



Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: Defined Contribution Plan Option
for New Employees in Unit 99

DATE: November 20, 2012

RECOMMENDATION

1. Approve an Ordinance amending Title 3 of the San Jose Municipal Code to add new Chapter 3.49 and amending various sections of Chapter 3.28 for the purposes of establishing an option between the Tier 2 Defined Benefit plan and a Defined Contribution 401(a) Plan that excludes participation in retiree healthcare, for Executive Management and Professional Employees (Unit 99), and who are hired on or after January 20, 2013.
2. Adoption of Resolution authorizing the City Manager to negotiate and execute the Adoption Agreement and Basic Plan Agreement for the Defined Contribution 401(a) Plan.

BACKGROUND

Unit 99 currently consists of Senior Staff, Executive Staff, senior managers under the City Manager's Appointing Authority, Council Office staff, and professional or management employees under the appointing authority of the City Attorney, City Auditor, and Independent Police Auditor. In addition, there are employees in Unit 99 in the City Clerk's office. There are currently approximately 214 full-time equivalent employees (FTEs) in Unit 99. Full-time employees in Unit 99 are a part of the Federated City Employees' Retirement System. Other employees, such as temporary employees and part-time employees are part of the City's defined contribution 457 PTC plan.

On June 5, 2012, voters passed Measure B, which set parameters for the creation of a second tier retirement program for new employees. Measure B allowed for either a defined benefit and/or defined contribution plan to be established. At the June 12, 2012, City Council Meeting, the Council voted to adopt a resolution approving a second tier defined pension benefit for new eligible employees hired on or after September 30, 2012, in the Federated City Employees' Retirement System.

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Although the recommended benefit changes on June 12, 2012 for new employees in Unit 99 included a defined benefit in Tier 2, Council was advised in the Council memo that the City would be exploring a defined contribution plan that would provide new employees, who are hired directly into Unit 99, the option to elect a defined contribution plan in lieu of a defined benefit program. As such, the proposed ordinance and adoption agreement creates a defined contribution plan that will allow new eligible employees who are hired directly into Unit 99 a one-time election when the person is hired between the Tier 2 benefit option and the defined contribution 401(a) plan (Tier 3). Those employees who elect to participate in the Tier 3 defined contribution plan will not participate in the retiree healthcare plan at this time. The ordinance provides parameters for the defined contribution plan, while the specific plan requirements are contained in the Adoption Agreement.

ANALYSIS

As noted above, Measure B approved by the voters on June 5, 2012, set parameters for a second tier of retirement benefits for eligible new employees, which allowed for either a defined benefit or defined contribution plan.

Defined Benefit Plans

Eligible employees in both Tier 1 and Tier 2 in the Federated City Employees' Retirement System receive a defined benefit pension. A defined benefit plan is a plan that promises its recipients a set level of benefits during retirement. It is typically based on a formula that includes the number of years served and an employee's salary, multiplied by a preset figure.

The Tier 2 defined benefit plan established by the Council for employees hired into the Federated City Employees' Retirement System was a lower level benefit than the Tier 1 benefit currently provided. It provides for 2% for every year of service with a retirement age of 65. The current cost of the Tier 2 defined benefit program is 6.68% for the City and 6.68% for employee.

In addition to the pension benefit, employees who reach 15 years of service are eligible for a retiree healthcare benefit. The retiree healthcare benefit is 100% of the lowest cost plan single or family available to any City employee. The current contributions for the retiree healthcare benefit is 7.91% for the City and 7.26% for employees. However, these do not reflect the full Annual Required Contribution for retiree healthcare, which is significantly more than the current amount being contributed by the City and employees.

Defined Contribution Plans

A defined contribution plan is a plan to which the employer, and often the employee, contributes a defined amount to an individual account in the employee's name while the employee is in

active service, but which does not guarantee any set benefit. The amount available for retirement is based solely on the amount of money that has been saved, along with investment income credited to the employee's account. When the funds are spent by the retiree, the benefit is exhausted.

The City has a voluntary defined contribution plan (457 Deferred Compensation Plan) that employees can elect to participate in (with no City contribution).

