San José's Pension Problems

Did you know that San José expects to spend about **$245 million in FY 2011-12** to pay for lifetime pension and retiree healthcare benefits for employees? That is three times more than it paid a decade ago! In addition, retirement costs now take up more than 20% of the General Fund.

Unfortunately, the City's retirement costs are expected to continue rising in the years ahead. Without significant retirement reform, these skyrocketing costs ***threaten the City's ability to provide basic public services and the long-term sustainability of the retirement funds***.

City Employees' Current Retirement Benefits

San José has two retirement systems. The Police and Fire Department Retirement System serves sworn public safety employees. The Federated City Employees' Retirement System serves all other employees.

The City's retirement systems offer **defined benefit plans**, meaning retirees receive a guaranteed pension for the rest of their lives. There are different pension formulas for police officers, firefighters and civilian/non-sworn employees. However, all plans feature:

1. A ***base pension*** determined by an employee's years of service and highest annual earnings.
2. A ***guaranteed 3% cost-of-living adjustment (COLA)*** every year.
3. ***Bonus payments*** when the plan's investment returns exceed actuarial projections.

In addition, employees with at least 15 years of service qualify for **free healthcare benefits when they retire**.

Current Base Pension Formulas for the City's Retirement Plans

	Police	Fire	Federated
Eligibility age when employee can begin collecting benefits	55 after 20 years 50 after 25 years Any Age after 30 years	55 after 20 years 50 after 25 years Any Age after 30 years	55 after 5 years Any Age after 30 years
Benefit Formula based on employee's final compensation	2.5% per year for the first 20 years of service 4% per year for every year after 20 years of service	2.5% per year if employee works 20 years or less 3% per year if employee works more than 20 years	2.5% per year for every year of service
Maximum Benefit	90% of final compensation	90% of final compensation	75% of final compensation

Police officers and firefighters with 10-19 years of service also qualify to receive benefits. However, they can not receive benefits until 20 years have passed from their initial employment date (no earlier than age 55).

Note: Employees who participate in the City's pension plans do not contribute to Social Security and do not earn credit for Social Security benefits while working for the City. The Mayor, City Councilmembers, and non-benefited (i.e. part-time, temporary, contract) employees do not participate in the city's pension plans.

How San José's Retirement Systems Are Funded

Both the City and employees make contributions into the retirement funds. However, the City is responsible for a significantly larger share of the costs than employees.

In fact, the City is currently paying about 3/4 of the total cost of employee retirement benefits.

Retirement contributions can include two different components. ***"Normal cost"*** contributions, along with investment earnings, are expected to pay for all future benefits. However, if retirement investments lose money in the market or don't meet actuarial projections, additional contributions are needed to pay down the resulting ***"unfunded liability."***

The City's and employees' contribution rates are set annually by San José's two independent Retirement Boards based on annual valuations and the cost-sharing formulas described below.

- **Cost-Sharing for Pension Benefits:**
  The City and employees split the normal cost for pension benefits on an 8 to 3 ratio (for every $8 the City pays, an employee contributes $3). However, ***the City is responsible for covering 100% of any "unfunded liabilities" in the pension plans***. In other words, taxpayers assume all of the risk for the performance of the pension plans' investments.

  Unlike some governments, the City of San José has consistently made its annual retirement contribution (ARC) for pension benefits.

2011-2012 Contribution Rates *
Percent of Employee's Base Salary

Retirement Plan	City	Employee
Police Plan	**56.90%**	**17.47%**
Pension Benefits	49.29%	10.46%
Retiree Healthcare	7.61%	7.01%
Fire Plan	**56.32%**	**15.62%**
Pension Benefits	51.05%	10.76%
Retiree Healthcare	5.27%	4.86%
Fire Plan	**35.50%**	**11.20%**
Pension Benefits	28.34%	4.68%
Retiree Healthcare	7.16%	6.52%

Source: Office of Employee Relations, January 2011

- **Cost-Sharing for Retiree Healthcare Benefits:**
  For retiree medical benefits, both the normal cost and the cost of any unfunded liabilities are split 50/50. Retiree dental benefits are split between the City and employees on either a 3:1 ratio (for police/fire employees) or an 8:3 ratio (for federated employees).

