Performance Audit of the San Diego City Employees' Retirement System

SDCERS' Unique Environment Increases Operating Expenses, But Cost-Cutting Opportunities Exist

SEPTEMBER 2011

Audit Report

Office of the City Auditor

City of San Diego

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THE CITY OF SAN DIEGO

September 30, 2011

Honorable Mayor, City Council, and Audit Committee Members
City of San Diego, California

Transmitted herewith is an audit report on the San Diego City Employees' Retirement System. This report is presented in accordance with City Charter Section 39.2. The Results in Brief is presented on page 3. Management responses from SDCERS and the City's Risk Management Department to our audit recommendations can be found after page 74 of the report.

If you need any further information please let me know. We would like to thank SDCERS' staff for their assistance and cooperation during this audit. All of their valuable time and efforts spent on providing us information is greatly appreciated. The audit staff responsible for this audit report are Sara Glick, Efrem Bycer, Kyle Elser, and Chris Constantin.

Respectfully submitted,

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Acronyms

Retirement Systems

ACERA	Alameda County Employees' Retirement Association
CCCERA	Contra Costa County Employees' Retirement Association
COAERS	City of Austin (TX) Employees' Retirement System
COPERS	City of Phoenix (AZ) Employees' Retirement System
DERP	Denver (CO) Employees' Retirement Plan
DCRB	District of Columbia Retirement Board
FERS	City of Fresno Employees' (General, non-safety) Retirement System
FFPRS	City of Fresno Fire and Police Retirement System
LACERS	Los Angeles City Employees' Retirement System
OCERS	Orange County Employees' Retirement System
SBCERA	San Bernardino County Employees' Retirement Association
SCERS	Sacramento County Employees' Retirement System
SDCERA	San Diego County Employees' Retirement Association
SDCERS	San Diego City Employees' Retirement System
SJFCERS	San Jose Federated City Employees' Retirement System
SJPFRP	City of San Jose Police and Fire Retirement Plan

Other Pertinent Terms

ARC	Annual Required Contribution
IDR	Industrial Disability Retirement
UAL	Unfunded Actuarial Accrued Liability
CAFR	Comprehensive Annual Financial Report
SDDPC	San Diego Data Processing Corporation
IRMAA	Income Related Monthly Adjustment Amount

Results in Brief

The San Diego City Employees' Retirement System (SDCERS) administers retirement, disability and death benefits for the City of San Diego (City), the San Diego Unified Port District (UPD) and the San Diego County Regional Airport Authority (Airport). SDCERS pays retiree benefits from the retirement plan's assets, which are funded from plan sponsor and employee contributions and investment earnings. SDCERS also pays its operating expenses from plan assets; therefore, administrative and investment expenses impact the level of assets available to pay current and future retiree benefits.

This audit report provides an assessment and peer comparison of SDCERS' administrative and investment expenses, plan funding level, and the actuarial assumptions used to determine employee and plan sponsor contributions. We also present recommendations to SDCERS and the City to reduce expenses.

When compared to peers, SDCERS' administrative expenses—approximately $15 million in fiscal year 2010—are higher, its plan funding level is lower, and actuarial assumptions are more conservative. However, the contentious history between SDCERS and the City has uniquely impacted its current operating environment. Expenses are higher than peers largely due to litigation and efforts to correct prior, well-publicized problems that enabled the City to underfund the pension for years. SDCERS' trustees also adopted more conservative actuarial assumptions in the past five years to be more in line with peers, after previously using methods that were not in line with industry standards.

SDCERS also spends more than any other system for fiduciary liability insurance—more than $500,000 in fiscal year 2010—to protect its Board of Administration trustees' personal assets in the event they are personally named in a lawsuit. Providing legal defense and indemnification for trustees, who are largely

citizen volunteers, is a complicated and contentious issue for both SDCERS and the City, but our report identifies potential alternatives to eliminate, or at least reduce, this expense.

We found that SDCERS' efforts to maintain independence and transparent decision-making contribute to higher-than-peer personnel, rent, and information technology expenses. While a significant consideration for all retirement systems, ensuring independence and transparency has been critical for SDCERS in order to address prior issues and to restore the public's faith in the system.

While many of SDCERS' administrative expenses are not within its control, our report provides recommendations to streamline operations and reduce expenses. For example, even after accounting for the impact of litigation, we found that actuary expenses are still high compared to peers. SDCERS is rebidding its actuarial service contract this fall and it should consider that it pays more for this service than peers when evaluating proposals and negotiating fees to reduce overall costs. We also found that SDCERS can reduce the workload of Benefit Administration staff if it allows members to obtain an estimate of the price to purchase service credit from the website or a Member Counselor. SDCERS can also implement the process improvements recommended by its outside consultant hired in fiscal year 2009 to assess operations. SDCERS also estimates that it can eliminate five positions when it implements a new pension administration information system in fiscal year 2014.

SDCERS' investment management expenses for fiscal year 2010 expenses were higher than peers, largely because its investment portfolio was actively-managed—as opposed to some assets invested in passively-managed funds, which carry significantly lower fees. In Spring 2011, SDCERS reallocated a portion of its equity and fixed income investment portfolio to passively managed funds and, as a result, expects to reduce fees by $3.5 million per fiscal year.

During the audit, we found that the City may be able to reduce costs for retiree health care and disability benefits. The City spent almost $100,000 in fiscal year 2010 to reimburse high-income retirees' for their Medicare Part B Income Related

Monthly Adjustment Amount (IRMAA) premium even though this benefit is not explicitly defined in the Municipal Code. In addition, the City could reduce expenses if it offsets Industrial Disability Retirement (IDR) benefits by the amount of income recipients receive from outside employment and/or a Workers' Compensation award.

Lastly, we found that the City's retirement plan has the lowest funding ratio of any of its peers and that its fiscal year 2010 ratio was below what many experts consider to be adequate. The City's plan also has, by far, the highest unfunded actuarial liability compared to peers. While the City underfunded the pension system for a number of years, it has fully paid its recommended contributions since 2006. The City now has one of the highest employee and employer contribution rates compared to other systems.

SDCERS' trustees made a number of changes to actuarial methodologies and assumptions over the past five years based on recommendations from its independent actuary, and to be more in line with peers and industry standards. We found that SDCERS' actuarial assumptions and methodologies are now more conservative than peers. For example, SDCERS amortizes annual unfunded liabilities over fifteen years, as opposed to the more commonly employed period of twenty years. SDCERS also smoothes its annual investment gains and losses over approximately four years rather than the predominate five year period. Conservative methodologies essentially mean that the City pays more over a shorter period of time to pay down unfunded liabilities and investment losses. While less conservative assumptions and methodologies may result in lower payments today, it essentially shifts funding the retirement plan to future generations of employees and taxpayers.

We provide a total of 12 recommendations to strengthen operations and reduce costs. Ten recommendations are directed to SDCERS and two are directed to the Department of Risk Management. SDCERS agrees with nine recommendations and partially agrees with one. The Department of Risk Management agrees with one recommendation and disagrees with the second.

Introduction

In accordance with the City Auditor's Fiscal Year 2011 Audit Work Plan, we have completed an audit of the San Diego City Employees' Retirement System. We conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We limited our work to those areas specified in the "Objectives, Scope, and Methodology" section of this report.

The City Auditor's Office thanks the management and staff of the San Diego City Employees' Retirement System (SDCERS) for their time, information, insight, and cooperation during the audit process.

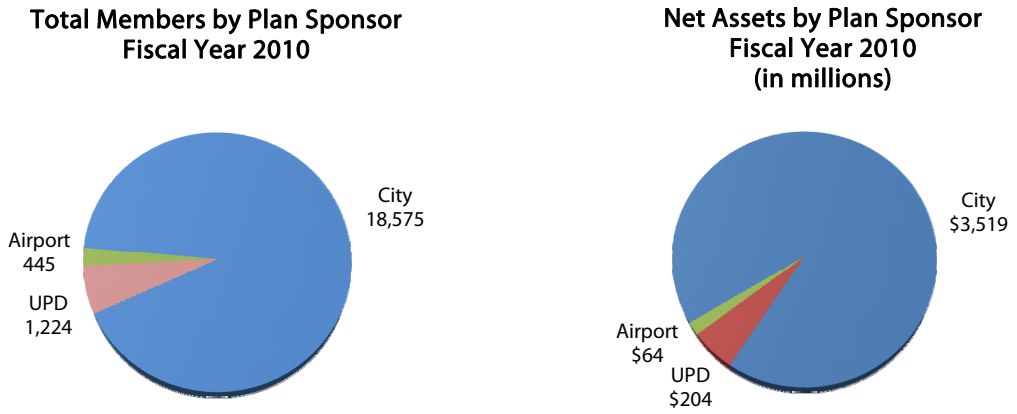
Background

Overview and History

The City of San Diego (City) established the San Diego City Employees' Retirement System (SDCERS) in 1927 to administer retirement, disability, and death benefits for its employees. The San Diego Unified Port District (UPD) and the San Diego Regional Airport Authority (Airport) joined in 1963 and 2003, respectively. As **Exhibit 1** illustrates, the City comprises the majority of SDCERS' assets and membership. Consequently, this report largely focuses on aspects of the pension system that relate to the City.

Exhibit 1

SDCERS' Assets and Membership by Plan Sponsor



Source: Auditor generated using data from SDCERS' fiscal year 2010 CAFR.

SDCERS is a defined benefit system, which guarantees employees a lifetime monthly benefit allowance upon retirement. The retirees' monthly allowance is based on a predetermined formula that considers years of service, age at retirement, and final compensation, as defined in the San Diego Municipal Code. In fiscal year 2010, retirees received an average annual benefit of $40,029.[1] As of June 30, 2010, the

[1] The figure includes the fiscal year 2010 average annual benefit for service retirees, disabled members, and beneficiaries. The average annual benefit for each group is as follows: Retired - $48,161; Disabled - $29,930; and Beneficiaries - $14,257.

actuarial liability,[2] which is used to determine the unfunded liability, was significantly higher for current retirees than active members—$3.9 billion versus $2.6 billion, respectively.

Disability benefits are similar to general retirement benefits in that they are determined by a formula. Industrial Disability Retirement (IDR) benefits are granted to employees who are injured on the job and can no longer perform their current function. Each IDR application requires an independent medical examination and review by SDCERS' staff of the applicant's medical records. The application may also be reviewed an outside adjudicator, i.e., retired judge. SDCERS Board of Administration approves or denies the application based on the results of these reviews.

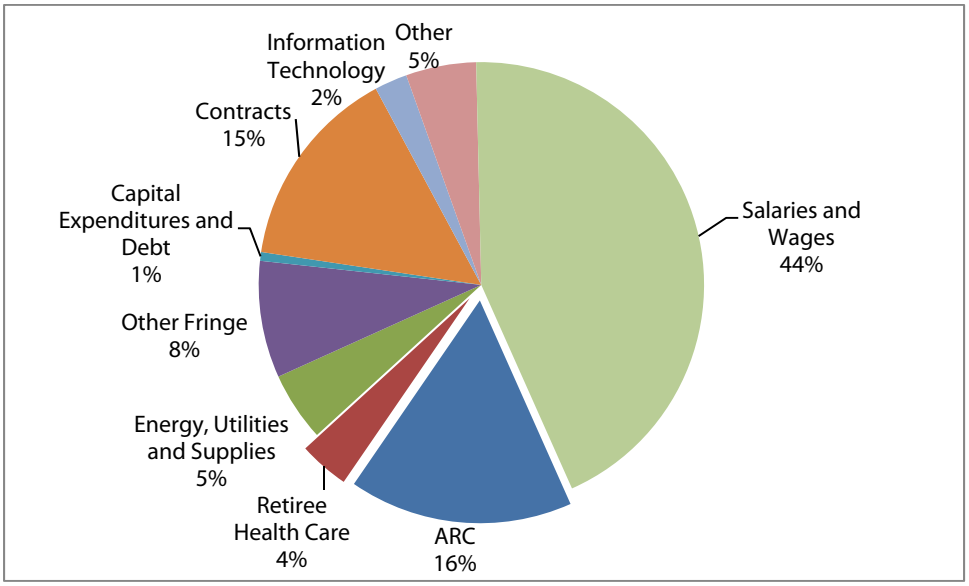
SDCERS also processes the City's retiree health care benefit. The City provides retirees an allowance to cover the cost of their post-employment health care. The current monthly allowance—fiscal year 2012—for non-Medicare eligible retirees ranges from $740 to $860. For Medicare eligible retirees, the City provides an allowance that ranges between $697 and $810. In addition, it reimburses the member's Medicare Part B premium.[3]

The retirement plan is funded by contributions from employees and plan sponsors, known as the annual required contribution[4] (ARC), in addition to income from investment earnings. The City pays current retirees' actual health care costs annually on a "pay-as-you-go" basis and pre-funds future retiree health care expenses through an investment trust administered by California Public Employees' Retirement System. As **Exhibit 2** shows, the City's costs for retirement benefits comprised 20 percent of the City's fiscal year 2011 General Fund—16 percent for the ARC payment and 4 percent for retiree health care.

[2] The actuarial liability is that portion of the present value of projected benefits that will not be paid by future employer Normal Costs or member contributions. The difference between this liability and the actuarial value of assets is the unfunded actuarial liability.
[3] The City, similar to other local governments that provide post-employment health insurance, offers medical coverage that supplements Medicare.
[4] GASB 27 defines the Annual Required Contribution (ARC) as the employer's required contributions for the year, calculated in accordance with certain parameters. The City's ARC is comprised of two components: the normal cost (the amount that, when combined with member contributions, will cover projected benefits of active members) and any payment required to amortize an unfunded liability.

Exhibit 2

Allocation of the City of San Diego Fiscal Year 2011 General Fund Budget



Source: Auditor generated from the City's fiscal year 2011 General Fund Budget.

As the City tries to improve its fiscal position and erase a structural budget deficit, there has been political and public interest in reducing retiree benefits and Other Post Employment Benefits. Consequently, the City has negotiated a number of reforms to curb growing retirement costs, including reducing pension benefits for employees hired after July 1, 2009 and eliminating retiree healthcare benefits for employees hired after July 1, 2005. Outside groups have also proposed several initiatives to further reduce employee retirement benefit expenses, including an effort to end guaranteed pensions for most new employees, cap pensionable salaries, and require eligible employees to contribute to their retirement health care costs.

The City's annual retirement cost is comprised of two components:

1) The "Normal Cost," the payment that, when combined with members' contributions and expected investment earnings, will accumulate to the amount necessary to fund retirement benefits, and

2) The actuarially-determined payment on the unfunded actuarial liability (UAL). The majority of the City's

retirement cost is related to paying down the UAL, not the Normal Cost—$168 million versus $63 million, respectively, in fiscal year 2012. Moreover, $91 million of the UAL payment is related to the remaining balance of the June 30, 2007 UAL, which the City is scheduled to pay down for 16 more years.

In the past decade, both SDCERS and the City have been criticized for decisions that allowed the City to underfund the plan, while simultaneously increasing benefits for members. The U.S. Department of Justice and Securities and Exchange Commission investigated these actions by former Board Members and City Officials. In addition, both SDCERS and the City retained firms to conduct independent investigations. The results were presented in two highly publicized reports: Kroll Report and Navigant Report.[5] Both reports noted a series of poor decisions and fiduciary breaches spanning decades and made a number of recommendations to correct deficiencies. SDCERS implemented the recommendations[6] and, in doing so, strengthened governance and operational transparency.

Governance

SDCERS is governed by a 13-member Board of Administration (board or trustee), which has "plenary authority and fiduciary responsibility"[7] to invest plan assets and administer the system. Plenary authority allows SDCERS' board to function and make decisions completely independent from its plan sponsors. Fiduciary responsibility requires that the Board act, first and foremost, in the members' interests, rather than in their own self-interest or the interests of the plan sponsors or the taxpayers at large.

With the passage of Proposition H in 2004, the Board's composition changed to include a greater number of trustees who are appointed by the Mayor and City Council, as opposed to elected by plan members. Specifically:

[5] "Investigation into the San Diego City Employees' Retirement System and the City of San Diego Sewer Rate Structure," August 8, 2006, often referred to as the Kroll report; and the "Investigation for the Board of Administration of the San Diego City Employees' Retirement System," January 20, 2006, often referred to as the Navigant report.

[6] The Office of the City Auditor's validated that SDCERS implemented the Kroll report recommendations through its formal bi-annual follow-up process. SDCERS asserts that it implemented the recommendations outlined in the Navigant report; however, we did not validate the status of the recommendations.

[7] Article XVI, section 17, of the California Constitution (California Constitution) was amended on November 3, 1992, by the passage of Proposition 162 to expressly provide a retirement board of a public pension system with plenary authority and fiduciary responsibility for investment of moneys and administration of the system.

- Seven are appointed by the Mayor and confirmed by City Council,[8]
- Four are elected by current members,
- One is elected by retired members, and
- One is designated by the Mayor.

This is consistent with best practices because it helps ensure that the majority of the board members are financially independent of the system and have relevant experience, while also recognizing that employees and retirees have a financial interest in the system and should have representation in decision-making. Also consistent with best practices, the majority of SDCERS' appointed trustees have financial and/or investment experience. SDCERS also created and filled an internal auditor position in 2007 that reports directly to the SDCERS' Audit Committee. The internal auditor develops a system-wide risk assessment and an annual audit plan to conduct audits covering the adequacy, efficiency, and effectiveness of SDCERS' internal control structure. The internal auditor also investigates claims of fraud and abuse and follows-up on recommendations made in audit reports.

To improve transparency, SDCERS televises full Board meetings[9] and makes the recordings available on its website. SDCERS also has a user-friendly website (www.sdcers.org), which provides its members and the public access to abundant information on the pension system.

SDCERS' Operations

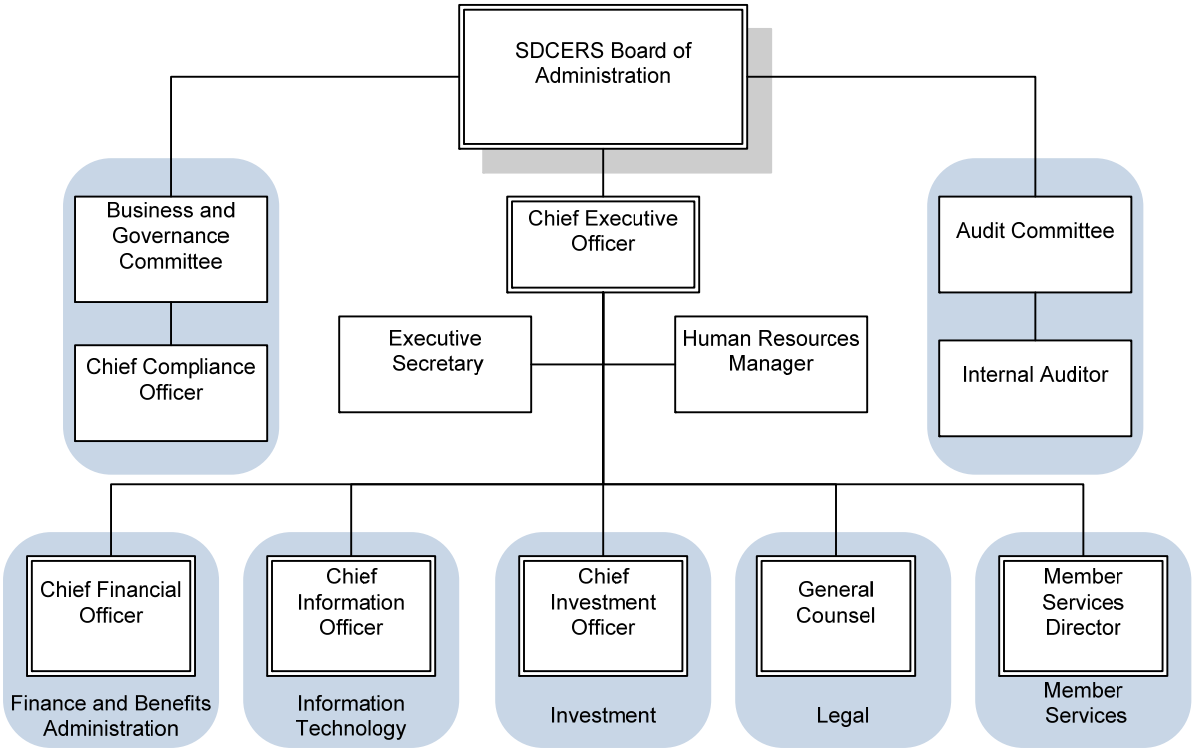
The Board appoints a Chief Executive Officer (CEO) to manage the daily operations of the system. The current CEO was appointed in June 2010; however, he had served as SDCERS' Chief Financial Officer since 2007. The current organization structure of SDCERS is illustrated in **Exhibit 3**.

