COUNCIL AGENDA: 1-13-09
ITEM: 3.4

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

# Memorandum

**TO: HONORABLE MAYOR AND CITY COUNCIL**

**FROM: Russell U. Crosby**

**SUBJECT: FINANCIAL STATUS OF THE RETIREMENT PLANS**

**DATE: December 18, 2008**

Approved Christine J. Shippey    Date 12/19/08

**COUNCIL DISTRICT:** City-Wide

## RECOMMENDATION

Accept report on staff's response to questions raised by the Rules and Open Government Committee on December 10, 2008 related to the financial status of the retirement plans.

## OUTCOME

Present the financial status of both the Federated City Employees' Retirement System and the Police & Fire Department Retirement Plan.

## BACKGROUND

A recent report by the City Manager indicated that the total market value of assets in the two retirement Plans had declined by approximately $950 million since the beginning of the fiscal year due to current economic conditions. Regardless of the long-term investment strategy of the plans, the decline of nearly $1 billion is of great concern.

At the December 10, 2008, the Rules and Open Government Committee, Mayor Reed requested that staff prepare a report for the January 13, 2009 City Council meeting regarding the status of the City of San Jose's ("City") two Retirement Plans to include:

a) The amount of investment losses in 2008;
b) Report on the impact of the City's required contribution to make up for the losses;
c) Benchmark comparisons to performance of other retirement plans, public and private, over the last five to ten years; and
d) Identify any best practices that might be considered to improve the Plans' investment performance and to protect the City's General Fund from additional losses.

This memorandum has been prepared in response to that request.

## ANALYSIS

### a) Performance

The following table illustrates the Federated City Employees' Retirement System's ("Federated System") and the Police & Fire Department Retirement Plan's ("Police & Fire Plan"), collectively referred to as "the Plans," performance.

| | Oct-08* | YTD* | 3rd Qtr. 2008** | ICC Rank | TUCS Rank | One Year** | ICC Rank | TUCS Rank | Three Years** | ICC Rank | TUCS Rank | Five Years** | ICC Rank | TUCS Rank |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Federated System** | **-11.7%** | **-23.7%** | **-9.1%** | **61** | **57** | **-14.0%** | **39** | **31** | **2.7%** | **40** | **47** | **6.8%** | **42** | **47** |
| *Policy Index~FED* | *-11.9%* | *-22.4%* | *-7.0%* | *16* | *12* | *-12.1%* | *14* | *15* | *3.3%* | *25* | *28* | *6.9%* | *40* | *40* |
| **Police & Fire Plan** | **-13.2%** | **-27.2%** | **-9.6%** | **79** | **68** | **-16.5%** | **81** | **79** | **3.0%** | **39** | **34** | **7.3%** | **19** | **33** |
| *Policy Index~P&F* | *-12.9%* | *-26.0%* | *-8.8%* | *60* | *45* | *-15.3%* | *62* | *58* | *3.6%* | *23* | *23* | *7.4%* | *17* | *32* |
| Public Funds^ | - | - | -8.0% | - | - | -14.2% | - | - | 2.7% | - | - | 6.5% | - | - |
| Corporate Funds^ | - | - | -8.2% | - | - | -14.4% | - | - | 2.4% | - | - | 6.7% | - | - |
| S&P 500 | -16.8% | -32.8% | -8.4% | 46 | - | -22.0% | 57 | - | 0.2% | 53 | - | 5.2% | 77 | - |
| MSCI EAFE (Intn'l Equity) | -20.2% | -43.5% | -20.6% | 62 | - | -30.5% | 73 | - | 1.1% | 82 | - | 9.7% | 84 | - |
| Barclays Capital Aggregate+ | -4.5% | -1.7% | -0.5% | 15 | - | 3.7% | 22 | - | 4.2% | 31 | - | 3.8% | 39 | - |
| NCREIF Real Estate Index | 0.6% | 2.0% | -0.2% | 67 | - | 5.3% | 28 | - | 13.2% | 38 | - | 14.2% | 42 | - |

** as of 10/31/2008 ** as of 9/30/2008 + Formerly Lehman Brothers Aggregate Bond Index*
*^ Median Data Source: ICC & TUCS (not available for 10/31/2008)*
*The Independent Consultants Cooperative ("ICC") uses systems supported by State Street Bank to deliver detailed performance and asset allocation rankings. The Wilshire's Trust Universe Comparison Service ("TUCS") is a collaborative effort between Wilshire Associates and custodian banks to provide comprehensive information on the effects of risk, allocation, and style.*

The Federated System has consistently ranked in the second and third quartiles of the ICC and TUCS universes. A more diversified portfolio including alternative investments would have improved the Federated System's quartile ranking. The Policy Index return is the return that the asset allocation would have achieved with passive managers who attempt to replicate and not outperform their benchmarks. For all time periods considered, except the month of October, the Federated System underperformed its Policy Index. In other words, active management has consistently detracted value.

