City of San José

Orientation and Current Status of the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan

March 2, 2018

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Background

- City Auditor recently completed an Audit of Retirement Services approved by City Council on January 9, 2018
- Audit included two recommendations regarding providing the Council with retirement information:

  1. Hold an annual joint study session with both retirement boards to review relevant topics
     - Will be scheduling a joint study session with the two retirement boards for May
  2. Structure a formal process to orient new Council members to retirement plans

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Purpose

- City Administration last provided Council with a retirement study session 2015
  - Alternative Pension Reform Framework has been implemented in this timeframe
- This presentation will provide the City Council with a formal orientation to the history and status of the two retirement plans

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AGENDA

- Overview of Retirement Benefits (Pension & Retiree Healthcare)
- Background and History of the City's Two Retirement Systems
- Overview of Actuarial Valuations
- Status Update on the City's Two Retirement Systems
- Public Comment

Retirement Benefits

Pension & Retiree Healthcare

Defined Benefit vs. Defined Contribution

Defined Benefit	Benefit regardless of amount of money contributed and investment performance of retirement fund
Defined Contribution	Benefit determined by amount contributed and investment performance

Current City of San Jose Retirement Benefits

Defined Benefit Plan	Defined Contribution Plan

• Independent Plan
    • Not a member of CalPERS
• Administered by two independent boards – Federated and Police and Fire
    • Fiduciary responsibility to ensure that there are sufficient assets to pay for the benefits
	• Tier 3 – 401(a)
	    • City match
	    • Unit 99 Only
	• 457 plan (401k equivalent)
	    • No City match
	    • Voluntary
	• Part Time, Temporary or Contract Employees (PTC) Plan

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Current City of San Jose Retirement Benefits

<table>
<tr><th>Defined Benefit Plan</th><th>Defined Contribution Plan</th></tr>
<tr><td>

Police and Fire employees
Tier 1 and Tier 2
Federated employees
Tier 1 and Tier 2
CalPERS
Councilmember option

</td><td>

Tier 3
Unit 99 employees can choose this plan
PTC Plan

Part-time employees
Temporary employees
Contract employees
Councilmember option

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Retirement Changes 2012-2018

2012 – City of San Jose voters passed Measure B

- **September 2012 -** Federated Tier 2 implemented
- **August 2013** – Police Tier 2 implemented
- **January 2015** – Fire Tier 2 implemented

2015 – Settlement Frameworks reached with the bargaining units and approved by Council

2016 – City of San Jose voters passed Measure F

- Modification of Tier 2 benefits

2017 – VEBA Opt-In Election for Tier 1 Employees

2018 – VEBA Implementation

What Are The Elements That Affect Cost?

1. Retirement Age
2. Benefit Formula
3. Maximum Benefit
4. Final Salary Calculation
5. Cost-of-Living Adjustments
6. Survivorship Benefits
7. Retiree Healthcare Benefits
8. Disability Retirements
9. Guaranteed Purchasing Power (GPP)

*Supplemental Benefits (SRBR) previously affected cost.

Defined Benefit Plan – Police & Fire

Retirement Tier	Benefit Accrual Rate	Retirement Age	Final Compensation	Maximum Benefit	COLA
Police & Fire Tier 1	**Police**: • 1-20 years: 2.5% • 21+ years: 4.0% **Fire**: • First 20 years: 2.5% • 21+ years: All years convert to 3%	• 50 with 25 years of service • 55 with 20 years of service	Highest 12 consecutive months	90%	**3%**
Police & Fire Tier 2	1-20 years: 2.4% 21-25 years: 3.0% 26+ years: 3.4%	57 *Or less with a 7% actuarial reduction factor per year*	Highest consecutive three years average	80%	**CPI or 2.00%**

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Defined Benefit Plan – Police & Fire

Retirement Tier	Average Salary	Years of Service	Accrual Rate	Annual Pension Benefit
Police & Fire Tier 1	$120,000	30 *Retirement Age: 50 years*	3.0%	**$108,000**
Police & Fire Tier 2	$120,000	30 *Retirement Age: 57 years*	Backloaded 3.4%	**$96,000**

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Defined Benefit Plan - Federated

Retirement Tier	Accrual Rate	Retirement Age	Final Compensation	Maximum Benefit	COLA
Federated Tier 1	2.5%	55 *Any age with 30 years of service*	Highest 12 consecutive months	**75%**	**3.0%**
Federated Tier 2	2%	62 *Or less with a 5% actuarial reduction factor per year*	Highest consecutive three years average	**70%**	CPI or • Years 1-10:1.25%* • Years 11-20: 1.5% •Years 21-25: 1.75% • Years 26+: 2.0%

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Defined Benefit Plan - Federated

Retirement Tier	Average Salary	Years of Service	Accrual Rate	Annual Pension Benefit
Federated Tier 1	$100,000	30 *Retirement Age: 55 years*	2.5%	**$75,000**
Federated Tier 2	$100,000	30 *Retirement Age: 62 years*	2.0%	**$60,000**

Cost Sharing - Pension

Tier 1	Tier 2
• City pays 8/11ths of Normal Cost and all UAL* • Employee pays 3/11ths of Normal Cost	• City and Employee split costs 50/50 • Tier 2 employees will contribute toward the unfunded liability in increments of 0.33% per year until the UAL is split 50/50

