

sd CERS
San Diego City Employees'
Retirement System

TO: Steve DeVetter, KPMG Audit Team
Andrew J. Paulden, Amanda E. Wilson; Brown Armstrong Audit Team
John McNally, Hawkins, Delafield & Wood, Disclosure Counsel

FROM: Diann Shipione, Trustee

CC: San Diego City Council
City Manager Lamont Ewell
City Attorney Michael Aguirre
City Auditor
The "New" SDCERS Board
Rick Roeder, Gabriel Roeder & Smith, SDCERS Independent Actuary

DATE: 3/31/05

RE: Net Pension Obligation (NPO); Actuarial; I.R.S. Compliance; Other Concerns

You have indicated your interest regarding additional relevant areas of financial review as part of your pending outside audits. As a Trustee, the financial ability of the Plan Sponsor to make future payments, whether legally deferred or otherwise, is a part of our management assessments analysis. With that in mind, the following are concerns I have regarding financial issues directly and indirectly affecting the future financial stability of the System.

Compliance With GASB 27

According to Paragraph 32 of GASB 27, the NPO should be calculated beginning on December 15, 1986. The City misstated the NPO in its FY 2002 Financial Statements. An NPO existed prior to 1996¹ and even prior to 1986 due to the City's practice of siphoning off money from the pension contribution and using pension assets to pay for retiree health care costs. When the City restates its NPO must it recalculate as of the 1986 requirement of GASB 27?

Calculation of Required Annual Pension Contribution

¹ See 10/11/04 Letter From KPMG to City of San Diego, Exhibit 1, page 3, reference to Actuary Letter To Mike Philips and 3/17/95 City of San Diego Memorandum, To: "File", From Ed Ryan, City Auditor and Comptroller, Subject: "Retirement Rate Stabilization Financial Statement and Disclosures": *"Today I met with Victor Calderon and Tom Sainz of Calderon, Jaham and Osborn to discuss what affect if any the Retirement Administrators (sic) and City's Rate Stabilization Proposals might have on the financial statements and related disclosures...I walked through an example of the actuary determining that the City's normal cost would be \$20 million for the next fiscal year, \$16 million from City contributions directly from funds other than retirement and \$4 million from a retirement rate stabilization reserve fund...Tom indicated that if we were going to try to take a payment holiday for a year, that there were some guidelines relative to that..."*

SDCERS' Annual Actuarial Valuations artificially lowered the required payment amounts and artificially inflated the pension plan's funded status in various ways including, but not limited to, the following:

1. Use of aggressive actuarial assumptions
2. Use of unaudited data that contains material errors, inaccuracies and omissions
3. Use of "Averages"
4. Hidden, omitted or excluded liabilities

Each of these reasons is described in detail below.

REASON #1: Use of Aggressive Actuarial Assumptions Artificially Reduce Contribution Rates (Including the Assumptions Required In the Gleason Lawsuit Settlement Agreement)

Intentional Underfunding Agreements Use Aggressive Assumptions

Aggressive actuarial assumptions specified by several intentional underfunding agreements such as MPI, MP2, and the *Gleason* settlement have resulted in reduced contribution rates for both current City employees and the City. This was noted by SDCERS' outside actuarial auditor Mercer in a recent report:

*"...the City contributions and the valuation assumptions used to determine the funded status of the System are based on **actuarial assumptions used under the Manager's Proposal [and] are more aggressive than the best estimates recommended by GRS.** This means that there is a higher risk that the System may experience negative actuarial experience in the future, which may lead to increases in actuarial liabilities and increased contribution rates. It also **creates a picture of the funded status of the System that may be overly optimistic...**"² (Emphasis added.)*

The *Gleason* agreement refers to "full actuarial funding" beginning in FY2006 however, the actuarial assumptions being used to determine the "full funding" are already known to be too aggressive and will result in future actuarial losses.

Former SDCERS fiduciary counsel, attorney Bob Blum of Hanson Bridgett, commented in a recent brief that if underfunding is "illegal" then the *Gleason* settlement is "illegal" because it continues intentional underfunding of the pension plan by requiring the following:³

² See Mercer Report, page 6.