[8] Pursuant to Article IX Section 144(a) of the San Diego City Charter, "No person who is a City employee, participant in the Retirement System, or City union representative may be eligible for appointment…Such appointees shall have professional qualifications of a college degree in finance, economics, law, business, or other relevant field of study or a relevant professional certification. In addition, such appointees shall have a minimum of fifteen (15) years experience in pension administration, pension actuarial practice, investment management, real estate, banking, or accounting…Such appointees shall not have any other personal interest which would create a conflict with the duties of a Board member or trustee."

[9] Board committee meetings are not televised.

Exhibit 3

SDCERS Organizational Chart



Source: Auditor generated.

SDCERS' operations, similar to most retirement systems, can be categorized into two primary activities:

- ***Administration*** includes enrolling and counseling members, paying retirees, handling all legal matters, and ensuring fiduciary soundness of the fund.
- ***Investment*** involves investing trust fund monies to generate adequate long-term returns that, when combined with employer and employee contributions, will result in sufficient assets to pay current and future pension benefits. SDCERS invests contributions in an investment portfolio that consists of equities, fixed income, real estate, and private equity according to the goals, objectives, and policies outlined in the Investment Policy Statement (IPS).[10]

[10] SDCERS' Investment Policy Statement is available online at https://www.sdcers.org/investments/Pages/InvestmentPolicyStatement.aspx

SDCERS' administrative and investment management expenses are paid from plan assets.[11] Consequently, administrative and investment management expenses reduce the level of assets available to pay retiree benefits. **Exhibit 4** illustrates the impact of these costs on net assets.

Exhibit 4

Impact of Investment and Administrative Expenses on Assets (in thousands)

	FISCAL YEAR 2009	FISCAL YEAR 2010
NET ASSETS AT JULY 1	**$4,384,847**	**$3,354,316**
ADDITIONS		
Contributions	248,590	280,681
Investment Earnings		
Total Investment Income (Loss)	(936,436)	514,043
Total Investment Expenses	(19,661)	(22,705)
Total Net Investment Earnings (Loss)	(956,097)	491,338
Total Additions	**($707,507)**	**$772,019**
DEDUCTIONS		
Total Benefit Payments	277,131	296,554
Refund of Member Contributions	4,069	3,478
Administrative Expenses	14,726	14,968
DROP Interest Expense	27,098	25,375
Total Deductions	**$323,024**	**$340,375**
Net Increase(Decrease)	**$(1,030,531)**	**$431,644**
NET ASSETS AT JUNE 30	**$3,354,316**	**$3,785,960**

Source: Auditor generated from SDCERS' fiscal year 2010 Comprehensive Annual Financial Report (CAFR).

Note: Administrative costs and net assets reflect the total for all three plan sponsors.

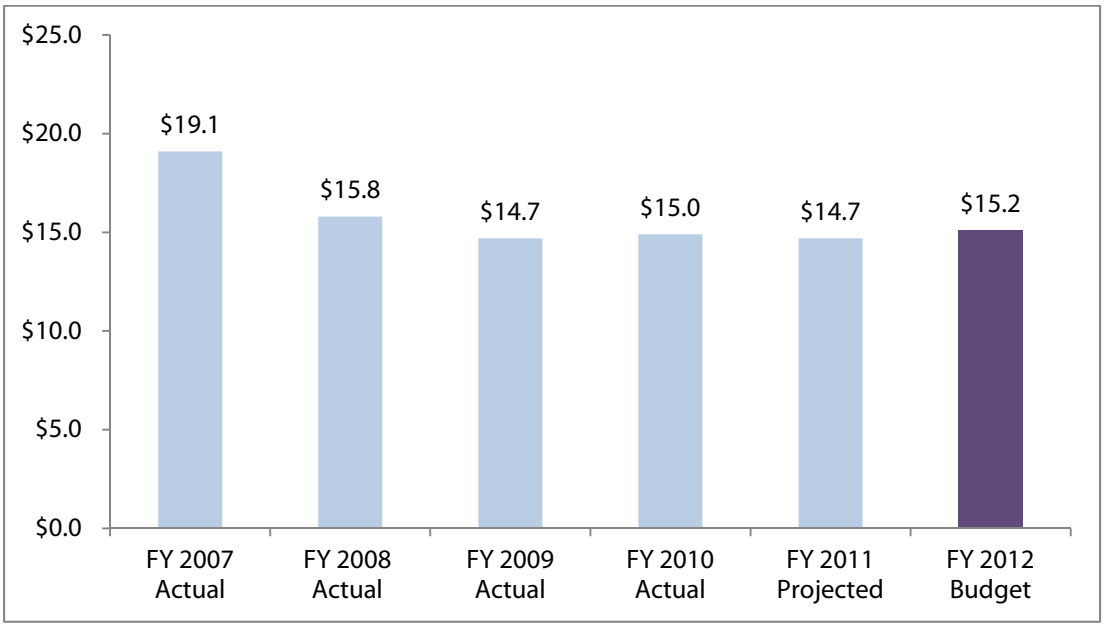
However, the impact of these expenses on the City's annual required contribution (ARC) to the pension plan is relatively small. The primary drivers of the ARC payment are the Normal Cost and the Unfunded Actuarial Liability (UAL) payment, as discussed in greater detail in the "Other Pertinent Information" section of this report. Nevertheless, this does not mean administrative and investment expenses should be ignored. Improving operational efficiency and effectiveness should be a goal of every organization.

[11] Fees for investment management, actuarial services, custodial bank services and other operational costs are netted against annual additions to plan assets.

As shown in **Exhibit 5**, SDCERS' administrative costs fell significantly between fiscal years 2007 and 2009, and have since remained stable at $15 million. The large drop after 2008 was largely because SDCERS completed a number of IT projects and transferred much of its ongoing IT support from outside consultants to San Diego Data Processing Corporation (SDDPC).

Exhibit 5

SDCERS' Administrative Expenses, Fiscal Year 2007 through Fiscal Year 2012 (in millions)



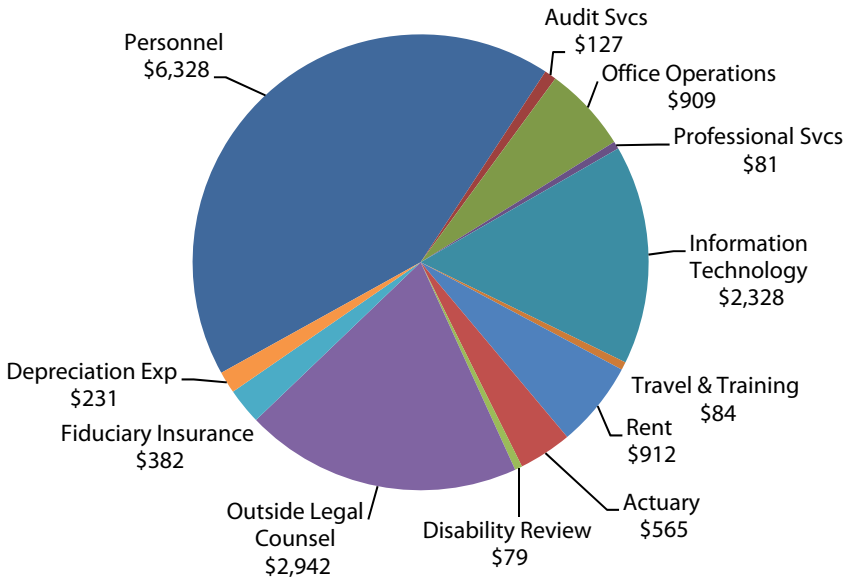
Source: Auditor generated from SDCERS' Comprehensive Annual Financial Reports (CAFR) and budget documents.

Exhibit 6 displays the breakdown of SDCERS' administrative expenses. The largest cost areas for SDCERS include personnel, information technology, rent, actuarial services, outside legal counsel and fiduciary insurance. The personnel costs include wages and fringe benefits for all of SDCERS' employees. Information technology expenses include the costs of SDDPC staff assigned to SDCERS, ongoing support for PensionGold, system maintenance and other IT services provided by contractors. Rent is the annual cost of office space for SDCERS' downtown location. SDCERS pays an independent actuary to complete annual valuations of the three plans. Outside legal counsel expenses represent the total cost to hire law firms to represent SDCERS in ongoing litigation, and provide advice on

fiduciary responsibilities and tax laws. It also includes the cost to hire adjudicators to review and provide an opinion on IDR applications. Lastly, fiduciary insurance costs represent the annual premium for fiduciary liability coverage to cover defense and indemnity costs for SDCERS' board members.

Exhibit 6

Breakdown of SDCERS' Fiscal Year 2010 Administrative Expenses (in thousands)



Source: Auditor generated from SDCERS' fiscal year 2010 Comprehensive Annual Financial Report (CAFR).

A big expense for SDCERS over the next two years will be implementation of its new pension administration information system. SDCERS' current pension administration system, PensionGold, was implemented in 2003, but it does not adequately support SDCERS' operations and creates numerous inefficiencies for staff. SDCERS hired a consulting firm in 2009 to assess its current operations and needs for a new information system. SDCERS, together with its consulting firm, drafted a Request for Proposals for a new software vendor.

After reviewing vendor proposals in the Winter of fiscal year 2011, SDCERS selected a firm with a strong history of implementing similar projects. The total cost of the pension replacement project is expected to be $7.8 million, including implementation and five years of maintenance and support. SDCERS also hired a firm to oversee project development and

implementation for $1 million because it does not have the in-house capacity to adequately monitor the process. SDCERS estimates that the system will ultimately result in cost savings and the project will break-even in 7 1/2 years. In addition, SDCERS estimates that five full-time equivalent (FTE) positions can be eliminated once the new system is implemented.

Objectives, Scope, and Methodology

We conducted a review of SDCERS to:

- Determine whether SDCERS' expenses are comparable to other retirement systems and identify reasons for anomalies;
- Identify potential reductions to administrative costs and investment management fees;
- Determine whether SDCERS allocates its administrative and investment management expenses appropriately to each sponsor;
- Determine the efficiency and effectiveness of SDCERS' disability pension approval process; and
- Determine if SDCERS' actuarial assumptions are comparable to peers.

We identified 15 systems, listed in **Exhibit 7**, with which to compare SDCERS' administrative costs, investment expenses, and actuarial assumptions.

Exhibit 7

List of Retirement Systems Used for Comparison

1. Los Angeles City Employees' Retirement System (LACERS)	California City Retirement Systems
2. City of Fresno Employees' Retirement System (FERS)[12]	
3. City of Fresno Fire and Police Retirement System (FFPRS)	
4. San Jose Federated City Employees' Retirement System (SJFCERS)	
5. City of San Jose Police and Fire Department Retirement Plan (SJPFRP)	
6. Contra Costa County Employees' Retirement Association (CCCERA)	California County Retirement Systems
7. San Diego County Employees' Retirement Association (SDCERA)	
8. Orange County Employees' Retirement System (OCERS)	
9. Alameda County Employee Retirement Association (ACERA)	
10. Sacramento County Employees' Retirement System (SCERS)	
11. San Bernardino County Employees' Retirement Association (SBCERA)	
12. City of Phoenix Employee Retirement System (COPERS)	Non-California Retirement Systems
13. Washington, D.C. Retirement Board (DCRB)	
14. City of Austin Employee Retirement System (COAERS)	
15. Denver Employees' Retirement Plan (DERP)	

Source: Auditor generated from SDCERS' fiscal year 2010 Comprehensive Annual Financial Report (CAFR).

In selecting peer systems, we considered a number of factors, including asset size, total membership, location in a metropolitan city, and availability of financial information. We also solicited SDCERS' input to identify systems they consider comparable. However, the most comparable systems, in terms of assets and membership size, were California county systems, which are subject to different financial reporting standards.[13] Consequently, we adjusted certain financial information reported by the county systems to improve comparability.[14] In

[12] The City of Fresno and the City of San Jose each have separate systems for general employees and public safety employees. While the systems are governed by different Boards of Directors, the City of Fresno Retirement Systems administers both Fresno systems, and the San Jose Department of Retirement Services administers both San Jose systems.

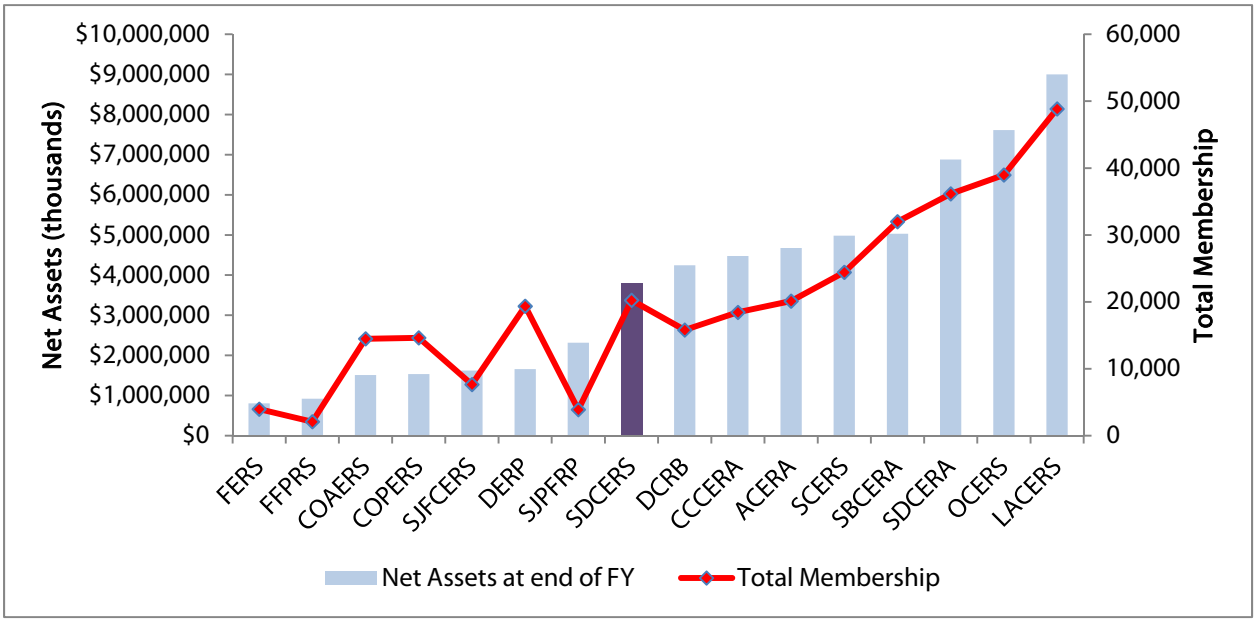
[13] California county systems are subject to the requirements of the California County Employee Retirement Law (CERL) of 1937. CERL states that investment and actuarial expenses will be borne by the pension system but are not considered costs of administration. In addition, it caps administrative costs at eighteen hundredths of one percent of the total assets.

[14] We identified certain investment management and consulting expenses that we could add back to administrative expenses. While it was possible to add these expenses to the systems' total administrative expenses, it was not possible to add them to a more detailed expenses line item, i.e., personnel, IT, etc.

addition, we included several California city systems that were significantly smaller and/or larger because their reporting was similar to SDCERS. Lastly, to ensure a robust analysis, we included several systems from other states. **Exhibit 8** shows how SDCERS compares with these other systems in terms of asset and membership size.

Exhibit 8

Net Assets and Total Membership by Pension System



Source: Auditor generated from each system's most recent CAFR available 6/1/2011.

The majority of our benchmarking analysis was conducted by comparing information reported in each system's most recently published Comprehensive Annual Financial Report (CAFR) and actuary valuation reports.[15] We compared administrative expenses in terms of actual annual cost, on a per-member basis, and as a fraction of year-end net assets expressed in basis points.[16] It should be noted, however, that a number of factors impact comparability between systems, including different financial reporting year-end dates—typically either June 30 or

[15] SDCERS, SDCERA, SJPF, SJF, SBCERA, FERS, FFPRS, COPERS, SCERS and LACERS have fiscal years ending June 30, 2010; ACERA, CCCERA, COAERS, DERP and OCERS have fiscal years ending December 31, 2009; DCRB has a fiscal year ending September 30, 2010.

[16] We reported costs in terms of basis points, as this is a common means to report financial costs for retirement systems. To calculate administrative expenses in basis points, we divided administrative costs by net assets and multiplied the percentage by 10,000. For example, if administrative expenses were .0010% of net assets, we reported them as 10 basis points.

December 31—and different funding levels. For example, administrative costs, when expressed in basis points, will be lower for systems with a higher funded ratio than the basis points ratio for systems with similar expenses but a lower funded ratio. In addition, at least one peer system has issued Pension Obligation Bonds, which provided additional assets that increase the funded ratio. Therefore, these systems' administrative expenses expressed in basis points will also be lower (assuming expenses are equal).

We contacted each system to obtain more detailed information; however, we only received information from a few systems. We asked each system to provide information on their fiduciary liability coverage, active versus passive investment strategy, ongoing and past litigation, and independence from their plan sponsors (specifically with regard how this impacts their legal, rent, and information technology expenses). We obtained all peer information from the systems' upper management in charge of finance, operations, investments, or external relations.

To identify potential cost savings and process efficiencies, we interviewed SDCERS' management and staff, and conducted numerous walk-throughs of business operations. We also interviewed several current and former Board of Administration trustees to solicit their input and concerns relative to SDCERS' operations.

To assess SDCERS' process for allocating costs to each plan sponsor, we interviewed accounting staff, and reviewed relevant policies, allocation methodology, and supporting documentation. We verified the accuracy of the allocation of expenses to plan sponsors during fiscal years 2009 and 2010 by reviewing invoices submitted by contractors and the calculations used by SDCERS' accounting staff.

To assess the disability approval process, we interviewed staff and reviewed policies and relevant documentation of the process. We also analyzed the impact of offsetting income earned by Industrial Disability Retirement (IDR) benefit recipients through outside employment or a Workers' Compensation award. Our analysis of an offset for a Workers'

Compensation award includes all 110 IDR benefit recipients (who filed for an IDR while a City employee) whose IDR applications were approved by SDCERS' Board of Administration in fiscal years 2006 through 2010. Our analysis on an offset for income from outside employment includes the 63 IDR benefit recipients who were not age-eligible for a service retirement.

To determine if SDCERS' actuarial assumptions were comparable to peers, we reviewed the assumptions and methodologies documented in each system's most recently published actuarial valuation. Specifically, we compared actuarial funding methods, Unfunded Actuarial Liabilities (UAL) amortization periods, asset smoothing periods, and practices with regard to negative amortization. We also reviewed reports from SDCERS' actuary and national organizations that track public pension system practices.

Audit Results

Finding 1: While SDCERS' Administrative Expenses are Higher than Peers, this is largely due to the Unique Environment in which it Operates. However, Opportunities Exist to Reduce Costs.

SDCERS' administrative expenses—approximately $15 million in fiscal year 2010—are higher than other retirement systems we reviewed, as shown in **Exhibit 9**.

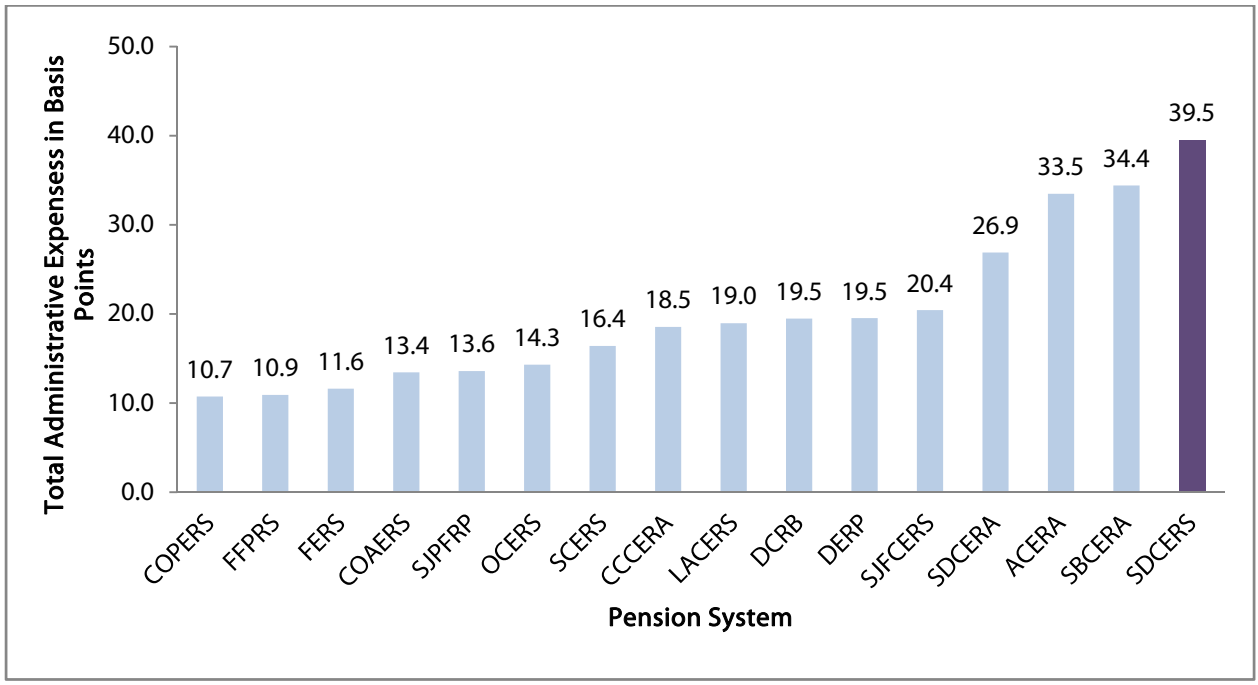
However, we found that the residual effects of SDCERS' history have resulted in a number of unique conditions that increase administrative costs, including:

- *Legal costs* to handle continuous litigation.
- *Fiduciary insurance premiums* to protect trustees' personal assets in the event they are named in a lawsuit.
- *Rent and information technology* expenses to ensure independence from plan sponsors and a transparent operating environment in accordance with best practices.
- *Actuary costs* due to non-valuation work related to lawsuits.

