

# SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM

## MEMORANDUM

**DATE:** October 12, 2006

**TO:** Board of Administration

**FROM:** David B. Wescoe



**SUBJECT:** EAN/PUC

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At the Board meeting next week, Gene Kalwarski of Cheiron will be discussing various funding methods, including EAN and PUC (SDCERS uses the latter).

In light of this presentation, I thought the attached excerpts from (1) the Vinson & Elkins Report on Investigation (pp 38-40), (2) Navigant's Investigation report (pp 31-32), and (3) Kroll's Investigation (pp 34-35), each of which discusses how SDCERS changed from EAN to PUC, would be of interest to you.

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Attachments

cc: Gene Kalwarsk  
Harvey Leiderman  
Executive Staff

~~\$145,288,143.<sup>127</sup> This report was the only formal attempt to estimate the cost of the healthcare benefit until recent events brought renewed scrutiny to this issue. The report's recommendation that the City actuarially fund the retiree healthcare liability has, to date, not been adopted. However, the City will be required to account for and report the annual cost of this benefit beginning in FY 2008.<sup>128</sup>~~

#### IV. SDCERS changes its actuarial methodology

The history of the relationship between the City of San Diego and SDCERS plays out as a series of initiatives by the City to reduce (at least in the short term) its contributions to the System, typically in response either to economic conditions that caused budgetary strain or to concessions made to the City's labor organizations. Many of these initiatives have been supported by the labor representatives on the Board. The result in each case was the postponement of difficult budgetary decisions into the future, often exacerbating the problems through the delay in confronting them.

In 1991, for example, the SDCERS Board approved a change in the method of calculating the System's annual cost. The annual cost consists of two components: (1) the actuarial present value of the pension benefits and expenses allocated to a particular year and (2) the amount necessary to amortize the portion of the actuarial accrued liability ("AAL") that exceeds System assets (i.e., "UAAL"). The annual cost, in turn, is used to determine the City's actuarially required contributions. Until this time, SDCERS had utilized the EAN method for determining the System's annual cost. The EAN method allocates the total value of a member's expected benefit liability as a level percent of payroll from entry age until retirement. If this level percent is contributed, all actuarial assumptions are met and there are no design changes, this level percent of pay contribution is designed to be sufficient to fund a member's retirement benefit and there is no UAAL. This level cost per person, when aggregated with the level cost for all members, will remain relatively constant for a fund if the average age at hire of the population remains relatively stable, design and actuarial assumptions are unchanged, and experience matches actuarial assumptions. Among the six actuarial funding methods approved by the Governmental Accounting Standards Board ("GASB"), it recommends itself as a relatively stable and conservative approach and, for this reason, is commonly used by governmental entities. Indeed, in a recent survey conducted by the SDCERS staff, 21 of 23 systems surveyed employ the EAN method.

SDCERS, however, chose to migrate from the EAN to the PUC method. The PUC method evaluates the future actuarial liability of the covered group as a whole, applying various

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<sup>127</sup> *Id.* at Appendix II. Both funding methods are described in the next section.

<sup>128</sup> See *GASB Statement No. 45*.

actuarial assumptions concerning population demographics and returns on system assets. For an individual member, the PUC method allocates a cost as a percent of payroll that increases geometrically from entry age until ultimate retirement. When combined for an entire population, the annual cost remains stable only if the average attained age of the membership remains stable, something few employee populations have experienced as the baby boomers have been aging. A notable characteristic of the PUC method is that, at least in the early years after its adoption, it tends to generate a lower annual cost than the EAN method, and therefore results in lower actuarially required employer contributions. In the case of SDCERS, the change in methodology resulted in an immediate decline in AAL of approximately 2.8%.<sup>129</sup> Jack McGrory, San Diego's City Manager at that time, explained in an interview with Vinson & Elkins attorneys that the change in method was intended to reduce City contributions to SDCERS at a time of intense pressure on the City's General Fund. SDCERS administrators have confirmed that there was no purpose for the switch in methods other than to provide temporary contribution relief to the City.

It was anticipated by the SDCERS staff and actuary that the PUC rate would eventually increase to the point that it equaled the EAN rate, at which time the City would resume making contributions at the EAN rate. This apparently never happened.<sup>130</sup> Although the gap narrowed significantly in the mid-1990s, the PUC rate, as applied to the City's contributions to SDCERS, has remained more volatile than the EAN rate without ever exceeding it. As described below, however, conversion back to the EAN method remains a stated goal of the City.

In addition, as of June 30, 1991, the City reset the period for the amortization of its UAAL. The amortization period remained 30 years, but was restarted from that fiscal year-end. The result was to stretch out the period for the amortization of the UAAL, thus reducing that component of the ARC. Again, there appears to have been no purpose for this action other than to reduce the City's contributions to SDCERS.

