

SDCERS NAVIGANT REPORT COMMITTEE/STAKEHOLDER MEETING

May 17, 2006 - Meeting Notes by Virginia Silverman

INTRODUCTION/PRELIMINARY

Committee members in attendance: Mark Sullivan (Chair), Thomas Hebrank, William Sheffler, Richard Kipperman, Wayne Kennedy, and Peter Preovolos (SDCERS Board President, ex officio member). William Sheffler was absent.

Chairman Mark Sullivan opened the meeting with brief remarks about the meeting topic - Surplus Undistributed Earnings - and explained that the issue would be for information and discussion only, that there would be no vote.

OVERVIEW AND HISTORICAL PERSEPCTIVE: SURPLUS UNDISTRIBUTED EARNINGS & 'WATERFALL'

Steve Stanton of Navigant Consulting, Inc. made a brief informational presentation about 'Surplus Undistributed Earnings, the 'Waterfall' and impacts on the pension fund. Questions and comments by committee members, stakeholders and the public followed. Information from the presentation along with comments and questions is grouped below by general subject area

A. Pension Fund Basics

SDCERS receives contributions from the City and from City employees to pay for retirement benefits. Retirement benefits are established by the City through the Meet and Confer process between City Management and the employee labor unions. The agreed upon benefits are enacted by ordinance into the municipal code, which authorizes SDCERS to administer and pay for them.

SDCERS invests the contributions to increase the total value of the trust fund used to pay retirement and disability benefits. The investment returns are a major component, of plan assets when compounded over time,

B. Surplus Undistributed Earnings- History

In 1980, the City Council adopted Ordinance 0-15353 to increase retiree benefits that had eroded in value due to high inflation.. To provide some relief, the municipal code was changed to permit 50% of the surplus undistributed earnings from the SDCERS trust fund to pay for an increased retirement benefit in years in which a surplus existed. (In subsequent years, the 50% formula was changed to \$30 per year of service – the 13th check.)

Stanton stated that this ordinance changed the normal procedure under which a new benefit would be calculated by an actuary and included in the City's required annual contribution. Under this new protocol the cost was not included in the annual actuarial valuation, and was no increase in employer contributions to pay for the benefit.

Doug McCalla, SDCERS Chief Investment Officer, provided additional details, commenting that when Ordinance 0-15353 was enacted, the City could only invest in bonds and similar investments which had a fixed rate of return. The earnings were therefore considerably lower and also more predictable. However, "things changed" when pension funds were permitted to invest in stocks and other investments in addition to bonds.

C. Definitions

Investment Earnings Received

Investment Earnings Received (as defined in SDMC 24.1501) are based on a cash (only), basis, and include interest on bonds, dividends on stocks, sales of stocks (difference between purchase price and sales price), and other cash revenues. Gains in the value of stocks and other investments are not included, unless the investment is sold (cash only, not total returns).

Surplus Undistributed Earnings and the 'Waterfall'

Surplus Undistributed Earnings (SDMC 24.1501, are all of the Investment Earnings Received for the previous fiscal year, **after** the following payments are made, in priority order (the 'Waterfall')

The Waterfall payments are:

- 1) An Interest credit (currently 8%) to the contribution accounts of SDCERS members (employees), the City, and the Unified Port District. (The SD County Airport Authority is not yet incorporated into the Municipal Code, but is also be included . The SDCERS Board determines the interest rate annually.
- 2) The SDCERS administrative budget: the personnel and non-personnel expenses of operating the Retirement System.
- 3) Reserves recommended by the SDCERS Board Actuary. At this time DROP interest payments are the only payments in this category.
- 4) The proportional share of Retirement System earnings which go to the Unified Port District and the San Diego County Airport Authority (reimbursement for payments collected for contingent benefits which these agencies do not provide).
- 5) Health Insurance premiums and payments to retirees. (Note: beginning in FY 2006 the City resumed paying the full cost of retiree health care costs, because of IRS rules.)
- 6) The Annual Supplemental Benefit (13th Check), if funds are available.
- 7) Corbett Settlement payments to pre-July 2000 retirees and beneficiaries. The right to the annual 7% increase in base retirement benefit accumulates monthly, but is paid in a lump sum annually when the 13th check is paid. If funds are not sufficient to pay the Corbett in one year, the liability for the payment carries forward to future years.
- 8) Reserves for the Supplemental COLA and Employee Contributions.

