MEMORANDUM OF LAW

DATE: August 18, 1993

TO: Lawrence B. Grissom, Retirement Administrator

FROM: City Attorney

SUBJECT: Change in Salary Growth Assumption

In a memorandum dated July 29, 1993 you indicate that the Board is considering a request to change the actuarial assumption regarding salary growth. It is our understanding that the change requested is a reduction from the current 5=% salary rate assump-tion to a 4=% salary rate assumption. It has been suggested that this change should only impact the employer contribution rate. If so, according to this proposal, the employer contribution rate would decrease, yielding approximately six million dollars to the City. The employee contribution rate would remain the same. You ask whether there is any Charter, San Diego Municipal Code ("SDMC") or other requirement that employee contribution rates be changed as a result of the contemplated reduction in the salary assumption.

After reviewing the relevant legal authority we conclude that the Board is required to revise the employee contribution rates. A change in an actuarial assumption underlying the system will trigger a review of the contribution rates for both the employees and the employer. While the employee rate will always be subject to revision, the employer rate may or may not be subject to revision depending on the specific facts and circumstances surrounding the revised actuarial assumption. Our analysis follows.

Background

The City's Retirement System is an actuarial based system. The employee and employer contributions to the retirement fund are computed upon the basis of actuarial advice designed to estimate the funding needed to accrue a guaranteed retirement allowance upon retirement. The retirement allowance contemplated is based on a formula involving the years of service, final compensation and age at retirement.

Section 143 of the Charter of the City of San Diego ("Charter") mandates that contributions to the Retirement System shall be made jointly by the City and its employees. Employees are required to contribute according to the actuarial tables adopted by the Board for normal retirement allowances. The City is required to contribute annually an amount substantially equal to that required of the employees.

The system is administered by an independent board. Pursuant to Charter section 143, the Board is required to adopt actuarial tables establishing the employee contribution rate. The Board is also required to provide a retirement allowance, also known as a creditable service pension, when certain age and service requirements are met. SDMC sections 24.0402 and 24.0403.

In addition, the Board is required to conduct yearly actuarial valuations of the assets and liabilities of the System and a thorough actuarial investigation of the mortality, service and compensation experience of members and beneficiaries, together with an actuarial evaluation of the assets and liabilities of the System, at least every five years. SDMC section 24.0901. It is our understanding that this comprehensive valuation is presently being conducted.

The employer contribution rate is "a percentage of earnable compensation as determined by the System's actuary pursuant to the annual actuarial valuation required by Section 24.0901." The Board is also required to determine the rate of interest being earned on the retirement fund. SDMC section 24.0901.

Finally, the Board has the authority and responsibility to revise employee contribution rates. SDMC section 24.0903. The calculations necessary to establish the formula for the guaranteed retirement allowance, including the establishment of contribution rates for both the City and employees in this process, the actuarial assumptions affecting contribution rates and the Board's role in the modification of the salary assumption and the corresponding changes in the contribution rates, are discussed in turn.

Calculating the Retirement Allowance

SDMC sections 24.0402 and 24.0403 set forth the Board's responsibility with respect to the calculations for service retirement for general members and safety members, respectively. These sections provide generally that upon retirement for service, a member "is entitled to receive a retirement allowance which shall consist of: (1) A service retirement annuity and (2) A current service pension." SDMC sections 24.0402 and 24.0403. The Board is required to provide for this benefit.

The service retirement annuity refers to the annuity established with the employee contributions pursuant to either SDMC section 24.0201 (general members) or section 24.0301 (safety members). The actuarial tables adopted by the Board establish the employee contribution rate. For general members, the normal rates of contribution shall be based on age and "shall be such as will provide an average annuity at age 57= equal to 1/120th of such member's final compensation . . . ." SDMC section 24.0201. The normal rates of safety members are also age based and must be set so as to provide an average annuity at age 50 equal to 1/100th of the safety member's final compensation. SDMC section 24.0301. According to SDMC section 24.0302, the employee contribution rates are to be contained in the Operating Tables furnished to the Board by the System's actuary.

