Distributed on:

SENT TO COUNCIL: JAN 20 2011

City Manager's Office

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: **Recent Retirement Actuarial Valuation and Methodology Changes and Discussion of 2011-2012 Budgetary Impacts**

DATE: January 20, 2011

INFORMATION

Since November 2008, I have provided periodic updates to the City Council on the City's retirement plans. The purpose of this memorandum is to provide the City Council with updated information regarding retirement contributions for Fiscal Year 2011-2012, actuarial methodology changes, and the budgetary impacts. Some of the issues and information discussed in this memorandum were also included in the recent memo regarding 2nd tier retirement benefits, but have been updated.

Retirement costs for the City and employees continue to rise significantly. On September 29, 2010, the City Auditor issued an audit titled Pension Sustainability: Rising Pension Costs Threaten the City's Ability to Maintain Service Levels – Alternatives for a Sustainable Future. The audit, approved by the City Council on October 26, 2010, 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. The Pension Sustainability Audit can be viewed at: http://www.sanjoseca.gov/auditor/AuditReports/1010/1010.pdf.

The retirement plans' actuaries have prepared the annual actuarial valuations that are used to determine the retirement contributions for the City and employees for Fiscal Year 2011-2012.[1] The Boards have recently approved changes to actuarial assumptions and methodologies that will result in additional increased costs for Fiscal Year 2011-2012.

As of January 2011, the valuation reports for the Federated City Employees' Retirement System have been approved and the contribution rates for Fiscal Year 2011-2012 for the City and employees have been established. For the Police and Fire Department Retirement Plan, the pension valuation and contributions have been approved; however, the OPEB (retiree healthcare) valuation is currently being prepared by the Board's actuary. It is anticipated that the OPEB valuation will be completed and presented to the Police and Fire Department Retirement Board in February 2011.

Liabilities and Funding Status

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,

---

[1] The actuarial valuations use data as of June 30th but establish contributions effective the following July. This results in a one-year lag between the valuations and the contribution changes.

and (2) based on the actuarial, smoothed, value of assets. The actuarial value is the basis of the City's contribution.

As of June 30, 2010, the unfunded liability and funding ratios under both calculations for each pension plan are detailed below. Based on the current difference between the market value of assets and the actuarial value of assets, a further decline in the funded status is expected over the next few years, as the asset losses for the 2008-2009 market downturn are fully recognized in the actuarial value of assets.

Pension Unfunded Liability As of June 30, 2010			
	Federated	**Police and Fire**	**Total**
Market Value	$1.0 billion	$1.0 billion	$2.0 billion
Funding Ratio	60%	69%	65%
Actuarial Value	$0.78 billion	$0.65 billion	$1.43 billion
Funding Ratio	69%	80%%	75%

Retiree Healthcare (OPEB) Unfunded Liability As of June 30, 2010			
	Federated	**Police and Fire[2]**	**Total**
Market Value	$0.82 billion	$0.72 billion	$1.54 billion
Funding Ratio	12%	7%	9%
Actuarial Value	$0.82 billion	$0.71 billion	$1.53 billion
Funding Ratio	12%	6%	10%

Changes in Actuarial Assumptions and Methodologies

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. 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."*

[2] 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. The retiree healthcare liability for Police and Fire demonstrated in this chart is the unfunded liability as of the June 30, 2009 valuation.

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

Earnings Assumption (Investment Rate of Return)

The investment rate of return is the estimated future net rate of return on current and future assets. This rate is used to discount the actuarial liability for each plan, and is one of the most important assumptions. The investment rate of return is also the expected return on the liabilities. This means that the required return on the assets is the assumed net rate of return divided by the funding ratio. For example, using the assumed net rate of return of 7.75% for the Federated plan and a 60% funding ratio, 7.75% is divided by 60%. This equals 12.9%. Consequently, if the Plan does not earn 12.9%, the contributions to the plan would increase to make up for the earnings that were not received.

The Federated City Employees' Retirement System Board recently approved changing its previous decision to phase-in lowering 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 Board is also considering whether 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. It is anticipated that the Board will make this decision in February 2011.

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

The earnings assumption actuarial change was made to each plan to more closely align expected net rates of return to assumed net 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 in the future. For example, in its November 22, 2010 report, The Segal Company's model produces a net investment return assumption of **6.93%**, which is significantly lower than the current assumption. The Federated Plan actuary has also indicated that the earnings assumption may need to be decreased further.

If the investments do not result in earnings that are at least as much as the assumptions set by the Boards (factoring in the funding ratios), 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% (7.75% effective June 30, 2011).

The City is 100% responsible for any 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. For retiree medical benefits, however, employees and the City share 50% of the cost, including unfunded liabilities.