³ Memorandum of Points and Authorities In support of Application For Determination of Good Faith Settlement dated February 23, 2005, *David W. Wood v. Hanson, Bridgett, Marcus Vlahos & Rudy, LLP, (HBMVR), Robert Blum, Constance M. Hiatt*; Action Filed May 26, 2004; Case NO: GIC830558; San Diego City Employees' Retirement System v. Hanson, Bridgett, Marcus, Vlahos & Rudy, LLP, A Limited Liability Partnership, Robert Alan Blum, and Individual; Constance Marie Hiatt, an individual; *Action Filed June 25, 2004; Case NO: GIC831983; Wood, et al. v. Hanson, Bridgett, et al.*; Case Number GIC831983 Consolidated into Case Number: GIC830558 by Order of January 13, 2005, Section IV, Item B, 3, "...if underfunding is not permitted, the *Gleason*

- Only \$130 million be contributed to the pension plan on 7/1/04 even though that contribution amount is intentionally deficient;
- The existing debt be refinanced **again** with yet another **new** 30-year amortization schedule, even though the debt was already refinanced once before in 1991, thus extending the burden of payment more than 40 years to future taxpayers and City employees. This violates the very premise of an actuarially sound pension plan in which benefits are paid for by the generation of employees that receive those benefits and by the generation of citizens that receive the City services provided by those employees;
- The exclusion from the valuation of certain known benefits paid for by the pension system including, but not limited to, the “contingent” Corbett, 13th Check, Star Cola and Retiree Health Care costs;
- The continued use of the PUC methodology instead of the actuarially recommended EAN;
- The continued use of an 8% discount rate even though the actuary and outside actuarial auditor Mercer recommended it be lowered to at least 7.75%. (Other experts have also suggested that an even lower rate be used given the System’s irregular use of “earnings” to pay for certain benefits);
- The inability for future Boards to change actuarial assumptions, until after 2008/09, even though such an agreement raises legal issues “concerning the ability of the current Board to bind future Boards.”⁴

“50-50 Split”; the “Employee Offset”; the “Employee Pickup”⁵

City Charter Section 143 stipulates City employees are to pay for the cost of their “normal retirement allowances” and the City is to contribute a substantially equal amount “for normal retirement allowances”, i.e. a 50-50 split.

The Pension Reform Committee raised concerns that the language of Charter Section 143 has been “*loosely interpreted to mean that the employees bear 50% of Normal Cost and that all other costs are borne by the City...Even if one agrees that the 50/50 split applies to Normal Cost only, then it appears that the Charter may not be being followed.*”⁶

settlement, approved by the Board, SDCERS’s beneficiaries (including Wood and his purported Class), and the Court, is illegal because it intentionally permits underfunding for Fiscal Year 2005.” In other words, this soon to be extinct SDCERS Board of Administration regularly plays the Courts to accomplish “illegal” objectives.

⁴ See letter from Attorney Jeffrey S. Leavitt of Jones, Day Reavis & Pogue to Bruce Herring dated 4/29/96, page 5, and footnote 15.

⁵From 1961 to 1978 the City imposed a pension tax on all City property owners to subsidize the City employees’ retirement program. With the passage of Prop 13 in 1978 the pension tax was discontinued. This resulted in an immediate higher cost to City employees for their retirement program and they negotiated a deal, known as the “Employee Offset”, that required taxpayers to pay for a portion of the employees’ retirement costs (in addition to the City’s required annual contribution). The “Offset” is still in existence today and has resulted in taxpayers paying a minimum of two times that of employees in 1980 and 1981, six times that of employees in 1987,⁵ and recent estimates are much higher.

⁶ Recommendation #17 of the Final Report, City of San Diego Pension Reform Committee, 9/15/04, pages 45 & 46.

REASON #2: SDCERS Annual Actuarial Valuations Use Unaudited Data That Contains Inaccuracies, Errors Omissions and Inconsistencies

SDCERS Actuary Rick Roeder includes the following statement in the SDCERS Annual Actuarial Valuations:

*“The member statistical data on which the valuation was based was furnished by the Retirement Office, together with pertinent data on financial operations. Data was reviewed for reasonableness, but **was not audited** by the actuary.”⁷*
(Emphasis added.)