The "current service pension" refers to that portion of the retirement allowance funded by the employer contributions. The City's contribution rate is governed by SDMC section 24.0801. It provides in pertinent part that the City

> shall contribute to the Retirement Fund in respect to members a percentage of earnable compensation as determined by the System's Actuary pursuant to the annual actuarial valuation required by Section 24.0901.

The resulting retirement allowance consisting of both of these components, known as the creditable service pension, is calculated as follows:F

Section 24.0403 sets forth the calculations for a credit-able service pension for safety members eligible and not eligible for Social Security benefits. The quoted material describes the calculation for those safety members who are not eligible because the formula is less complex and more easily understood. The general principles, however, are identical for general or safety members, with or without Social Security benefits. General member calculations can be found in SDMC section 24.0402.

> The creditable service pension for safety members who are not eligible for Social Security benefits is a pension derived from the contributions of the City, sufficient, when added to the service retirement annuity that is derived from the accumulated normal contributions of the safety member, to equal the fraction set forth in the following table opposite said safety member's age at retirement taken to the preceding completed quarter year, multiplied by the sum of 1/50th of final compensation for

> each year, and fractions thereof, to which the safety member is entitled to be credited at retirement.

SDMC section 24.0403.

Specifically, SDMC section 24.0403 and its general member contribution counterpart, SDMC section 24.0402, provide that the City shall contribute an amount sufficient to fund a current service pension funded by employer contributions which when added to the service retirement annuity funded by employee contri-butions provides the guaranteed retirement allowance. In short, the service retirement annuity is fixed by the Municipal Code. The current service pension fluctuates.

Actuarial Assumptions and Contribution Rates

Actuarial assumptions and contribution rates for the employees and the City are inextricably related. A change in an assumption directly impacts the employee contribution rates. The City contribution rate is in turn affected by any impact to the employee contribution rates.

As an actuarial based system, the Retirement System establishes contribution rates which recognize the employee's age at entry into the system. This is necessary because the employee's age at entry will largely determine the number of years of active employment prior to retirement. Or, stated another way, the number of years an employee will have to accumulate contributions.

To each age attaches a different rate of contribution. That rate is calculated based on three variables or actuarial assumptions: mortality, interest earned and salary increases during employment. Each of these assumptions is recognized in and contained within the employee contribution rates for the City's Retirement System. According to the Annual Actuarial Valuation dated June 30, 1992, the rate tables are based upon an 8% interest rate assumption and a 5=% salary rate assumption. With respect to mortality, the tables incorporate an industry standard arising out of the universally accepted 1971 Group Annuity Mortality Tables. A change in any of these assumptions necessarily affects the employee contribution rates.

As noted by the System's actuary:

> Actuarial experience of the system will not coincide exactly with assumed experience, regardless of the choice of assumptions, the skill of the actuary and the precision of the many calculations made. Each valuation provides a complete recalculation of assumed future

> experience and takes into account all past differences between assumed and actual experience. The result is a continual series of adjustments (usually small) to the computed contribution rate. From time to time it becomes appropriate to modify one or more of the assumptions, to reflect experience trends (but not random year-to-year fluctuations).

San Diego City Employees' Retirement System Annual Actuarial Valuation, June 30, 1992 (page 39).

The California Supreme Court concurs. In a continuing discussion of the contribution rates for the City's Retirement System, the court held:

> When, pursuant to periodic reevaluation, those actuarial assumptions are modified, so too must the contributing rate be ad-justed to generate the funds necessary to provide the normal retirement allowance prescribed by the system. Change in con-tribution is implicit in the operation of City's system and is expressly authorized by that system . . . .

International Assn. of Firefighters v. City of San Diego, 34 Cal. 3d 292, 303 (1983).

Modification of the Salary Assumption

The salary rate assumption is obviously critical to benefit calculations under the System. A member's final compensation is an essential element in the calculation of his or her retirement allowance. A reduction of the salary rate assumption reduces the projected final salary which in turn results in a decrease of the employee contributions necessary to actuarially fund that retirement allowance. This scenario provides the basis for the Board to exercise its authority under SDMC section 24.0903 to revise employee contribution rates.

Under SDMC section 24.0903, the Board is required to revise employee contribution rates when "necessary to provide the benefits for which the rates for normal contribution are required to be calculated."