* Police and Fire Tier 1 employees contribute toward a small portion of the UAL

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Current Retiree Healthcare Benefits

- Tier 1 (Federated, Police, & Fire) & Tier 2a
  - Defined Benefit Retiree Healthcare
    - Lowest cost healthcare plan available to active employees
  - VEBA Opt-In Option in 2017
    - Implementation in 2018

- Tier 2 (Police & Fire) & Tier 2b (Federated)
  - VEBA (in April 2018)
    - Defined Contribution
    - No City Match
    - Mandatory Contributions determined by bargaining unit

Background – Defined Benefit Retiree Healthcare Plan

- What is the City's current defined benefit retiree healthcare plan?
  - 100% of the lowest cost healthcare plan premium available to actives based on your insurance tier (i.e. single, retiree+spouse, etc)
    - Retirees must pay the difference between the premium of lowest cost plan and the premium of a higher cost plan
    - Kaiser 3000 deductible plan single premium = $409.70
    - Blue Shield PPO single premium = $1,104.14
  - Fifteen (15) years of service needed to be eligible for retiree healthcare benefit
  - Retirees are required to enroll in Medicare Parts A and B at age 65

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Voluntary Employees' Beneficiary Association (VEBA)

- What is a VEBA?
  - A tax-qualified healthcare trust fund under Internal Revenue Code Section 501(c)(9)
  - The funds in the VEBA may be used to reimburse post-retirement out-of-pocket health care costs incurred by you, your spouse, and qualified dependents
  - Funds that are contributed or reimbursed from the VEBA are all pre-tax
  - VOYA Financial will be the VEBA administrator
  - VEBA members who receive a disability retirement may qualify for the Catastrophic Disability Retiree Healthcare benefit
  - Members can purchase City plans after five (5) years of service
    - VEBA will have its own experience pool
  - www.sanjoseca.gov/VEBA

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Defined Benefit and VEBA Opt-In Contribution Rates

Employee Unit	Current Retiree Healthcare Defined Benefit Contribution Rate	NEW Retiree Healthcare Defined Benefit Contribution Rate (when VEBA is effective)	New VEBA Contribution Rate
Police	9.51%	8.0%	4.0%
Fire	9.74%	8.0%	4.0%
Federated- Management (CAMP, AEA, AMSP, ALP)	8.76%	7.5%	2.5%
Federated – Non-Management (MEF, CEO, IBEW, OE#3, ABMEI)	8.76%	7.5%	3.5%
Unit 99 & Units 81/82	8.76%	7.5%	No Contribution

- Employees who elect to opt-in to the VEBA will receive an amount estimated to be their previous retiree healthcare contributions, without interest, to their individual VEBA account.
- There is no City contribution to the VEBA.

Tier 2 VEBA Contribution Rates

All sworn Tier 2 and Federated Tier 2B employees will be placed into a VEBA and make mandatory contributions.

Employee Unit	Current Retiree Healthcare Defined Benefit Contribution Rate	New VEBA Contribution Rate
Police	---	4.0%
Fire	---	4.0%
Federated	---	2.0%
Unit 99 & Units 81/82 – Tier 2	---	No Contribution

- Unit 99 and Units 81/82 will not be mandated and will not be eligible to make contributions into a VEBA

