COUNCIL AGENDA: 11/18/10
ITEM: 3.3a2

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: PLEASE SEE BELOW

DATE: November 8, 2010

COUNCIL DISTRICT: City-Wide
SNI AREA: N/A

SUBJECT

INPUT REGARDING RETIREMENT REFORM FROM RE-CONVENING OF GENERAL FUND STRUCTURAL DEFICIT ELIMINATION PLAN STAKEHOLDER GROUP

RECOMMENDATION

Accept the staff report and the General Fund Structural Deficit Elimination Plan Stakeholder Group input regarding retirement reform.

OUTCOME

Council receives input about retirement reform from the re-convened General Fund Structural Deficit Elimination Plan Stakeholder Group that can help City Council develop guiding principles for retirement reform and identify the City's reform goals.

BACKGROUND

On August 3, 2010, the City Council's decision to proceed with a ballot measure on Pension Reform included direction to reconstitute the General Fund Structural Deficit Elimination Plan (GFSDEP) Stakeholder Group as an engagement component of the reform process. The adopted work plan, which involved four meetings, focused on identifying major considerations and concerns with the existing retirement systems and priority elements for reform.

This direction mirrored a recommendation of the General Fund Structural Deficit Elimination Plan (November 2008), as indicated on page 47, section (c):

> ***Implement a Two-Tier Retirement Benefit****: In 2008-2009, employee retirement contributions are projected to cost the City over $135M. The cost has increased 2 1/2 times from the $54 million annual cost in 1996. Given this rate of increase, and forecasts that costs will continue to escalate rapidly, the City should examine an alternate retirement system for new employees while maintaining the current system for current employees. A two-tier retirement system is a cost savings strategy that may require meet and confer and would have a beneficial impact on the City in the future. Specifically, new employees would be offered a different type or level of retirement than that of current employees. Several private and public organizations have implemented two-tier systems with success.* ***The City should continue its analysis of the strategy and examine possible models for implementation of revised retirement structures for new employees in the future.***

The full text of this five-year plan to reduce the City's deficit can be viewed at http://www.sanjoseca.gov/budget/FY0809/GFStructuralDeficitEliminationPlan112008.pdf

On November 2, 2010, the ballot measure on Pension Reform (also known as "Measure W") was passed by an overwhelming margin by the San Jose voters. The Measure allows the City Council to adopt an ordinance to exclude future City officers and employees from any existing retirement plans or benefits and to establish retirement plans for future employees that do not provide for the current minimum requirements in the City Charter. The full text of Measure W can be found at
http://www.sanjoseca.gov/clerk/elections/2010Election/novembermeasures/pension.pdf

General Fund Structural Budget Deficit

The City is entering its tenth year of General Fund shortfalls. In order to achieve a balanced budget for Fiscal Year 2010-2011, the Mayor and City Council were faced with closing a $118.5 million General Fund budget gap. In addition, many of the City's special funds had significant shortfalls to rectify. Consequently, many difficult decisions had to be made to balance the Fiscal Year 2010-2011 budget, including the elimination of 660 City jobs resulting in approximately 200 employees being laid off.

Retirement benefits are currently the most expensive benefits provided to employees. The City has two retirement plans: the Police and Fire Department Retirement Plan and the Federated City Employees' Retirement System. The City recognizes the importance of pension and retiree healthcare benefits and the significant cost implications now, as well as to future generations. Retirement reform is essential to the long-term sustainability and availability of retirement benefits for City employees.

Pension Sustainability Audit

On September 29, 2010, the City Auditor issued an audit entitled *Pension Sustainability: Rising Pension Costs Threaten the City's Ability to Maintain Service Levels – Alternatives for a Sustainable Future.* The audit focused on the rising cost of City retirement benefits, identifying the major cost drivers and recommendations to achieve more sustainable retirement costs for the future. On October 26, 2010, the City Council took action to accept the City Auditor's recommendations. The Pension Sustainability Audit can be viewed at http://www.sanjoseca.gov/auditor/AuditReports/1010/1010.pdf

Information from this audit was provided in detail to the GFSDEP Stakeholder Group as part of the education component of the process.

Current Retirement Benefits in San Jose

The City's two retirement systems provide defined retirement benefits to eligible employees. Both retirement plans use investment income and employer and employee contributions to provide eligible retirees with pensions based on years of service and highest average annual salary. The plans also provide a 3% guaranteed annual cost of living adjustment (COLA) for all retirees, retiree healthcare benefits, survivor benefits, and permanent disability benefits to eligible members and beneficiaries.