The Police & Fire Plan has ranked in different quartiles in the various time periods considered. The reason for the volatility of returns is a heavy allocation to equity investments. A more diversified portfolio including alternative investments would have improved the Plan's quartile ranking. For all time periods considered, the Police & Fire Plan underperformed its Policy Index. Again, active management has consistently detracted value.

More important than performance against other plans, however are the Plans' progress towards full funding. Progress towards full funding is achieved by performing at least as well as the actuarial assumptions. The following discussion will explain the potential impact of falling short of the actuarial assumptions.

The following table illustrates the Plans' balances as of recent dates and a year-to-date percent change, which is calculated without accounting for cash flows:

| | Nov. 30, 2008* | Oct. 31, 2008 | Sept. 30, 2008 | Jun. 30, 2008 | Dec. 31, 2007 |
|---|---|---|---|---|---|
| **Federated System** | $1,398,610,000 | $1,457,774,000 | $1,654,258,000 | $1,774,276,000 | $1,884,199,000 |
| **YTD $ Loss** | ($485,589,000) | ($426,425,000) | ($229,941,000) | ($109,923,000) | - |
| ***YTD % Loss*** | *-25.8%* | *-22.6%* | *-12.2%* | *-5.8%* | - |
| **Police & Fire Plan** | $1,992,396,000 | $2,031,499,000 | $2,348,046,000 | $2,561,590,000 | $2,776,959,000 |
| **YTD $ Loss** | ($784,563,000) | ($745,460,000) | ($428,913,000) | ($215,369,000) | - |
| ***YTD % Loss*** | *-28.3%* | *-26.8%* | *-15.4%* | *-7.8%* | - |

** unaudited data*

As illustrated above, as of November 30, 2008, the market values of the Federated System and Police & Fire Plan have declined 25.8% and 28.3%, respectively, since the beginning of the calendar year. The decline in the third quarter is slightly understated due to the City's prepayment of the retirement contributions for fiscal year 2008-09.

**<u>b) The impact of the Plans' investment losses on the City of San Jose</u>**

The impact of the Plans' investment losses on the City's contribution rate will be determined through an actuarial valuation. The City's required pension contribution, determined as a percentage of payroll, is based on an actuarial valuation report that is currently performed on a biennial basis for both Plans. The current pension contribution rates are based on the June 30, 2007 actuarial valuation and will be effective through June 30, 2010, unless the Retirement Boards modify the current biennial valuation process.

The following table illustrates the two Plans' normal valuation schedule:

| FUNDS' CONTRIBUTION SETTING PROCESS | | |
|---|---|---|
| **Actuarial Valuation** | **Date rates adopted by the Board** | **Rates Effective** |
| 6/30/2007 | June 2008 | Fiscal Year 2008-09<br>Fiscal Year 2009-10 |
| 6/30/2009 | June 2010 | Fiscal Year 2010-11<br>Fiscal Year 2011-12 |

Given the current process, new rates based on the June 30, 2009 actuarial valuation will be implemented beginning July 1, 2010. These rates will reflect the largely smoothed actuarial investment losses incurred to the valuation date. The Police & Fire Plan has a "corridor" trigger, which ceases smoothing of losses when the losses exceed certain levels. Retirement Services has requested additional information from the actuary relating to the level at which the "corridor" trigger stops the smoothing of losses.

The actuarial loss or experience loss due to investment performance is defined as the difference between the "expected investment income" that the actuarial valuation assumed would be earned on the Plan's assets, based on an 8.75% gross rate of return assumption for Police & Fire (8.00%

net) and 9.00% gross rate of return for Federated (8.25% net), and the realized investment income. Actuarial losses are smoothed over five years except when losses exceed the "corridor" trigger for the Police & Fire Plan.

The current pension funding arrangement provides for the following cost sharing of benefits:

1. The current service cost or Normal Cost is the cost of funding an additional year of service for all the current active participants. Current service rate cost sharing is eight-to-three between the city and the employees. This year the City's portion of the normal cost was paid in full at the beginning of the fiscal year; whereas, members pay through payroll deductions during the year; and

2. The current service and past service deficiency cost is the cost of funding the Unfunded Actuarial Liability ("UAL"), which is the difference between the Plans' assets and liabilities. Current service deficiency cost refers to service accrued by members on and after July 1, 1975 while the past service deficiency cost refers to service prior to July 1, 1975. In other words, this deficiency cost pays for experience gains or losses relative to the assumptions in the actuarial valuation. Deficiency cost is amortized over 30 years, similar to a 30-year mortgage, and for pension benefits, entirely paid for by the City.