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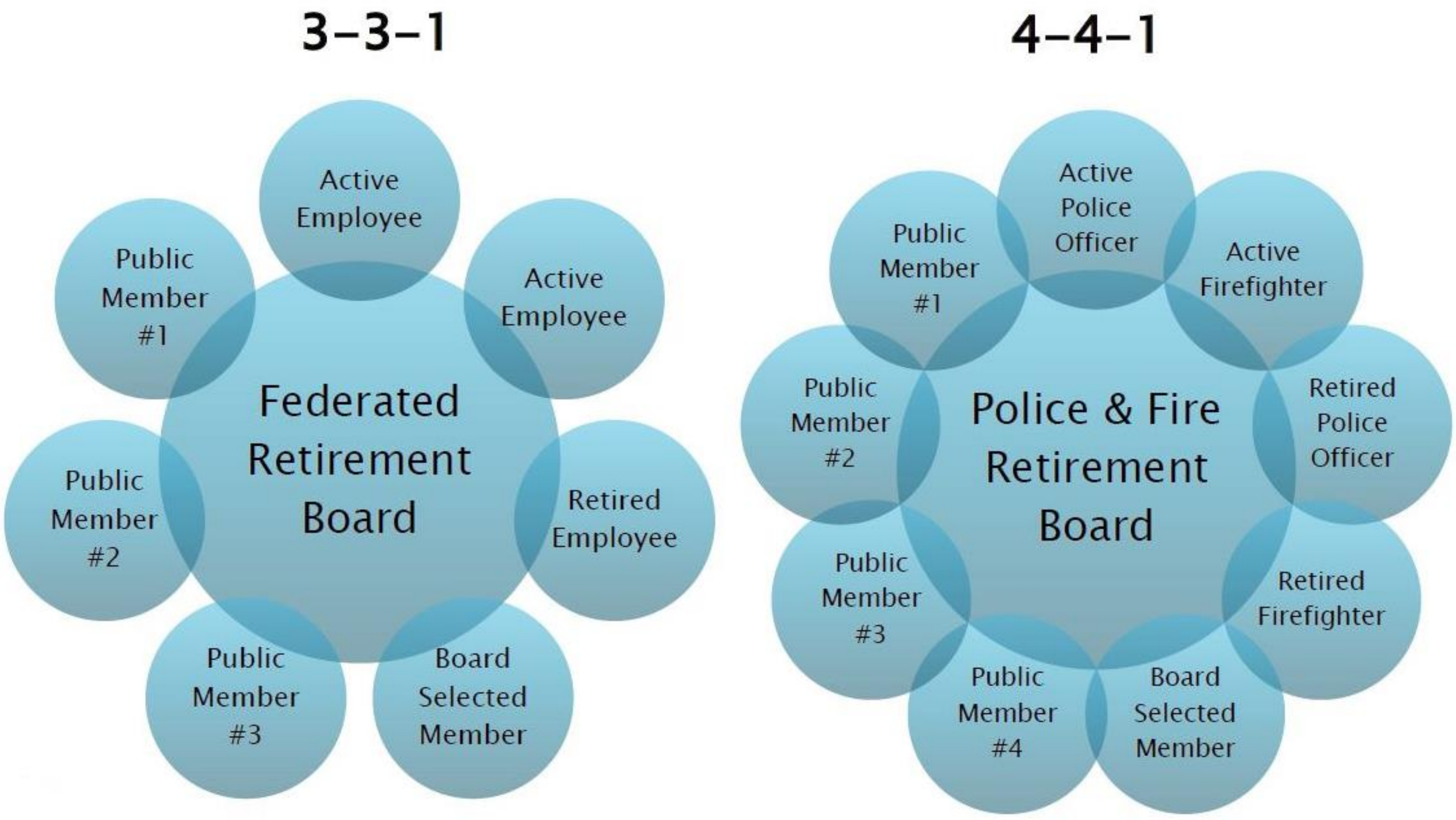
Background and History of the City's Two Retirement Systems