Both the City and employees make contributions for retirement benefits which are calculated as a percentage of payroll. The City will contribute approximately $155 million into the two retirement plans in Fiscal Year 2010-2011, $89 million for the Police & Fire Plan and $66 million for the Federated Plan. The City recognizes that this is an important benefit that also has significant cost implications, which is why we must ensure that the costs of retirement benefits are sustainable in the long-term.

The Fiscal Year 2010-2011 retirement contributions for the City and employees are listed below. These rates were approved by the each of the retirement boards. It should be noted that several employee units have agreed to pay a portion of the City's retirement contributions for Fiscal Year 2010-2011.

Current Retirement Contribution Rates[1]

	Federated		**Police**		**Fire**	
	City	Employee	City	Employee	City	Employee
Pension	23.18%	4.54%	38.32%	9.81%	40.24%	10.09%
Health	6.41%	5.76%	6.26%	5.76%	3.92%	3.61%
TOTAL	**29.59%**	**10.30%**	**44.58%**	**15.57%**	**44.16%**	**13.70%**

The City's contributions to the retirement plans are established by the retirement boards, based on actuarial reports, and are based on many factors, including the cost-sharing arrangement between the City and employees and the level of benefits provided. Increases in the City's contribution rates can occur for various reasons, including retirement benefit enhancements.

[1] Board adopted rates. Does not include the discount rate for the City prepaying the retirement contributions.

The difference between the pension liability and the value of plan assets is called the unfunded liability. The unfunded liability is calculated two ways: (1) based on the market value of assets, and (2) based on the actuarial value of assets.

The current unfunded liability under both calculations is detailed in the charts below.

Pension Unfunded Liability			
	Federated	**Police and Fire**	**Total**
Market Value	$1.1 billion	$1.0 billion	$2.1 billion
Actuarial Value	$0.7 billion	$0.4 billion	$1.1 billion

Retiree Healthcare (OPEB) Unfunded Liability			
	Federated	**Police and Fire**	**Total**
Market Value	$0.7 billion	$0.7 billion	$1.4 billion
Actuarial Value	$0.7 billion	$0.7 billion	$1.4 billion

The San Jose Municipal Code provides that the City is responsible for 100% of the unfunded liability for the pension benefit.

As a result of this significant unfunded liability, funding ratios for both plans have fallen significantly. The current funding ratios for both retirement plans are detailed in the chart below.

Retirement Funding Ratios		
Pension	**Federated**	**Police and Fire**
Market Value of Assets	55%	66%
Actuarial Value of Assets	71%	87%

Retiree Healthcare (OPEB) Plans	Federated	Police and Fire
Market Value of Assets	11%	6%
Actuarial Value of Assets	11%	7%

The following chart provides the City's projected retirement rates through Fiscal Year 2014-2015.

City's Projected Retirement Contribution Rates					
	FY 10-11	**FY 11-12**	**FY 12-13**	**FY 13-14**	**FY 14-15**
Federated	**29.59%**	**34.29%**	**38.42%**	**42.71%**	**45.14%**
Police	**44.58%**	**52.39%**	**60.64%**	**69.89%**	**74.89%**
Fire	**44.16%**	**52.39%**	**60.64%**	**69.89%**	**74.89%**

It is important to note the pension contribution rates shown above are projections only. The actuary for the Police and Fire Department Retirement Plan and the Federated City Employees' Retirement System will be preparing the actuarial valuation that will lead to the actual contribution rates for Fiscal Year 2011-2012. The rates are anticipated to be established by the boards in the next several months.

Negotiations with the majority of the bargaining groups will commence in January 2011 and the issue of retirement reform will be discussed.

ANALYSIS

General Fund Structural Deficit Elimination Plan Stakeholder Group Input

In recognition of the significant cost implications of pension and retiree healthcare and the importance of retirement reform to the long-term sustainability and availability of retirement benefits for City employees, the City re-convened the GFSDEP Stakeholder Group. This group was charged with providing input to the City Council regarding major considerations and concerns with the existing retirement systems and priority elements for reform. Through a four-meeting process, the Group was provided with a significant volume of background information and asked to address four key questions:

1. What are the Major Strengths of the existing retirement benefits system (i.e., that should ideally be preserved?)

2. What are the Major Weaknesses/Concerns with the existing retirement benefits system (i.e., that should ideally be addressed)?

3. What should be the End Goals of a reformed retirement benefit system?

4. What changes should be considered to the current retirement benefits system?

A summary of all responses to these questions is attached to this Memo. The top five most widely accepted ideas in each category are summarized below.

