDO
Chairperson
Retirement Stakeholder Solutions Working Group

¹ Figure based on the 2020 Actuarial Valuations for the Federated Employees Retirement System and the Police and Fire Department Retirement Plan. This does not include Other Postemployment Benefits.

Appendix A

Retirement Stakeholder Solutions Working Group Meeting Agendas

DRAFT



Retirement Stakeholder Solutions Working Group Meeting Agendas

<u>November 12, 2019</u>
<u>December 9, 2019</u>
<u>January 13, 2020</u>
<u>February 10, 2020</u>
<u>October 13, 2020</u>
<u>November 9, 2020</u>
<u>December 14, 2020</u>
<u>January 11, 2021</u>

DRAFT

Appendix B

Additional Contribution Scenarios

DRAFT



Via Electronic Mail

January 7, 2021

Ms. Cheryl Parkman
Assistant to the City Manager
City Manager's Office of Employee Relations
200 E Santa Clara Street, 3rd Floor Wing
San José, CA 95113-1905

Re: Additional Contribution Scenarios for Retirement Stakeholders Solutions Working Group (RSSWG)

Dear Cheryl:

The purpose of this letter is to convey projections of the impact of various potential additional City contributions to each of the San José pension plans. We understand that RSSWG is exploring potential additional sources of funds to dedicate to the pension plans in an effort to reduce the ongoing pressure on the City budget and intends to use this information to assess what level of additional contribution to the pension plans would make a significant difference.

Previously we had shown the RSSWG the impact of additional contributions of \$20 million per year under current Retirement Board policies that would amortize the additional contribution over 15 and 20 years from the time of the additional contribution for the Police and Fire and Federated systems respectively. These projections, based on the 2019 actuarial valuations, did not show a significant impact.

The projections attached to this letter are based on the 2020 actuarial valuations and take a different approach to the amortization of the additional contributions that would have to be approved by each Retirement Board in order to better meet the objectives of making the additional contributions.

For Federated, the largest portion of the amortization of the Unfunded Actuarial Liability (UAL) was established in 2009 and has 18 years remaining on its amortization period. If the additional contributions are targeted to pay off this portion of the UAL, the reduction in the Actuarially Determined Contribution (ADC) will be recognized more quickly, but will not affect projected contributions after 18 years when this portion of the UAL is scheduled to be paid off. At that point, though, the ADC is already projected to be much lower. The pressure on the City's budget comes from scheduled pension contributions over the next 18 years.

To reap the rewards of the additional pension contributions in terms of reduced stress on the City's budget, the additional contributions do not need to be made for the full 18 years. Consequently, for illustration purposes, we prepared three additional contribution scenarios for the Federated System:

1. \$25 million additional contribution for 10 years
2. \$50 million additional contribution for 10 years
3. \$50 million additional contribution for 5 years

Ms. Cheryl Parkman

January 7, 2021

Page 2

While the Police and Fire Plan does not have the same amortization schedule, for illustrative purposes, we also prepared the same scenarios for the Police and Fire plan.

Note that the additional contribution is in addition to the ADC calculated for that year, but as additional contributions are made, future ADC's are reduced. So, compared to the current projected contributions, the actual additional amount contributed in each scenario declines each year. Also, because the additional contribution is targeted to the Tier 1 UAL, there is no impact on member contributions.

The charts in the attachment show the projected ADC from the 2020 valuation as a red line compared to the revised ADC under the scenario (gold bar) and the additional contribution (green bar). The table below the chart shows the amounts for each component of the projection as well as the net difference in City contributions for each year. These projections assume that all assumptions from the actuarial valuation are met each and every year of the projection, including an investment return of 6.625%. Deviations in experience from the assumptions or changes in assumptions will change these projections and the net difference in contributions. The valuation reports contain an assessment of the key risks to these projections. We would be happy to expand these assessments to cover the additional contributions if it would be helpful to the RSSWG.

This letter and its attachments have been prepared in accordance with generally recognized and accepted actuarial principles and practices and our understanding of the Code of Professional Conduct and applicable Actuarial Standards of Practice set out by the Actuarial Standards Board as well as applicable laws and regulations. Furthermore, as credentialed actuaries, we meet the Qualification Standards of the American Academy of Actuaries to render the opinion contained in this letter. This letter does not address any contractual or legal issues. We are not attorneys and our firm does not provide any legal services or advice.