This statement suggests the actuary may have concerns about the quality of the data. It raises questions as to what procedures would need to be done to consider the data “audited”. It is not clear how significant the changes in the data would have to be before impacting the contribution rates.

SDCERS data, calculations and reports have contained numerous errors and omissions including, but not limited to, the following:

- Monies belonging to the Port have been improperly attributed to the City thus artificially *increasing* the City’s funded ratio and artificially lowering the City and City employees’ contributions. This resulted in artificially *decreasing* the Port’s funded ratio and artificially increasing the Port’s and its employees’ contributions;⁸
- The method used to calculate the Port’s share of undistributed earnings improperly credited more earnings to the City than what the City had a right to receive and thus improperly credited less to the Port than it should have received;⁹
- The method used to calculate the Port’s share of administrative expenses resulted in the Port being overcharged for many years;
- The method used to allocate assets among the City and Port has resulted in more assets being allocated to the City than the City should have had and less to the Port than it should have had;
- Investment market values have been artificially inflated with the use of stale quotes (for illiquid investments such as international stocks and bonds as well as certain small and micro cap stocks); incorrect values and numbers that are simply made-up. For example, the 2001/2002 SDCERS Annual Actuarial Valuation inflated the values of real estate investments by more than 20% (~\$40 million);¹⁰

⁷ See page i of the SDCERS Annual Actuarial Valuation dated June 30, 2004.

⁸ See \$5.6 million of Port money improperly included in City’s money in June 30, 2001 Actuarial Valuation which artificially inflated the City’s funded ratio by about 1%. As of the March 18, 2005 SDCERS Board meeting, the Port had only recently become aware of this issue. It came to the Port’s attention as a result of the Vinson & Elkins report. The June 30, 2001 was never corrected.

⁹ See 4/29/01 & 5/2/01 Emails from Terri Webster to Lawrence Grissiom re: UPD.

¹⁰ This was not due to a quarterly lag in the real estate monitoring report; in fact the number used for real estate investments could not be sourced to any document. It was just made up.

- The Actuarial Valuation Of Assets has been manipulated *and* “excess surplus earnings” generated to improperly pay for the cost of continued increases in benefits by:
 - The use of an irregular “smoothing” technique (that Mercer noted was more appropriate for portfolios of primarily fixed income that were popular about 20 years ago) that uses a ratio of cost basis to market value allows for the manipulation of the amount of “earnings” and the actuarial valuation of assets by the termination of certain investment managers at the end of the fiscal year;¹¹
- According to Mercer, a large number of SDCERS members have insufficient data and in some cases no data at all;¹²
- Members that are deceased are improperly reflected as living, sometimes for *years* after they have died;
- A multimillion dollar liability for purchase service credit was omitted for several years and then “phased-in” for several more years (this “phase-in” practice of liabilities should be reviewed);
- Money intended to purchase years of service was improperly accounted for as part of the employees’ annual required contribution thus improperly reflecting employees contributed more money than what was actually contributed;
- The City has no line item for payroll in its annual budget and the budgeted payroll number does not reconcile back to the average annual payroll number use in the valuation.
 - The June 30, 2004 SDCERS Annual Actuarial Valuation, Comment J, noted that the valuation payroll was significantly less than the City’s budgeted payroll.
- Some ‘Retirement Dates’ and ‘Dates of Birth’ are missing;
- Members are in a “suspended” status for years;
- Incorrect social security numbers have been used;
- Pension payments to deceased individuals have been made, not just for a few months, but for years;
- According to Mercer there are “members with compensation data for a period following their date of separation. Many of the dates of separation were in the year 2000. Usually such data inconsistencies are resolved during the first valuation following an employee’s termination of service.”¹³

¹¹ SDCERS uses a ratio of book value to market value that is smoothed over 5 years. This technique was noted by Mercer (in the 2004 Audit of Actuarial Work) to be one that it has not been used by retirement systems for about 20 years.