While SDCERS' has little control over certain administrative expenses, opportunities do exist to streamline operations and reduce expenses. For example, we identified several potential alternatives to fiduciary insurance to eliminate, or at least reduce, this cost. In addition, we found that actuary expenses are still high compared to peers even after considering litigation, and that SDCERS should identify whether costs can be reduced when it rebids the actuarial service contract this fall.

Exhibit 9

Total Administrative Expenses as a Fraction of Net Assets (in Basis Points)



Source: Auditor generated from retirement systems' most recent CAFRs as of 6/1/2011.[17] See Page 2 for list of acronyms.

Note: See comments on page 20 regarding how each system's funding status affects comparability of basis points data.

We also found that SDCERS can streamline operations if it implements the process improvements recommended by its outside consultant and that SDCERS should reassess its staffing level once it implements a new pension administration information system in fiscal year 2014.

SDCERS' Litigious Operating Environment Results in Higher-than-Peer Legal Expenses

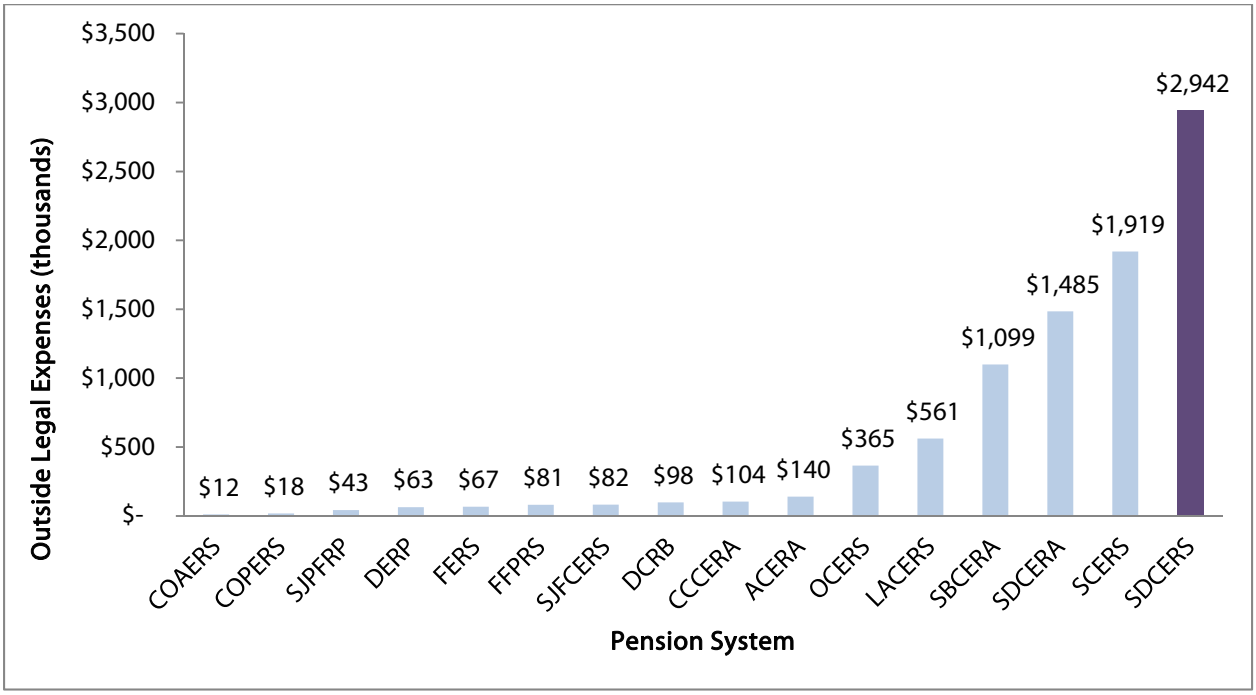
SDCERS has been embroiled in lawsuits for years due, in part, to the actions of prior trustees and City officials. When SDCERS is named in a suit, they hire outside legal counsel for representation. SDCERS also maintains an in-house legal team to monitor their outside counsel, in addition to handling routine legal responsibilities, such as interpreting governing documents and providing guidance to trustees and staff.

[17] We based our analysis on the June 30, 2010 year-end CAFR date for SDCERS, SDCERA, SJPFRP, SJFCERS, SBCERA, FERS, FFPRS, COPERS, SCERS and LACERS; December 31, 2009 year-end CAFR date for ACERA, CCCERA, COAERS, DERP and OCERS; and September 30, 2010 year-end CAFR date for DCRB.

Consequently, outside legal costs are one of the largest expenses for SDCERS, comprising 20 percent ($2.94 million) of their fiscal year 2010 expenses, or 7.8 basis points. SDCERS' legal expenses were also significantly higher than any other system in our benchmarking study, as shown in **Exhibit 10.** However, other systems do not have the litigation workload of SDCERS. For example, SDCERS was involved in seven active lawsuits during fiscal year 2010, which continued through the period of this audit (they the defendant in six cases and the plaintiff in one), other systems had minimal litigation. Costs related specifically to litigation accounted for close to 60 percent of SDCERS' total outside legal costs.

Exhibit 10

Comparison of Outside Legal Expenses by Pension System



Source: Auditor generated from retirement systems' most recent CAFRs as of 6/1/2011.

Subtracting litigation costs brings SDCERS' cost closer in line with SDCERA. While still on the high side compared to peers, some of SDCERS' peers use their City Attorney's Office or equivalent. This arrangement is often free for the system or provided at a fraction of the cost of hiring in-house legal staff or a private firm. However, this arrangement is not considered a best practice since it compromises independence and

objectivity. COPERS, one system that relied on the City Attorney's Office for legal representation and guidance during the fiscal year 2010 CAFR reporting period, recently began hiring outside counsel, and San Jose's Retirement Department uses their City Attorney, but indicated that they would prefer an independent attorney.

In addition to outside legal costs related to litigation, SDCERS also spent $170,000 in fiscal year 2010 on adjudicators (retired judges) to evaluate the eligibility of Industrial Disability Retirement (IDR) applications. Trustees are responsible for approving IDR benefits. While SDCERS' staff review the facts and present a recommendation to approve or deny the application, trustees often refer cases to an adjudicator for an opinion, particularly if any of the facts are disputed. Trustees indicated that using an adjudicator helps ensure impartiality and objectivity of the final decision, and therefore reduce the likelihood that their decision will be legally challenged by the applicant.

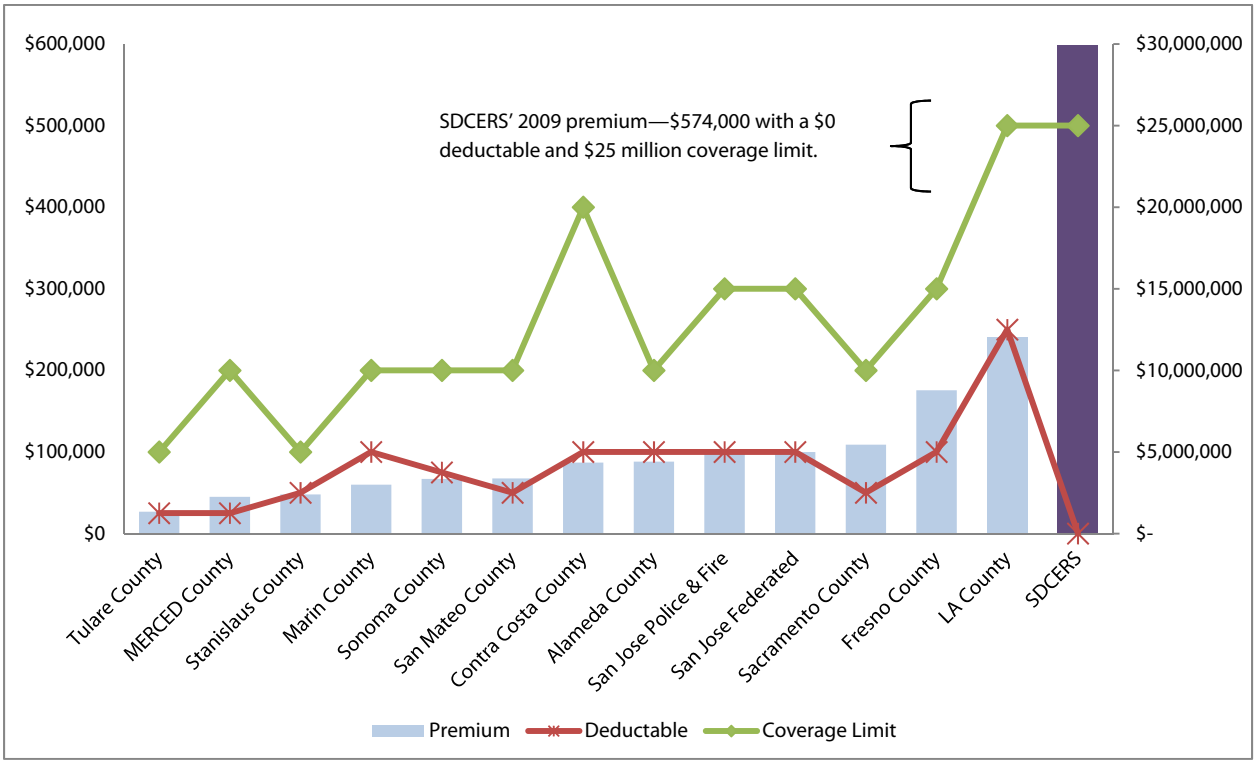
SDCERS' Annual Premium for Fiduciary Insurance is Significantly Higher than Peers

SDCERS purchases annual fiduciary liability insurance to protect its trustees from being personally liable for legal costs if they are named in a lawsuit resulting from their official duties. The current coverage premium is $557,000, which is a decrease from the prior year premium of $574,000. Fiduciary insurance is not uncommon among California retirement systems, as a 2009 survey of California public retirement systems conducted by Los Angeles City Employees' Retirement System (LACERS) revealed. However, as illustrated in **Exhibit 11**, SDCERS pays significantly higher premiums than other systems, which is likely a function of SDCERS':

- High coverage level,
- $0 deductible, and
- Litigious history.

Exhibit 11

Comparison of California Retirement Systems' Fiduciary Insurance Premiums, Deductibles, and Coverage Limits



Source: Auditor generated from survey conducted in December 2009 by Los Angeles City Employees' Retirement System (LACERS).

The majority of SDCERS' trustees are volunteers charged with making difficult, and sometimes unpopular, decisions. Trustees function amid SDCERS' tumultuous history and ongoing litigation; therefore, they bear an increased inherent risk that their decisions could be legally challenged. To attract and retain experienced and committed trustees, SDCERS and the City should have a cost-effective means to assure trustees that their decisions and actions, as long they are made within the scope of their fiduciary responsibilities, will not result in personal financial loss.

However, despite the cost, SDCERS' fiduciary insurance policy does not fully provide this assurance. First, coverage only applies after board members have exhausted their options to obtain defense and indemnification from the City or SDCERS. Second, numerous coverage exclusions exist, something SDCERS acknowledges. For example, coverage does not apply

to claims related to alleged wrongful acts occurring prior to April 1, 2005. Consequently, trustees may not be covered if they act on an issue that is related to a decision made by former trustees prior to April 2005. All of these coverage exceptions undermine the benefit of fiduciary insurance.

Recognizing that fiduciary insurance is costly and does not provide adequate assurance to trustees, SDCERS' CEO and Board President requested, at a March 2011 Rules, Open Government, and Intergovernmental Relations Committee (Committee) meeting, that the City: 1) affirm its obligation to defend and indemnify Board members pursuant to California Government Code Section 995, and 2) permit SDCERS' trustees to hire their own attorneys at the City's expense if a lawsuit is filed against them, including cases where Trustees are sued by the City. The City Attorney advised the Committee not to approve the request. The Committee ultimately decided not to take action on the request. According to SDCERS, several trustees threatened to resign, with one ultimately doing so.

History

SDCERS first purchased fiduciary insurance in 2007. Between 2002 and 2006, the City was required to defend and indemnify SDCERS' board by City Council approved resolution (R-297335). However, the City refused to defend trustees in accordance with R-297335 when trustees were sued.[18] In addition, a former City Attorney recommended that the resolution be repealed because it did not exempt the City when trustees acted outside the scope of their duties or due to fraud, corruption or malice. The City Council agreed and repealed the resolution for any acts or omissions by board members occurring after April 2006.

With the repeal of R-297335, the City decided to base its decision to defend and indemnify current board members on the rules outlined in California Government Code section 995. This code requires that public entities defend employees against any civil action that arises out of an act or omission that is within the scope of their responsibilities. However, the code also lists a number of exceptions, including instances of fraud, corruption or malice, or when providing a defense constitutes a conflict of interest.

[18] The City ultimately did reimburse the former trustees, but only after the Court required them to do so in accordance with R-297335.

SDCERS' trustees do not believe that California Government Code section 995 provides adequate protection. First, if the City brings a civil action against the board members, a conflict of interest may exist and the City would not be required to provide legal defense and indemnity. Second, trustees must rely on the City to determine whether their actions were a result of fraud, corruption, or malice, and therefore, whether the City is required to provide a defense. For systems that do not have SDCERS' history, this might not be concern. SDCERS, to the contrary, has a contentious history with the City Attorney's Office and City Officials, and trustees fear that the City will not defend and indemnify them. Moreover, in the past, the City has brought civil action against individual board members and refused to pay their attorney fees.

Alternatives to Fiduciary Insurance

Defending and indemnifying trustees is a very complex and serious issue. It is imperative that SDCERS attract competent and committed board members who are willing to take on the significant, and often difficult, responsibilities required. Without a skilled board, SDCERS' policy making function will be at risk. However, neither California Government Code section 995 nor fiduciary insurance appear to be the best solution, and the City and SDCERS should identify a more effective and economical solution.

For example, SDCERS could investigate the option of self-insuring.[19] According to the City Attorney's Office, in the past 10 years, the cost to defend and indemnify board members has been $2.2 million. SDCERS will spend that amount on annual fiduciary insurance premiums in less than four years. If SDCERS were to self-insure, they could set aside a pre-determined amount likely to cover trustees' expected legal costs.

Self insurance could be beneficial to all involved parties – SDCERS, the City and trustees. First, self-insurance programs

[19] With self insurance, SDCERS would assume the risk of providing coverage to their employees or board members. The employer pays out of pocket for each claim as they are incurred rather than paying a fixed premium to an insurance carrier. Generally, self-insured employers set up a special account with funds reserved to pay incurred claims. The annual contributions to the account are determined by expected annual payout and risk tolerance. Investment income can be earned on the funds. In California, most self-insured employers contract with a third-party administrator to administer their plan. As of January 1, 2011, a total of 7,466 California employers, including 3,201 public employers, were actively self insured, not counting past self insured employers that were still paying claims from their periods of self insurance.

can be operated at a lower cost than obtaining commercially available insurance policies, resulting in lower administrative expenses. SDCERS would have control over how the funds are managed and claims are processed. Transferring the control to SDCERS should provide trustees with greater assurance that their request for legal defense and indemnification will be granted. The California Public Employees' Retirement System (CalPERS) maintains a self-insurance program for breach-of-fiduciary-duty claims brought against its trustees.

According to SDCERS' management, trustees, in conjunction with its legal counsel, have explored the option of self-insurance; however, they have not yet identified a legally viable means to self-insure based on initial analysis.

If SDCERS determines that self-insurance is not feasible, SDCERS should explore other options, including working with the City to develop a mutually agreeable plan to defend and indemnify board members. For example, the City could consider drafting a formal resolution that provides Board members with greater protections than what is afforded under California Code section 995 but provides the City prudent exceptions that weren't allowed under the prior City resolution (R-297335). For example, the City could commit to paying for board members' outside legal counsel when a conflict of interest arises, but exempt the City from providing coverage if the trustee acts outside the scope of his or her responsibilities or fraudulently.

SDCERS and the City might also consider agreeing to use an independent third party to review and validate the City's determination if it finds that trustees were not acting within the scope of their responsibilities. Lastly, SDCERS could explore ways to reduce the cost of its fiduciary insurance, including evaluating its current coverage limit to verify that current risk continues to warrant such broad coverage. The options presented in this report are not intended to be an exhaustive list. What is central to this discussion is that it spurs a dialogue between SDCERS and the City to identify a solution to this complicated, yet costly, issue.

Recommendation #1 SDCERS' management and trustees should work with its legal counsel to identify alternatives to fiduciary insurance, including, for example:

a) Investigating the feasibility and cost-effectiveness of self-insuring for trustee defense and indemnification costs.

b) Working with the City Attorney's Office to develop a mutually satisfactory agreement for City Council consideration to defend and indemnify trustees for acts or omissions that arise of out the scope of their responsibilities. Such an agreement should provide greater assurance to trustees than what is currently afforded under California Code 995, but provide prudent exceptions, such as if a trustee acts fraudulently.

c) Using an independent third party to validate the City's determination if it finds that trustees were not acting within the scope their responsibilities.

d) Evaluating the current risk and coverage level, and, if prudent, adjust to lower annual premiums.

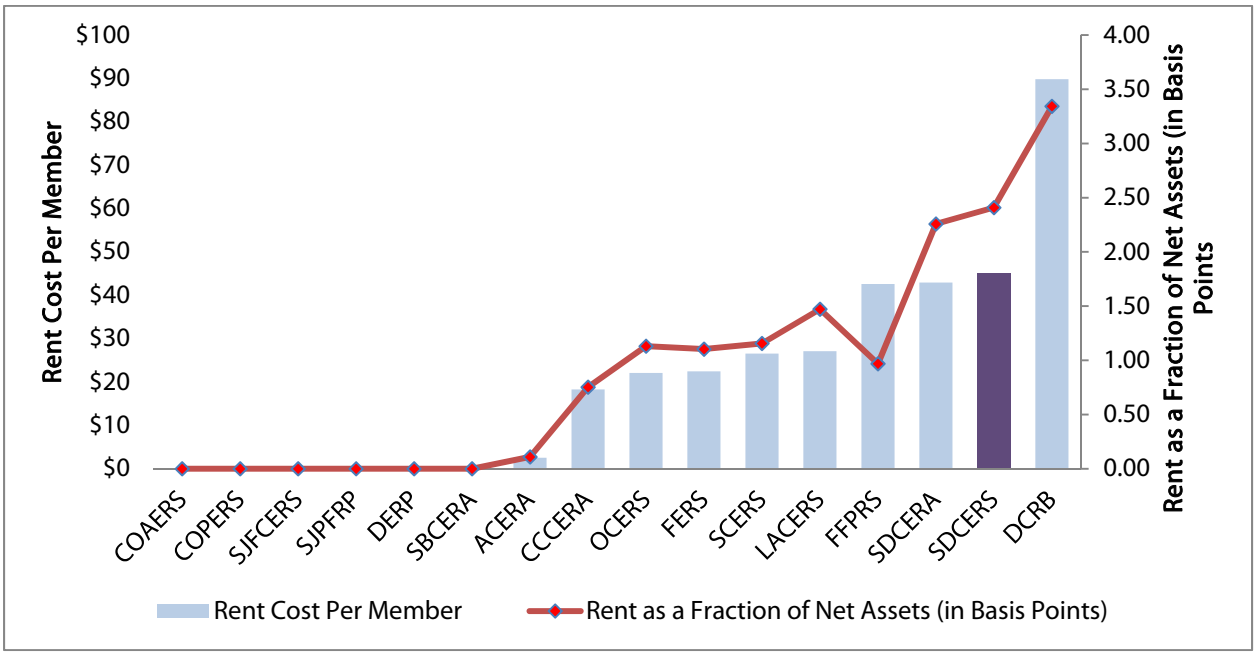
SDCERS management should recommend to its trustees that they cancel the current fiduciary insurance policy when a more suitable and cost-effective alternative is identified and implemented. (Priority 2)

SDCERS' Rent Expense is Higher than Peers because it does not Own its Building nor Rent Space from Plan Sponsors

SDCERS rents office space for all administrative functions in downtown San Diego. SDCERS paid $912,000 for the space during fiscal year 2010. While on the high side compared to peers, it is not completely out-of-line either—particularly when costs are compared per member and in basis points, as illustrated in **Exhibit 12**. Moreover, several unique factors contribute to SDCERS' relatively higher-than-peer rent costs.