Major Strengths of Existing Retirement Systems

The top five strengths identified by the Stakeholder Group included the following:

- Attracts a high-caliber workforce
- Rewards experience and commitment to public service
- Enables healthy retirees who have healthcare coverage and security
- Avoids high cost of turnover
- Very stable/certain for employees

Major Weaknesses/Concerns with the Existing Retirement Benefit Systems

The top five weaknesses/concerns identified by the Stakeholder Group included the following:

- Is affecting service levels to residents, which are not okay now; retirement costs are causing reduction in services to City residents
- City bears virtually all the risks for market losses, inflation and bargaining changes
- 3% Cost of Living Adjustment (COLA) bears no relationship to actual Consumer Price Index (CPI)
- Comparative analyses to other cities is not done in detail
- Though a generous plan, it is fiscally unsustainable

End Goals of Reformed Retirement Benefit Systems

The top five end goals for retirement reform identified by the Stakeholder Group included the following:

- Fiscally sound City
- Solution should be collaborative; should work for citizens, employees and the City; should eliminate "us vs. them" dynamic
- Stable City services, in quantity and quality
- More predictable, smoother costs in the future--no major up, downs, surprises; retirement system is financially sustainable
- Competitive total employee compensation/labor market equality

Changes That Should Be Considered to the Current Retirement Benefit Systems

The top five high-level ideas for potential changes identified by the Stakeholder Group included the following:

- Create a second-tier pension system for new employees
- Increase the retirement age
- Change automatic 3% COLA to link increases to the CPI or to the increase given to Social Security recipients
- Change to a defined contribution plan, like a 401(k)--could be a hybrid, could be an option, consider which group of employees the City wants to incent to stay due to training investment
- No City pension holiday; always pay full normal cost

CONCLUSION

There is no question that with a tenth year of General Fund budget shortfalls and deficits projected the next several years, the City Council will continue to be faced with very difficult decisions. A major consideration will be reform of the City's retirement systems in order to ensure the sustainability of the retirement benefits and the City, and reduce need for continued staff downsizing. The Stakeholder Group has provided one valuable source of input to aid the

Council in developing guiding principles for reform and determining the City's goals for retirement reform. Although there is clear tension between the strengths and weaknesses of the existing system, there is room to discuss evolving the retirement systems in order to preserve the City staffing and service levels and the long-term viability of the retirement benefits and the City itself.

EVALUATION AND FOLLOW-UP

When agreements are reached on retirement reforms, they will be brought to Council in open session for approval.

PUBLIC OUTREACH/INTEREST

- ☐ **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 memo has been coordinated with the City Manager's Budget Office.

CEQA

Not a project.

Debra Figone
City Manager

For questions please contact Kim Walesh, Chief Strategist, at 535-8181.

Attachment A: GFSDEP Stakeholder Group Retirement Reform Summary of Group Exercises

Summary of Group Exercises

Retirement Reform
GFSDEP Stakeholder Group

1. What are the Major Strengths of the existing retirement benefits system (i.e., that should ideally be preserved?)

Group members were asked to brainstorm the Major Strengths of the existing retirement benefits system. Each member had three dots to spread among three Major Strengths. The top five vote-getters are identified in bold below.

14	**Attracts a high-caliber workforce**
9	**Rewards experience and commitment to public service**
7	**Plans enable healthy retirees, who have health care coverage and security**
5	**Avoids high cost of turnover**
3	**Very stable, certain for the employees**
2	All employees have a common benefit structure.
2	Retains employees
2	Sustains San Jose “business model”: keeps an under-funded city going with high high-quality employees
2	Managed by the City, so can be responsive to local market conditions
2	Have made some changes already
1	Protects retired employees from inflation
	Stable under normal economic circumstances
	No risk to employees
	Protects the city from financial loss associated with inexperienced personnel
	Makes public service attractive
	Is a reasonably generous plan
	Relatively easy to understand
	Is a known commodity to employees
	Supports a long-term policy of compensating employees slightly above other cities in order to retain them

2. What are the Major Weaknesses/Concerns with the existing retirement benefits system (i.e., that should ideally be addressed)?

Group members were asked to brainstorm the Major Weaknesses/Concerns of the existing retirement benefits system. Each member had three dots to spread among three Major Weaknesses/Concerns. The top five vote-getters are identified in bold below.