Future projections may differ significantly from the current projections presented in this letter due to such factors as the following: plan experience different from that anticipated by the assumptions; changes in assumptions; and, changes in plan provisions or applicable law.

This letter was prepared exclusively for the City of San José for the purpose described herein. Other users of this letter are not intended users as defined in the Actuarial Standards of Practice, and Cheiron assumes no duty or liability to any other user.

Sincerely,
Cheiron



William R. Hallmark, ASA, FCA, EA, MAAA
Consulting Actuary



Anne D. Harper, FSA, EA, MAAA
Principal Consulting Actuary

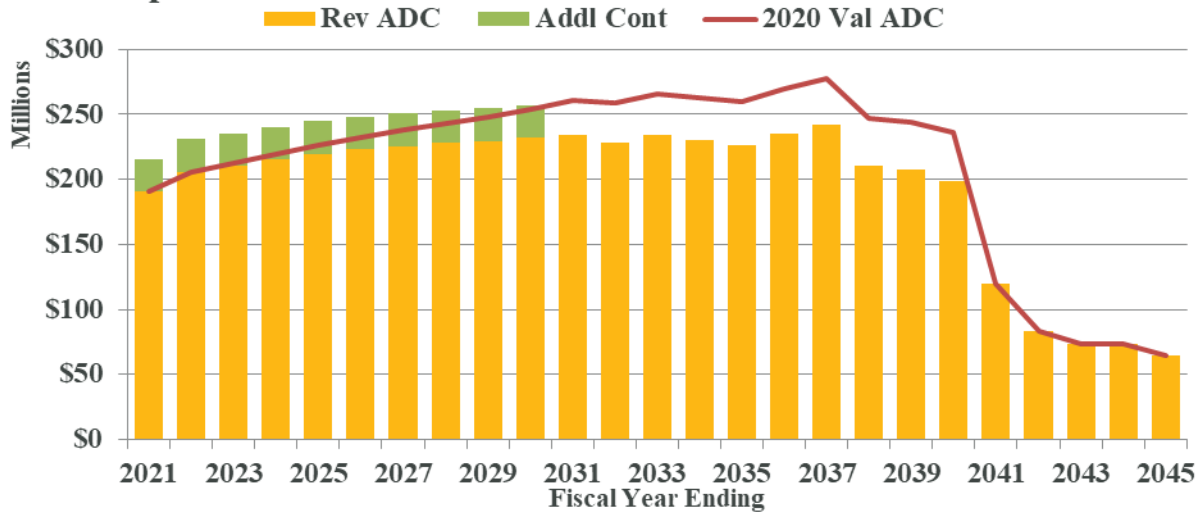
Attachment

cc: Roberto Peña



Additional Contribution Scenarios
San José Federated City Employees Retirement System