Exhibit 12

Rent Expenses as a Fraction of Net Assets (in Basis Points) and Per Member



Source: Auditor generated from systems' most recent CAFRs as of 6/1/2011.

First, SDCERS maintains independence from its plan sponsors and rents its own space in an off-site location. Some systems, for example COPERS, reside in city-owned space and therefore do not pay rent. Second, SDCERS does not own its building. DERP, ACERA and COAERS are among plans that own their administrative office buildings and use them as assets of the system. Third, San Diego's real estate market is generally more expensive than several other areas in our benchmarking study. However, SDCERA, which is also located in the City of San Diego, also has similar rent expenses—both per member and in

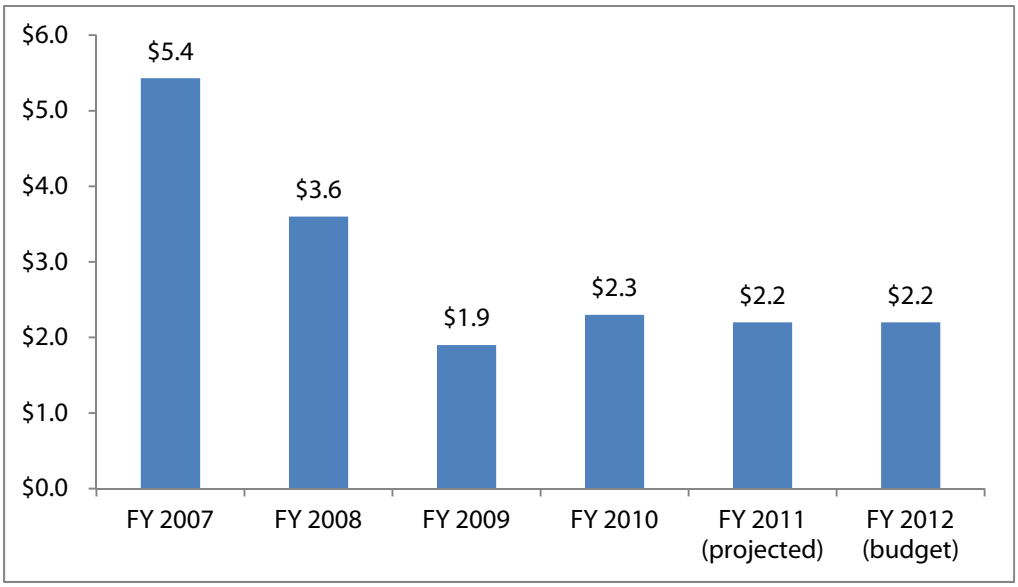
basis points.[20] In addition, a central location in any major city generally comes at a premium. However, SDCERS' close proximity to its plan sponsor affords convenient access for its members and for staff who need to frequent City Hall. LACERS, located in downtown Los Angeles, cited similar factors for their high rent costs.

SDCERS Reduced its Information Technology Expenses but Independence and Transparency may Drive up Costs

SDCERS' fiscal year 2010 computer and data processing costs were $2.3 million, which represent a significant reduction from 2007 expenses, as illustrated in **Exhibit 13**. The reduction was largely because SDCERS completed several projects and transferred IT support services from outside contractors to San Diego Data Processing Center (SDDPC).

Exhibit 13

SDCERS' IT Expenses from Fiscal Years 2007 – 2012



Source: Auditor generated from SDCERS' CAFR and budget documents.

When comparing SDCERS' IT expenses to other systems' reported costs, SDCERS appears higher. However, reporting differences among systems make an accurate comparison extremely difficult, if not impossible. For example, SDCERS primarily uses SDDPC staff, whereas other systems use their own internal staff. When IT staff are employees of the system, the cost is a personnel expense rather than a data processing cost. We were able to obtain additional information from one

[20] SDCERA staff noted rent expenses will decrease from fiscal year 2010, as a lease they were holding on a downtown office space expired during fiscal year 2011.

system—SDCERA—to better understand IT costs. SDCERA's data processing costs were reported as $329,000 in its fiscal year 2010 CAFR; however, its management indicated that the system's total IT cost is closer to $3 million – more than SDCERS. Consequently, while SDCERS' IT expenses may appear high based on information reported in CAFRs, this may not actually be reflective of reality.

SDCERS, however, does have some unique circumstances that may drive-up its IT expenses compared to other systems. First, SDCERS largely maintains independent IT operations from its plan sponsors, which means it bears the brunt of software licensing and support costs. SDCERS' IT division manages 48 applications ranging from pension specific programs to databases, MS/Unix servers, and mainframe applications. Maintaining a broad range of applications requires specialized staff, which can be costly. However, SDCERS' CIO devised a cost-effective approach for managing its applications, wherein full-time staff—three SDCERS employees and eight SDDPC staff—are supplemented with additional specialized SDDPC employees who work on a part-time, as-needed basis. This flexible staffing arrangement enables SDCERS to manage the broad range of applications with fewer full-time employees, lowering overall IT costs.

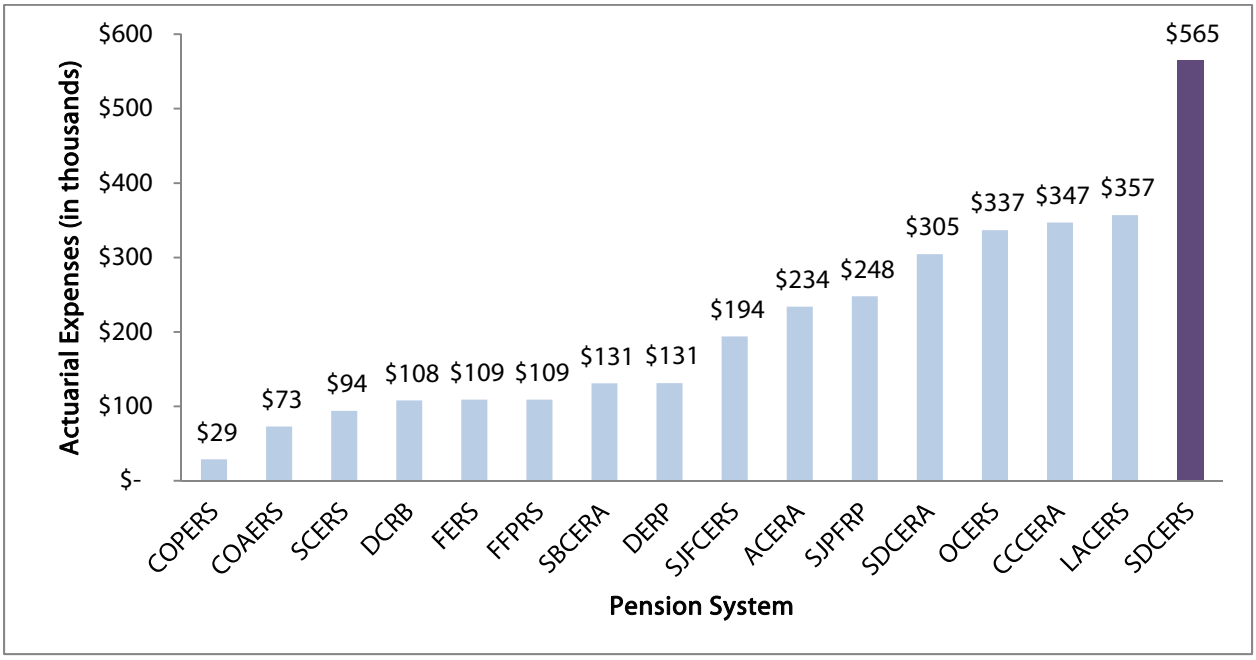
Initiatives to improve transparency may also result in higher IT costs. Specifically, we found that SDCERS maintains one of the most user-friendly websites of any of its peer systems. SDCERS also televises its full board meetings and makes the video recordings available on its website to ensure decisions are fully transparent.

Work Related to SDCERS' Litigation has Resulted in SDCERS' Higher than Peer Actuary Costs

SDCERS spent $565,000 on actuarial services in fiscal year 2010. This is significantly more than any pension system in our study, as shown in **Exhibit 14**; however, this is attributable to several factors. First, non-valuation work related to litigation accounted for $170,000 of this cost. According to SDCERS, the actuary analyzes the actuarial impact of any plan changes that may result from litigation. For example, in fiscal year 2010, the actuary performed work related to "substantially equal" City Charter language and associated member contribution rate work.

Exhibit 14

Comparison of Actuarial Expenses by Pension System



Source: Auditor generated from retirement systems' most recently available CAFRs as of 6/1/2011.

In addition, SDCERS' actuary conducts three separate valuations—one for each plan sponsor. Moreover, SDCERS must complete three valuations as a requirement of the Group Trust.[21]

We found that all other systems conducted only one annual actuarial valuation even if they had multiple employers. In addition, each of SDCERS' plans includes multiple tiers based on an employee's classification and hire date, and includes both general and public safety employees. Other cities, such as Fresno, San Jose and Los Angeles, have separate systems for general and public safety employees.

Even after accounting for these factors, SDCERS' actuarial expenses still appear to be high compared to peers. SDCERS intends to issue an RFP for actuarial services in the Fall of 2011. SDCERS should consider that its costs are higher than peers when it evaluates the proposals and negotiates fees with the selected firm.

[21] SDCERS established a group trust in 2007 to provide legal protection for each plan sponsor's assets in the SDCERS pooled investment fund.

Recommendation #2

SDCERS should consider that its current actuary costs are high compared to peers when they evaluate proposals received in response to its Fall 2011 RFP for actuarial services and negotiate fees with the selected firm. (Priority 3)

Certain Operational Inefficiencies Exist Due, in part, to SDCERS' Current Pension Administration Information System

SDCERS' current pension administration system, PensionGold, does not adequately support the Benefit Administration function. SDCERS implemented PensionGold in 2003. However, it is not capable of accurately calculating the numerous complexities of SDCERS' retirement benefits. This has resulted in operational inefficiencies since staff must complete critical calculations manually, outside of PensionGold.

Recognizing PensionGold's limitations, SDCERS hired a consultant in 2009 to assess their business practices to identify operational needs for a new information system and to recommend process improvements. The consultant identified 107 operational issues resulting from inadequate information systems and inefficient business processes. The consultant made a number of recommendations for SDCERS to address through both process improvements and implementation of a new information system. They also found that about five positions in could be eliminated if the system inefficiencies are resolved.

SDCERS executed a contract in May 2011 with an information system firm to develop and implement a new system—expected implemented is January 2014. However, SDCERS decided that it would not begin implementing any of the recommended process improvements until it selected a new pension software package. Given the efficiencies that will result from these process improvements, SDCERS should ensure that it does not lose sight of these recommendations as it focuses on developing and deploying the new information system. SDCERS should designate an individual, likely its Internal Auditor, to ensure the consultant's recommendations are implemented. Implementing the process improvements will only bolster the operational benefits of the new pension administration system.

Recommendation #3

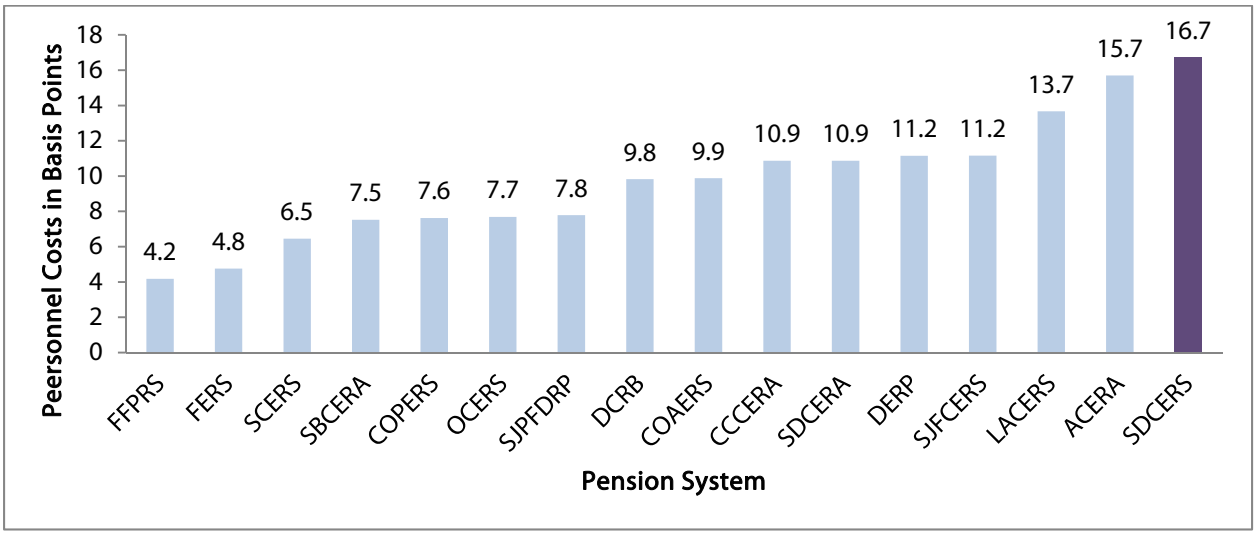
SDCERS should designate an individual, possibly its Internal Auditor, to ensure the business process recommendations made by its consultant are implemented. (Priority 3)

While Difficult to Accurately Compare, SDCERS' Personnel Costs Appear on the High-End of Peer Systems

SDCERS spent more than $6.3 million on salary and fringe benefits during fiscal year 2010. When comparing personnel expenses as a fraction of net assets with peer systems, SDCERS appears higher, as shown in **Exhibit 15**. However, it is difficult to accurately compare personnel expenses because not all systems report their entire staffing costs as a personnel expense. Some systems, particularly 1937 Act County systems, allocate certain staff costs to another budget item, in particular the costs for in-house investment staff. In addition, variances in cost-of-living by region may impact the staff salaries paid. And, as previously mentioned, relative funded ratios affect the comparability of basis point measurements.

Exhibit 15

Personnel Costs as a Fraction of Net Assets (in Basis Points)

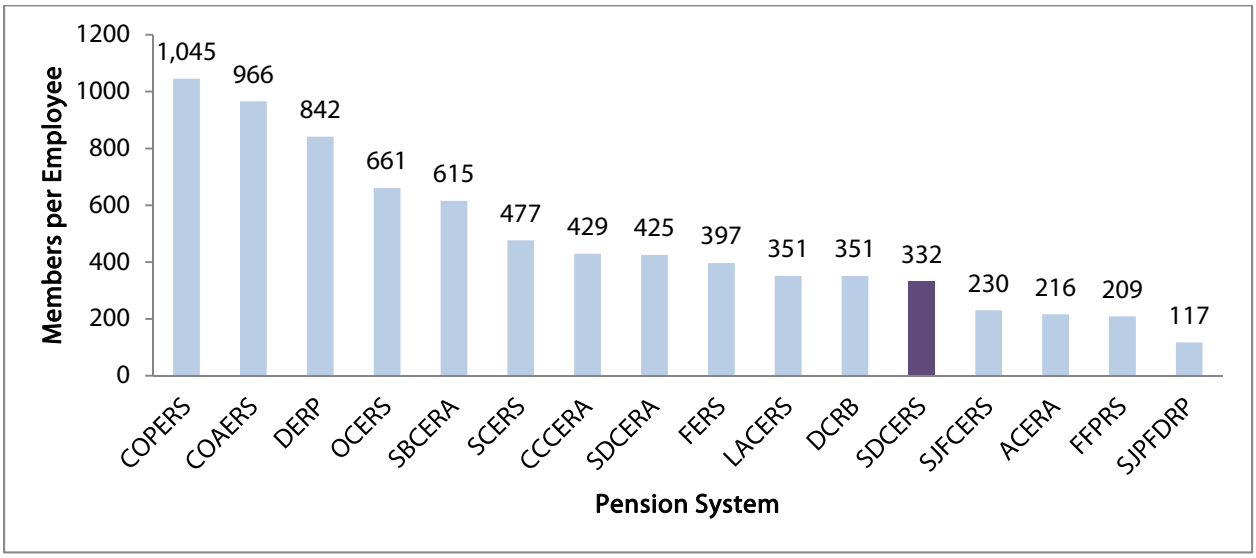


Source: Auditor generated from retirement systems' most recently available CAFRs as of 6/1/2011.

When we compare members per employee, SDCERS has one of the lower, but not the lowest, member to employee ratios of its peers, as shown in **Exhibit 16**. Again, this is a difficult comparison because some systems—COPERS, for example—share staff resources with their plan sponsor. In addition, a lower ratio of members to staff may indicate better customer service; however, we did not assess customer service as part of this audit.

Exhibit 16

Members per Employee by Pension System



Source: CAFR documents or respective system budget documents.

As noted previously, operational inefficiencies within SDCERS do exist – largely as a result of inadequacies with its current pension administration system. SDCERS is implementing a new system, which they expect will automate a number of manual processes and, therefore, result in streamlined operations and reduced staff costs. SDCERS anticipates that it could eliminate five positions once its new system is implemented.

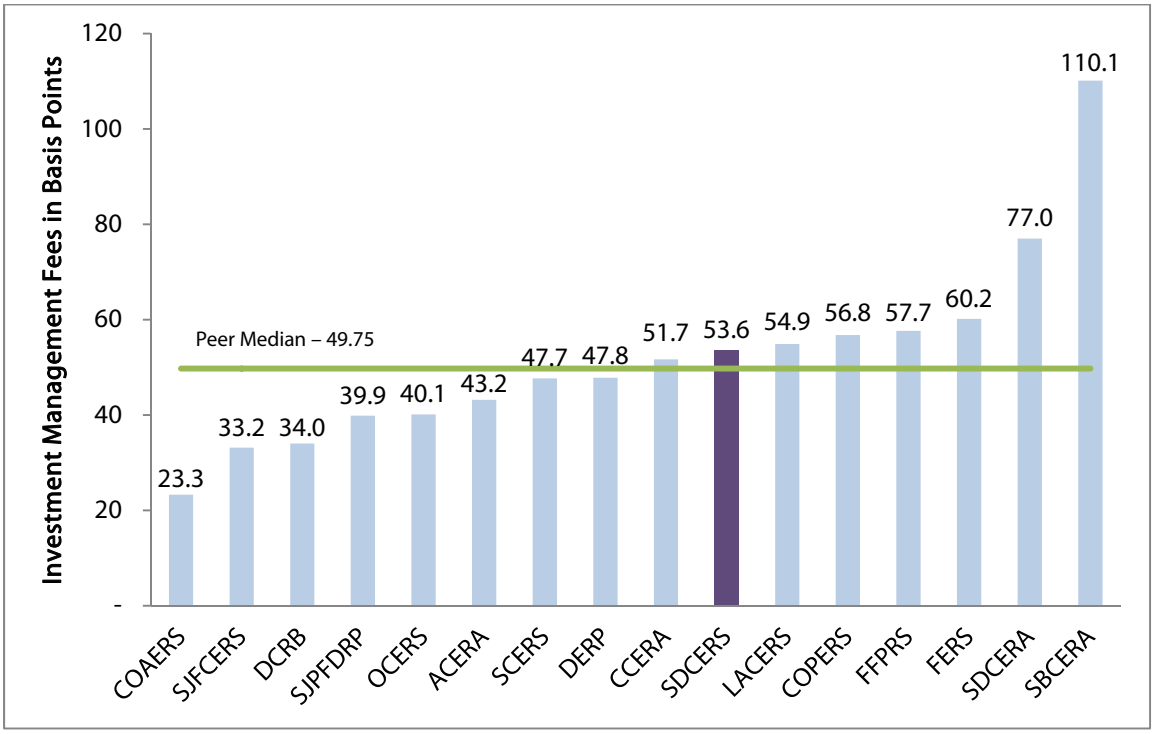
Recommendation #4 **SDCERS should reassess its staffing level once the new pension administration system is implemented and eliminate unnecessary positions to reduce personnel costs. (Priority 3)**

Finding 2: Opportunities May Exist to Reduce Investment Expenses

SDCERS' fiscal year 2010 investment expenses were slightly higher than the peer median, as illustrated in **Exhibit 17**, yet its five-year rate of return on investments as of June 30, 2010 (2.80 percent)[22] was slightly lower than the peer median rate of return of 2.90 percent. However, SDCERS' investment performance marginally outperformed its own benchmark, as shown in **Exhibit 18**.