The System's actuary acceded to actions of this type, so long as they remained within the sometimes-vague standards that govern actuarial science. This remained the case in later years as the City struggled to restrict the impact on its General Fund of escalating liabilities to the retirement system. In 1998, for example, at the suggestion of SDCERS actuary Gabriel Roeder Smith & Company, the City adopted a 40-year amortization period, for purposes of *expensing* (and consequently reporting) its UAAL, in contrast to the 30-year amortization period used for calculating its annual contributions to SDCERS. As described below, this treatment has allowed

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<sup>129</sup> Letter from Lawrence B. Grissom, Retirement Administrator, SDCERS, to Ann M. Smith, Tosdal, Levine, Smith & Steiner (May 16, 1996).

<sup>130</sup> For many years no calculation was made of what the contribution rates would have been under the EAN method. But for the last three years, the SDCERS actuary has calculated the City's ARC under both the PUC and the EAN methods and, in each case, the PUC rate resulted in a significantly lower contribution.

the City to report a lower “net pension obligation” (“NPO”) every year from FY 1997 forward, and was not clearly disclosed by the City until January 2004.

Although migrating to the PUC funding method and resetting the amortization period did not violate established actuarial standards, these actions eventually made a contribution to the under-funding of SDCERS. Then, as now, California law recognizes the minimization of employer contributions as a legitimate objective for pension system fiduciaries.<sup>131</sup> This objective, however, is clearly subordinate to their responsibility to protect the actuarial soundness of the systems they serve.<sup>132</sup>

~~V. The City seeks additional contribution relief from SDCERS~~

In the mid-1990s, the City was under significant financial pressure due to a downturn in the local economy.<sup>133</sup> According to former City Manager Jack McGrory, the City’s budget woes were compounded by its limited revenue sources – the result of San Diego’s strong anti-tax bias – and by repeated raids on the City Treasury by the California Legislature. In 1995, in response to warnings from City officials, including City Auditor Edward Ryan, that the alternative would be significant lay-offs of City staff, the SDCERS Board entertained proposals to grant one-time contribution relief to the City.

The contemplated mechanism for this concession was the “Earnings Stabilization Reserve,” established by transferring \$10 million of FY 1994 surplus earnings to an account held outside SDCERS’ assets. Under the City’s proposal, this reserve would be depleted to reduce the City’s contribution to SDCERS for FY 1996. As with any diversion of funds from “countable” fund assets, the Earnings Stabilization Reserve increased the System’s under-funding by the amount of the diversion, and would be recovered, over time, through increased City contributions to amortize the increased UAAL.<sup>134</sup> The System actuary advised that granting this one-time contribution holiday was within the fiduciary discretion of the Board.<sup>135</sup>

~~In a seven to six vote, the Board agreed to this proposal, contingent upon approval of the Board’s fiduciary counsel, Morrison & Foerster.<sup>136</sup> Such approval, however, was not~~

<sup>131</sup> Cal. Const. art. XVI, § 17.

<sup>132</sup> *Sacramento v. Public Employees Retirement System*, 229 Cal. App. 3d 1470, 1493-94 (1991).

<sup>133</sup> The City was reported at that time to be facing a budget shortfall of approximately \$10 million. Philip J. LaVelle, *Pension trustees OK parts of plan to ease city’s ills*, San Diego Union-Tribune, June 22, 1996, at A1.

<sup>134</sup> Also considered was the possibility of establishing a “corridor funding” mechanism that would allow the City to pay a reduced contribution rate over a period of five years as it “ramped up” to the “actuarially required rate.” This concept was further developed and implemented as an element of Manager’s Proposal I, discussed immediately below.

<sup>135</sup> Minutes of SDCERS Board Meeting, at 5 (Mar. 24, 1995) (remarks of Mr. Roeder).

<sup>136</sup> Minutes of SDCERS Special Board Meeting, at 10 (March 24, 1995).

## VII. Analysis of the Changes in the SDCERS' Funding Status

### A. SDCERS Converted from the Entry Age Normal Actuarial Cost Method to Projected Unit Credit Funding Method

In 1991, SDCERS changed its actuarial method from Entry Age Normal ("EAN") to Projected Unit Credit ("PUC") concurrent with additional benefits granted to City employees. This is the earliest instance Navigant Consulting has identified where the SDCERS' Board agreed to lower the City's contribution levels at the same time that the City increased benefits for SDCERS' members, resulting in the SDCERS' Board positioned in the middle of labor negotiations. In a memo from Mr. Grissom to Bruce Herring, Deputy City Manager, dated May 14, 1991, Mr. Grissom wrote, "This is to confirm my understanding of the retirement items which were agreed upon in this year's meet and confer process. All of these benefit changes are subject to Retirement Board approval of the conversion from the entry age normal to the projected unit credit method of actuarial valuation."