Retirement Boards



Measure G Charter Changes

Effective December 19, 2014

Provides greater administrative autonomy

810. Retirement Boards

- Boards hire their own Counsel(s)
- Budget approved by Council

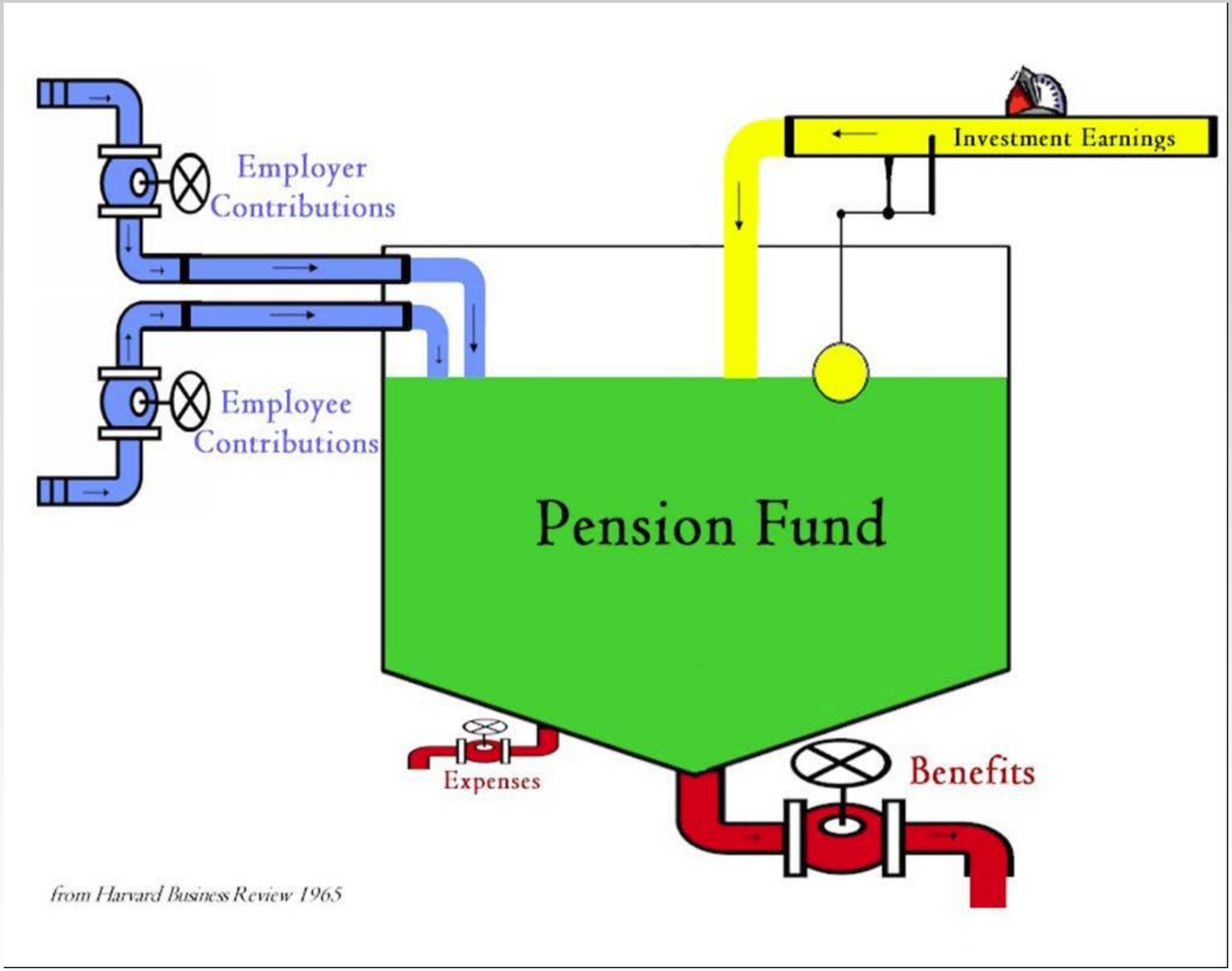
810.1 Power of Appointment

- Boards appoint the CEO and CIO
- Boards to jointly manage the CEO and CIO
- Office of Retirement Services staff reports to CEO

Retirement Board Responsibilities

- Administration
- Actuarial Assumptions
- Discount Rate
    - Amortization
    - Wage Inflation
    - Life Expectancy
- Investments

Overview of Actuarial Valuations and Future Projections


Employer
Contributions
Employee
Contributions
Investment Earnings
Pension Fund
Expenses
Benefits
from Harvard Business Review 1965

Actuarial Valuations

- *An **actuarial valuation** is a type of appraisal which requires making economic and demographic assumptions in order to estimate future liabilities. The assumptions are typically based on a mix of statistical studies and experienced judgment.*
- Performed by independent actuaries selected by the Retirement Boards
- Performed annually using data as of June 30^{th}
- Sets Annual Required Contribution for the following year
  - Example:
    - Valuation as of June 30, 2017 establishes Annual Required Contribution for Fiscal Year 2018-2019

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Actuarial Valuation Process

1.	**Collect information** • Member data • Plan provisions • Asset information
2.	**Apply assumptions** • Demographic • Economic
3.	**Project all future benefit payments**
4.	**Determine a present value of the benefits**
5.	**Compare to assets**
6.	**Calculate employer and employee contribution**

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Actuarial Assumptions

- **Actuarial Assumption:** *an estimate made for the purposes of calculating benefits*
- Assumptions affect only the timing of costs, ultimate level of costs determined by actual experience

Contributions + Investment Earnings = Benefits + Expenses

- Assumptions needed to form best estimate of contribution requirement
- Actuarial process is self-correcting
  - Amortization of gains/losses
  - Periodic experience studies

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Actuarial Assumptions

- Two types of assumptions: *demographic and economic*

Demographic Assumptions	Economic Assumptions
When will benefits be payable and for how long?	How will inflation grow? How will assets grow? How will salaries increase?

• Rates of Termination
• Rates of Mortality
• Rates of Disability
• Rates of Retirement
	• Inflation is the foundation for all economic assumptions
	  • Expected Return (Nominal) = Inflation + Real Return
	  • Base Wage growth = Inflation + Real Wage Growth
	  • Expected Return: 6.875%
	• Lower expected returns result in higher liability and level of *current* cost
	• Overall cost will depend on actual (not assumed) returns

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Annual Required Contribution (Annual Determined Contribution)

"The ***amount of money*** *that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period."* (Emphasis added)

-- Pew Center Report Glossary

Annual Required Contribution, con't.

- The *annual required contribution* to finance a public pension plan usually is expressed as a percentage of payroll and contains two components:

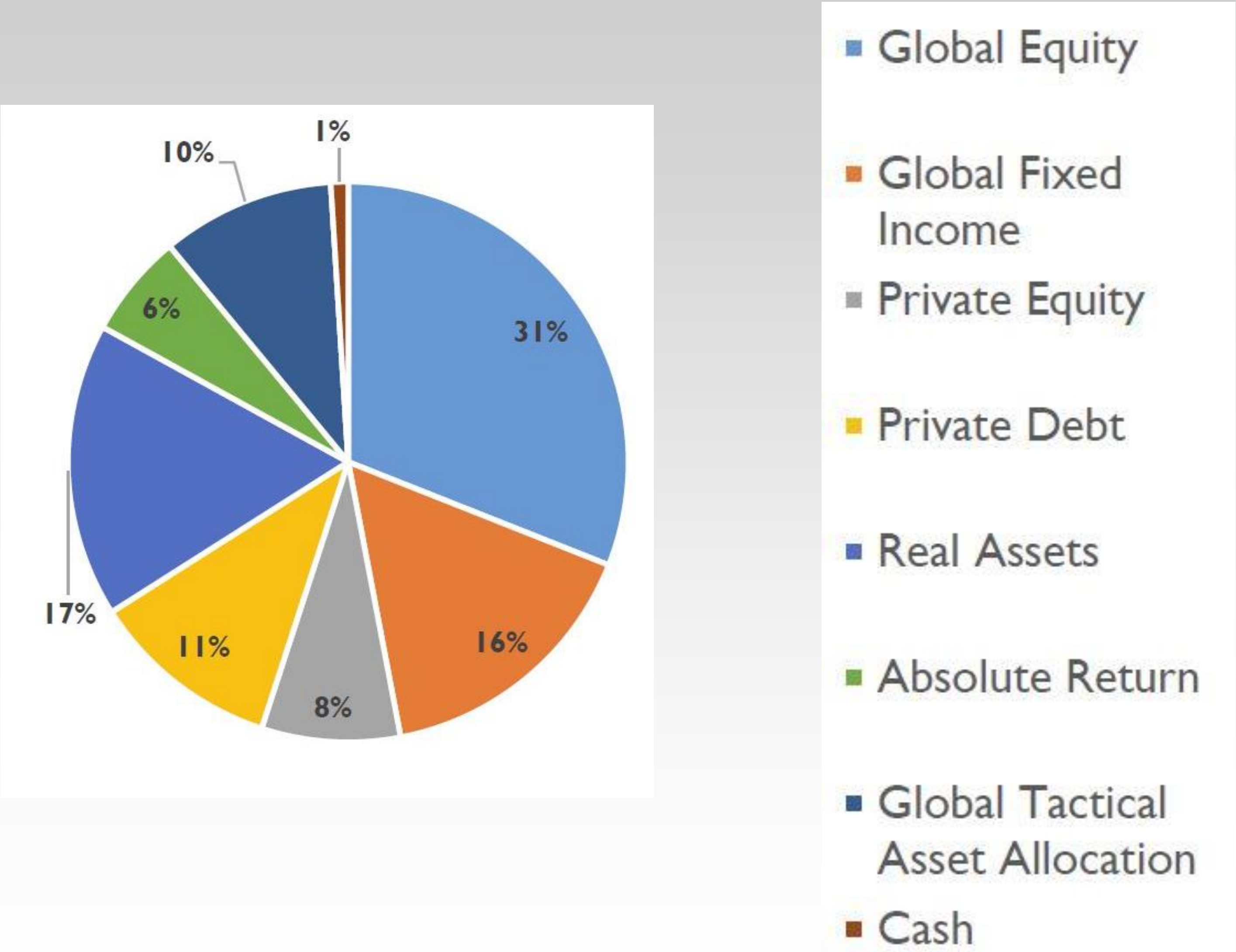
  - **Normal Cost -**the cost of benefits accrued in the current year
  - **Amortization Payment -**the cost to amortize any unfunded actuarial liability (the liability for benefits earned for which assets have not yet been accrued)

As directed by the City Charter, both the City and employees shall always make the full annual required plan contributions as calculated by the Retirement Board actuaries.

What Are The Elements That Affect the Annual Required Contribution?

- Combination of past experience and assumptions going forward
- Key Assumptions
  - Rate of return/earnings assumption
  - Life expectancy
  - Number of disability retirements
  - Salary increases
  - Retirement age

Target Asset Allocation – Police & Fire



Data from Audit of Retirement Services: Greater Transparency Needed in the Budgeting Process, Interactions Among Stakeholders, Investment Policies, and Plan Administration