Exhibit 17

Comparison of Investment Management Costs as a Percent of Assets under Management (in basis points)

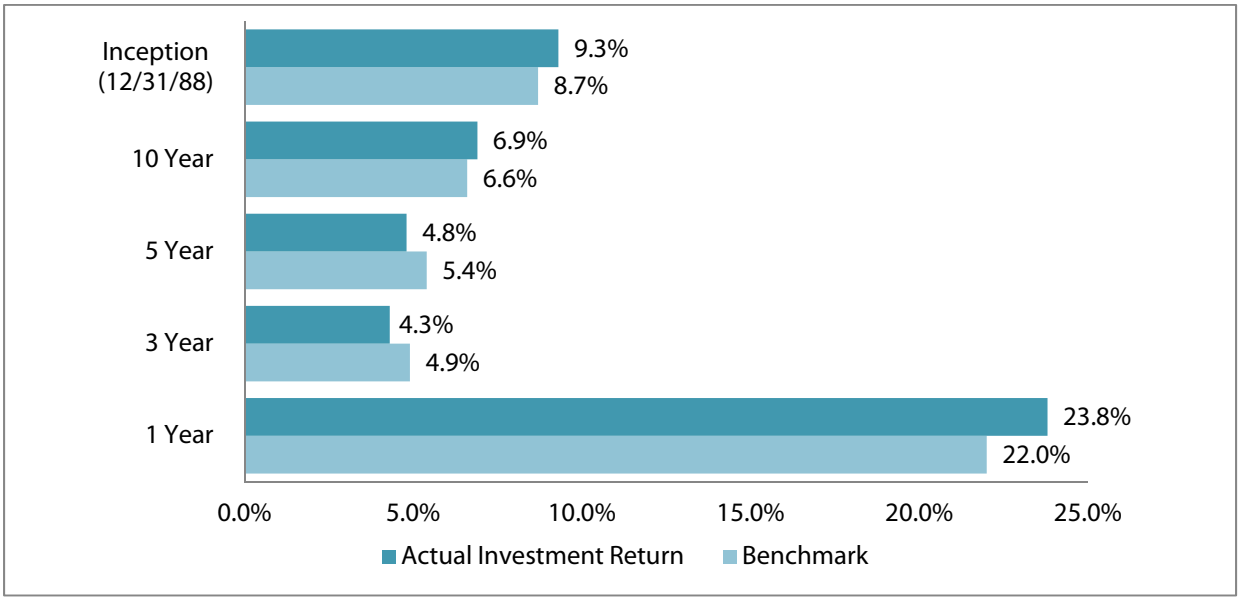


Source: Auditor generated from retirement systems' most recently available CAFRs as of 6/1/2011.

[22] The five year rate of return of 2.8 percent corresponds to the fiscal year ending June 30, 2010. However, the five year rate of return reported in Exhibit 18 corresponding to the fiscal year ending June 30, 2011. Consequently, the two numbers do not match.

Exhibit 18

Comparison of SDCERS' Actual Rate of Return with its Benchmark as of June 30, 2011



Source: SDCERS' Investment Consultant's Second Quarter 2011 Market Environment Report.
Note: Rates beginning July 1, 2010 are shown net of fees. Prior periods are shown gross of fees.

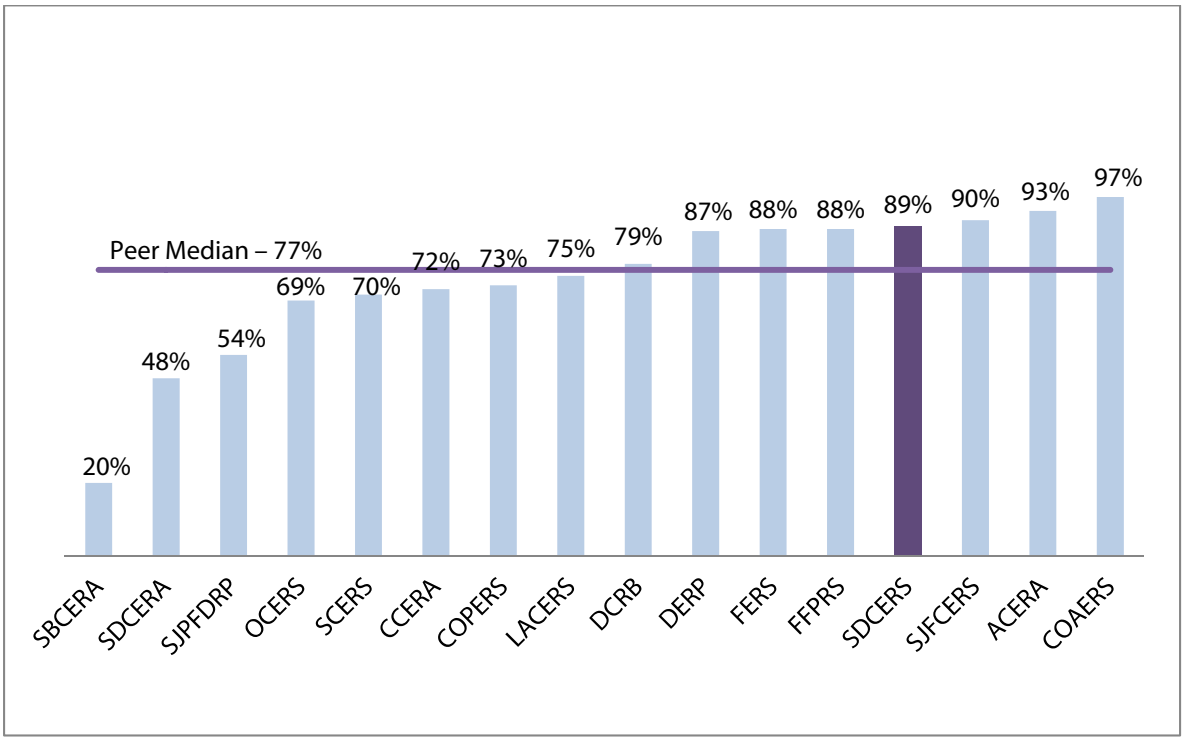
Investment expenses are primarily a function of the fees charged by firms to manage the investments, which are determined by a combination of:

1. Total assets under management, i.e., the more assets a system has invested the more fees (in total dollars) they will pay.
2. The allocation of the investment portfolio, where certain investments, e.g., equity and fixed income portfolios, have inherently lower fees than other investments, such as private equity or real estate. In addition, an actively managed portfolio will cost more than one that is passively managed.
3. The system's ability to effectively negotiate standard fees.

Compared to the peer median, SDCERS' portfolio as of June 30, 2010 was more biased toward equity and fixed income investments, as illustrated in **Exhibit 19**. These types of investments tend to have lower fees and a greater likelihood of being negotiated. Because of this, we might have expected SDCERS' investment management expenses to be lower than, or at least closer to, the peer median.

Exhibit 19

Comparison of Investment Portfolio Allocation to Equity and Fixed Income

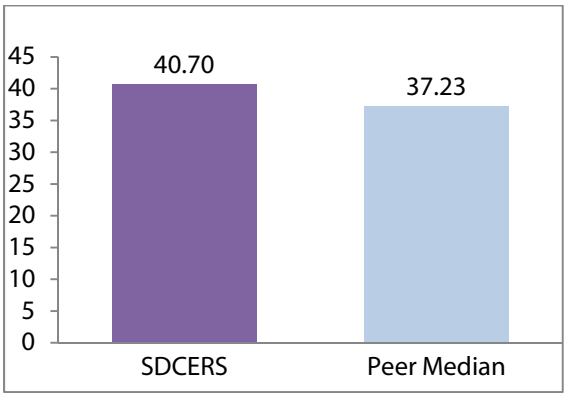


Source: Auditor generated from retirement systems' most recently available CAFRs as of 6/1/2011.

Moreover, SDCERS' fees for equity and fixed income investments are higher than peers, as **Exhibit 20** shows. This could indicate that peers utilize investment firms with lower management fees, are more successful at negotiating fees, or employ a more passive investment strategy, which carries extremely low management fees.

Exhibit 20

Comparison of Equity and Fixed Income Investment Management Fees (in Basis Points)



Source: Auditor generated from most recent CAFRs available as of 6/1/2011.

Note: DCRB's and COARS' Equity and Fixed Income Investment Management Fees were excluded in the calculation of the peer median since these specific fees could not be identified from their CAFRs.

We reviewed the fees charged by each of SDCERS' investment managers and found that its investment management staff successfully negotiate lower fees, particularly for the equity and fixed income portfolio. Consequently, SDCERS' higher fees in fiscal year 2010 may be explained by active portfolio management.

SDCERS' investment portfolio was almost entirely actively managed in fiscal year 2010. By comparison, 39 percent of Denver Employees Retirement Plan's equity and fixed income portfolio was passively managed and 32 percent of City of Austin's Employee Retirement System's total portfolio is in passive investments. SDCERS' own investment management consultant reported that public funds used passively managed investment vehicles for 52 percent of U.S. Equity and 24 percent of international equity portfolios.

A passive strategy involves purchasing exactly the same stocks and bonds, in the same proportions, as a particular index, e.g., S&P 500 or Russell 1000. By contrast, an active management approach involves "actively" buying and selling stocks in an attempt to realize better returns than the stock market index. Passive management strategies carry significantly lower fees than those charged by active managers, often just a few basis points versus 30 basis points or more. Many analysts argue that

passive investing is an effective strategy, particularly for certain asset classes, such as large cap investments, because it is difficult to actually outperform the market.

In fiscal year 2010, SDCERS' board approved allocation of a portion of its Equity and Fixed Income portfolio to passively managed investment strategies with the goal of reducing risk and investment management fees without significantly reducing returns. SDCERS' board set the target allocation of passive investments to about 25 percent of the total portfolio (roughly, 20 percent for equities and 5 percent for Fixed Income). SDCERS estimates that this re-allocation will reduce investment management fees by approximately $3.5 million per year.[23] SDCERS' trustees plan to reassess this allocation and may reallocate additional investments to a passive strategy if deemed appropriate.

Recommendation #5 **SDCERS' board should periodically reassess its asset allocation and rate of return versus investment management costs to identify if its mix of active and passive investments is still appropriate. (Priority 2)**

[23] Assuming total Equity and Fixed Income assets under management remain unchanged at $3.8 billion from June 30, 2010, this would translate into a $3.5 million savings in fiscal year 2012.

Finding 3: The City Could Reduce Costs for OPEB Health Care and Disability Benefits through Policy Changes.

The City spends almost $100,000 a year to reimburse high-income retirees' Medicare Part B IRMAA premiums—a benefit not explicitly outlined in the City's Municipal Code

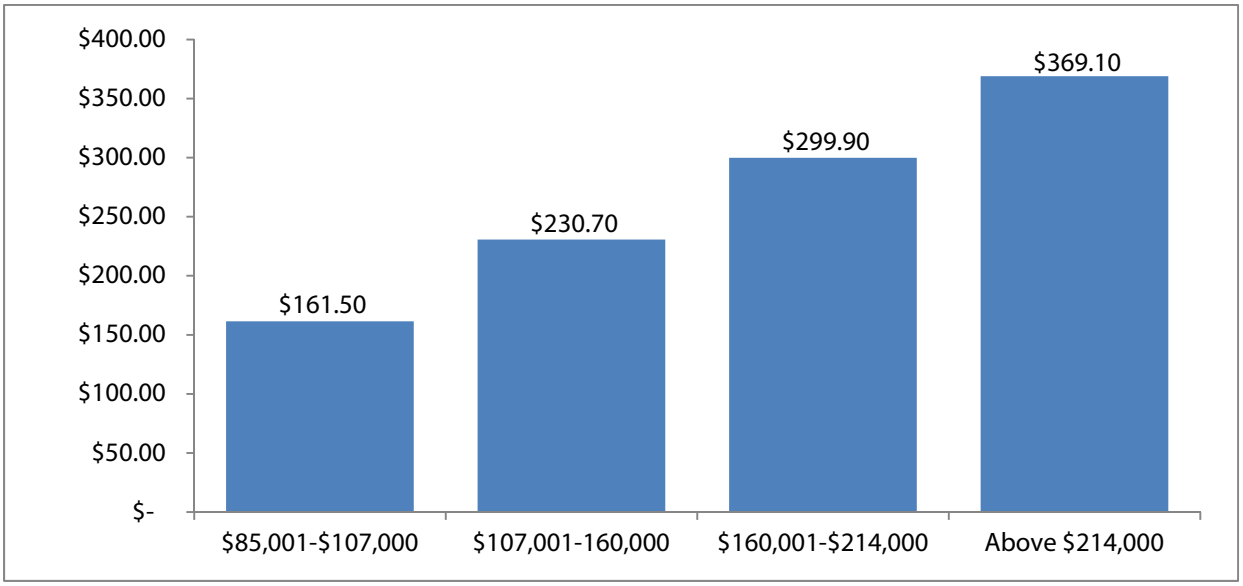
Retiree health care costs are the responsibility of the City and are paid from a City trust fund. SDCERS processes benefits according to the City's adopted health plan and reimbursement requirements. In addition to rising pension costs, retiree health care, also known as Other Post-Employment Benefits (OPEB), is a financial concern for City officials. OPEB includes the City's costs to provide an allowance for retirees' health care[24] and reimbursement for Medicare Part B premiums. The City also reimburses high-income retirees for their Medicare Part B Premium Income Related Monthly Adjustment Amount (IRMAA). We found that the City reimbursed $93,000 for retirees' IRMAA expenses in calendar year 2010. While this is small relative to total OPEB costs, costs have escalated rapidly since 2007 ($14,000 in 2007 versus $93,000 in 2010).

Medicare Part B premiums vary depending on the beneficiary's income. Retirees earning less than $85,000 annually (or $170,000 if taxes are filed jointly) only pay the standard Medicare Part B premium, which ranges from $96.40 to $115.40 monthly. However, individuals whose income exceeds the threshold are subject to IRMAA and, therefore, pay a higher Medicare premium. **Exhibit 21** shows the Medicare Part B premium amount, including the IRMAA, for beneficiaries whose income exceeds the "standard" threshold.

[24] The City provides post-employment benefits for members that were on the active payroll on or after October 5, 1980, retired on or after October 6, 1980 and were hired prior to July 1, 2005.

Exhibit 21

Monthly Medicare Part B Premium for Individuals Who Earn More than the Standard Income Threshold Shown by Income Range[25]



Source: https://questions.medicare.gov/app/answers/detail/a_id/2306

Municipal Code section 24.1202(a)(5) states that a health eligible retiree enrolled in Medicare is entitled to be reimbursed the cost of their Part B Medical Expense Premium. It appears that this benefit was adopted in 1997, a decade prior to the creation of IRMAA; therefore, the Municipal Code does not address reimbursement of IRMAA.

After IRMAA was created, the Risk Management Department (Risk Management) determined that retirees were eligible to be reimbursed for the full amount of their Medicare Part B premium, inclusive of IRMAA, because the Municipal Code did not specify how much the City will reimburse. We recommend that the City Attorney's Office analyze whether the City was legally obligated under the Municipal Code to reimburse IRMAA in addition to the Part B standard premium. If it finds that the City was never obligated to pay the benefit, the City Attorney's Office should determine whether the City can legally discontinue reimbursing current retirees' IRMAA premiums on a go-forward basis, or if it would now be considered a vested

[25] Based on Medicare beneficiaries that file an *individual* tax return. The income ranges are higher for beneficiaries that file a joint tax return.

benefit pursuant to the City Attorney's January 2010 opinion on pension and OPEB benefits.[26]

Medicare Part B Reimbursement and the New Tentative Agreement on Retiree Health Care

In Spring 2011, the City reached a tentative agreement with labor groups that caps health care benefits for members retiring after April 1, 2012. If SDCERS' members agree to the terms of the tentative agreement, City Council will vote to adopt revised Municipal Code language that excludes members retiring after April 1, 2012 from the current health benefits and adds a new section applicable to future retirees. If the proposed Municipal Code language is adopted, future retirees will be reimbursed for their health care premiums up to a set amount. The tentative agreement does not state whether Medicare Part B premiums, inclusive of IRMMA, are considered a reimbursable health care expense. Per Risk Management, it is conceivable that certain members retiring after April 2012 can be reimbursed for Medicare Part B premiums, including IRMAA, as long as their total health care premiums do not exceed the maximum health reimbursement allowance.

Risk Management should work with the City Attorney to analyze the tentative agreement and determine what exactly constitutes a health insurance premium—specifically, whether this includes Medicare Part B premiums and IRMAA—and clarify the eligibility of this benefit in the upcoming Memorandums of Understanding with labor groups. In addition, if the City Attorney's Office determines that Medicare Part B and/or IRMAA are not reimbursable expenses, Risk Management should work with the City Attorney's Office to revise the Municipal Code to explicitly exclude this expense, and present the revised Municipal Code language to City Council for adoption. Per Risk Management, the Municipal Code section related to retiree health care can only be changed through "meet and confer" with labor unions, and this can only occur after July 2014 with six votes by Council.

Since the establishment of the retiree health benefit, the City

[26] The Office of the City Attorney opined in January 2011 (Opinion Number – 2010-1) that retiree health care is a vested benefit. Specifically, it noted that "in Thorning v. Hollister School District, 11 Cal. App. 4th 1598 (1992), the court held that retiree health benefits for retirees were vested, and vested on the terms set forth in the policy providing for the benefits that existed at the time of their retirement".

has not fully paid the actuarially determined Annual Required Contribution (ARC) for OPEB, creating an unfunded actuarial accrued liability (UAL) of $1.13 billion. To address this growing concern, the City has undertaken several initiatives in the last several years to reduce its retiree health care cost. The tentative agreement reached in Spring 2011, for example, is expected to reduce the City's annual required contribution by $33 million and the UAL by $330 million.

The expected cost savings of the tentative agreement are significant; however, the City could save additional money from its "pay-as-you-go"[27] contributions if it no longer reimbursed high-income retirees for the IRMAA portion of their Medicare Part B premium. While peer systems' Medicare Part B premium reimbursement policies vary widely, we found that several do not offer any reimbursement, one caps the reimbursement at $93 per month, and another only reimburses the standard premium.

Because post-employment health care costs are a concern to City leaders, we recommend that the City Attorney analyze whether the City is obligated to reimburse high-income retirees for their IRMAA premium expense.

Recommendation #6 **The Risk Management Department should request the City Attorney's Office to:**

a) **Determine whether the City is legally obligated to reimburse current retirees' IRMAA expenses under the San Diego Municipal Code section 24.1202(a)(5). If the City Attorney's Office determines that the City is not legally obligated to reimburse IRMAA under the Municipal Code language, it should determine whether the City can discontinue reimbursing current retirees on a go-forward basis, or whether it is now considered a vested benefit. If the City Attorney's Office determines that it is not a vested benefit, Risk Management should work with the City Attorney's Office to identify the steps necessary to discontinue reimbursing current high-income**

[27] The City pays current retirees' actual health care costs annually on a pay-as-you-go basis and pre-funds future retiree health care expenses through an investment trust administered by CalPERS.

retirees' Medicare Part B IRMAA premiums, and present options to City Council and City administration for consideration.

b) Review the retiree health care tentative agreement and make a legal determination about whether Medicare Part B premiums, including IRMAA, are eligible to be reimbursed from the health care allowance. Risk Management should work with the City Attorney's Office to clarify the eligibility of this benefit in the upcoming Memorandums of Understanding with labor groups. In addition, if the City Attorney's Office determines that Medicare Part B and/or IRMAA are not reimbursable expenses, Risk Management should work with the City Attorney's Office to revise the Municipal Code after July 2014 to explicitly exclude this benefit and present the revised Municipal Code language to City Council for adoption. (Priority 3)

Industrial Disability Retirement benefit payouts are not offset by income received from outside employment or Workers' Compensation

SDCERS provides an Industrial Disability Retirement (IDR) benefit, in accordance with SDCERS' Board Rules and the San Diego Municipal Code, for employees who were injured on the job and consequently can no longer perform their expected duties. Employees may receive an IDR at any age, i.e., before they are eligible for a service retirement. The IDR benefit is equal to the greater of 50 percent of the employee's salary or their service-retirement amount, should he or she be eligible for a service retirement. From fiscal year 2006 through fiscal year 2010, SDCERS approved 110 IDR applications.

We found that a number of individuals who currently receive an IDR benefit also earn additional income from outside employment or a Workers' Compensation award.[28] While the City's Municipal Code explicitly prohibits the City from offsetting IDR benefits by Workers' Compensation awards,[29] the Municipal Code does not prevent the City from offsetting

[28] The City requires all non-service retirement eligible IDR benefit recipients submit annual affidavits to SDCERS, where recipients are required to declare any outside employment, as a condition of maintaining their IDR benefit eligibility. The Board uses the outside employment information to determine if the recipient is still entitled to an IDR benefit.

