DATE ISSUED: June 25, 2004 REPORT NO. 04-143

ATTENTION: Rules Committee
Agenda of June 30, 2004

SUBJECT: Proposed Charter Amendment to the Pension System

SUMMARY

Issue – Should the Pension Reform Committee recommendations regarding Charter Section 141 and the amortization of pension costs be forwarded for consideration by City Council?

Manager's Recommendation – The language contained in the Pension Reform Committee recommendations regarding Charter Section 141 and the amortization of pension costs be clarified to avoid any ambiguity.

Other Recommendation – The Pension Reform Committee has proposed three amendments to the Charter regarding the Pension System. The City Attorney has

prepared a separate analysis of the proposals.

Fiscal Impact – Implementation of a fifteen-year rolling amortization schedule in FY 2009, after the proposed Settlement Agreement ends, would have a projected retirement contribution of $261 million as compared to the FY2008 projection contribution of $191 million under the proposed Settlement Agreement, based upon current estimates.

BACKGROUND

The Pension Reform Committee (Committee) was created by the Mayor and approved by the City Council on September 9, 2003. The Committee, which is comprised of nine members who were appointed by the Mayor and City Council, began weekly meetings on October 1, 2003. The City Council established the following objectives for the Committee:

1 Report back to the City Council no later than 120 days from the date appointments are confirmed.

2 After reviewing and considering the scope and depth of audit activity currently conducted by SDCERS, conduct any additional or supplemental independent audits, studies, or investigations deemed necessary and appropriate.

3. Provide recommendations to address any unfunded liability problems of the system.
4. Examine how the existing pension system has performed compared to other similar systems, including examinations of action other systems have taken to address funding shortfall problems, such as issuance of pension obligation bonds.
5. Examine whether changes should be made to the existing pension system.
6. Examine whether the make-up and representative constitution of the Retirement Board should be restructured.
7. Examine whether the system should be changed from a defined benefit plan to a defined contribution plan for new employees.

8. Examine whether the City should join the California Public Employees Retirement System or any other retirement system.
9. Make any other recommendations as appropriate.

The Pension Reform Committee presented an interim report to the City Council on January 26, 2004 which focused on three areas: 1. Educational process to date, 2. Status of the Retirement System's Audit process, and 3. Status of final report for Mayor and Council. It is expected that the Committee will complete their final report in July 2004 and forward their recommendations to the City Council.

As part of their deliberations, the Pension Reform Committee has recommended amendments to the San Diego City Charter pertaining to the composition of the Retirement Board, Disability Retirement Hearings and Amortization of Retirement Costs. At the Rules Committee meeting on June 16, 2004, the City Attorney was requested to analyze these three conceptual amendments to the City Charter contained in a memo to the City Clerk dated June 9, 2004.

DISCUSSION

The City Attorney has prepared a separate legal analysis of the three proposals. This report will focus on the Amortization of Retirement Costs as this Charter amendment directly impacts the City of San Diego budget. The other two amendments, Composition of the Board and Disability Retirement Hearings, are focused on the administration of the Retirement System.

Recommended Changes from the Pension Reform Committee

The Pension Reform Committee recommends the following change to Charter Section 141:

> "The Retirement Board shall have exclusive control of the administration and investment of the fund. However, when setting and establishing amortization schedules for the funding of the unfunded accrued actuarial liability, the Board shall place the cost of the past service liability

associated with a new retirement benefit increase on no greater than a fixed, straight-line, five year amortization schedule. Similarly, the Board shall place the cost associated with net actuarial gains and losses on no less than a five year schedule and no greater than a fifteen year schedule."

Past Service Liability - This change addresses the funding of new or enhanced retirement benefit changes which may be approved by City Council after the Charter change is implemented. Past service liability is that portion of an increased benefit cost for current employees related to the years of service they have worked to date. The past service liability would be amortized on a fixed, straight-line, amortization schedule which would be no longer than five years compared to the current thirty-year fixed amortization schedule. Prior to considering and approving any future retirement benefits, the cost of the past service liability as well as the impact on normal retirement costs (or annual retirement rates) would need to be assessed by City Council. This change in amortization would significantly increase the annual cost of any new benefits.