The benefit enhancements described in Mr. Grissom's memorandum included an increase in the retirement benefit formula for Police and Fire members and retiree health insurance benefits to be paid from a newly created trust fund. The memorandum also discussed the reduction in the City's contribution rate resulting from the change to PUC identified as "Savings from PUC." The City contribution rates were shown to decline from 10.81% to 8.04% for Safety members and from 5.51% to 2.74% for General members.

The reduction in City contribution rates was directly offset by the added costs of the new benefits. However, ongoing costs of retiree health insurance costs not intended to be covered by the City's contribution to SDCERS. An amount equal to the reduction in City contributions for the fiscal year ended June 30, 1992 was to be placed into the retiree health insurance trust fund for that year only. Thereafter, the retiree "health insurance premium costs will continue to be paid from surplus undistributed earnings. In any year in which surplus undistributed earnings are insufficient to pay health insurance premium costs, the deficit will be paid from the health insurance trust fund." The impact of these changes was that the City would be contributing at a lower contribution rate even though additional retirement and retiree health benefits were granted.

In subsequent years, SDCERS experienced increases in its PUC rates because the average attained age of the active members increased. Nonetheless, the System's actuarial consultants, Gabriel Roeder Smith ("GRS"), advised that shifting back to EAN may result in a significant near-term contribution increase in its June 30, 1996 actuarial valuation.

The City made payments for retiree health costs directly into a separate trust and received a credit from SDCERS by reducing the pension contribution for an equal amount. At the time, the cost of retiree health premiums was approximately \$5 million per year. This practice continued through fiscal year 1995 when fiduciary counsel opined that contributions for pension benefits should not be reduced for post-retirement medical benefits.

The PUC actuarial method is an accepted method for determining contribution rates and funded status of a retirement plan. In 1991 and continuing today, PUC is less commonly used than EAN. Although this change pre-dated the appointment of GRS as the SDCERS' actuary, Rick Roeder told Navigant Consulting during his interview that the main reason retirement plans change from EAN to PUC would be to achieve a reduction in contributions. When Mercer performed its audit of actuarial work in 2004, they commented that "The Projected Unit Credit method tends to have a normal cost which increases as an employee ages. This causes more costs to be borne by those active taxpayers later in the member's career." Mercer further observed that "The PUC is an accepted cost Method under GASB. Based on a survey by the Public Coordinating Council, only 11 percent of public sector funds use the PUC method. The primary reason for this is that the PUC method tends to push more of the costs into the later part of a member's service. For this reason, the PUC method generally has a lower accrued liability than the most prevalent method which is Entry Age Normal."

The SDCERS' Board recognized that PUC was a less desirable method for establishing contributions and Board members expressed the desire to eventually return to the EAN method. GRS was asked to calculate EAN contribution rates in its valuations in the June 30, 1999 valuation. The contribution rates established under MP1 were to be increased by 0.50% per year until they reached the EAN rate.

~~B. The SDCERS' Board Changed the Amortization Period~~

~~At the same time as the change to the PUC method (1991), the SDCERS' Board changed the amortization period used in its actuarial valuations to a declining 30 year period, which is the maximum time period permitted under actuarial standards.<sup>33</sup> During his interview, Mr. Grissom told Navigant Consulting that this change occurred because the previous amortization period was close to ending and needed to be reset. The impact of~~

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<sup>33</sup> Unfunded liabilities are typically funded over a specific time period. Thirty years is traditionally the longest period used for pension funds. The thirty years is approximately equal to the average time between the date of hire and the date of retirement. In 1991, there were no specific limits on the period that could be used for public sector plans and a few plans used a funding period of as long as forty years. GASB Statement No. 25 permitted amortization periods of up to forty years through 2004. After 2004, GASB No. 25 limited amortization periods to no more than thirty years.

~~benefits came to be known as the "Waterfall"<sup>140</sup> As long as the financial markets continued to deliver strong investment returns, the impact of the Waterfall on the financial health of SDCERS was neither transparent or noticeable. But, the habit of raiding Surplus Earnings left SDCERS poorly positioned to weather inevitable financial hard times.~~

#### D. Events Leading To MP-1

In addition to the development of the "Waterfall," several pre-1996 events appear, in retrospect, as red flags signaling SDCERS's lack of proper independence from the City. In 1991, the City granted substantial new retirement benefits to employees, but made these additional benefits contingent on an agreement by SDCERS to change the cost method it used to estimate its AAL from Entry Age Normal ("EAN") to Projected Unit Credit ("PUC").<sup>141</sup> Although both EAN and PUC are cost methods accepted by the Governmental Accounting Standards Board ("GASB"), the two methods produce different results for the timing of required City contributions.<sup>142</sup> SDCERS adopted the change from EAN to PUC in 1991 primarily because the change was expected to lead to reduced annual payments by the City, at least in the short run,<sup>143</sup> and its agreement to make this change was a condition of the City's granting new pension benefits to its employees.<sup>144</sup> As SDCERS Administrator Lawrence Grissom recorded, "[a]ll of these benefit changes are