[29] Sections 24.0515(b) and 24.0515(c) of the San Diego Municipal Code prohibit the offsetting of IDR benefits for Workers' Compensation awards to safety members and general members, respectively.

IDR benefits when an individual earns income from outside employment. Nevertheless, the City could reduce its ARC payment and UAL if it offsets IDR benefits by income from outside employment and Workers' Compensation awards because this benefit is included in the calculation of the system's total actuarial liability.[30] We also found that multiple jurisdictions require that IDR benefits be offset by the amount of outside income.

Potential Cost Savings from Implementing IDR Offsets

We found that the municipalities that offset IDR benefits generally employ one of two methods.

- In the first (option 1), the offset is a one dollar reduction in the IDR benefit for each dollar in outside income earned and Workers' Compensation awarded.
- In the second (option 2), the offset is a one dollar reduction in the IDR benefit for each dollar the combined income (IDR benefit plus Workers' Compensation award and/or outside income) exceeds the salary the retiree was earning as an employee.

If City policymakers offset IDR payments by the amount an individual earned from outside employment, its total payout for IDR applications approved between fiscal years 2006 and 2010 could have been significantly reduced. We calculated that if the City applied option 1, IDR distributions could have been reduced by between $880,000 and $1.3 million from fiscal year 2006 through 2010. If it applied option 2, payouts could have been between $54,000 and $313,000 less.[31] Restated, option 1 could have resulted in a 21.7 percent to 32.8 percent reduction in IDR payouts to recipients not of age for a service retirement, and option 2 could have resulted in a 1.3 percent to 7.7 percent reduction.

We also found that if City policymakers applied option 1 to IDR recipients who also received Workers' Compensation awards,

[30] In order to identify potential savings in the ARC payment, the City or SDCERS would need to conduct an actuarial study.

[31] We could not determine the exact salary each person earns from outside employment because SDCERS is not required to, nor does it, collect income information from IDR recipients. The total savings identified are estimates based on average wage information. Specifically, the lower bound of each range is based on annual income calculated by multiplying the hourly wage equal to the City Council-established living wage for San Diego by the average for weekly hours worked in San Diego-Carlsbad-San Marcos. The upper bound of each range is based on annual income calculated by multiplying the average hourly wages for civilian workers in the San Diego-Carlsbad-San Marcos area by the average weekly hours worked in San Diego-Carlsbad-San Marcos.

SDCERS could have reduced its IDR payout by nearly $1.4 million or 10.7 percent of the total payout for IDR recipient approved from fiscal year 2006 thorough fiscal year 2010. If policymakers implemented option 2, SDCERS could have reduced its IDR payout by $226,000 or 1.75 percent.

While our assessment and recommendations are based on the potential savings, the issue also raises some philosophical and ethical issues that the City's policy leaders should consider. For example, should an individual be compensated twice—by receiving both a Workers' Compensation and an IDR benefit for the same injury? Does the fact that IDR benefit recipients are able to earn more money in retirement than when they were employed by the City run "contrary to the purpose and intent of a disability retirement program?[32]" In determining the purpose of the IDR benefit and analyzing costs, policymakers should decide whether it is appropriate to offset the benefit for income from other sources.

Recommendation #7 **The Risk Management Department should request the City Attorney's Office to review the permissibility of offsetting IDR benefits by income from outside employment and/or Workers' Compensation awards. If the City Attorney's Office determines that an IDR benefit offset policy is feasible, Risk Management should work with the City Attorney's Office to identify and present implementation options to City Council for consideration. (Priority 3)**

[32] R. P. Koptic, a former Employee Services Director for the City, questioned the appropriateness of a retiree's ability to earn more income through a disability retirement than they did when formerly employed by the City in a memorandum to SDCERS' Board of Administration dated November 17, 1975.

Finding 4: SDCERS Can Strengthen Certain Processes to Improve Operations

SDCERS' Purchase of Service Credit Process Could be more Efficient

The City allows active employees to purchase service credit for certain periods of missed retirement contributions, including situations in which the member was serving a probationary work period, on unpaid military leave, or on leave under the Family Medical Leave Act. Employees hired prior to July 1, 2005 can also purchases up to five years of time to supplement their service years, but must pay both the employee and employer costs. The purchase of service credit (PSC) program is intended to be cost neutral to the system.

We found that SDCERS could improve the way in which it processes members' PSC applications if it allowed members to obtain estimates from Member Counselors and/or its website. Currently, the only way for members to obtain a purchase price is to submit a formal request to SDCERS. This triggers a time-consuming review of the member's eligibility by Benefits Administration staff and results in a contract guaranteeing the price for 60 days. However, according to SDCERS, only an estimated 10 to 20 percent of contracts are actually purchased by members. SDCERS could reduce the number of formal requests if members could obtain an estimate of the purchase price from Member Counselors or the website.

Member Counselors used to provide members with estimates until SDCERS changed the way it calculated the purchase amount to improve the accuracy of the price—from a flat percentage to a complex service and age based calculation. SDCERS' management stated that it would be difficult to provide members with access to the calculator either through a Member Counselor or the website because it requires members to their final average salary, current creditable service years and current contribution rate, and that members would not know this information. However, SDCERS' online retirement benefit calculator requires that the member input estimated creditable years of service and high one-year salary. The last piece, contribution rates, can be obtained from SDCERS' website.

SDCERS' management stated that it has considered providing a grid on the website that would give members an estimate of the purchase price, but that the calculator is very complicated and they have not been able to figure out how to make it available on the website. To reduce the PSC application workload and the resulting burden on Benefit Administration staff, SDCERS should pursue making service credit purchase estimates available to members on the website or, at the very least, through the Member Counselors.

Recommendation #8

SDCERS should allow members to obtain price estimates for service credit purchases through Member Counselors and/or their website to reduce the workload of Benefit Administration staff. (Priority 2)

SDCERS Can Improve its Process for Allocating Administrative Expenses to its Plan Sponsors

In accordance with the Declaration of Trust Document,[33] SDCERS allocates the majority of administrative expenses to each plan sponsor based on respective membership size. The system also allocates certain easily identifiable costs directly to the plan sponsors. These include costs to administer the City's retiree health care benefit and work performed by outside contractors, e.g., its actuary and outside legal counsel. We found that SDCERS accurately allocates administrative costs based on the formula outlined in the Declaration of Trust Document; however, we found that it can improve its process for identifying costs incurred by outside contractors that are directly attributable to a specific plan sponsor.

Specifically, we found that SDCERS' Finance Department staff review contractor invoices to identify whether any of the work performed directly pertains to a specific plan sponsor; nonetheless, they are not as familiar as department mangers with the work being performed and cannot easily identify costs that can attributed to a certain sponsor. The department managers who oversee the contractors are in a better position to identify work, and therefore costs, that directly relate to a plan sponsor.

The department managers already review and approve the

[33] The Declaration of Trust Document sets forth the policies and rules relative to the establishment of the Group Trust.

invoices for payment prior to forwarding them to the Finance Department. SDCERS should also require that department managers clearly denote for the Finance Department which costs can be directly attributable to a certain plan sponsor. This will improve efficiency of the process and mitigate the risk that the Finance Department might miss any costs that can be allocated to a plan sponsor.

Recommendation #9

SDCERS should require department managers to identify costs from contractor invoices that can be directly attributable to particular plan sponsors as part of their routine review and approval process. The department managers should clearly indicate for the Finance Department the total costs that can be assessed to a plan sponsor. (Priority 3)

SDCERS Follows Best Practices by Regularly Completing Experience Studies, but Should Consider Revising its Policy to Reflect the Frequency with which it Completes these Studies

Realistic assumptions of member demographics, i.e., termination, retirement, disability and death rates, and market behavior are critical to determine a plan's funding status and the appropriate ARC payments. Consequently, it is important that retirement systems periodically compare their assumptions against actual experience, known as "experience studies."

The City's Municipal Code and SDCERS' Board Rules require SDCERS to complete an experience study at least every five years. In reality, SDCERS has conducted experience studies every three years. Most of SDCERS' peers conduct experience studies every three years, which is in part due to a requirement for California county retirement systems. However, other cities not subject to this requirement also conduct experience studies every three years. Because SDCERS completes experience studies every three years, as opposed to every five years as required, it should consider revising the formal requirements to be more reflective of reality, particularly if SDCERS believes that three years is a more appropriate timeframe.

SDCERS' actuary completed the most recent experience study in June 2011, covering the period of July 1, 2007 to June 30, 2010. The actuary discovered a number of assumptions that were not reflective of actual experience and recommended

changes, namely lowering the wage inflation and investment return assumptions. SDCERS trustees will vote on whether to adopt the new assumptions in September 2011.

Recommendation #10

SDCERS should assess the current City and board policy that requires experience studies to be conducted at least every five years to determine if this timeframe is still appropriate, particularly since the actual timeframe is closer to three years. If SDCERS' management and trustees determine that a more frequent timeframe is more appropriate, they should consider revising the Board Rule and working with the City Council to revise the Municipal Code. (Priority 3)

SDCERS Should Ensure it Adheres to its own Policies and Best Practices and Rebid its Actuary Contract and Conduct an Actuarial Audit

The Kroll report recommended that that SDCERS rebid its actuary contract every five years and that the actuary not be engaged for more than two consecutive five-year terms. SDCERS' board revised its policy to require SDCERS to rebid the actuary contract every five years and to retain an independent firm to conduct an audit of the actuary's services if the same actuary is selected.

SDCERS' current actuary has provided services for five years,[34] and the Board approved that the contract be extended to cover the fiscal year 2011 valuation period. However, SDCERS' trustees plan to issue a Request for Proposal (RFP) for a five year actuarial services contract in the late summer/fall 2011. At the same time, it plans to issue an RFP for an independent firm to audit the actuary's services.[35] Conducting periodic audits of actuarial valuations is considered a best practice because it helps ensure that actuarial valuations are performed correctly and that the methods and assumptions used are reasonable.

SDCERS' managers should draft the RFPs and present them to the Board for approval in a timely manner to ensure the firms are selected prior to expiration of the current contract.

[34] SDCERS first executed a contract with its actuary for a three year term in June 2006 to conduct valuations for three years – 2005, 2006, and 2007. In July 2008, SDCERS renewed the contract for three additional valuation periods – 2008, 2009, and 2010. In July 2011, the board approved a one year extension to cover the 2011 valuation period.

[35] SDCERS issued a RFP for actuarial audit services in 2010; however, they were unable to identify a firm.

Recommendation #11 **SDCERS should draft the Request for Proposals for its actuarial and actuarial audit services and present it to the Board for approval within the next three months to ensure the firms are selected prior to expiration of the current contract. (Priority 3)**

Finding 5: SDCERS Could Not Demonstrate that it Fully Addressed the Findings and Recommendations Presented in the September 2005 Audit of Corbett Payments

In September 2005, the prior Office of the Auditor and Comptroller issued an audit report that identified a number of retirees for whom SDCERS paid incorrect monthly pension benefits and Corbett settlement payments[36] due to system weaknesses and inadequate compensating controls. Specifically, for the audit period—fiscal years 2002 through 2004—the audit identified $93,000 in net pension benefit overpayments and $10,000 in net Corbett underpayments.

SDCERS addressed some of the recommendations in 2008; however, it is unable to demonstrate that it corrected the remaining recommendations due to staff turnover. Because the 2005 Corbett audit's findings related to retirees who continue to receive ongoing payments, it is possible that SDCERS continued to make inaccurate payments to these retirees, potentially resulting in aggregate overpayments and/or underpayments. SDCERS' staff stated that they do not believe this to be the case based on the Corbett benefit accrual calculation process. However, members should be paid what is owed to them—no more, no less. SDCERS should take action to ensure that Corbett and monthly benefit payments are calculated correctly for the retirees identified in the 2005 audit. In addition, SDCERS should work with its legal counsel to determine the feasibility of collecting overpayments and reimbursing members who were underpaid, if applicable.

[36] The Corbett payment is the result of a settlement in a class action lawsuit. The Corbett payment is equal to 7% of the retiree's annual base retirement benefit, not including the supplemental 13th Check and supplemental COLA amounts. Any City of San Diego retiree who was on the June 30, 2000 retirement payroll is eligible for the Corbett payment. The annual Corbett payment is paid to eligible retirees in any year when a 13th Check is paid. In the event payment is not made in a given year, the accrued amounts will be carried over for distribution in the next year that the 13th Check is paid.

Recommendation #12 **SDCERS should demonstrate that it corrected the Corbett and monthly benefit calculations for the retirees identified in the 2005 audit. In addition, SDCERS should work with its legal counsel to determine the feasibility of collecting overpayments and reimbursing members who were underpaid, if applicable. (Priority 3)**

Other Pertinent Information

SDCERS Has One of the Lowest Funding Positions and Highest Contribution Rates of Any Peer System

A primary risk to any public defined benefit system is that it will be unable to pay current and future benefits. Various factors contribute to this risk, including plan benefit changes, market volatility, demographic changes, and insufficient funding. One way a retirement system can mitigate this risk is to conduct regular actuarial valuations to assess the financial health of the plan and to identify the appropriate level of employer contributions.

SDCERS hires a professional actuarial firm to evaluate the financial condition of the retirement fund annually. In conducting the valuation, the actuary assesses the plan's assets and liabilities to determine the funding ratio, unfunded actuarial liability, and the necessary contributions—from both members and plan sponsors—to achieve adequate funding.

We compared SDCERS' valuation results to peers and found that the City's plan has the lowest funding ratio, and has one of the largest unfunded actuarial liabilities and member and employer contribution rates.

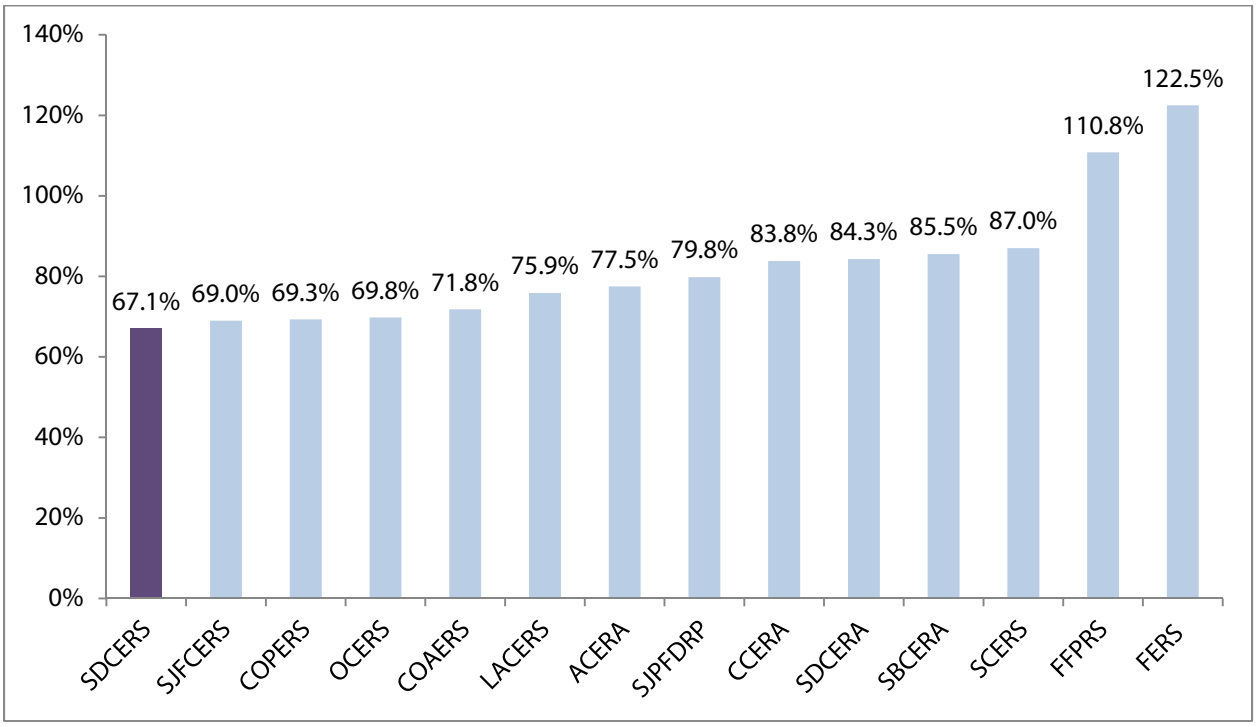
Funding Ratio

The funding ratio is the value of actuarial assets[37] expressed as a percent of liabilities. It essentially shows what percentage of current and future pension benefits can be paid by current assets. SDCERS' funding ratio as of June 30, 2010 was 67.10 percent, the lowest ratio of its peers, as shown in **Exhibit 22**. However, underfunding does not necessarily mean the plan is about to run out of money, and experts do not agree on what is considered an adequate ratio. Many experts consider a funded ratio of 80 percent to be adequate; however, Fitch Ratings recently reported that a ratio as low as 70 percent is sufficient. Nevertheless, SDCERS' funding ratio is below 70 percent.

[37] The actuarial value of assets is different than market value. In calculating the actuarial value of assets, full investment gains/losses are not recognized in the same year they are realized. Rather, they are "smoothed" over a set period of time to mitigate the impact of market volatility on the plan sponsor's ARC payment.

Exhibit 22

Comparison of Funding Ratios



Source: Retirement systems' June 30, 2010 or December 30, 2009 Actuarial Valuations.

The funding ratio is a snapshot of the value of assets to liabilities on a specific day – the valuation date. In reality, retirement plan funding is an ongoing, long-term process. For that same reason, experts debate whether it is necessary to set 100 percent funding as the ultimate goal. What is important is that the plan sponsor has a funding plan to which it adheres.

Unfortunately, the City underfunded the pension for many years; however, it has paid its full Annual Required Contribution (ARC) since 2006 and made excess payments in several of those years. While we are not able to determine the impact of the prior underfunding on the current funding level, an independent analysis conducted in 2004 found that 17 percent of the Unfunded Actuarial Liability (UAL) as of June 30, 2003 was attributable to the City's contribution shortfall between 1996 and 2003. In addition, a June 2011 study by the National Institute on Retirement Security found that the funding ratios of systems that were not well-funded prior to 2008 only further deteriorated as a result of 2009 economic downturn.

SDCERS' funding ratio, as compared to peers, may also be lower because their method for determining the actuarial value of assets is more conservative than the other systems. Consequently, they recognized more of the 2009 investment losses in this valuation year than other systems, which results in a lower asset value. We present a more detailed explanation of SDCERS' actuarial methodology beginning on page 62.

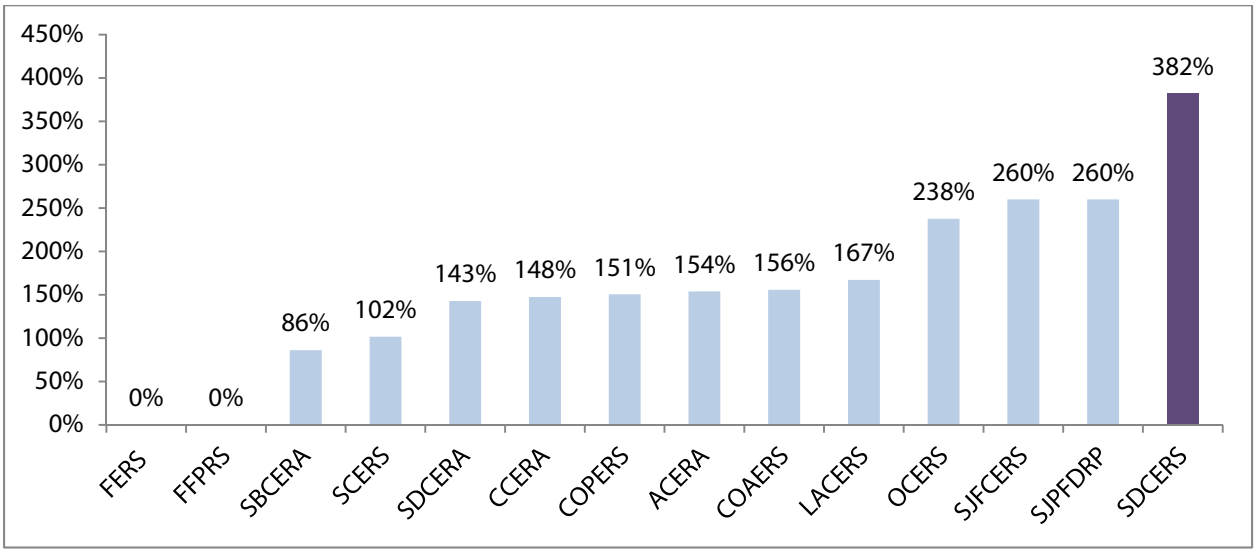
Unfunded Actuarial Liability (UAL)

A UAL occurs when the present value of benefits expected to be paid (liabilities) exceed the actuarial value of assets. As of June 30, 2010, the UAL for the City's plan was $2.1 billion. As **Exhibit 23** shows, the City's plan has by far the highest UAL as a percent of payroll compared to peers.