9	**Is affecting service levels to residents, which are not OK now; costs are causing reduction in services to city residents**
9	**City bears virtually all the risks for market losses, inflation, bargaining changes**
6	**3% “COLA” bears no relation to actual CPI**
6	**Comparative analyses to other cities not done in detail**
4	**Though a generous plan, it is fiscally unsustainable**
2	Vulnerable to economic meltdown/apocalypse
2	Businesses may leave the City if costs of doing business are too high to pay for retirement benefits
2	Lack of “sustainability metrics” make it difficult to identify a reasonable, sustainable benefit and cost
1	Underfunding of plans has been long-standing. No public review on an annualized basis of plan status.
1	Locally managed plan can be influenced by politics and special interests.
1	Attracting employees to public service could prevent the city from looking at what services could be privatized.
1	Attracts employees to public service instead of to the private sector, where they could be creating wealth in the free market
1	.Unfunded liability created
1	Need public discussion to change longstanding policy
1	Need better communication with employees and public about the plan details, positives and negatives
1	The process by which the pan and its funding are determined is not working
1	City employees don’t get social security
1	Vulnerable to spiking
1	Vulnerable if there is too much time between actuarial analyses.
	“Early’ retirement at 50/55 means City loses some very talented employees.
	Perceived as too generous compared to private sector
	Are hardened positions in some factions
	Different elements of change might require difference procedural paths
	City was slow to identify and respond to the problem
	Impossible to determine what are “normal” market conditions.
	Could encourage employees to stay in a job they don’t like to hit ‘magic numbers’
	People chose public service for reasons other than retirement

3. What should be the End Goals of a reformed retirement benefit system?

The group identified a range of ideas for potential End Goals of a reformed retirement benefit system. Each member had three dots to indicate the three End Goals that resonated most with them.

14	**Fiscally sound city**
13	**Solution should be collaborative; should work for citizens, employees, and the City; should eliminate "us" vs. "them" dynamic**
12	**Stable city services, in quantity and quality**
9	**More predictable, smoother costs in the future—no major ups, downs, surprises; retirement system is financially sustainable**
5	**Competitive total employee compensation/labor market equality**
4	Employees retained; Employee motivation maintained
2	Checks and balances that allow us to react to change/flux
2	Cost transparency
2	Transparency in bargaining
1	Risk-sharing
1	Reduced overall risk
	Pension costs that don't increase business taxes above local cities
	City makes only those promises that it can keep
	Decent standard of living for retirees
	Decent standard of living for taxpayers
	Portability
	Stability for City and employees
	High-quality, competitive personnel
	Retirement security
	Competitive retirement to both other governments and private companies
	Health care contemporary for better living behaviors
	Continue incremental approach to change
	Transition problems of any change minimized
	Initiatives statewide should not drive change
	Link benefit increases to actual CPI
	Increase retirement age closer to private companies and social security (except for public safety)
	Increase retirement age to reflect increased lifespan
	No benefit changes resulting in an unfunded liability
	More timely, better utilized retirement data
	Initiatives statewide should not drive change
	Link benefit increases to actual CPI
	Increase retirement age to reflect increased lifespan; Increase retirement age closer to private companies and social security (except for public safety)
	No benefit changes resulting in an unfunded liability
	More timely, better utilized retirement data

4. What changes should be considered to the current retirement benefits system?

The group generated ideas about potential changes that should be considered to the current retirement benefit system. Each member had three dots to indicate the three change ideas that they thought deserved most consideration.

12	**Create a second tier pension system for new employees**
10	**Increase retirement age**
8	**Change automatic "3% COLA" to link to CPI or the increase given social security recipients**
8	**Change to defined contribution plan, like a 401(k)…could be a hybrid, could be an option, consider which groups of employees want to incent to stay due to training investment**
5	**No city pension holiday (always pay full nominal cost)**
4	Pension obligation bonds
4	Change the formula to a lower percentage of salary
4	Flexible alternatives/solutions for different groups and individuals
2	Offer alternative pay/retirement combinations to new and current employees; allow current employees to opt into any new Tier 2 system
2	Move pension to CALPERS
2	Employee education forums regarding costs, essential services at widespread city locations, all shifts, use technology
1	Longer vesting period
1	Prohibit pension/salary spiking
1	City should support regulation of the financial industry
1	Use stakeholder panels (city leaders, employees, citizens) to re-define "essential services"—use of social media, surveys too for input
1	Share cost of medical plans, in line with private business
	Review and prioritize services every budget cycle with a panel of citizens
	Benchmark total compensation to private industry
	Review investment return assumptions (the 8%)
	Prohibit employees with disability or retirement from being re-employed by city
	Do more analysis of other cities' reforms and share with stakeholders
	Combine unions in negotiations; are too many separate unions
	More equal contributions by City, employees
	Change charter to ensure that city must fully fund pension obligations, except for extreme emergency circumstances
	Define essential services that should be stable
	Benchmark who is doing this well
	Smooth expenses by having more frequent actuarial reviews (to reduce risk)
	Management structure may be too top heavy