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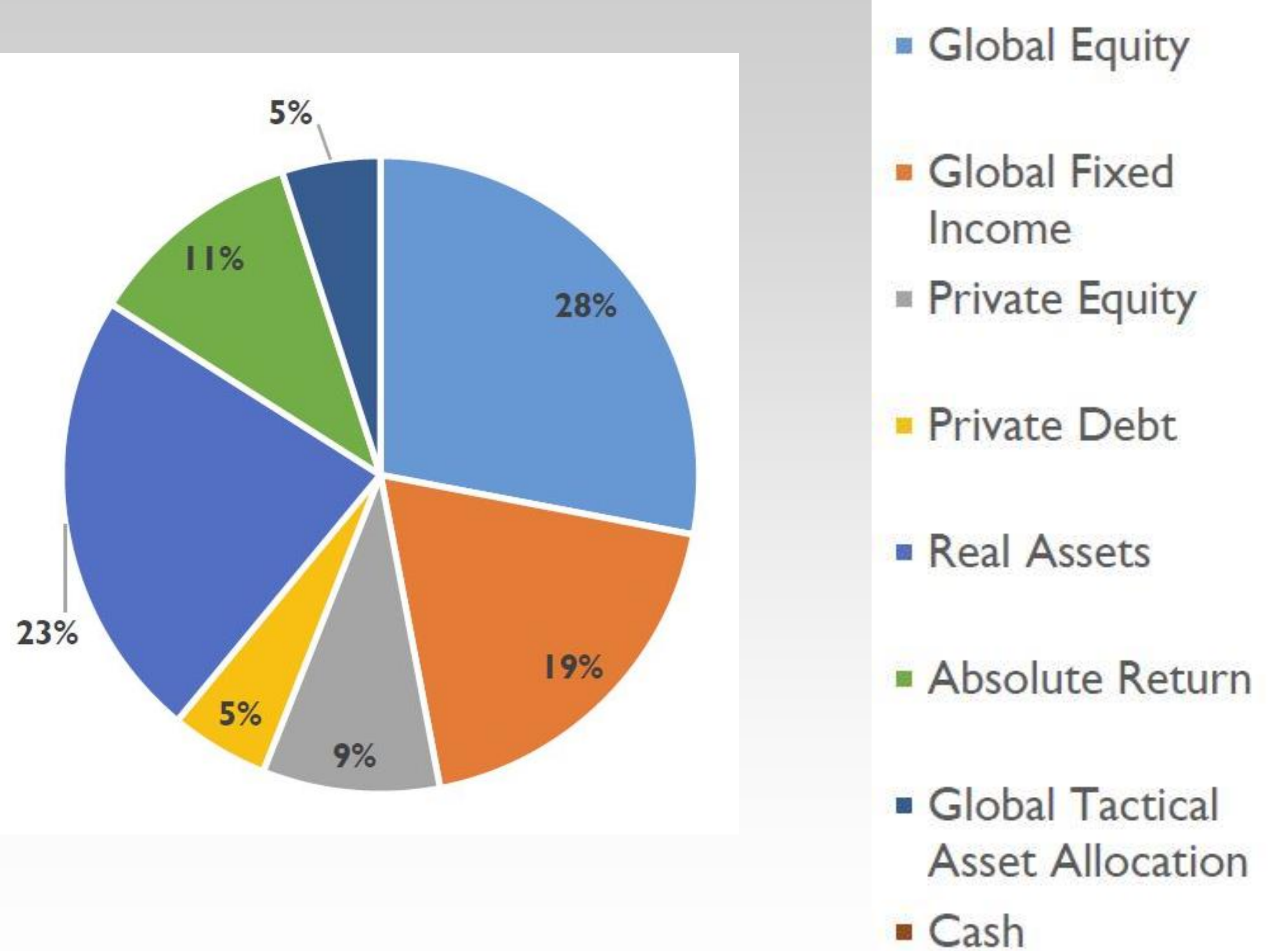
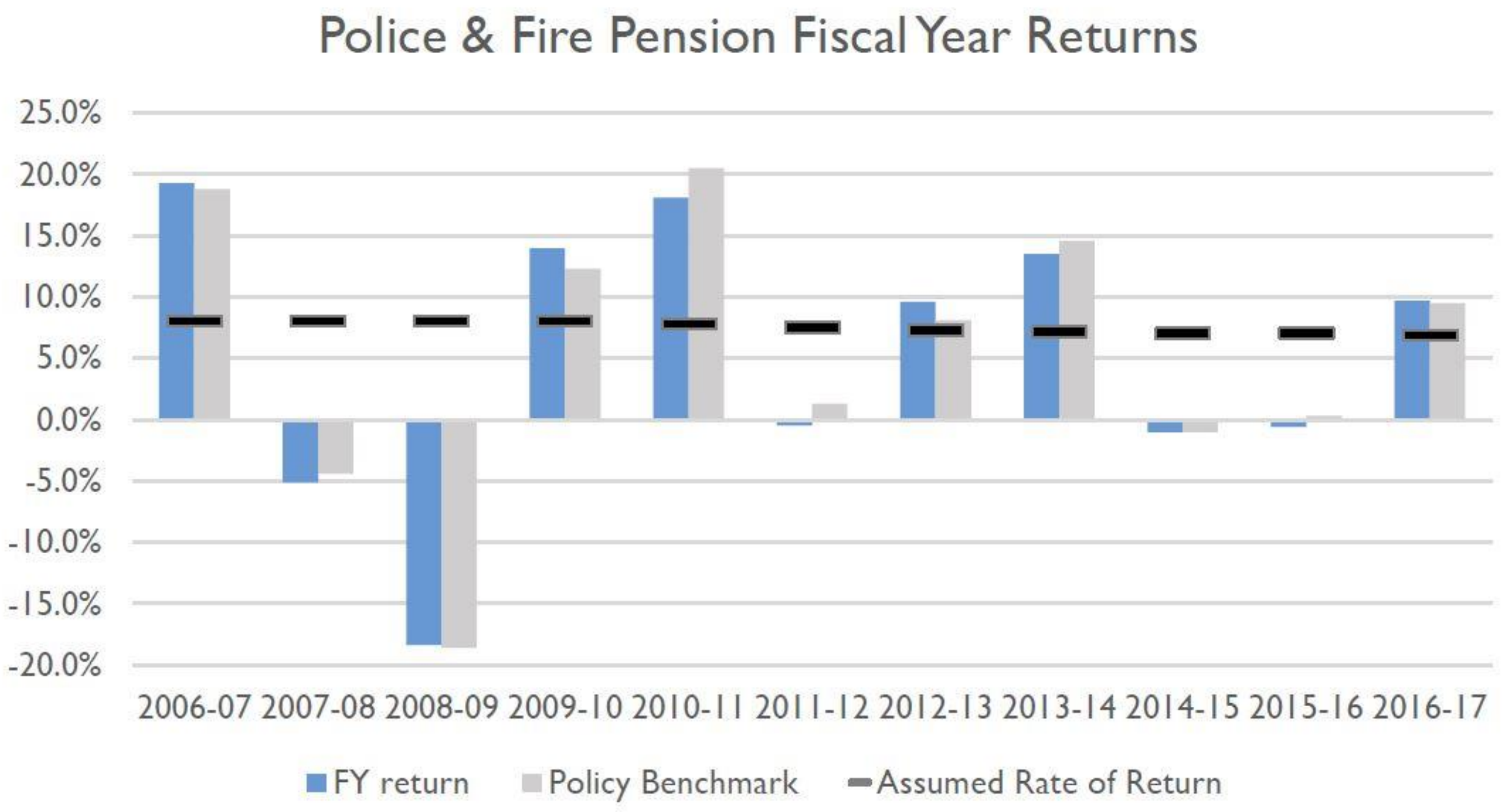
Target Asset Allocation – Federated



