CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Chuck Reed
MAYOR

February 15, 2012

City of San Jose Elections Commission
c/o Dennis Hawkins, City Clerk
200 E. Santa Clara Street
San Jose, CA 95113

Dear Election Commissioners:

Anyone who wants the facts about my statements regarding future retirement cost estimates can see exactly what I said by looking at my June Budget Message,[1] which was approved by the City Council on June 14, 2011.

> *"Unfortunately, the huge increase to fund retirement costs to date is just beginning. Using the most optimistic assumptions, retirement costs, if left unchecked, will increase to $400 million per year by 2016 - or almost 30% of the General Fund - and will continue to go up for another 10 or 15 years. Even greater increases in retirement costs are likely if actuarial assumptions, such as life expectancy, retirement ages, or rates of investment return, are modified by the retirement boards that are independent from the City and have fiduciary obligations to modernize assumptions and keep the plans solvent. That could cause retirement costs to jump to $650 million per year by 2016."*

As Mayor, I need to look out for the interests of the residents and taxpayers, and I have an obligation to bring these kinds of risks to the attention of the Council and the public before disaster strikes.

Given the amount of misleading information published about my use of this $650 million figure last year, it's important to keep a few critical facts in mind:

1. $650 million was our retirement department's professional staff estimate of how high our retirement costs could reach if things got worse.

2. This $650 million figure was cited alongside the official projection from the independent retirement boards' actuaries.

3. The pay concessions that were negotiated last year were based on the actual size of last year's budget deficit, not future projections.

4. The City paid $245 million in retirement costs this year and the retirement boards' actuaries are predicting that costs will go up over the next 14 years.

5. A 10% cut in compensation for all employees and the elimination of hundreds of positions in this year's budget reduced our payroll by 24% and slowed down the rate of growth in our retirement costs.

6. Due to these actions taken by the City Council, the probability of reaching $650 million in retirement costs has been reduced, but the risk has not been eliminated.

We are awaiting new retirement costs projections and it is unclear just how much the city's contributions will go up by 2016. But given the current assumptions that are being used by the independent retirement boards, the City's actual retirement costs could end up being hundreds of millions of dollars higher than the official projections. Here's why:

- The independent retirement boards have adopted an assumed rate of return of 7.5% per year. This is an optimistic assumption, but it has a low probability of occurring. If the retirement plans' investments don't meet this rate of return, the plans' unfunded liabilities will grow and costs will rise above the projections.

  Paying off the retirement plans' existing unfunded liabilities has already driven the City's annual retirement costs significantly higher. Unfunded liabilities also push the burden onto future generations and end up costing taxpayers more than it would if a more realistic assumption had been used up front.

- If the independent retirement boards decide to adopt lower-risk assumptions – as the boards' own actuaries have recommended – the City's contributions would rise to more accurately reflect the true costs of employees' retirement benefits.

  For example, the boards could adopt an assumed rate of return based on a high-quality, long-term corporate bond yield, which is what the federal government requires private sector pension plans to use. That rate is generally less than 5%.[2] According to data presented to the retirement boards, the city's costs go up by about $80 million for every 1% that the assumed rate of return is reduced. [3] So, adopting this "low-risk' investment assumption could add about $200 million per year to the projections *(Note: last year, shifting to a 5% assumed rate of return would have added about $300 million).*

- If other actuarial assumptions (such as life expectancy, retirement ages and pay rates) also change or prove to be incorrect, costs could go up even further.

A combination of these factors could drive the City's costs up by hundreds of millions of dollars, and depending on the new projections, potentially into the ballpark of $650 million.

Unfortunately, it appears that some of our employee unions are trying to use this complaint to distract the public from the fact that we are in a real crisis and trying to avoid a fiscal disaster.

Because even if you ignore all of these future estimates, the fact remains that the City paid $245 million in retirement costs this year, *three times more than a decade ago*. Retirement benefits now cost more than 50% of payroll and consume 20% of the General Fund budget. The huge amount we have actually spent on retirement costs – not projections – is why we've had to close libraries and community centers, layoff police officers and firefighters, and watch our streets and infrastructure deteriorate.

Sincerely,

Chuck Reed
Mayor

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[1] Mayor Reed's June 2011 Budget Message is available online (see pages 2-3): http://www.sanjoseca.gov/mayor/news/memos/11June/JuneBudgetMessage_06032011.pdf

Here are links to other documents in which Mayor Reed cited the "$650 million" figure:

- Press Release: Mayor Reed and Vice Mayor Nguyen to Discuss Impacts of Pension Costs on San José Budget (4/13/2011): http://www.sanjoseca.gov/mayor/news/releases/11April/ReedNguyenDiscussPensionCosts.pdf
- Memo: Fiscal Reforms (5/13/2011, see page 5): http://www.sanjoseca.gov/mayor/news/memos/11May/FiscalReforms_05132011.pdf
- Press Release: Mayor Reed Releases Fiscal Reform Plan (5/13/2011): http://www.sanjoseca.gov/mayor/news/releases/11May/FiscalReformPlan_05132011.pdf
- E-Mail Blast: Mayor Reed Releases Fiscal Reform Plan (5/13/2011): http://www.sanjoseca.gov/mayor/news/Share/PU_FiscalReforms.asp
- Press Release: Mayor Reed Releases June Budget Message (6/3/2011, see page 2): http://www.sanjoseca.gov/mayor/news/releases/11June/JuneBudgetMsg_06032011.pdf
- Sacramento Bee OpEd: Why Pension Reform is Now a Top Priority in San Jose (7/3/2011): http://www.sacbee.com/2011/07/03/3742639/why-pension-reform-is-now-a-top.html

[2] Stanford Institute for Economic Policy Research, *Shrinking Services: Public Pension Costs and Their Impacts on San Jose* (12/14/2011), page 6: http://siepr.stanford.edu/system/files/shared/pubs/Nation_public_pension_sj.pdf

[3] For more information on how changing the assumed rate of return can impact the City's retirement contributions, please view:

- Cheiron presentation to the Federated City Employees' Retirement System Board of Administration, October 20, 2011 Board Meeting, Item 4.1 (see page 9 of the presentation / page 10 of the PDF): http://www.sjretirement.com/uploads/FED/4_1itemFedOct11.pdf#page=10.
- Cheiron presentation to the San Jose Police and Fire Department Retirement Plan Board of Administration, November 3, 2011 Board Meeting, Item 2.1 (see page 9 of the presentation / page 10 of the PDF): http://www.sjretirement.com/uploads/PF/2_1itemPFNov11.pdf#page=10.

The Stanford Institute for Economic Policy Research (SIEPR also discusses the potential impacts of using a more realistic investment return assumption on the City's retirement contributions in its report, *Shrinking Services: Public Pension Costs and Their Impacts on San Jose* (12/14/2011), see page 19: http://siepr.stanford.edu/system/files/shared/pubs/Nation_public_pension_sj.pdf