Any funds remaining from Investment Earnings Received after payments to the Waterfall are designated Surplus Undistributed Earnings and are credited to the Reserve for Employer Contributions for the sole purpose of reducing Retirement System liability.

D. Drawbacks/Problems with Surplus Undistributed Earnings and the Waterfall

Expenditures in the Waterfall are not included in the Annual Actuarial Valuation. This distorts the true present value of benefits being paid, and does not require the City to fully fund benefits. The SDCERS Board should require these expenditures to be in the Annual Actuarial Valuation, and the City should be required to fully fund these benefits up front.

Doug McCalla commented that cash income is held in reserves to pay the Waterfall, when the cash should be reinvested and earning additional income; then cash could be taken out as needed to pay bills. The Waterfall is really just an accounting hierarchy for payments. And even in a year when there are no earnings, certain things got paid anyway.

Mark Sullivan commented that the Waterfall and Surplus Undistributed Reserve created another fund outside the pension trust fund – taking from one fund and putting in another.

There seemed to be general agreement among committee members to the statement that there was no such thing as ‘excess’ or ‘surplus’ earnings, and that the practice was at odds with generally accepted accounting rules.

(Note: Two written reports critical of the concept/practice of Surplus Undistributed Earnings and the Waterfall were distributed at this meeting, and included the September 2004 Report by Vincent & Elkins; and a Minority Report to the Pension Reform Committee by Richard Vortmann, former SDCERS Board Member and member of the Pension Reform Committee, in Fall 2004.)

E. DROP Issue/Comments

Questions were raised about the 8% crediting rate for DROP accounts by some committee members, asking for clarification on whether a different rate could be approved for DROP. Richard Kipperman noted that an 8% guaranteed rate is not available anywhere else. It was explained that the rate could fluctuate for active DROP’s, but once retired the rate in effect upon retirement was set for the rest of the period the DROP account remained in SDCERS. (Steve Stanton, of Navigant, suggested that SDCERS Drop program be compared with other DROP programs to see what they did about interest rates.)

Mark Sullivan commented that DROP funds now represent 25% of total SDCERS funds, so the recent IRS-mandated changes on withdrawal may cause a large exodus of funds and a drop in investment power.

Sullivan also stated (in response to my question) that there was no separate trust fund from Drop participants. An account is established for each participant, but the funds are in the Pension Trust Fund (only one fund)

Jim Clem, Stakeholder representative for the retired Fire and Police Association, commented on his situation with DROP. He said there had been a tradeoff in 1996 between accepting a 90% wage cap on retirement benefits (in place of uncapped retirement benefits) in exchange for the DROP program. He said he might have been better off with the increased retirement benefits without the cap and without the DROP.

F. Other Comments and Questions

Wayne Kennedy suggested that the SDCERS Board meet with Jay Goldstone, the City’s Chief Financial Officer.

Tom Hebrank commented that the Navigant Committee is tasked with recommending changes in SDCERS procedures and operations. He asked when the committee is going to start making proposals to make improvements to the funding level, and deal with other problems? (No specific answers given, but the June meeting topic will be Restoring the Funding Level).

NEXT MEETING

Chairman Mark Sullivan announced the next meeting will be on Wednesday, June 14, 2006 at 1:00 p.m at the SDCERS Office. The topics will be Restoring the Funding Level/Actuarial Soundness, and Safeguarding and Maintaining Independence. There was no mention of why Retiree Health was removed from today’s agenda, or when (if) it would be discussed at a future meeting.