Data from Audit of Retirement Services: Greater Transparency Needed in the Budgeting Process, Interactions Among Stakeholders, Investment Policies, and Plan Administration

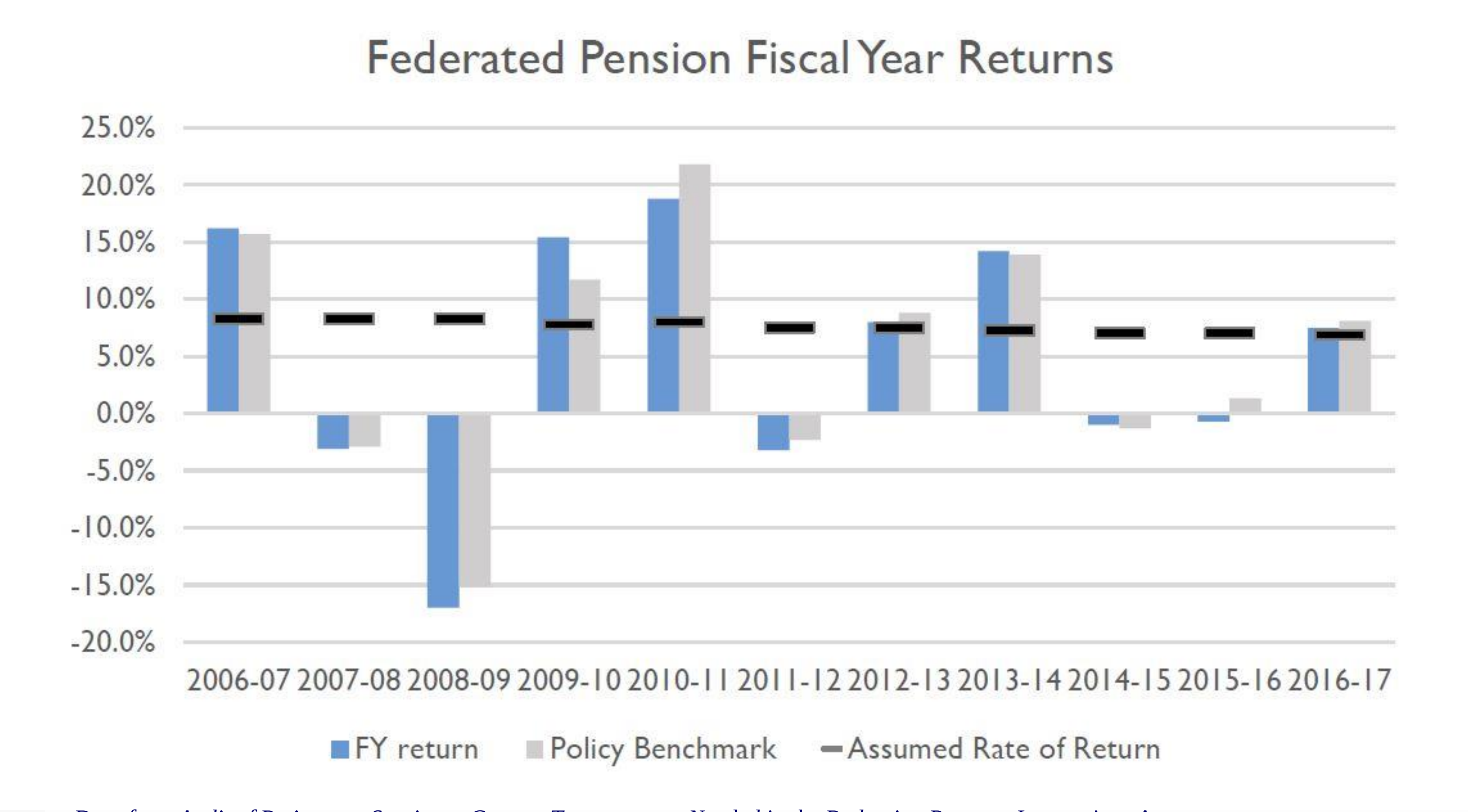
Investment Gains & Losses – Police and Fire



Source: Retirement Services CAFRs

Data from Audit of Retirement Services: Greater Transparency Needed in the Budgeting Process, Interactions Among Stakeholders, Investment Policies, and Plan Administration

Investment Gains & Losses – Federated



Data from Audit of Retirement Services: Greater Transparency Needed in the Budgeting Process, Interactions Among Stakeholders, Investment Policies, and Plan Administration

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Status Update on the City's Two Retirement Systems

Actuarial Value of Assets

Actuarial Value of Assets *–*
The value of pension plan investments and other property used by the actuary for the purpose of an actuarial valuation (sometimes referred to as valuation assets). Actuaries often select an asset valuation method that smooths the effects of short-term volatility in the market value of assets.