Impact of Additional Contribution of \$25 Million for 10 Years

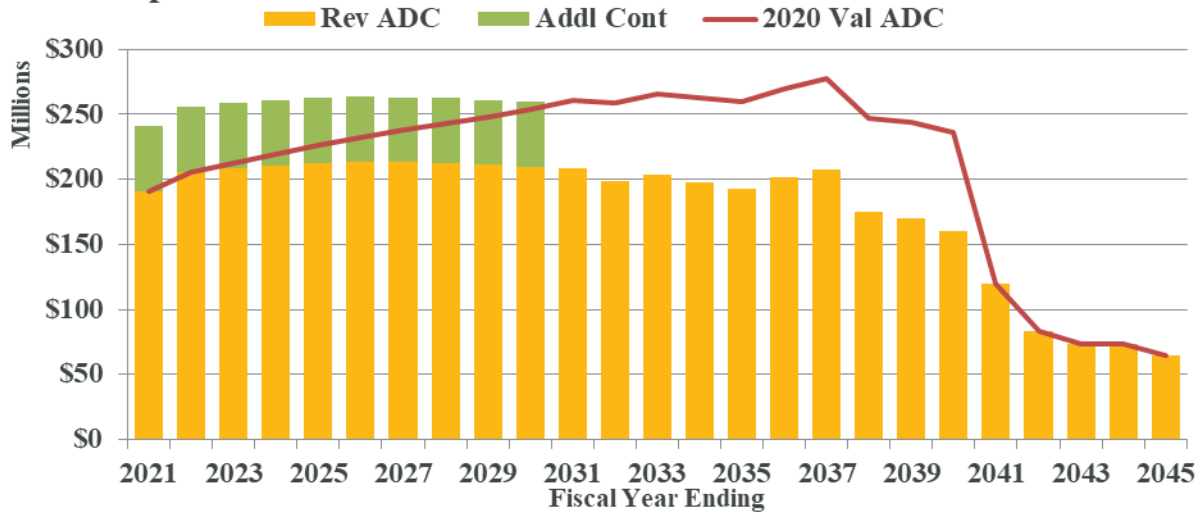


Impact of Additional Contribution of \$25 Million for 10 Years						
FYE	2020 Valuation Projected ADC	Revised ADC	Additional Contribution	Total City Contribution	Difference	
2021	\$ 190.9	\$ 190.9	\$ 25.0	\$ 215.9	\$ 25.0	
2022	206.0	206.0	25.0	231.0	25.0	
2023	212.8	210.6	25.0	235.6	22.8	
2024	219.8	215.4	25.0	240.4	20.6	
2025	226.6	219.8	25.0	244.8	18.2	
2026	232.5	223.1	25.0	248.1	15.6	
2027	237.8	225.5	25.0	250.5	12.7	
2028	243.2	227.9	25.0	252.9	9.7	
2029	248.3	229.7	25.0	254.7	6.4	
2030	254.2	232.0	25.0	257.0	2.8	
2031	260.4	234.3	0.0	234.3	(26.1)	
2032	259.3	228.8	0.0	228.8	(30.5)	
2033	265.8	234.5	0.0	234.5	(31.3)	
2034	262.5	230.3	0.0	230.3	(32.2)	
2035	259.4	226.3	0.0	226.3	(33.1)	
2036	269.5	235.5	0.0	235.5	(34.0)	
2037	277.4	242.4	0.0	242.4	(35.0)	
2038	246.7	210.8	0.0	210.8	(35.9)	
2039	244.4	207.5	0.0	207.5	(36.9)	
2040	236.4	198.5	0.0	198.5	(37.9)	
2041	119.6	119.6	0.0	119.6	0.0	
2042	83.3	83.3	0.0	83.3	0.0	
2043	73.3	73.3	0.0	73.3	0.0	
2044	73.2	73.2	0.0	73.2	0.0	
2045	64.7	64.7	0.0	64.7	0.0	

Amounts in millions

**Additional Contribution Scenarios
San José Federated City Employees Retirement System**

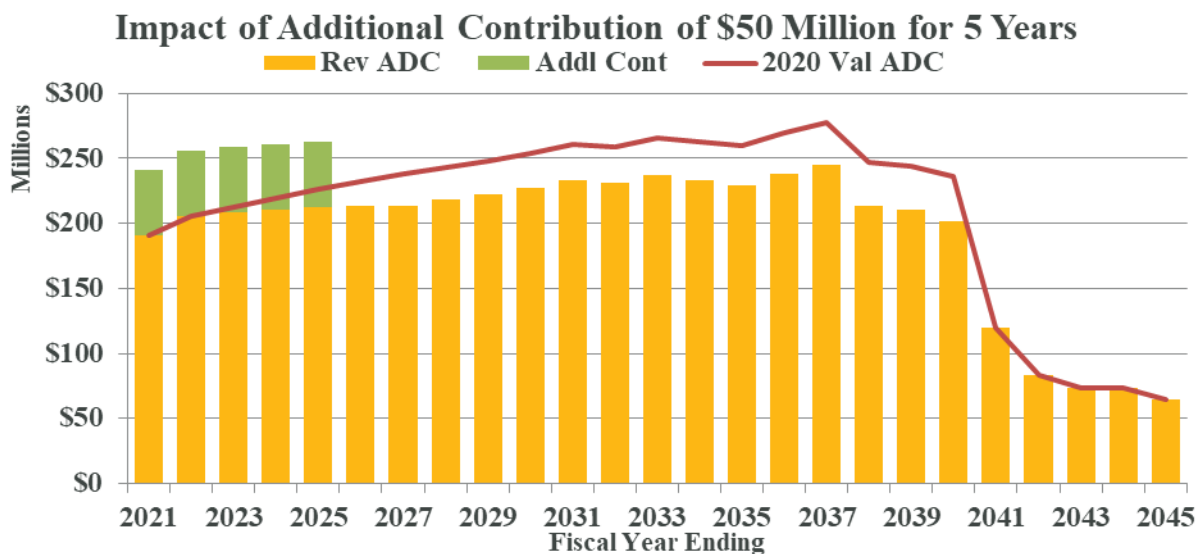
Impact of Additional Contribution of \$50 Million for 10 Years