Net Actuarial Gains and Losses – This change addresses amortization of the unfunded accrued actuarial liability, net of the past service liability provision above. It is our understanding that 'net actuarial gains and losses' is intended to cover all other elements in the unfunded actuarial liability such as actuarial gains and losses, investment gains and losses, demographic changes, assumption changes, and contingent benefit payments. Based on consultation with the Retirement Administrator, the Annual Actuarial Valuation normally prepared for the Employee's Retirement System does not use the term 'net actuarial gains and losses' to set a liability amount to be amortized. The term that is universally utilized is 'Unfunded Accrued Actuarial Liability'. It is recommended that the terminology in the Charter be clearly defined to avoid any misinterpretations.

The Pension Reform Committee is recommending that that the cost associated with net actuarial gains and losses be placed on an amortization scheduled that is no less than five years and no greater than fifteen years compared to the current thirty-year fixed amortization schedule. Discussions at the Pension Reform Committee regarding the fifteen-year amortization period focused the desire to eliminate negative amortization; the current thirty-year fixed amortization schedule does have negative amortization in the early years.

The proposed Settlement Agreement (Gleason v SDCERS, et al) provides that the City make full actuarially calculated contributions to San Diego City Employees' Retirement System (SDCERS) beginning in FY2006. Beginning with the June 30, 2004 Annual Actuarial Valuation, the amortization period for the unfunded Actuarial Accrued Liability will be reset to a new thirty-year fixed amortization period. The FY 2005 contribution is a fixed amount of $130 million. The City's contribution amount for Fiscal Years 2006, 2007, and 2008 will be calculated on the reset amortization period. After FY 2008, SDCERS is free to adopt any amortization it and its actuary select, including a shorter fifteen-year schedule, for example. The City will remain obligated pursuant to the Charter to contribute to SDCERS an amount derived from the rates calculated by the SDCERS actuary in its annual valuation and approved by the SDCERS Board of Administration. The proposed Settlement Agreement is scheduled to be approved by the Court and City Council in July.

Based on discussions at the Pension Reform Committee, the amortization period of no less than five years was included to 'smooth' or spread investment gains and losses over several years to avoid volatility in the City's funding plan. We would recommend the draft language be clarified regarding this issue. The Retirement Administrator advises that it is currently Board Policy, based on the advice of the actuary, to 'smooth' or spread the impact of investment gains and losses over a rolling five-year period. The Board and the actuary are currently studying whether or not to use some period other than five years for this purpose, such as three years.

FISCAL IMPACT

The chart below shows the impact of a fifteen-year rolling amortization schedule, assuming implementation in Fiscal 2009 when the proposed Settlement Agreement is scheduled to end. In FY 2009, SDCERS can adopt any amortization schedule, including a shorter fifteen-year schedule. This projection assumes the adoption of the Settlement Agreement with projections to FY 2008 using FY 2005 Proposed Budget as a base, that there are no further benefits changes and the City takes no action to mitigate the projected retirement contributions between FY 2005 and FY 2009, such as the issuance of Pension Obligation Bonds. This projection does not include any cost impact of post retirement health insurance costs.

FISCAL YEAR	**RETIREMENT CONTRIBUTION**	**ANNUAL INCREASE**
FY 2005	$130 million	
FY 2006	$165 million	$35
FY 2007	$177 million	$17
FY 2008	$191 million	$14
FY 2009	$261 million	$70

The implementation of a fifteen-year rolling amortization schedule in FY2009, based on the above assumptions, would require a $70 million increase in retirement contributions over FY2008. This follows fairly modest increases in the preceding fiscal years. This increase would be in addition to other normal budget considerations such as personnel expense increases, new facility costs, inflationary increases and deferred maintenance.

As indicated to the City Council earlier, a three-year financial plan in being prepared by the City Manager's Office which will outline all the City's financial needs and resources and give a better indication of the City's capacity to address its needs in the FY 2006 through FY 2008 timeframe. It is expected that document will be produced in the fall of this year.

ALTERNATIVE

None.

Respectfully submitted,

____

P. Lamont Ewell

City Manager

(PF/PF)