¹² Page 11 of Mercer’s report states, “One of the data questions that GRS asked of the System was with regard to a large number of members who did not have sufficient data. This group was indicated to be not active and therefore required no additional information.” I inquired of GRS regarding this issue and was told that they could not recall the situation. At the 1/21/05 Board meeting, upon my inquiry, both Rick Roeder and Larry Grissom said they could not recall. Rick said that I should ask Patrick Lane of SDCERS. Mr. Lane said that he could not recall and that I should cite the page number of the Mercer report.

¹³ See Mercer Report, page 11.

- There have been problems with the SDCERS quarterly/annual health reimbursements, particularly for the quarter ending 6/30/00.

REASON #3: SDCERS Annual Actuarial Valuations Use Calculated Averages

Information in the Annual Valuation Report includes several calculated averages including, but not limited to:

- average retiree allowance,
- average attained age,
- average age at retirement,
- average annual payroll, and
- average allowance of new retirees.

It is possible that some, or all, of these average calculations impact the calculation of the fund’s future liabilities and for the City’s contribution rates. This may artificially reduce the required contributions and artificially increased the funded status of the pension plan.

REASON #4: SDCERS Annual Actuarial Valuations Contain Undisclosed Liabilities

The following list includes, but is not limited to, some of the ways in which the true obligation to the pension plan has been hidden:

- An assumed rate of return has been used that is too high given SDCERS’ irregular use of “surplus earnings”. The system’s long-standing practice of using surplus earnings to pay for benefits not valued by the actuary makes it virtually impossible to attain the 8% assumed rate of return. The system’s actuary,¹⁴ the system’s outside actuarial auditor,¹⁵ the Pension Reform Committee, and the City’s

¹⁴ SDCERS’ Business & Procedures Minutes, Friday February 6, 2001, Page 4:

“Mr. Grissom said it would be prudent to get the information from Mr. Roeder with Staff to do the trigger points on the Manager’s Proposal while maintaining the Manager’s Proposal on a funding rate going forward.

Ms. Lexin asked about paying the potential cost of contingent benefits with earnings. She questioned whether that is saying the contingency has a risk that is not being paid.

By lowering the assumption rate, Mr. Roeder said the fund in given additional revenue.

Ms. Lexin asked what the purpose is in doing this.

Mr. Roeder responded that with enough contingent benefits being paid out over the year, the investment earnings are siphoned off. Since investment assumptions are set, some of the investment money that was to be used to pay existing benefits would be gone. Since this is difficult to explain, Mr. Roeder said he would bring a chart to next month’s meeting to better explain his point...Mr. Roeder stated that the Board needs to recognize that these benefits are being paid and that future investment earnings will be siphoned off to pay for them.”

¹⁵ Audit of Actuarial Work of San Diego City Employees Retirement System, Mercer, May 11, 2004, page 33, Mercer recommended the long-term interest rate assumption be lowered stating, “*The use of investment earnings to fund non-vested benefits indicates a drag on investment earnings that justifies a lower return assumption...If*

outside attorney's Vinson & Elkins¹⁶ have all made note of this dangerous and inappropriate practice. The SDCERS investment consultant has suggested that a "structural change in the capital markets" would lower investment returns going forward.¹⁷

Notwithstanding the fact that the Board used attorney Robert Klausner to opine as to the legality of this practice of distributing pension assets to fund reserves for future City contributions, employees' contributions and for the COLA payments to retirees questions still remain.¹⁸

- The City's "hybrid" version of DROP creates an undisclosed liability. This has not been fully reflected in any of the valuations.¹⁹
- An undisclosed liability results from the "discount" provided to the City's 'picked up' employee contributions, and from discounting the employees' actual contributions for the portion picked up, which is not related to any forfeiture.²⁰ The City receives a discount for making its

administrative expenses are assumed to come from the interest rate assumption, our conclusions would be impacted."¹⁵ On page 31 they determine "an expected net return on assets of 6.95%."

