**RULES COMMITTEE:** 02-29-12
**ITEM:** G2

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

# *Memorandum*

**TO:** RULES AND OPEN GOVERNMENT COMMITTEE

**FROM:** Mayor Chuck Reed

**SUBJECT: PENSION COST ESTIMATES**

**DATE:** February 27, 2012

Approved Chuck Reed

Date 2/28/12

## RECOMMENDATION

I recommend that the Rules Committee schedule a study session for the City Council on retirement cost projections as soon as the independent retirement boards have finished their work on the projected costs for pension and healthcare for the next fiscal year.

## BACKGROUND

The Stanford Institute for Economic Policy Research recently released a report on the 24 largest independent pension plans in the state, including San José's two plans: *MORE PENSION MATH: Funded Status, Benefits, and Spending Trends for California's Largest Independent Public Employee Pension Systems* (posted online at http://siepr.stanford.edu/system/files/shared/pubs/papers/pdf/Nation_More_Pension.pdf).

The report concludes, in part, that **"each of the systems substantially understates liabilities and overstates funded rations"** and that **"(s)ystems may now arbitrarily change assumptions or methods involving investment rates of return, amortization periods, asset smoothing, and other key factors. Not surprisingly, those changes typically exaggerate the financial well-being of systems, delaying awareness of potential problems and solutions."** (p.17)

The Kellogg School of Management, Northwestern University released a report in 2010 on local government pension obligations: *The Crisis in Local Government Pensions in the United States* by Robert Novy-Marx and Joshua Rauh (posted online at http://www.kellogg.northwestern.edu/faculty/rauh/research/nmrlocal20101011.pdf)

The report concludes, in part, that **even if investment returns of 8% are achieved, San José's plans' assets are adequate to pay accrued benefits only until 2027 and that the cost of benefits in the following year would be $777.4 million.** (Table 3-7, pages 64-68)

These reports raise some troubling questions about San José's retirement plans that the City Council should discuss. Both studies analyzed only pension costs. Retiree healthcare benefits (OPEB) also have a significant additional annual cost to the city on top of the pension costs and are rising rapidly.

In addition, several efforts are underway to push local governments to use risk-free discount rates and assumed rates of return, including the Government Accounting Standards Board's proposed improvements to financial reporting of pensions for local governments (www.GASB.org) and the Public Employee Pension Transparency Act (HR6484). These efforts could have significant impacts on San José. As noted by the Association of Local Government Auditors in their written comments to the GASB dated September 28, 2011 (posted online at: http://www.gasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175823013447&blobheader=application%2Fpdf):

> **". . . the governmental accounting standards should be changed to address the challenges posed by the use methodology that permits the use of investment return assumptions that have generally proven to be excessive. To that end, we believe that utilizing a discount rate that represents a risk-free rate of return as the investment return assumption would be more appropriately conservative. Using a risk-free rate of return assumption would increase the actuarially-determined annual required contributions in the earlier plan years . . ."**

At the study session, staff should be prepared to answer the questions raised by Councilmembers Campos, Chu, Kalra, Pyle and Rocha as well as the following questions:

What would be the impact on the City's retirement costs if:

- The discount and rate of return assumptions were reduced to so-called risk-free rates pegged to a tax-exempt, 30-year AA or higher-rated municipal bond index, for both pension and OPEB obligations?
- Increases in medical costs continue at double-digit rates for the next 30 years?
- There is another recession where the plans lose 25% of their market value over two years, followed by a "lost decade" of relatively flat economic growth in which the plans investment return is half of the assumed rate of return?
- Employee wage increases occur at twice the rate assumed by the retirement boards?
- All of the above occur?

Prior to the study session, staff should provide Councilmembers with links to the pension plan disclosures that the City Council approved and that were filed with the issuance of Airport and Convention Center bonds.