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City, and the Unified Port District at an interest rate determined by the Board; (ii) operating costs of SDCERS are paid; (iii) reserves are maintained at the discretion of the Board on the advice of its actuary; (iv) a proportional amount of Surplus Undistributed Earnings are credited to the Unified Port District; (v) post-retirement healthcare premiums are paid for the next fiscal year provided that in the next fiscal year the City contributes an equal amount into the 401(h) reserve and that this contribution is part of their normal employer contributions; (vi) the 13th Check is paid if there is more than \$100,000 available for the purpose (if there is not enough, this amount is rolled over into subsequent years until the rolled-over amount combined with the current year's available funds exceed \$100,000); (vii) the contingent portion of the *Corbett* settlement is paid; and finally (viii) the Supplemental COLA is paid. In the event that there are Surplus Earnings remaining after the distribution listed above is completed, the remaining funds are credited to the Reserve for Employer Contributions for the sole and exclusive purpose of reducing the Retirement System liability.

<sup>140</sup> Minutes, SDCERS Special Board Meeting at 26 (May 29, 2002).

<sup>141</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991). In addition to adopting PUC to calculate its AAL, SDCERS also adopted PUC to calculate its normal cost, which is the actuarial present value of retirement system benefits allocated to the current year by the actuarial cost method. Gabriel, Roeder, Smith & Co., San Diego Employees' Retirement System Annual Actuarial Valuation June 30, 1995, at 51 (Jan. 19, 1996).

<sup>142</sup> Under EAN, the actuarial present value of the projected benefits of each individual "is allocated on a level basis over the earnings or service of the individual between entry age and assumed exit age(s)." Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 § 40(B)(2) (June 30, 2005). Under PUC, the projected benefits are allocated by a consistent formula to valuation years. Governmental Accounting and Financial Reporting Standards, Vol. II, GASB 27 § 40(B)(1) (June 30, 2005).

<sup>143</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991); Interview by the Audit Committee with Chuck Woolever (Apr. 20, 2006).

<sup>144</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991).

subject to Retirement Board approval of the conversion from the entry age normal to the projected unit credit method of actuarial valuation.”<sup>145</sup> At the same time, SDCERS extended the repayment period for the UAAL by instituting a new 30-year amortization period on July 1, 1991 (effective the subsequent year), which further reduced the City’s ARC.<sup>146</sup>

Either change might have been unobjectionable if it had reflected a good faith belief by SDCERS or its actuary that the newly-adopted method was more accurate or otherwise more appropriate than the old method. In each case, however, the change in fact seems to have been made solely or primarily to save the City money, an objective potentially inconsistent with the SDCERS Board’s mandate to safeguard the integrity of the pension system.<sup>147</sup> The change from EAN to PUC was an express condition to the City’s granting of new pension benefits.<sup>148</sup> This linkage compromised the SDCERS Board’s role in safeguarding the financial soundness of the pension system.<sup>149</sup>

In 1994, the City was experiencing “one of the worst economic cycles in its history,” and started discussing proposals with the SDCERS Board that dealt with alternative funding methods.<sup>150</sup> In addition, the SDCERS Board was about to approve the June 30, 1993 actuarial valuation that contained significant changes in the actuarial methodology, which would likely result in increased costs to the City. Before the SDCERS Board approved the actuarial valuation, City Manager Jack McGrory wrote a letter to the SDCERS Board requesting that the Board not approve the June 30, 1993 valuation until the City had time to review the “impact of increased costs to the General Fund as a result of the significant changes in the actuarial methodology.”<sup>151</sup>

~~By May 26, 1994, the City asked and the SDCERS Board approved the request to use approximately \$10 million of Surplus Earnings for a one-time reduction in the City’s annual pension~~

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<sup>145</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991).

<sup>146</sup> Gabriel, Roeder, Smith & Co., *San Diego City Employees’ Retirement System Annual Actuarial Valuation June 30, 1997*, at 42 (Jan. 16, 1998).

<sup>147</sup> Cal. Const. art. XVI, § 17.

<sup>148</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991).

<sup>149</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Bruce Herring, Deputy City Manager (May 14, 1991).

<sup>150</sup> Memorandum from Lawrence B. Grissom, Retirement Administrator, to Business and Procedures Committee (May 6, 1994); Memorandum from Jack McGrory, City Manager, to City Employees Retirement System Board of Directors via Larry Grissom, Retirement Administrator (Feb. 17, 1994).

<sup>151</sup> Memorandum from Jack McGrory, City Manager, to City Employees Retirement System Board of Directors via Larry Grissom, Retirement Administrator (Feb. 17, 1994).