¹⁶ Report on Investigation, The City of San Diego, California's Disclosure of Obligation To Fund the San Diego City Employees' Retirement System and Related disclosure Practices 1996-2004 With Recommended Procedures and Changes to the Municipal Code, September 16, 2004, page 6, Vinson & Elkins noted "...in the early 1980s the results coming out of San Diego's "meet and confer" process began to treat surplus earnings as available for a variety of uses other than to support the underlying soundness of the retirement system...Rather than paying the premium cost of the healthcare policies from its operating funds, it dedicated SDCERS surplus earnings for this purpose. To this day, all costs of health insurance for City retirees have come from this source."

¹⁷ In 2002, the SDCERS Investment Consultant noted there has been a structural change in the capital markets. And, there is significant research available to support the U.S. equity markets are in a secular trading range environment that historically lasts from 8 to 20 years. In addition, the assumed rate of return on fixed income may prove to be too high as a result of the long-term decline in interest rates experienced from 1982 through 1999.

¹⁸ See June 10, 1998 Legal Opinion from Robert D. Klausner, P.A. RE: Proposed Set Aside of Reserves, File No. 97-0134 and San Diego City Attorney Letter to Lorraine Chapin, SDCERS General Counsel Dated 7/28/99 re: California State Bar Admission Status of Robert Klausner which states, "I have recently been advised by the State Bar that Mr. Klausner is not licensed to practice law in the State of California."

¹⁹ Apparently the fact that DROP is not cost-neutral was clearly known as far back as 1999. The cost of DROP is noted in letters from GRS to SDCERS Staff (not shared with all Trustees, specifically myself) and in the B&P Minutes July 16, 1999, page 3. The cost was again confirmed in the year 2000 via an email from SDCERS Trustee Terri Webster to Deputy City Manager Bruce Herring. However, this fact was withheld and not publicly disclosed as recently as May 2004 in a report by Retirement Administrator Larry Grissom to the Pension Reform Committee. It was further withheld from the City Council as recently as October 2004 and a January 2005 Memo from City Manager Lamont Ewell confirms just the opposite, that DROP saves money.

²⁰ SDCERS Business & Procedures Meeting, July 16, 1999, page 3, comment from Karen Steffen of Milliman & Robertson (M&R) Actuarial Audit Report, dated June 10, 1999, "Since these portions can't be refunded if an employee terminates, she said these assumptions are extremely out of alignment and would recommend the Board look at this...Ms. Steffen said she is aware this is a politically sensitive area, but from a professional standpoint, said the Board should be aware of these assumptions. When the City does the pick up, they assume there is a 22% refund rate for general employees and a 7% refund rate for safety employees. Based on M&R's evaluation, she said it is her opinion the 22% general member rate should only be 4.3% and the 7% safety member rate should only be 1.5%. When the City makes their determination on the pick up and then reduces the dollar amount of the contribution for this "non forfeiture," they are reducing it by a significant amount different than what the actuarial assumptions would assume on an actuarial basis. Although a portion of the difference with the rates relating to the Manager's Proposal (I) is partially made up from the reserve transfer allocation, the System also gets some benefit from that reserve allocation. However, the difference between what the City assumes on the offset is greater than

contribution at the beginning of the year under the assumption that a certain number of employees will leave and forfeiture the money the City contributed on their behalf. Due to low turnover these forfeitures have not occurred thus this “discount” has been too high. In addition, a discount was provided to the employees for their actual contribution even though that money would never be forfeited.

- An undisclosed liability results from an improper “bundling” of the money used to purchase years of service with the employee annual retirement contributions.
 - In a recent conversation with Mr. Roeder he noted that the employee contributions have risen significantly in the past few years and should possibly be looked at.
- An undisclosed liability has resulted from the discounted price given to employees when they purchase years of service.
- An undisclosed liability results from the bundling the City’s contribution on behalf of employees into the City’s contribution as a plan sponsor thus artificially inflating the amount the City reports it is contributing.
- An undisclosed liability results from administrative expenses being paid from the returns on System assets. Mercer recommends an explicit recognition of administrative expenses. The System’s actuary has indicated that this is going to occur but it did not occur in the June 30, 2004 valuation.
- An undisclosed liability results from the use of money in the “old health reserve” as part of the City’s 7/1/00 payment.²¹
- An undisclosed liability may result from Local 145 members’ conversion of annual leave into “cash dollars” to purchase years of service for which no actual money is deposited into the System.
- An undisclosed liability may result from the City’s use of a “one-year lag” with respect to the timing of their required annual contribution.
- An undisclosed liability may result from the use of the 1994 Uninsured Pension Mortality Table as opposed to the RP-2000 mortality table.