The existence of a UAL is not unusual, and it does not represent a debt that is due today. Most retirement systems have an unfunded actuarial liability, which is paid off over a set period of time (called amortization)—usually between 15 and 30 years.

Exhibit 23

Comparison of Unfunded Actuarial Liability as a Percent of Payroll



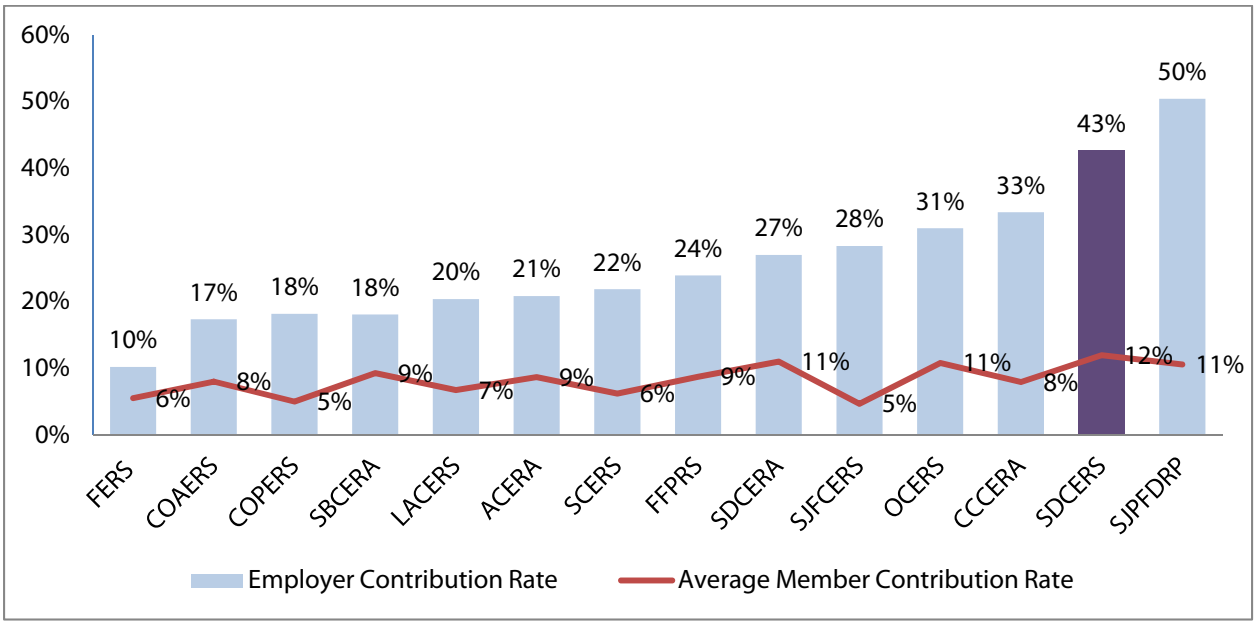
Source: Retirement systems' June 30, 2010 or December 30, 2009 Actuarial Valuations.

Note: FERS and FFPRS are pre-funded thus have no UAL.

Contributions Both employees and plan sponsors contribute to the retirement fund. As **Exhibit 24** shows, the City has the second highest employer and the highest employee contribution[38] rates of the systems surveyed. The amount that the plan sponsor contributes is called the annual required contribution (ARC).

Exhibit 24

Comparison of Employer ARC and Average Member Contributions as a Percent of Payroll



Source: Retirement systems' June 30, 2010 or December 30, 2009 Actuarial Valuations.

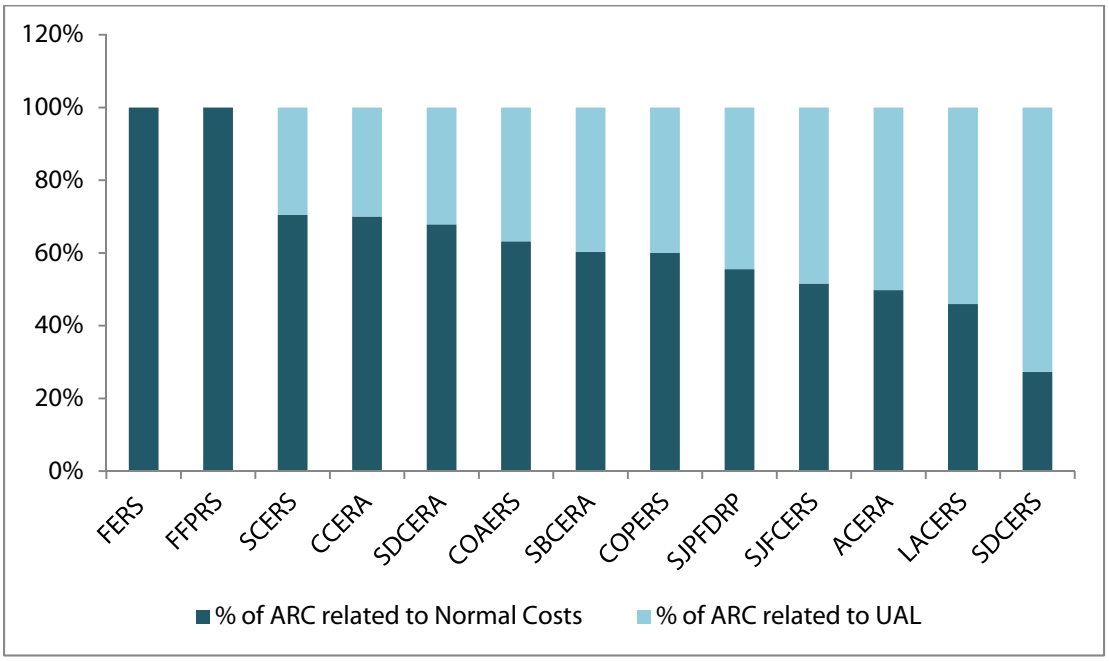
The ARC payment is comprised of two components: the normal cost and the amortization payment on the unfunded actuarial liability. The normal cost is essentially the annual payment amount that, when combined with the members' contributions, will accumulate to the amount necessary to fund retirement benefits. The majority of the City's ARC payment is related to the UAL—$168 million (72 percent) versus $63 million (28 percent) for the normal cost.

As **Exhibit 25** shows, the UAL comprised more of the City's ARC payment than any other system.

[38] The City subsidizes a portion of the employees' contribution rate.

Exhibit 25

Comparison of ARC Payment Components: UAL versus Normal Cost



Source: Retirement systems June 30, 2010 or December 30, 2009 Actuarial Valuations. OCERS was excluded because the information was not readily available.

This is a function of several factors, including:

- SDCERS' total UAL as a percentage of payroll is significantly higher than any of its peers, as shown in **Exhibit 23**. The majority of the ARC's UAL payment is related to the outstanding UAL balance as of 2007, which SDCERS states is primarily attributable to retroactive benefit increases and the City's contribution shortfalls. The UAL that resulted in fiscal year 2009 was a result of the significant drop in the investment portfolio.
- SDCERS has adopted a shorter UAL amortization period for its annual gains and losses than many of its peers, meaning that it will pay more annually over a shorter period of time. A discussion of SDCERS' actuarial assumptions follows.

SDCERS' Actuarial Assumptions and Methodology are in Line with Peers, but are More Conservative

In conducting a retirement plan valuation, the actuary employs certain demographic and economic assumptions and funding methodologies. Assumptions and methodologies impact the funding status and ARC payment and, therefore, should be chosen based on past plan experience, future expectations of member demographics and market trends, and sound professional judgment. SDCERS' trustees adopted the current assumptions and funding methodologies based on information presented by their actuary and the investigation reports. Specifically, SDCERS' board made a number of changes to their principal methodologies and assumptions over the past 5 years to be more in line with industry standards and peer systems. Some of these changes are outlined below.

Adopted the Entry Age Normal (EAN) actuarial funding method

EAN is an actuarial cost method designed to fund a member's total plan benefit over the course of his or her career. This method is designed to produce stable employer contributions that increase at the same rate as the employer's payroll. We found that the vast majority of peer systems we reviewed also employ the EAN actuarial funding method and it is the method preferred by the Governmental Accounting Standards Board (GASB).

Adopted more conservative UAL amortization periods

Retirement systems amortize their unfunded actuarial liability (UAL) over a set period of time to help stabilize ARC payments from year to year. For example, market losses during fiscal year 2009 added $810 million to SDCERS' UAL. Paying this amount in full would have crippled the City's budget. Due to amortization, however, the City's fiscal year 2011 payment on this loss is $74 million, and it will continue to make annual payments over the course of 15 years.

In general, amortization periods should have a reasonable relationship to the average duration of active members' working years or the source of the UAL. Longer amortization periods—if they are not based on sound rationale—may result in lower ARC payments today but essentially push the burden of funding pension benefits onto future generations of employees and taxpayers.

Beginning with the 2008 valuation, SDCERS adopted the following amortization periods:

A) Twenty years for the unfunded actuarial liability as of June 30, 2007. Previously the period was 27 years.

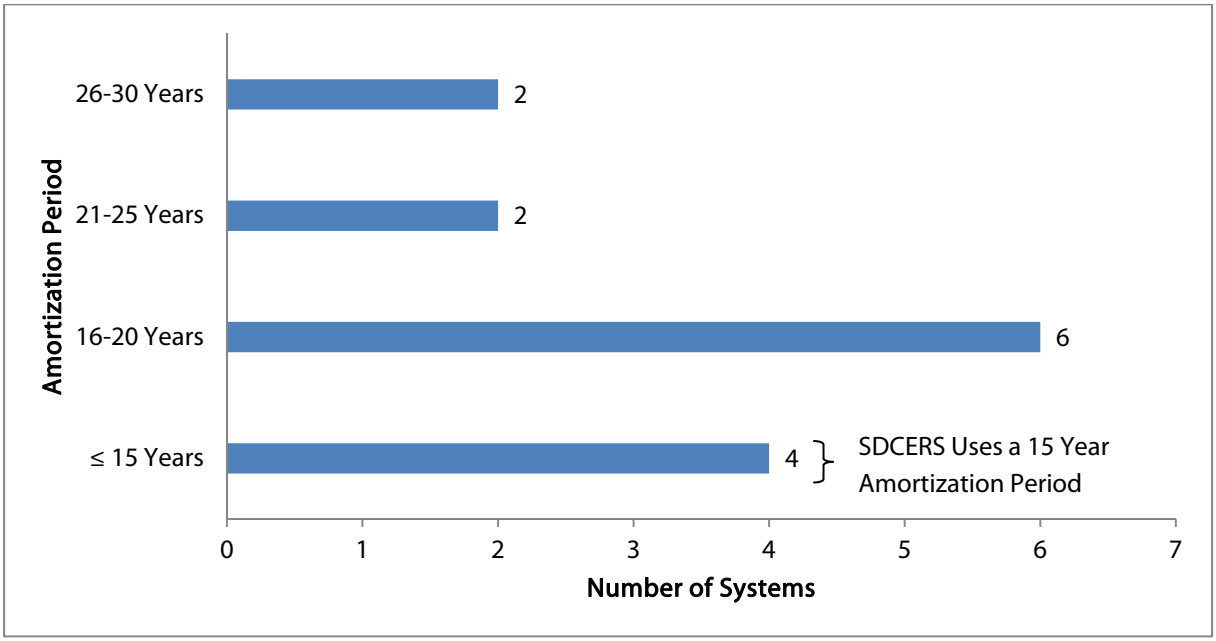
B) Fifteen years for annual gains and losses incurred after 2007.

C) Thirty years for any changes in actuarial methods or assumptions.

We found that it is not uncommon for systems we reviewed to have multiple, tiered amortization periods. As **Exhibit 26** shows, most systems we surveyed amortize their annual gains and losses over 16 years or more; SDCERS uses a 15 year amortization period. We also found that peer systems' amortization periods for *prior* UAL balances ranged from 15 to 30 years with no obvious commonality. Of the systems that use a separate amortization period for assumption changes, most used 30 years — the period used by SDCERS.

Exhibit 26

Peer Retirement Systems' Amortization Periods for Annual Gains and Losses



Source: Retirement systems' June 30, 2010 or December 30, 2009 Actuarial Valuations.
Note: Some peer systems were excluded because we could not obtain the information from their most recent valuation report.

Each system's amortization period should be reflective of their unique plan structure and experience, therefore differences are expected. While SDCERS' amortization period for annual gains and losses appears to be more conservative than peers, their rationale is based on sound judgment. Moreover, GASB is considering adopting an amortization period that matches the "future working lifetime" of active members, which for many systems translates to 10 to 15 years. If this does occur, SDCERS will be ahead of other systems since its amortization period is already set at 15 years.

Changed the asset smoothing method to Expected Value of Assets

Pension systems employ a technique called asset smoothing to mitigate the impact of annual market volatility. The most common method appears to be one in which annual market gains/losses are phased-in over a pre-determined period of time. SDCERS uses a slightly different method—the Expected Value of Assets (EVA).

The EVA determines the actuarial value of assets by first determining the *expected* value (based on the actuary's assumptions and expectations of market return, contributions, and disbursements) and then adding a pre-determined percentage of the difference between the expected value and actual market value. **Exhibit 27** illustrates the difference between the two methods.

Exhibit 27

Comparison of Methods for Calculating the Actuarial Value of Assets

SDCERS EVA – 25 percent			SBCERA[39] Actuarial Value of Assets over 5 Years					
1. Expected Actuarial Value of Assets	$4,475,884		1. Market Value of Assets					$5,029,474
2. Market Value of Assets	$3,900,538		2. Calculation of Unrecognized Returns		(Gain/Loss)	Percent not Recognized	Amount not Recognized	
				6/30/10	$113,095	80%	$90, 476	
				6/30/09	(2,083,822)	60%	(1,250,293)	
				6/30/08	(741,818)	40%	(296,727	
				6/30/07	593,926	20%	118,785	
				6/30/06	178,047	0%	0	
3. Diff Btwn Expected & Actual	($575,346)		3. Total Unrecognized Return				($1,337,759)	
4. Actuarial Value of Assets (1+25% of 3)	$4,332,047		4. Actuarial Value of Assets (1 - 3)					$6,367,232
5. Actuarial Value as a % of Market Value	**111%**		**5. Actuarial Value as a % of Market Value**					**126.6%**

Source: SDCERS' and SBCERA's June 30, 2010 valuation reports.

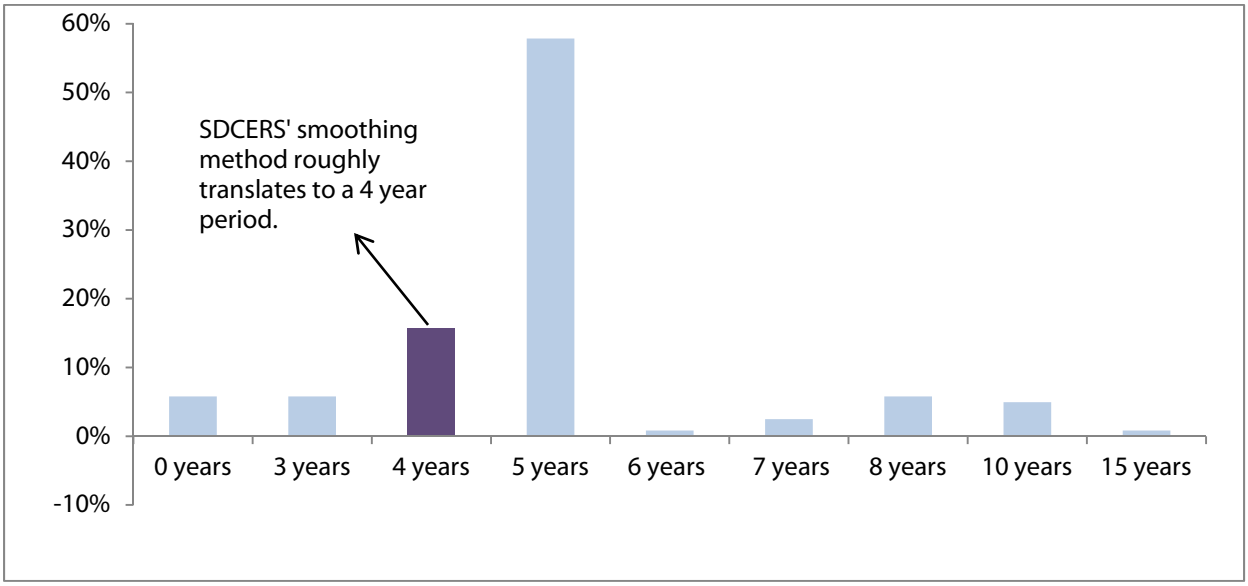
Note: All dollar figures are in (thousands)

In 2008, the National Association of State Retirement Administrators (NASRA) conducted a survey of retirement systems to identify common asset smoothing periods. As **Exhibit 28** shows, the most common period is five years. SDCERS' method translates into a smoothing period of approximately four years, which is a bit more conservative than other systems since it recognizes market gains and losses over a shorter period time.

[39] San Bernardino County Employees' Retirement System (SBCERA) was selected to demonstrate the difference between SDCERS' smoothing method and the one more commonly used by peer retirement systems.

Exhibit 28

Percent of Public Retirement Systems that Use Each Smoothing Period

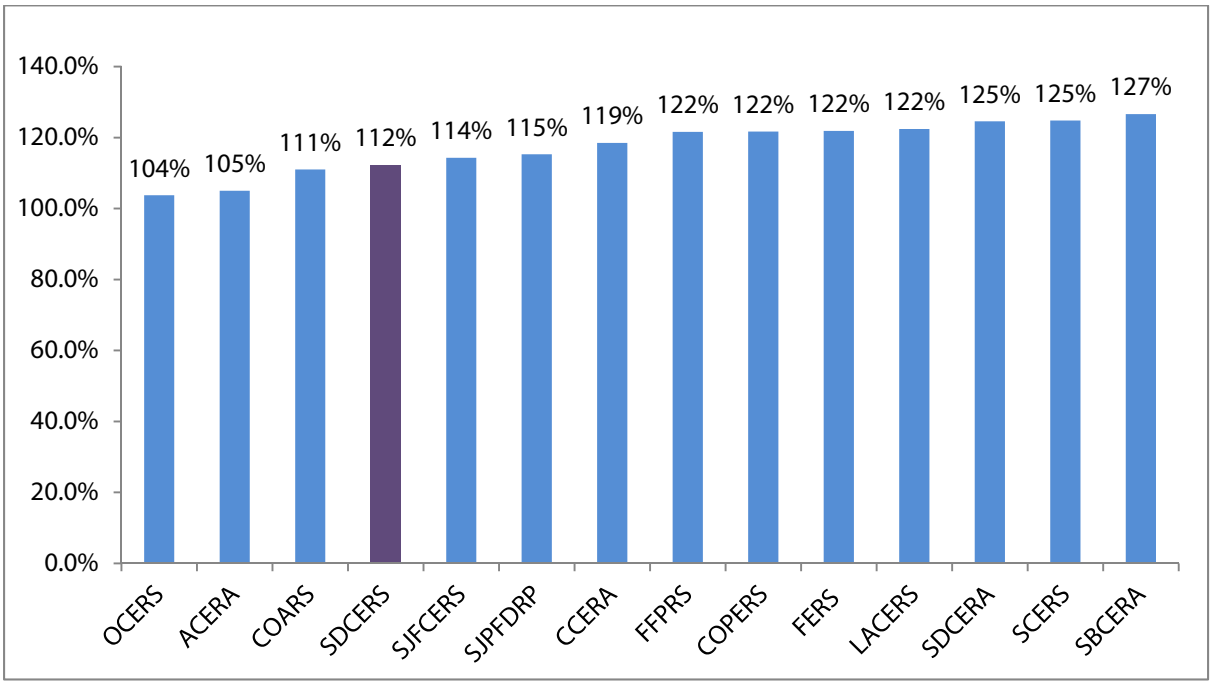


Source: National Association of State Retirement Administrators Survey 2008.

While there is no one correct method to smooth year-to-year market returns, the method should produce an "actuarial value" of assets that bears a reasonable relationship to the actual market value. As **Exhibit 29** shows, of the retirement systems we reviewed, SDCERS has one of the lowest ratios of actuarial assets to market assets compared to the peer systems we reviewed — meaning that its actuarial value of assets are within a reasonable range of the market value.

Exhibit 29

Comparison of Peer Systems' Ratio of Actuarial Value to Market Value



Source: Retirement systems June 30, 2010 or December 30, 2009 Actuarial Valuations.