  Both the City and employees are still in the phase-in period for paying the full annual retiree healthcare contribution. Once the phase-in is complete, there will be dramatic increases in retiree healthcare contributions for both the City and employees.

It is important to note that the current contribution rates are based on optimistic assumptions adopted by San José's independent retirement boards, including a 7.5% assumed rate of return. Using a more realistic investment assumption would significantly increase the City's and employees' annual contribution rates.

The Retirement Systems' Unfunded Liabilities

Unfortunately, the City's retirement systems are significantly underfunded. As of June 30, 2011, the City's two retirement systems had about **$3 billion in unfunded liabilities**. These unfunded liabilities are the result of retroactive benefit enhancements, changing demographics, and overly optimistic assumptions that haven't held true *(these factors are discussed further in the "Why Retirement Costs Have Grown So Much" section)*.

The plans' growing unfunded liabilities have been accompanied by a decline in the plans' funding ratios. ***In particular, the plans only have a small fraction of the money needed to fund retiree healthcare benefits.*** This is largely due to the fact that the City and employees have only been partially pre-funding their retiree healthcare benefits. However, both are now in a "phase-in" period for fully-funding their annual retiree healthcare contributions.

These unfunded liabilities represent a huge debt that must be paid off in the future. This not only shifts the costs for today's employees onto future generations, it also ends up costing more in the long run. And the larger the unfunded liability grows, the greater the risk that the retirement plans will not be able to pay retirees the benefits they have earned and accrued.

The Out-of-Control Growth in Retirement Costs

Providing these generous retirement benefits and paying down the plans' unfunded liabilities have taken a significant financial toll on the City of San José. The City's retirement costs have more than tripled over the past decade - growing from $73 million in FY 2001-02 to **$245 million in FY 2011-12**. Retirement benefits now cost more than 50% of base payroll and consume **more than 20% of the City's entire General Fund**.

While the City's FY 2012-13 retirement costs are expected to stay flat (due to recent layoffs and pay cuts), ***the City's annual retirement contribution is projected to increase to $320 million in FY 2015-16 and continue rising for many more years after that***. In addition, retirement costs could grow much larger than currently projected if the independent retirement boards adopt more realistic actuarial assumptions (for example, the boards currently assume a 7.5% annual return on investments).

Retirement costs are also rising for employees. In particular, both the City and employees will see dramatic increases once they complete the phase-in period for paying the full annual retiree healthcare contribution.

As a result, these growing retirement costs threaten the City's ability to provide basic public services.

Why Retirement Costs Have Grown So Much

There are a number of factors that have contributed to the City's growing and unsustainable retirement costs. The following three factors have had a particularly large impact on retirement costs.

1. Retirement Benefits Have Been Continually Enhanced

The City Council - and in some cases, outside arbitrators – have enhanced pension benefits numerous times over the past two decades. Among these fiscally irresponsible actions:

- The maximum pension benefit for San José police officers and firefighters was increased multiple times: first to 80%, then to 85%, and finally to 90% of compensation.
- The cost-of-living adjustment (COLA) was changed to a guaranteed 3% annual adjustment.
- The definition of "final compensation" (which is used to calculate pension benefits) was changed from highest 3-year average to highest 12 consecutive months for the Federated Plan.