Impact of Additional Contribution of \$50 Million for 10 Years					
FYE	2020 Valuation Projected ADC	Revised ADC	Additional Contribution	Total City Contribution	Difference
2021	\$ 190.9	\$ 190.9	\$ 50.0	\$ 240.9	\$ 50.0
2022	206.0	206.0	50.0	256.0	50.0
2023	212.8	208.5	50.0	258.5	45.7
2024	219.8	211.0	50.0	261.0	41.2
2025	226.6	212.9	50.0	262.9	36.3
2026	232.5	213.7	50.0	263.7	31.2
2027	237.8	213.3	50.0	263.3	25.5
2028	243.2	212.6	50.0	262.6	19.4
2029	248.3	211.1	50.0	261.1	12.8
2030	254.2	209.9	50.0	259.9	5.7
2031	260.4	208.1	0.0	208.1	(52.3)
2032	259.3	198.3	0.0	198.3	(61.0)
2033	265.8	203.2	0.0	203.2	(62.6)
2034	262.5	198.1	0.0	198.1	(64.4)
2035	259.4	193.2	0.0	193.2	(66.2)
2036	269.5	201.5	0.0	201.5	(68.0)
2037	277.4	207.5	0.0	207.5	(69.9)
2038	246.7	174.9	0.0	174.9	(71.8)
2039	244.4	170.6	0.0	170.6	(73.8)
2040	236.4	160.6	0.0	160.6	(75.8)
2041	119.6	119.6	0.0	119.6	0.0
2042	83.3	83.3	0.0	83.3	0.0
2043	73.3	73.3	0.0	73.3	0.0
2044	73.2	73.2	0.0	73.2	0.0
2045	64.7	64.7	0.0	64.7	0.0

Amounts in millions

Additional Contribution Scenarios
San José Federated City Employees Retirement System