Contributions for retiree medical benefits are made by the City and employees in the ratio of one-to-one for both Plans. Contributions for retiree dental benefits are made by the City and employees in the ratio of three-to-one in the Police and Fire Plan and in the ratio of eight-to-three in the Federated System.

The following table illustrates the two Plans' Schedule of Funding Progress as of the most recent actuarial valuation.

**Schedule of Funding Progress**

| HEALTHCARE | Valuation Date | Actuarial Value of Assets* | Liabilities | Actuarial Unfunded Liability | Funded Ratio |
|---|---|---|---|---|---|
| Federated | 6/30/2006 | $ 81,288,000 | $ 702,939,000 | $ 621,651,000 | 12.0% |
| P&F | 6/30/2006 | 38,381,000 | 851,217,000 | 812,836,000 | 5.0% |
| **Total** | | **$ 119,669,000** | **$ 1,554,156,000** | **$ 1,434,487,000** | **8.0%** |
| | | | | | |
| **PENSION** | **Valuation Date** | **Actuarial Value of Assets*** | **Liabilities** | **Actuarial Unfunded Liability** | **Funded Ratio** |
| Federated | 6/30/2007 | $ 1,622,851,000 | $ 1,960,943,000 | $ 338,092,000 | 82.8% |
| P&F | 6/30/2007 | 2,365,790,000 | 2,372,386,000 | 6,596,000 | 99.7% |
| **Total** | | **$ 3,988,641,000** | **$ 4,333,329,000** | **$ 344,688,000** | **92.0%** |

* *includes gain/loss smoothing, if any.*

Source: *P&F Healthcare: CAFR 2006-07, Segal Report 2/21/2007; P&F Pension: Segal Actuarial Valuation 1/31/2008*
*Federated Healthcare: CAFR 2006-07, GRS Report 2/28/2007; Federated Pension: GRS Actuarial Valuation 1/2/2008*

While all actuarial assumptions could generate deficiencies, the two actuarial assumptions that typically generate the most significant deficiencies are:

1. Investment risk, which is the risk that the plan will not achieve its stated rate of return assumption, 8.75% gross rate of return assumption for the Police & Fire Plan and 9.00% gross rate of return for the Federated System;

2. Mortality risk, which is the risk that retired members survive and receive pensions for longer than anticipated by the actuary.

Deficiency cost is amortized over 30 years, similar to a 30-year mortgage, and for pension benefits, paid entirely by the City. The following paragraphs illustrate how the deficiency cost could affect the City's contribution level. Admittedly the following is an oversimplification of actuarial methodology and calculations; however, the illustration is valid.

For the last ten years ending September 30, 2008, combined, the Plans underperformed the actuarially assumed rates of return by roughly $1.7 billion, of which roughly $0.7 billion predate the stock market crash of the third quarter of 2008. Normally, large underperformance over periods such as ten years or longer is an indication that the actuarial assumption, in this case the rates of return, 8.75% gross rate of return assumption for Police & Fire Plan and 9.00% gross rate of return for the Federated System, are inappropriately high.

An UAL relating to the actuarial rate of return assumption of roughly $1.7 billion would be created once all the investment losses are smoothed in; the total UAL consists of surpluses or deficiencies relating to all assumptions. The City will be responsible for making annual payments sufficient to pay interest on the UAL and to amortize the UAL over approximately 30 years.

The adoption of a more conservative investment return assumption will increase Normal Cost of the Plans, but decrease the total cost of the Plans and reduce the potential for additional increases in the UAL.

**c) Discussion on Best Practices**

Academic studies show that pension plans that follow best practices deliver the promised benefits at a lower cost. On a typical pension plan, an industry rule of thumb is that if the annual investment rate of return can be increased by 0.1%, the plan's liability decreases by roughly $100 million for plans with total liability of approximately $5.0 billion. Using this rule of thumb, the City's contribution rate would drop by about 1.0% of payroll, and the employees' contribution rate would drop by roughly 0.2%.

Pension plan best practices fall into the following three categories: governance, investments, and administration.

1. Governance is by far the most important area to focus a study of best practices since it directly impacts both investments and administration.

Technical skills are required to understand the complex issues that are present in the governance of the Plans. The combination of highly technical rules for pension administration and the need to understand the use of actuarial science in the measurement of present and future pension plan liabilities requires an experienced and highly trained Board member to effectively govern the plan.

While some may argue that the purpose of the Board is to set policy and that technical aspects are handled by trained professionals, a lack of understanding of the finer points of governance, administration, or investments means that a Board member may not be able to ask meaningful questions or fully understand the implications of a recommended course of action. Consequently, ineffective policies and inferior plan governance result. Inferior plan governance always leads to suboptimal decisions and higher costs for the City.