Payment of Annual Required Contribution (ARC)

Currently, the Boards' actuaries perform the annual valuation of plans and calculate retirement contribution rates based on estimated payroll data. 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 actual 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 payroll estimated by the actuaries is significantly higher than actual payroll currently experienced and since the retirement contributions have been 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.

To address this issue, the Federated and Police and Fire Boards 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 2011-2012 contributions to the plans, 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, however, it will result in an unfunded liability to the City primarily related to retiree healthcare if the contributions received from the employees is less than the dollar amount expected from employees when applying the percent of payroll contributions reported in the actuarial valuation. The City is responsible for paying 100% of the unfunded liability for pension benefits.

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

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 Administration has not completed its analysis of this change and the resulting impact on City retirement contributions for Fiscal Year 2011-2012. However, a preliminary analysis is included below.

Projected City Retirement Contributions for Fiscal Year 2011-2012

As a result of the recent changes in contribution methodology, in addition to other factors such as investment losses and actuarial assumption changes, the City's retirement contributions will increase significantly from Fiscal Year 2010-2011 to 2011-2012.[3] It should be noted that five employee units in the Federated Plan have agreed to continue to pay a portion of the City's pension unfunded liability contributions on an ongoing basis.

The following charts include the current board adopted City retirement contribution rates and approved retirement contribution rates for Fiscal Year 2011-2012 for the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan.

Federated City Employees' Retirement System				
	City		Employee	
	FY 10-11	FY 11-12	FY 10-11	FY 11-12
Pension	23.18%	28.34%	4.54%	4.68%
Medical and Dental	6.41%	7.16%	5.76%	6.51%
Total	**29.59%**	**35.50%**	**10.30%**	**11.19%**

Police and Fire Department Retirement Plan (Police)				
	City		Employee	
	FY 10-11	FY 11-12	FY 10-11	FY 11-12
Pension	38.32%	49.78%[4]	9.81%	10.46%
Medical and Dental[5]	6.26%	6.26%	5.76%	5.76%
Total	**44.58%**	**56.04%**	**15.57%**	**16.22%**

Police and Fire Department Retirement Plan (Fire)				
	City		Employee	
	FY 10-11	FY 11-12	FY 10-11	FY 11-12
Pension	40.24%	51.54%[6]	10.09%	10.76%
Medical and Dental[7]	3.92%	3.92%	3.61%	3.61%
Total	**44.16%**	**55.46%**	**13.70%**	**14.37%**

[3] These rates do not include the discount rate for the City because of the prepayment of retirement contributions.
[4] Does not include an SRBR offset of 0.49% of pay for 2011-2012 only.
[5] 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.
[6] Does not include an SRBR offset of 0.49% of pay for 2011-2012 only.
[7] 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 2011.

Based on the actuarial valuations that have been completed, it is estimated that the City's costs will be approximately **$248 million** for all funds for Fiscal Year 2011-2012.[8]

	Pension	Retiree Healthcare
Federated	$86.9 M	$21.5 M
Police	$75.5 M	$11.5 M
Fire	$46.3 M	$6.0 M
Total	$208.7 M	$39.0 M
Grand Total City Costs for FY 11-12	$247.7 M	

Discussion of 2011-2012 Budgetary Impacts to the City's General Fund

On November 8, 2010, the Budget Office issued the 2011-2012 Preliminary General Fund Forecast as an initial planning tool in the development of the 2011-2012 Proposed Operating Budget. At that time, based on information available including retirement rate projections from February 2010, the General Fund shortfall was projected to be $70 million. In the Preliminary Forecast, retirement costs were adjusted for the impact of step increases, ongoing employee-employer cost sharing agreements, 2010-2011 cost-of-living adjustments for two bargaining units, and estimated changes in the City's contribution rates to both retirement plans.

At the time the Preliminary Forecast was issued, no decision had been made by the retirement boards on any changes to assumptions and methodologies as previously described. As a result of key changes in retirement methodologies and assumptions approved and considered by the Boards during the November meetings, on December 2nd, 2010, the Preliminary 2011-2012 General Fund Shortfall was updated to at least $90 million.

It is anticipated that once all of the pension and retiree healthcare valuations are finalized and the impacts have been analyzed, the General Fund shortfall for Fiscal Year 2011-2012 will increase further. The actual amount of the General Fund shortfall will not be known until staff has reviewed all revenue and expenditure projections including retirement boards' actions on the pension and retiree healthcare valuations. As a next step for projecting the 2011-2012 General Fund Shortfall, the 2012-2016 Five Year Forecast is scheduled to be released on February 28, 2011.

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

Debra Figone
City Manager

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

---

[8] The retiree healthcare contributions for Police and Fire Plan are estimates since the actuarial valuation has not been completed. In addition, it should be noted that five employee units in the Federated Plan have agreed to pay a portion of the City's pension unfunded liability contributions on an ongoing basis. Also, these amounts include the City discount for prepayment of the retirement contributions.