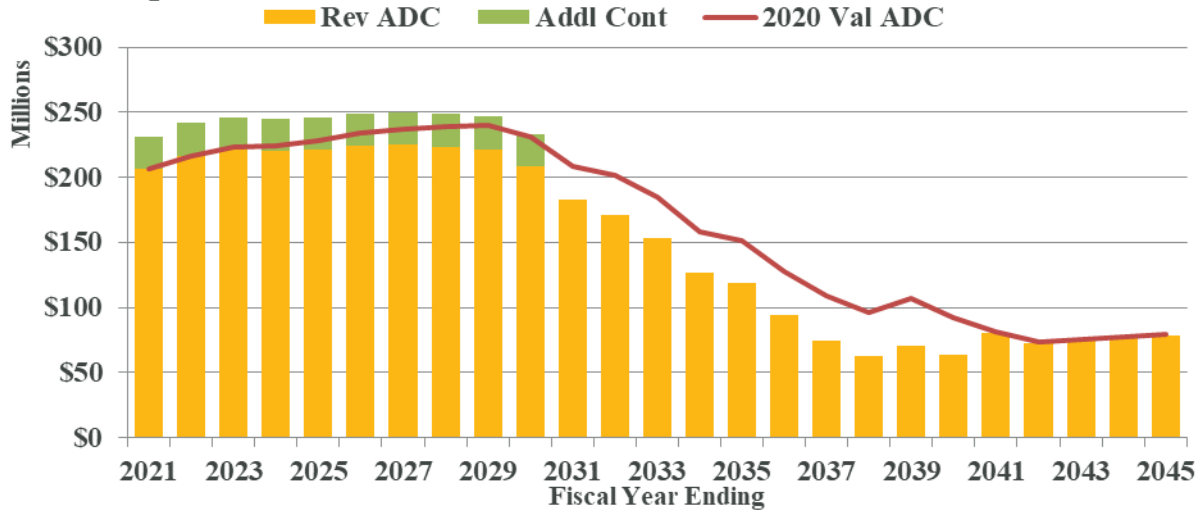


Impact of Additional Contribution of \$50 Million for 5 Years					
FYE	2020 Valuation Projected ADC	Revised ADC	Additional Contribution	Total City Contribution	Difference
2021	\$ 190.9	\$ 190.9	\$ 50.0	\$ 240.9	\$ 50.0
2022	206.0	206.0	50.0	256.0	50.0
2023	212.8	208.5	50.0	258.5	45.7
2024	219.8	211.0	50.0	261.0	41.2
2025	226.6	212.9	50.0	262.9	36.3
2026	232.5	213.7	0.0	213.7	(18.8)
2027	237.8	213.3	0.0	213.3	(24.5)
2028	243.2	218.0	0.0	218.0	(25.2)
2029	248.3	222.4	0.0	222.4	(25.9)
2030	254.2	227.7	0.0	227.7	(26.5)
2031	260.4	233.1	0.0	233.1	(27.3)
2032	259.3	231.2	0.0	231.2	(28.1)
2033	265.8	237.0	0.0	237.0	(28.8)
2034	262.5	232.9	0.0	232.9	(29.6)
2035	259.4	229.0	0.0	229.0	(30.4)
2036	269.5	238.2	0.0	238.2	(31.3)
2037	277.4	245.2	0.0	245.2	(32.2)
2038	246.7	213.7	0.0	213.7	(33.0)
2039	244.4	210.4	0.0	210.4	(34.0)
2040	236.4	201.5	0.0	201.5	(34.9)
2041	119.6	119.6	0.0	119.6	0.0
2042	83.3	83.3	0.0	83.3	0.0
2043	73.3	73.3	0.0	73.3	0.0
2044	73.2	73.2	0.0	73.2	0.0
2045	64.7	64.7	0.0	64.7	0.0