Recent court cases also highlight problems with the current construct of the Plans' Board membership. The ongoing Lexin (San Diego) case involves a Board with composition similar to the existing Police & Fire and Federated Boards and demonstrates issues that arise with Boards whose membership have potential conflicts of interest. Issues of potential conflict of interest can be resolved through changes to Board membership and improved internal Board governance procedures.

Over the years, there have been numerous conflicts between the Boards and City Administration that highlight the perception that the Board membership represents various constituencies rather than plan participants as a whole. Board members are currently perceived as being "representative" of a particular nominating group, even though each trustee must act as a fiduciary on behalf of all participants and beneficiaries rather than a "representative" of a particular nominating group. In addition, requirements for Trustees to be a "member" of the nominating group rather than "nominated by" the underlying group leads to potential conflicts of interest and limits the expertise and quality of trustees to individuals in the member pools who are willing to serve on the Boards.

One example of governance leading to suboptimal decisions and higher costs for the City is the issue of active money manager performance. This memo has pointed out in the performance section that active managers have detracted from the Plans' performance. Typically investment consultants are reluctant to recommend the termination of an active manager without making the same recommendation to all clients, which often implies that the consultant will allow the manager to underperform for a length of time. Knowledgeable Trustees can provide direction to the consultant on this issue to ensure no underperforming manager is retained for an excessive period of time.

Since proper governance is the key that leads to professionalism and excellence in all areas of practice, a consultant who has seen the governance structures of many different plans is in the best position to advise the City as the plan sponsor regarding the necessary governance changes.

2. The two retirement plans have made a number of changes toward best practices in their investment programs during the past year. The Federated System expanded the contract with its investment consultant to include full service consulting and adopted a new asset allocation in January 2008. The new allocation increases the allocation to alternative investments.

   The Police & Fire Plan replaced their investment consultant in April 2008 and adopted a new asset allocation in June 2008. The new asset allocation increases the allocation to alternative investments, and includes absolute return, real assets, private equity, and opportunistic strategies.

   - Had the Plans previously diversified their asset allocations to include alternative investments their rankings would very likely have been top quartile across the time periods considered. For example, the San Bernardino County Employees' Retirement Association ("SBCERA"), which began implementing an alternative investments strategy in 2003, outperformed its Policy Index by 1.9% and ranked in the 18th percentile at one-year, 2.0% at three-years (ranked in the 3rd percentile), and 0.9% at five-years (ranked in the 3rd percentile). SBCERA's nine-member Board consists of the County Treasurer (ex officio member), four members appointed by the San Bernardino County Board of Supervisors, two members elected by "General" members, one member elected by the "Safety" members (along with an Alternate), and a member elected by "Retired" members. SBCERA outperformed the San Jose Plans' returns by significant margins. Best practices do in fact translate into higher investment returns and lower contributions for all parties.

   During the year, the San Jose Plans hired a Chief Investment Officer, an Investment Officer, and a Senior Accountant. The Chief Investment Officer is an actuary and a former investment consultant. The Investment Officer is a Ph.D. and a former Director of Research for an investment consulting firm. The Senior Accountant is a former accounting manager of a private equity-owned firm.

3. Recent administrative best practices include the retention of the Segal Company in April 2008 to perform a review of Retirement Services administrative practices and HIPAA compliance; an ongoing audit of City payroll contributions to the retirement plans by the Plans' independent auditor, Macias Gini & O'Connell, LLP; approval of a staff request to conduct a review and develop a request for proposals to determine whether the Pension Gold processing software used by the Retirement Services Department is the best and lowest cost solution going forward; and a review of all insurance coverage for the Plans and their assets. Additionally, there has been renewed emphasis on ensuring that all calculations and procedures are in compliance with the Municipal Code. This lead to the recalculation of the Federated Supplemental Retirement Benefit Reserve ("SRBR") to at least 2005 and possibly further back in time to account for excessive transfers and potential overpayments in prior years.

As noted above, best practices in plan governance will yield the greatest benefits. Governance impacts all aspects of pension plan operations and leads to professionalism, excellence, and ultimately increased returns for the Plans.

## EVALUATION AND FOLLOW-UP

This memorandum is provided as an informational item and may be updated upon the City Council's request.

## PUBLIC OUTREACH/INTEREST *(Not Applicable)*

☐ **Criterion 1:** Requires Council action on the use of public funds equal to $1 million or greater. **(Required: Website Posting)**

☐ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

☐ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

## COORDINATION

This memorandum has been coordinated with the City Manager's Office, the City Auditor's Office, the City Attorney's Office, the Office of Employee Relations, and Human Resources.

## CEQA

Not a project.

Russell U. Crosby, DIRECTOR
Retirement Services

For questions please contact Ronald R. Kumar, Financial Analyst, at (408) 392-6708.