In addition, SDCERS is one of the few systems among its peers to limit its actuarial assets to a specific "corridor" around the market value. Specifically, SDCERS' actuarial value of assets cannot be lower than 80 percent or greater than 120 percent of the market value. Of the peers with corridors, a range of 80 percent to 120 percent is the most common and most narrow. Two systems have a corridor as wide as 60 percent to 140 percent.

When the stock market experienced a significant drop in 2009, many retirement systems considered increasing their smoothing and amortization periods to soften the impact on their plan sponsors' ARC payment. SDCERS' actuary analyzed SDCERS' options and ultimately found that SDCERS had two suitable options: make no changes or increase its corridor to 130 percent. However, the actuary made it clear that the plan's financial condition would be better if it made no changes. The board ultimately decided to make no change.

Prohibiting negative amortization

Negative amortization occurs when the ARC payment does not fully cover the interest portion of the UAL. Similar to a personal credit card, if the owner pays less than the interest charge, his or her balance will to grow to the point where it will be extremely difficult to ever completely pay down. The intention of an amortization method is to make steady progress on paying down the UAL, not to allow the UAL to increase to infinity over time.

One way a system can incur negative amortization is to employ an open amortization, which allows the period to reset with each annual valuation. SDCERS uses a closed method in which the amortization pay-off period decreases each year. Most of SDCERS' peers employ a closed amortization period; however, several do allow their amortization period to reset each year. Moreover, SDCERS' actuarial methods are designed to ensure that there is no negative amortization.

Conclusion

Our audit found that SDCERS, when compared to peers, has higher expenses, a lower funding level, and more conservative actuarial assumptions. Expenses are higher than peers largely due to litigation and efforts to correct prior, well-publicized problems that enabled the City to underfund the pension for years. SDCERS' trustees adopted more conservative actuarial assumptions to be more in line with peers.

We found that numerous, ongoing lawsuits drive-up legal and actuarial costs, SDCERS spends more than any other system for fiduciary liability insurance, and SDCERS' efforts to maintain independence and transparency contribute to higher-than-peer personnel, rent, and information technology expenses. We identified opportunities to streamline operations and reduce expenses. SDCERS can also implement the process improvements recommended by its outside consultant hired in fiscal year 2009 to assess operations. SDCERS estimates that it can eliminate five positions when it implements a new pension administration system in fiscal year 2014.

SDCERS' investment expenses for fiscal year 2010 were higher than peers, largely because its investment portfolio was entirely actively managed. In fiscal year 2010, SDCERS' board approved reallocation of a portion of the equity and fixed income investment portfolio to passively managed funds; SDCERS expects to reduce costs by $3.5 million per year, as a result.

We also found that the City may be able to reduce costs for retiree health care if it does not reimburse high-income retirees for their Medicare Part B IRMAA premiums and for disability benefits, if it offsets benefits by income received from outside employment and/or a Workers' Compensation award.

Lastly, we found that the City's retirement plan has the lowest funding ratio of any its peers and that its fiscal year 2010 ratio was below what many experts consider to be adequate. The City's plan also has the highest unfunded actuarial liabilities and

one of the highest contribution rates. SDCERS' trustees made a number of changes to actuarial methodologies and assumptions over the past five years to be more in line with peers and industry standards; SDCERS' methodologies are now more conservative than peers. While less conservative assumptions and methodologies may result in lower ARC payments today, it essentially shifts retirement plan funding to future employees and taxpayers.

Recommendations

1. SDCERS' management and trustees should work with its legal counsel to identify alternatives to fiduciary insurance, including, for example:
   a) Investigating the feasibility and cost-effectiveness of self-insuring for trustee defense and indemnification costs.
   b) Working with the City Attorney's Office to develop a mutually satisfactory agreement for City Council consideration to defend and indemnify trustees for acts or omissions that arise of out the scope of their responsibilities. Such an agreement should provide greater assurance to trustees than what is currently afforded under California Code 995, but provide prudent exceptions, such as if a trustee acts fraudulently.
   c) Using an independent third party to validate the City's determination if it finds that trustees were not acting within the scope their responsibilities.
   d) Evaluating the current risk and coverage level, and, if prudent, adjust to lower annual premiums.

   SDCERS management should recommend to its trustees that they cancel the current fiduciary insurance policy when a more suitable and cost-effective alternative is identified and implemented. (Priority 2)

2. SDCERS should consider that its current actuary costs are high compared to peers when they evaluate proposals received in response to its Fall 2011 RFP for actuarial services and negotiate fees with the selected firm. (Priority 3)

3. SDCERS should designate an individual, possibly its Internal Auditor, to ensure the business process recommendations made by its consultant are implemented. (Priority 3)

4. SDCERS should reassess its staffing level once the new pension administration system is implemented and eliminate unnecessary positions to reduce personnel costs. (Priority 3)

5. SDCERS' board should periodically reassess its asset allocation and rate of return versus investment management costs to identify if its mix of active and passive investments is still appropriate. (Priority 2)

6. The Risk Management Department should request the City Attorney's Office to:

   a) Determine whether the City is legally obligated to reimburse current retirees' IRMAA expenses under the San Diego Municipal Code section 24.1202(a)(5). If the City Attorney's Office determines that the City is not legally obligated to reimburse IRMAA under the Municipal Code language, it should determine whether the City can discontinue reimbursing current retirees on a go-forward basis, or whether it is now considered a vested benefit. If the City Attorney's Office determines that it is not a vested benefit, Risk Management should work with the City Attorney's Office to identify the steps necessary to discontinue reimbursing current high-income retirees' Medicare Part B IRMAA premiums, and present options to City Council and City administration for consideration.

   b) Review the retiree health care tentative agreement and make a legal determination about whether Medicare Part B premiums, including IRMAA, are eligible to be reimbursed from the health care allowance. Risk Management should work with the City Attorney's Office to clarify the eligibility of this benefit in the upcoming Memorandums of Understanding with labor groups. In addition, if the City Attorney's Office determines that Medicare Part B and/or IRMAA are not reimbursable expenses, Risk Management should work with the City Attorney's Office to revise the Municipal Code after July 2014 to explicitly exclude this benefit and present the revised Municipal Code language to City Council for adoption. (Priority 3)

7. The Risk Management Department should request the City Attorney's Office to review the permissibility of offsetting IDR benefits by income from outside employment and/or Workers'

Compensation awards. If the City Attorney's Office determines that an IDR benefit offset policy is feasible, Risk Management should work with the City Attorney's Office to identify and present implementation options to City Council for consideration. (Priority 3)

8. SDCERS should allow members to obtain price estimates for service credit purchases through Member Counselors and/or their website to reduce the workload of Benefit Administration staff. (Priority 2)

9. SDCERS should require department managers to identify costs from contractor invoices that can be directly attributable to particular plan sponsors as part of their routine review and approval process. The department managers should clearly indicate for the Finance Department the total costs that can be assessed to a plan sponsor. (Priority 3)

10. SDCERS should assess the current City and board policy that requires experience studies to be conducted at least every five years to determine if this timeframe is still appropriate, particularly since the actual timeframe is closer to three years. If SDCERS' management and trustees determine that a more frequent timeframe is more appropriate, they should consider revising the Board Rule and working with the City Council to revise the Municipal Code. (Priority 3)

11. SDCERS should draft the Request for Proposals for its actuarial and actuarial audit services and present it to the Board for approval within the next three months to ensure the firms are selected prior to expiration of the current contract. (Priority 3)

12. SDCERS should demonstrate that it corrected the Corbett and monthly benefit calculations for the retirees identified in the 2005 audit. In addition, SDCERS should work with its legal counsel to determine the feasibility of collecting overpayments and reimbursing members who were underpaid, if applicable. (Priority 3)

Appendix A: Definition of Audit Recommendation Priorities

DEFINITIONS OF PRIORITY 1, 2, AND 3
AUDIT RECOMMENDATIONS

The Office of the City Auditor maintains a classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

Priority Class[40]	Description[41]	Implementation Action[42]
1	Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring.	Immediate
2	A potential for incurring significant or equivalent fiscal and/or non-fiscal losses exist.	Six months
3	Operation or administrative process will be improved.	Six months to one year

[40] The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number.

[41] For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of $50,000 or more to be involved or for a potential loss (including unrealized revenue increases) of $100,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its residents.

[42] The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration.

SDCERS
San Diego City Employees' Retirement System

Mark A. Hovey
Chief Executive Officer

September 23, 2011

Eduardo Luna, City Auditor
1010 Second Avenue, Suite 1400
San Diego, CA 92101

Dear Mr. Luna,

We have received your final report titled "Performance Audit of the San Diego City Employees' Retirement System" dated September 2011. This letter is in response to the recommendations made to SDCERS that are included in your report. Recommendations 6 and 7 are addressed to the City's Risk Management Department and are therefore not included in our response.

The following are SDCERS' management responses to your audit recommendations:

1. **Recommendation:** SDCERS' management and trustees should work with its legal counsel to identify alternatives to fiduciary insurance, including, for example:

   a) Investigating the feasibility and cost-effectiveness of self-insuring for trustee defense and indemnification costs.

   b) Working with the City Attorney's Office to develop a mutually satisfactory agreement for City Council consideration to defend and indemnify trustees for acts or omissions that arise of out the scope of their responsibilities. Such an agreement should provide greater assurance to trustees than what is currently afforded under California Code 995, but provide prudent exceptions, such as if a trustee acts fraudulently.

   c) Using an independent third party to validate the City's determination if it finds that trustees were not acting within the scope their responsibilities.

   d) Evaluating the current risk and coverage level, and, if prudent, adjust to lower annual premiums.

SDCERS management should recommend to its Trustees that they cancel the current fiduciary insurance policy when a more suitable and cost-effective alternative is identified and implemented. (Priority 2)

Management Response:

Partially agree. For Recommendation 1.a), both SDCERS' legal and fiduciary counsel have determined that there is no legally viable method that exists for SDCERS to self insure for fiduciary liability insurance. CalPERS, as a state entity, is able to self-insure for fiduciary insurance because of the specific statutory guidelines in Government Code section 7511 that do not apply to local entities such as SDCERS.

For Recommendation 1.b), SDCERS has already worked with the City Attorney's Office. This led to a City Attorney recommendation to the City Council at its March 9, 2011 council meeting not to afford any additional fiduciary protections to SDCERS trustees other than that already provided by California Government Code 995. The City Council accepted the City Attorney's recommendation and took no action.

For recommendation 1.c), Trustees seek assurance that they will have defense and indemnification until there is a judicial determination that their acts were not within the scope of their responsibilities. If the City refuses defense and indemnification, Trustees have the right to ask the courts if defense is owed, and are unlikely to give up their right to dispute the City's determination. A process using an independent third party to validate the City's determination (that a particular trustee was not acting within the scope of his or her responsibility) would provide no greater comfort to a Trustee than what is currently present unless the third party determination was quick and binding on the City, but not on the Trustee. If the City is free to reject the third-party determination, then the process only adds delay to the final determination.

For recommendation 1.d), the SDCERS Board of Administration, in open session, annually discusses the renewal of its fiduciary insurance policy and its associated coverage, exclusions and costs. At this meeting, the Board receives the advice of its legal counsel and its insurance broker to review its options and then votes in open session to approve a selected level of coverage and the expenditure of funds to pay the required insurance premium expense from SDCERS' operating budget.

It will be a Board of Administration decision on whether to maintain or cancel fiduciary insurance policy coverage each year at the time of policy renewal.

2. **Recommendation:** SDCERS should consider that its current actuary costs are high compared to peers when they evaluate proposals received in response to its Fall 2011 RFP for actuarial services and negotiate fees with the selected firm. (Priority 3)

Management Response:

Agree. As is standard practice, SDCERS will negotiate the best possible terms in our next contract with the Board-approved actuarial firm. As noted, the next RFP for actuarial services will be issued in Fall 2011.

3. **Recommendation:** SDCERS should designate an individual, possibly its Internal Auditor, to ensure the business process recommendations made by its consultant are implemented. (Priority 3)

Management Response:

Agree. The CEO and Information Technology Director will designate a project management staff member, with oversight by the project steering committee, to track the implementation of recommendations for the new pension administration system that were made by consultant L.R. Weschsler (LRW). The new system is scheduled to go live January 1, 2014. SDCERS will also evaluate for earlier implementation 12 of the 107 LRW recommendations that were unrelated to the new pension administration system software.

4. **Recommendation:** SDCERS should reassess its staffing level once the new pension administration system is implemented and eliminate unnecessary positions to reduce personnel costs. (Priority 3)

Management Response:

Agree. Our management team and Board understand the importance of appropriate staffing levels and personnel costs. We have taken steps to reduce our budgeted staff by seven positions in the last four fiscal years. We expect that efficiencies gained in the new pension administration system, particularly in the processes surrounding member service credit tracking, will enable us to further streamline our staffing levels when the new system is implemented in 2014.

5. **Recommendation:** SDCERS' board should periodically reassess its asset allocation and rate of return versus investment management costs to identify if its mix of active and passive investments is still appropriate. (Priority 2)

Management Response:

Agree. This ongoing process is currently in place. Annually, the Investment Committee reviews the recommendations of staff and our investment consultant Hewitt EnnisKnupp regarding the pooled investment asset allocation. This includes the allocation mix of active vs. passive management as well as the percentages allocated to the various investment sectors. All changes in the target allocations are approved by the Board.

8. **Recommendation:** SDCERS should allow members to obtain price estimates for service credit purchases through Member Counselors and/or their website to reduce the workload of Benefit Administration staff. (Priority 2)

Management Response:

Agree. SDCERS will evaluate website internet portal options to make informal, non-binding Purchase of Service Credit (PSC) price estimates available to members. The PSC calculation methodology requires input of the member's plan, service purchase type,

age, current years of service, time period to be purchased and current high salary. Members do not always know where to obtain this information. That said, by offering an informal price estimate, SDCERS could cut staff workload by reducing the number of formal purchase requests. We will review whether this type of non-binding PSC estimate is best accomplished in our current systems or in the portal of our new pension administration system.

9. **Recommendation:** SDCERS should require department managers to identify costs from contractor invoices that can be directly attributable to particular plan sponsors as part of their routine review and approval process. The department managers should clearly indicate for the Finance Department the total costs that can be assessed to a plan sponsor. (Priority 3)

Management Response:

Agree. We expect our division managers to note on invoices they approve amounts that should be charged to one plan sponsor rather than allocated to all three. This primarily occurs for legal, actuarial and certain information technology services. Finance staff, in their oversight role, will review and question division managers to ensure all SDCERS administrative expenses continue to be charged properly and accurately in accordance with the group trust plan participation agreements.

10. **Recommendation:** SDCERS should assess the current City and board policy that requires experience studies to be conducted at least every five years to determine if this timeframe is still appropriate, particularly since the actual timeframe is closer to three years. If SDCERS' management and trustees determine that a more frequent timeframe is more appropriate, they should consider revising the Board Rule and working with the City Council to revise the Municipal Code. (Priority 3)

Management Response:

Agree. In recent history, SDCERS has conducted actuarial experience studies in three year intervals. The most recent experience study for the three year period ended June 30, 2010 is being presented to the Board for approval at its upcoming September 2011 meeting. However, it may be appropriate to lengthen the time frame between studies in order to avoid over-reacting to short-term experience variations in the process of modifying actuarial assumptions. We will request our actuary to make a formal recommendation to the Board for their decision. If the Board decides to increase the time periods between experience studies, we do not foresee a need to change either the Municipal Code or Board Rule requirements.

11. **Recommendation:** SDCERS should draft the Request for Proposals for its actuarial and actuarial audit services and present it to the Board for approval within the next three months to ensure the firms are selected prior to expiration of the current contract. (Priority 3)

Management Response:

Agree. SDCERS staff will issue the RFP for actuary and actuarial audit services this fall and will ensure the process is completed prior to the expiration of the current contract.

12. **Recommendation:** SDCERS should demonstrate that it corrected the Corbett and monthly benefit calculations for the retirees identified in the 2005 audit. In addition, SDCERS should work with its legal counsel to determine the feasibility of collecting overpayments and reimbursing members who were underpaid, if applicable. (Priority 3)

Management Response:

Agree. We will review the incomplete items from the 2005 audit to determine if the calculations were accurate and then follow-up accordingly to collect amounts owed or pay amounts due in accordance with Board policies. This will be completed in FY 2012.

We appreciate the diligence and professionalism shown by your staff auditors Sara Glick and Efrem Bycer during the conduct of your audit.

Sincerely,

Mark A. Hovey, CEO
San Diego City Employees' Retirement System

cc: Ray Ellis, SDCERS Board President
Marilyn Creson Brown, SDCERS Audit Committee Chair

THE CITY OF SAN DIEGO

MEMORANDUM

DATE: September 26, 2011

TO: Eduardo Luna, City Auditor

FROM: Greg Bych, Risk Management Director

SUBJECT: Management Response to the Performance Audit of the San Diego City Employees' Retirement System (SDCERS)

This memorandum is in response to the City Auditor's Performance Audit of the San Diego City Employees Retirement System (SDCERS). While the audit was focused on the performance of SDCERS, there were several recommendations pertaining to employee benefits policies, which are determined by the City. In the case of these benefits, the recommendations were directed to the Risk Management department.

The Risk Management department has reviewed the Performance Audit of SDCERS and provides the following responses to the recommendations:

Recommendation #6: The Risk Management department should request the City Attorney's Office to:

a) Determine whether the City is legally obligated to reimburse current retirees' IRMAA expenses under the San Diego Municipal Code section 24.1202(a)(5). If the City Attorney's Office determines that the City is not legally obligated to reimburse IRMAA under the Municipal Code language, it should determine whether the City can discontinue reimbursing current retirees on a go-forward basis, or whether it is now considered a vested benefit. If the City Attorney's Office determines that it is not a vested benefit, Risk Management should work with the City Attorney's Office to identify the steps necessary to discontinue reimbursing current high-income retirees' Medicare Part B IRMAA premiums, and present options to City Council and City administration for consideration.

b) Review the retiree health care tentative agreement and make a legal determination about whether Medicare Part B premiums, including IRMAA, are eligible to be reimbursed from the health care allowance. Risk Management should work with the City Attorney's Office to clarify the eligibility of this benefit in the upcoming Memorandums of Understanding with labor groups. In addition, if the City Attorney's Office determines that Medicare Part B and/or IRMAA are not

> reimbursable expenses, Risk Management should work with the City Attorney's Office to revise the Municipal Code after July 2014 to explicitly exclude this benefit and present the revised Municipal Code language to City Council for adoption. (Priority 3).

Response to recommendation 6a: Disagree. The City reached agreement with its labor organizations in 1997 to reimburse Medicare Part B. This is codified in §24.1201(d) of the current version of the Municipal Code and §24.1202(b)(4) of the pending Ordinance revising the Municipal Code to reflect the changes to retiree health pursuant to the Tentative Agreement reached with the labor organizations to go into effect April 1, 2012. In 2007 the federal government created a law that began to increase the cost of Part B for higher income retirees. This is known as IRMAA. However, the Municipal Code does not differentiate between "Medicare Part B" and "Medicare Part B – IRMAA" premiums. It simply states "...Retiree timely enrolled in Medicare is also entitled to reimbursement of the cost of the Part B Supplemental Medical Expense Premium." In 2009 SDCERS clarified with Risk Management that their interpretation to reimburse the full cost of Part B, regardless of income level, was correct. Risk Management staff consulted with the City Attorney's Office on this issue, and the City Attorney's office concurred that the Medicare Part B - IRMAA premiums were reimbursable by the City based on the Municipal Code language.

Additionally, the City Attorney's office Opinion 2010-1 indicates that retiree health is a vested benefit upon retirement and states:

> "As to the question of whether the retiree health benefit can be modified for retired employees, it is our opinion that a court would find the benefit vested and would look to the language of the benefit at the time of an employee's retirement to determine what aspect of the benefit is vested."

While the City may be able to change the benefit going forward for active employees, and has based on the Tentative Agreement reached with all of its labor organizations, the City Attorney's opinion indicates that retiree health is a vested benefit upon retirement.

Response to recommendation 6b: Agree. Risk Management agrees with recommendation 6b and will seek to clarify this issue in the MOU language on retiree health going forward.

Recommendation #7: The Risk Management department should request the City Attorney's Office to review the permissibility of offsetting IDR benefits by income from outside employment and/or Workers' Compensation awards. If the City Attorney's Office determines that an IDR benefit offset policy is feasible, Risk Management should work with the City Attorney's Office to identify and present implementation options to City Council for consideration. (Priority 3).

Response: Agree. It should be noted that the disability income offset provision was eliminated in 1997 after negotiations with the labor organizations and subsequent 143.1 vote by the

SDCERS membership. As such, reestablishing a disability income offset provision may need to follow the same process.

Greg Bych
Risk Management Director

GJB

cc: Honorable Mayor Jerry Sanders
Honorable Councilmembers
Jay M. Goldstone, Chief Operating Officer
Wally Hill, Assistant Chief Operating Officer
Mary Lewis, Chief Financial Officer