Amounts in millions

**Additional Contribution Scenarios
San José Police and Fire Department Retirement Plan**

Impact of Additional Contribution of \$25 Million for 10 Years

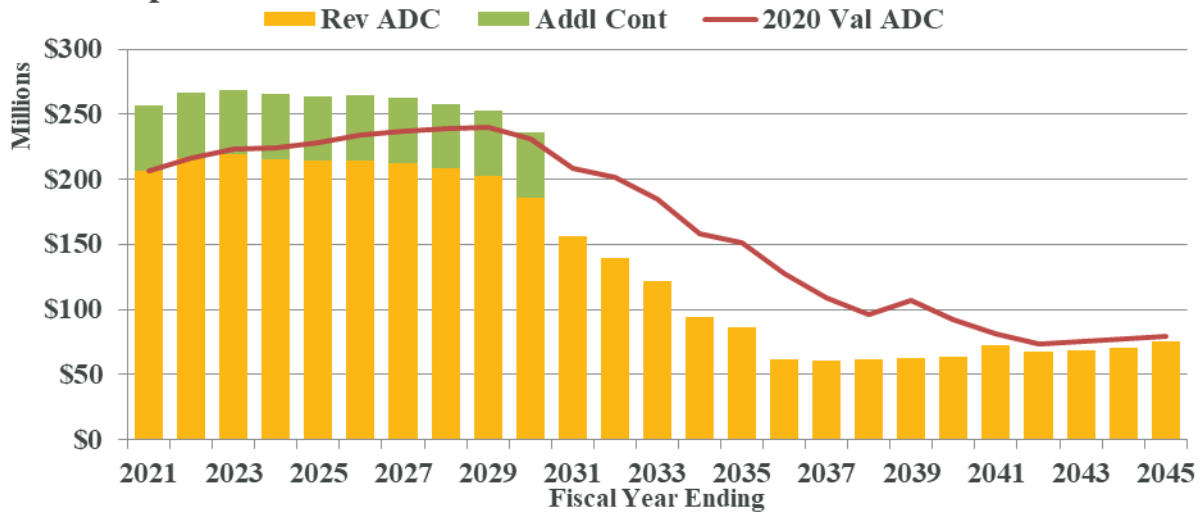


Impact of Additional Contribution of \$25 Million for 10 Years					
FYE	2020 Valuation Projected ADC	Revised ADC	Additional Contribution	Total City Contribution	Difference
2021	\$ 206.5	\$ 206.5	\$ 25.0	\$ 231.5	\$ 25.0
2022	216.9	216.9	25.0	241.9	25.0
2023	223.5	221.3	25.0	246.3	22.8
2024	224.8	220.3	25.0	245.3	20.5
2025	228.1	221.0	25.0	246.0	17.9
2026	233.9	224.3	25.0	249.3	15.4
2027	237.6	225.0	25.0	250.0	12.4
2028	239.4	223.8	25.0	248.8	9.4
2029	240.6	221.7	25.0	246.7	6.1
2030	230.8	208.4	25.0	233.4	2.6
2031	208.9	182.5	0.0	182.5	(26.4)
2032	201.4	170.7	0.0	170.7	(30.7)
2033	185.0	153.6	0.0	153.6	(31.4)
2034	158.4	126.3	0.0	126.3	(32.1)
2035	151.6	118.8	0.0	118.8	(32.8)
2036	127.6	94.0	0.0	94.0	(33.6)
2037	108.7	74.4	0.0	74.4	(34.3)
2038	95.8	62.6	0.0	62.6	(33.2)
2039	106.7	70.9	0.0	70.9	(35.8)
2040	92.3	63.9	0.0	63.9	(28.4)
2041	81.0	80.8	0.0	80.8	(0.2)
2042	73.8	72.7	0.0	72.7	(1.1)
2043	75.7	74.6	0.0	74.6	(1.1)
2044	77.6	76.5	0.0	76.5	(1.1)
2045	79.7	78.6	0.0	78.6	(1.1)

Amounts in millions

**Additional Contribution Scenarios
San José Police and Fire Department Retirement Plan**

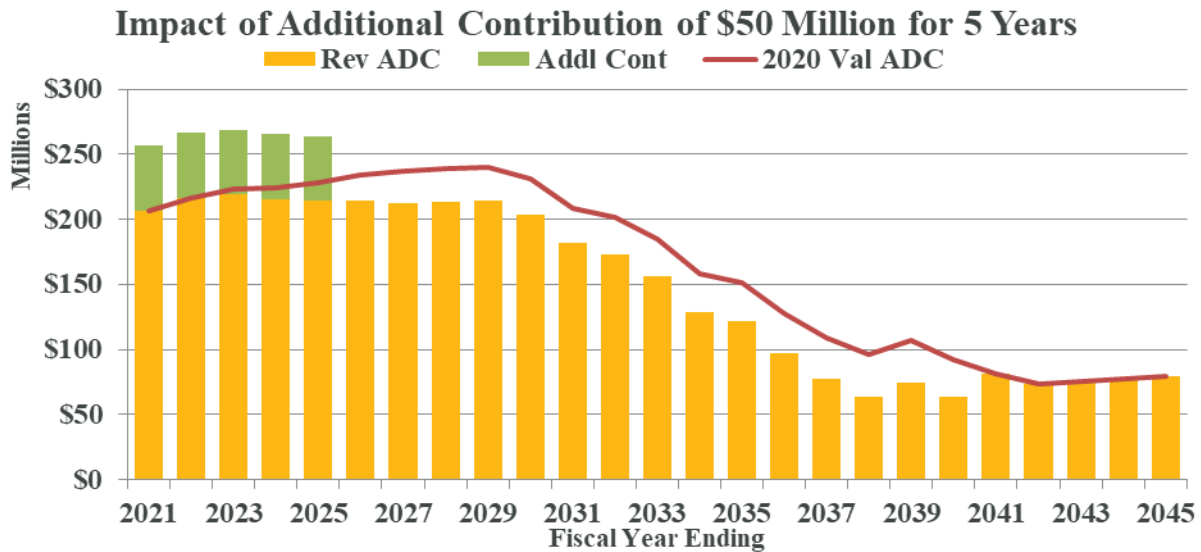
Impact of Additional Contribution of \$50 Million for 10 Years