New 401a Defined Contribution Plan

Under the proposed ordinance and Adoption Agreement, a defined contribution retirement benefit option for employees in Unit 99 will be established in accordance with Section 401(a) of the Internal Revenue Code. New employees to the City hired directly into Unit 99 on or after January 20, 2013, will have the ability to make the one-time election to participate in the defined benefit Tier 2 plan or the defined contribution plan (Tier 3). It is important to note that this option will be available to only new City employees hired directly into Unit 99 who have never previously been employed by the City. The election must be made when the employee is first hired.

Under the optional defined contribution plan, separate accounts will be created for each new employee in Unit 99 hired on or after January 20, 2013, who chooses to participate. Each separate participant in the defined contribution plan will be vested 100% in the account upon enrollment. This account can be recovered at the time of the participant's separation from City service. The 401(a) plan meets the qualifications to be in lieu of Social Security.

The City's current administrator for its defined contribution 457 plan is ING and it is planned that ING will also administer the 401(a) plan. The fiduciary trustees will be appointed by the City Manager at a later date. An amended contract with ING will be brought forward to Council prior to January 20, 2013.

Although Measure B allows for a maximum City contribution of 9%, the Adoption Agreement currently establishes the 401(a) with a City contribution of 3.75% and an employee contribution of 3.75%. If employees want to elect additional voluntary contributions into a deferred compensation plan, they would do so in the 457 plan. The contributions into the 401(a) plan do not count towards the IRS annual deferred compensation maximum that applies to the 457 plan.

Approval of the resolution would also authorize the City Manager to negotiate and execute the Adoption Agreement and Basic Plan Document for the Defined Contribution 401(a) Plan. The Adoption Agreement and the Basic Plan Document specify the specifics of the plan not outlined in the ordinance, such as the Plan Year, election period and contribution amount.

Benefits of a Defined Contribution Plan

With increasing retirement costs for both employees and the City, it is important to look for ways to reduce those costs, while still providing a retirement benefit that matches an employee's stage in their career and other personal considerations.

Defined contribution plans have the potential to significantly reduce retirement contribution costs for the City and employees. The following chart shows the comparison of costs for the Tier 2 defined benefit program and the proposed Tier 3 defined contribution option.

	Tier 2 Defined Benefit Current Contribution Rate (including retiree healthcare)	Tier 3 Defined Contribution Rate
City	14.59%	3.75%
Employees	13.94%	3.75%

As shown above, due to the decrease in the contributions for retirement benefits should an employee elect Tier 3, employees will have fewer deductions from their paychecks, and therefore, more take home pay than if they elected the Tier 2 defined benefit plan. It also allows some flexibility to provide more compensation in base pay to Tier 3 employees since a smaller amount of total compensation is allocated to retirement benefits.

In addition, there is no minimum vesting requirement (which is 5 years for the defined benefit pension plan and 15 years for retiree healthcare). Further, the increased portability of the defined contribution plan will allow for employees to rollover their accounts into another eligible plan if they choose to leave City service. This is a possible recruiting tool for those potential employees who are interested in the flexibility and portability of a defined contribution plan as opposed to a defined benefit plan. The defined contribution plan also may be more appealing for employees in the later stages of their career and/or who have retirement benefits elsewhere. This is particularly important as we continue with our Senior Staff recruitments.

It is also important to note that defined contribution plans do not create unfunded liabilities because the amount that will be paid to an employee has been contributed prior to the employee's separation from the City. The additional fiscal sustainability inherent in the defined contribution plan is in accordance with the provisions included in Measure B.

Setting up this defined contribution option for new City employees hired directly into Unit 99 provides them with an important choice and it will be important that communication and guidance is provided to these new employees as they make this important decision. We will

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work closely with the Department of Retirement Services and the Department of Human Resources on this communication.

COORDINATION

This memorandum was coordinated with the City Attorney's Office and the Department of Human Resources.

CEQA

Not a Project, File No. PP10-069 (b), Personnel Related Decision.

A handwritten signature in black ink, appearing to read 'Debra Figone', with a long horizontal flourish extending to the right.

Debra Figone
City Manager

For more information, please contact Alex Gurza, Deputy City Manager at (408) 535-8155.