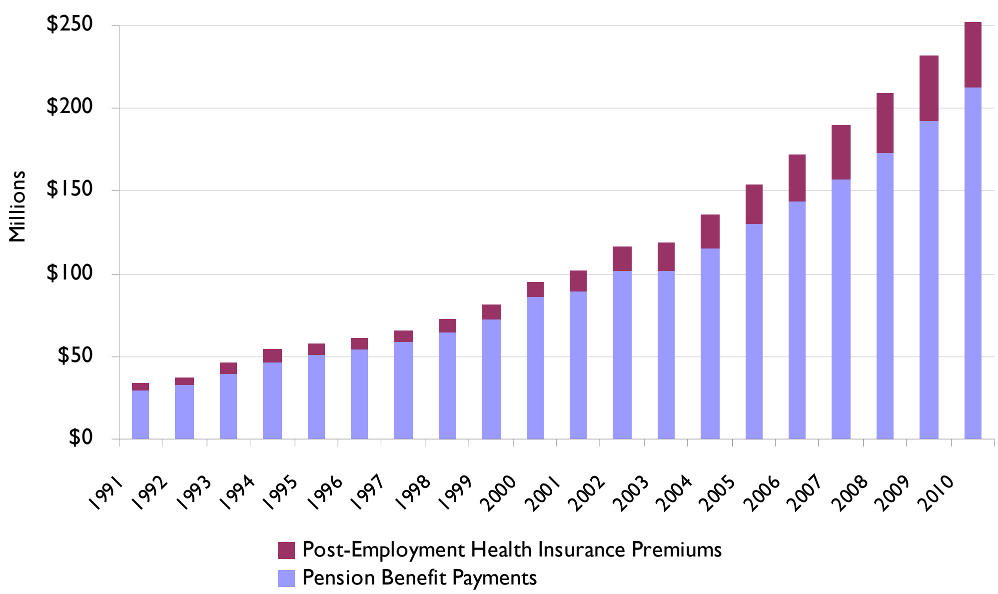
Even worse, some of the above enhancements were made retroactively. This is what happened when police officers (in 2006) and firefighters (in 2008, via outside arbitration) were awarded a maximum pension benefit equaling 90% of final compensation. These retroactive increases immediately added more than $70 million in unfunded liabilities that the City has been obligated to pay.

Overall, retirees are receiving significantly larger pension payments today than they did 20 years ago. Even after adjusting for inflation:

- The average annual pension benefit has increased by 75% for Police and Fire retirees.
- The average annual pension benefit has increased by 54% for Federated retirees.

Furthermore, total annual pension benefit payments from the retirement funds have grown seven-fold over the past 20 years *(see chart to right)*.

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



Why Retirement Costs Have Grown So Much *(Continued)*

2. Employees Are Living Longer and Retiring Earlier.

The average life expectancy continues to rise (currently 78 years in the U.S.) and more individuals are opting to retire at an early age. This means that ***retirees are collecting benefits for a longer period of time***. In fact:

- The average retiree in the Police and Fire plan receives a pension benefit for 21 years.
- The average retiree in the Federated plan receives a pension benefit for 18 years.

In addition, the overall number of retirees receiving benefits is now 2½ times greater than 20 years ago.

These changing demographic factors have had a significant impact on the cost of providing the City's retirement benefits. It has also meant that past actuarial assumptions (i.e. those based on a lower life expectancy) haven't held true, resulting in new unfunded liabilities.

3. Investment Gains Have Not Kept Up with Projections

Any time that retirement fund investments fall short of their projected returns, a new unfunded liability is created. Most recently, investment losses between 2007 and 2009 created a $978.8 million unfunded liability.

However, the retirement funds were experiencing gaps between projections and actual returns ***long before the current economic downturn***. That's because, over the past 30 years, the retirement systems have assumed an unrealistic rate of return - typically between 8.0% and 8.25% annually - that has outpaced its actual investment earnings *(note: the retirement boards have recently begun using a more realistic rate of return)*.

Paying off these unfunded liabilities drives up retirement costs in future years. And because the City is responsible for 100% of the plans' unfunded liabilities, the burden falls completely on the taxpayers.

Sources: Office of Employee Relations, City Manager's Budget Office, City Auditor's Report on Pension Sustainability: Rising Pension Costs Threaten the City's Ability to Maintain Service Levels, San José Retirement Systems' Comprehensive Annual Financial Reports and Actuarial Valuations, Cheiron's Five Year Projections Dated February 8, 2012 and February 21, 2012.