Impact of Additional Contribution of \$50 Million for 10 Years					
FYE	2020 Valuation Projected ADC	Revised ADC	Additional Contribution	Total City Contribution	Difference
2021	\$ 206.5	\$ 206.5	\$ 50.0	\$ 256.5	\$ 50.0
2022	216.9	216.9	50.0	266.9	50.0
2023	223.5	219.1	50.0	269.1	45.6
2024	224.8	215.7	50.0	265.7	40.9
2025	228.1	214.0	50.0	264.0	35.9
2026	233.9	214.6	50.0	264.6	30.7
2027	237.6	212.5	50.0	262.5	24.9
2028	239.4	208.2	50.0	258.2	18.8
2029	240.6	202.8	50.0	252.8	12.2
2030	230.8	185.9	50.0	235.9	5.1
2031	208.9	156.1	0.0	156.1	(52.8)
2032	201.4	140.0	0.0	140.0	(61.4)
2033	185.0	122.2	0.0	122.2	(62.8)
2034	158.4	94.2	0.0	94.2	(64.2)
2035	151.6	86.0	0.0	86.0	(65.6)
2036	127.6	61.5	0.0	61.5	(66.1)
2037	108.7	60.7	0.0	60.7	(48.0)
2038	95.8	61.6	0.0	61.6	(34.2)
2039	106.7	62.7	0.0	62.7	(44.0)
2040	92.3	63.9	0.0	63.9	(28.4)
2041	81.0	72.1	0.0	72.1	(8.9)
2042	73.8	67.1	0.0	67.1	(6.7)
2043	75.7	69.0	0.0	69.0	(6.7)
2044	77.6	70.9	0.0	70.9	(6.7)
2045	79.7	75.4	0.0	75.4	(4.3)

Amounts in millions

**Additional Contribution Scenarios
San José Police and Fire Department Retirement Plan**



Impact of Additional Contribution of \$50 Million for 5 Years					
FYE	2020 Valuation Projected ADC	Revised ADC	Additional Contribution	Total City Contribution	Difference
2021	\$ 206.5	\$ 206.5	\$ 50.0	\$ 256.5	\$ 50.0
2022	216.9	216.9	50.0	266.9	50.0
2023	223.5	219.1	50.0	269.1	45.6
2024	224.8	215.7	50.0	265.7	40.9
2025	228.1	214.0	50.0	264.0	35.9
2026	233.9	214.6	0.0	214.6	(19.3)
2027	237.6	212.5	0.0	212.5	(25.1)
2028	239.4	213.7	0.0	213.7	(25.7)
2029	240.6	214.4	0.0	214.4	(26.2)
2030	230.8	204.0	0.0	204.0	(26.8)
2031	208.9	181.5	0.0	181.5	(27.4)
2032	201.4	173.4	0.0	173.4	(28.0)
2033	185.0	156.3	0.0	156.3	(28.7)
2034	158.4	129.1	0.0	129.1	(29.3)
2035	151.6	121.7	0.0	121.7	(29.9)
2036	127.6	97.0	0.0	97.0	(30.6)
2037	108.7	77.4	0.0	77.4	(31.3)
2038	95.8	63.9	0.0	63.9	(31.9)
2039	106.7	74.0	0.0	74.0	(32.7)
2040	92.3	63.9	0.0	63.9	(28.4)
2041	81.0	81.0	0.0	81.0	0.0
2042	73.8	73.3	0.0	73.3	(0.5)
2043	75.7	75.1	0.0	75.1	(0.6)
2044	77.6	77.0	0.0	77.0	(0.6)
2045	79.7	79.2	0.0	79.2	(0.5)

Amounts in millions