Potential Pension Fraud

Hundreds of individuals who died (from at least 1989 through 2004) continued to receive pension checks, in some cases for years, after they died. Hundreds of others were underpaid as a result of various problems including, but not limited to, the way the Corbett Benefit Increase was handled and also the way “one-year high compensation” has been calculated.

I.R.S. Compliance

what an actuary would recommend.” This “offset” discount issue was mentioned in Rick Roeder’s 1992-1993 reports.

²¹ See 4/29/01 Email From Terri Webster to Lawrence Grissom re: Health Ins.

The System and/or City have never received a determination letter or approval from the IRS for the pension plan. There are no Trust documents. The System and/or City have never received private letter rulings for any aspect of the system including, but not limited to, the following:

- The City’s “hybrid” version of the DROP program in which the City and the City employees continue to contribute pretax contributions; a *defined benefit* assumed rate of return of 8% is applied to the accounts yet the accounts are allowed to “roll over” into IRAs like *defined contribution* accounts, etc.
- The use of 457 money for purchase of 5 years of “air time” (i.e. years the employees never worked),
- The conversion of “annual leave” into a cash equivalent to either purchase years of service or to extend the DROP program (a benefit for local 145 only),
- Compliance with 415 limits and potential risk of plan disqualification:²² The City provides employees with three qualified pension plans: 1. The SDCERS defined benefit pension plan, 2. A 401k, and 3. A “SPSP/SPSP-M” (Supplemental Savings Plan. The City also provides employees with one unqualified IRC section 457 deferred compensation plan,
- The accounting “wash” procedure used to fund the retiree health care costs,
- Allowing pretax payments of retiree health insurance premiums,
- Pretax treatment of Purchase of Service,
- Pretax treatment of DROP,
- The Union President Benefit that allows unions to make contributions to the City’s pension plan,
- The use of pension assets to pay for the “Employee Pickup”,
- The effect of the Pickup on IRC section 415 limitations,²³
- The accounting/reporting of the “Employee Offset”,
- The Retirement Systems use of granting numerous benefits and other items “retroactively”.

Payments for health insurance for active employees needs to be audited for Federal compliance given that for many years labor union health insurance packages were offered through the City as a pretax benefit.

No Disclosure Has Yet Been Provided For the FY 2002 Water Utility Financial Statements

²² See January 25, 1990 Memorandum of Law To SDCERS Retirement Administrator Lawrence Grissom from San Diego City Attorney John Witt who states, “*We are seriously concerned over the impact IRC section 415 has on voluntary additional employee after tax contributions.*” Also see the March 25, 1991 Memorandum of Law to Risk Management Director Cruz Gonzalez from City Attorney John Witt.

²³ See City Attorney Memorandum of Law to Larry Gardner, Labor Relations Manager, dated November 3, 1992, “Subject: Internal Revenue Code Section 414(h); Impact of the City’s “Pick-up” of a Portion of the Employee’s Contribution to the Retirement System”.

The City was to disclose the results of its review of the Water Utility Fund FY 2002 Financial Statements for inaccuracies, errors and omissions in January of 2004. This disclosure has still not occurred. Must the City disclose the errors and omissions it has discovered in the FY 2002 Water Utility Fund Financial Statements before any statute of limitations runs out for bondholders who purchased the \$286 million of Water Revenue bonds in October of 2002? The City acknowledged that it overcharged City water customers in 2002 and 2003 and now the City Manager is in the process of changing the water billing software program, which may result in the destruction of all records related to the overcharges.

SDCERS needs to be comprehensively audited including, but not limited, to the actuary, the benefits delivery system, the investment assets, board governance, and operations.

The recent audits done by Mercer were superficial, limited in scope and time, and compromised due to Mercer's reluctantly disclosed conflicts of interest resulting from its prior tax work for SDCERS and its ongoing "examination" by the SEC.