Although modification of the City's rate of contribution is not expressly provided for in SDMC section 24.0303, such modification is implicit in the operation of the City's system and is expressly authorized by the System. International Assn.

of Firefighters v. City of San Diego, at 303. "Rather than being foreign to the City's retirement system, modification of the contribution rates of both employees and City is intrinsic to the ordinances basing those rates on actuarial facts which can be revised." Id. at 303.

Modification of the employer contribution rate, however, is not automatically required. As discussed earlier, the creditable service pension is the combination of the current service pension derived from employer contributions plus the service retirement annuity funded by the employee contributions necessary to fund the guaranteed retirement allowance. An adjustment to the employer rate is secondary to the initial revision of the employee contribution rate.

The critical issue is whether, after a change in the employee contribution rates, the employer contributions are sufficient to fund a current service pension which when added to the service retirement annuity provides the guaranteed retirement allowance. If the employer contributions are sufficient, then there need not be any change to the employer contribution rate. If, however, the employer contributions are more than sufficient for this purpose, then the employer will experience a reduction in its contribution rate. Likewise, if the employer contributions are insufficient, then the employer will see a corresponding increase in its contribution rate.

Other Considerations

Article XVI, section 17 of the state constitution provides that the retirement board of a public pension or retirement system shall have primary authority and fiduciary responsibility for investment of monies and administration of the system. Consistent with this mandate, the Constitution provides that

> (b) The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the retirement system solely in the interest of and for the exclusive purposes of providing benefits to, participants and their benefi-ciaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system . . . . Emphasis added.

In our view, the constitutional mandate to minimize employer contributions is accommodated by the procedures concerning modification of contributions (employee or employer) envisioned by the City's Retirement System. The revision of one or more actuarial assumptions underlying the System necessarily triggers a revision of the employee contribution rate. The employer rate, however, will only be revised when the employer contributions used to fund the pension portion of a member's retirement allowance is either more than or less than sufficient to fund the guaranteed retirement allowance.

We also note that the reduction of the salary rate assumption from 5=% to 4=% without any modification to the interest rate assumption currently at 8% will increase the differential or "spread" between these assumptions. According to the System's actuary and all other factors being equal, a larger spread produces a lower level of plan assets. The median spread is currently 2%. The proposal before the Board would increase this differential to 3=%. Addressing the spread when changing actuarial assumptions, the actuary notes:

> The idea that an identical differential be maintained when changing actuarial assump-tions is not entirely valid. An argument can be made that the assumed real rate of return could be set slightly higher than pre-existing assumptions to reflect the significant surge in both the bond and equity markets that began in August 1982. Also, if one holds a gloomy view of compen-sation levels during the rest of the 1990's, an argument could be made that the merit & longevity component of assumed salary increases should be decreased or eliminated on either a temporary or permanent basis. Such viewpoints, IF held, actually suggest that the widening of this differential be considered. Emphasis in original.

1993 Benefits Survey of Independent California Public Retirement Systems prepared by Gabriel, Roeder, Smith & Company (page 26).

In light of the foregoing, we can't emphasize enough the importance of the Actuary's input in this overall question of contribution rates. In light of the fact that the Board has already requested the actuary to conduct a thorough actuarial investigation of the mortality, service and compensation experience of members and persons receiving benefits, together with an actuarial valuation of the assets and liabilities of the

System pursuant to SDMC section 24.0901, the Board may wish to postpone its decision until the results of this comprehensive study have been completed and submitted to the Board.

Conclusion

The Board has the ultimate authority to revise contribution rates of members "as it deems necessary to provide the benefits for which the rates of normal contributions are required to be calculated." SDMC section 24.0903. Generally speaking, employee contribution rates will be revised when one or more actuarial assumptions are modified. Employer contribution rates will only be adjusted when, after a change in the employee rates, employer contributions are more than or less than sufficient to fund a current service pension which when added to the service retirement annuity will provide for the guaranteed retirement allowance.

The Board's ability to provide the guaranteed retirement allowance and the Board's responsibility to minimize the employer contribution when such action can be done without interfering with the Board's primary responsibility to promptly deliver the benefits **guaranteed by the City and administered through the Retirement System are ensured in this process. Importantly, the Board's decision in this regard, if arrived at in good faith, shall be conclusive. SDMC section 24.0903.

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