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Unfunded Liability

Unfunded Actuarial Liability (UAL) *–*
The difference between the actuarial accrued liability and the actuarial value of plan assets on hand. This is the unfunded obligation for past service.

Current Status of the Plan – Unfunded Actuarial Liability (UAL) Pension

Valuation Date	June 30, 2016	June 30, 2017	Difference
Federated	$1.75B	$1.82B	4.0%
Police & Fire	$1.06B	$1.02B	-3.3%

Data from June 30, 2016 and June 30, 2017 Actuarial Valuations

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Current Status of the Plan – Unfunded Actuarial Liability (UAL) OPEB

Valuation Date	June 30, 2016	June 30, 2017	Difference
Federated	$510.9M	$381.9M*	-25.2%
Police & Fire	$553M	$538M**	-2.7%

**Preliminary Valuation as of 2/15/18*
***Preliminary Valuation as of 3/1/18*

Data from June 30, 2016 and June 30, 2017 Actuarial Valuations

Historical Changes to UAL

Over the last 5 years, the pension UAL has grown by $1.1 billion. Of this:

- $518 million (48%) was due to assumption changes (primarily discount rate reduction)
- $335 million (31%) was due to net investment returns being lower than expected
- $212 million (20%) was due to net liability losses (e.g. retirements, mortality, and salaries being different than expected)
- $18 million (2%) was due to plan changes from Measure F

The growth in the UAL was offset by $9 million (-1%) of contributions that exceeded the normal cost and the interest on the UAL.

Includes valuations of years ending June 30, 2013 – June 30, 2017. Federated 2017 valuation is preliminary. Totals provided are a summation of amounts reported in each valuation unadjusted for the date of the valuation

Funding Ratio

Funding Ratio–

The ratio of the actuarial value of assets (AVA) to the actuarial accrued liability (AAL). Plans sometimes calculate a market funded ratio, using the market value of assets (MVA), rather than the AVA

Current Status of the Plan – Funding Ratio (Pension)

Valuation Date	June 30, 2016	June 30, 2017	Difference
Federated	53.7%	53.6%	-0.1
Police & Fire	75.7%	77.1%	1.4

Data from June 30, 2016 and June 30, 2017 Actuarial Valuations

Current Status of the Plan – Funding Ratio (OPEB)

Valuation Date	June 30, 2016	June 30, 2017	Difference
Federated	30.7%	39.0%	8.3%
Police & Fire	18.24%	21.0%	2.76%

Data from June 30, 2016 and June 30, 2017 Actuarial Valuations

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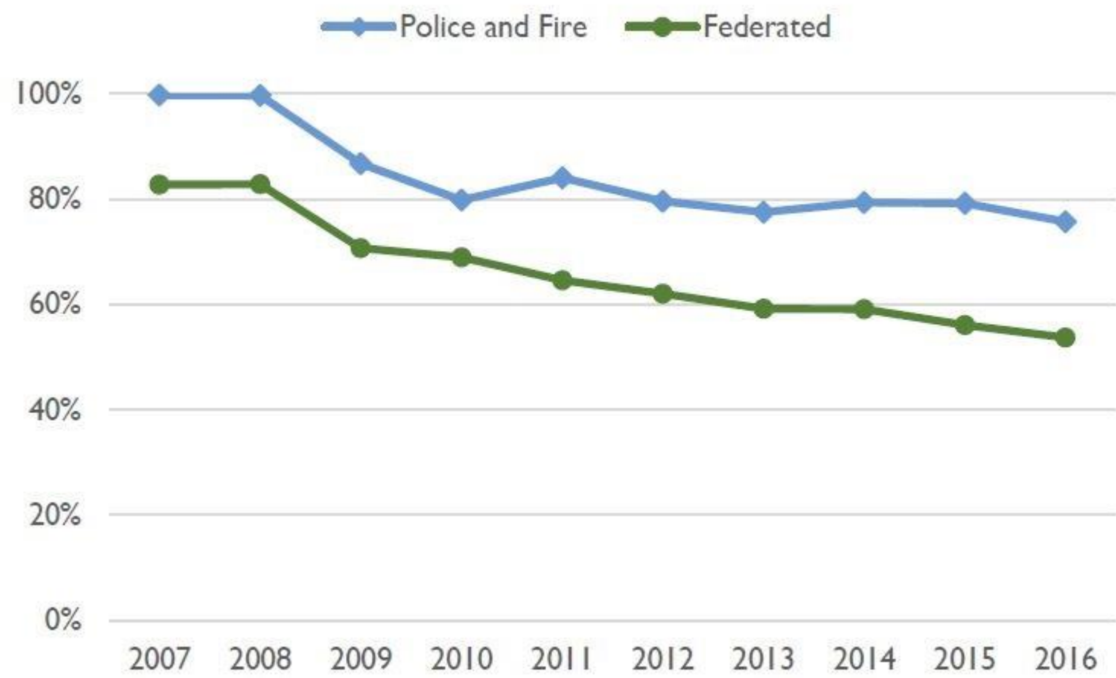
Funded Status Has Decreased

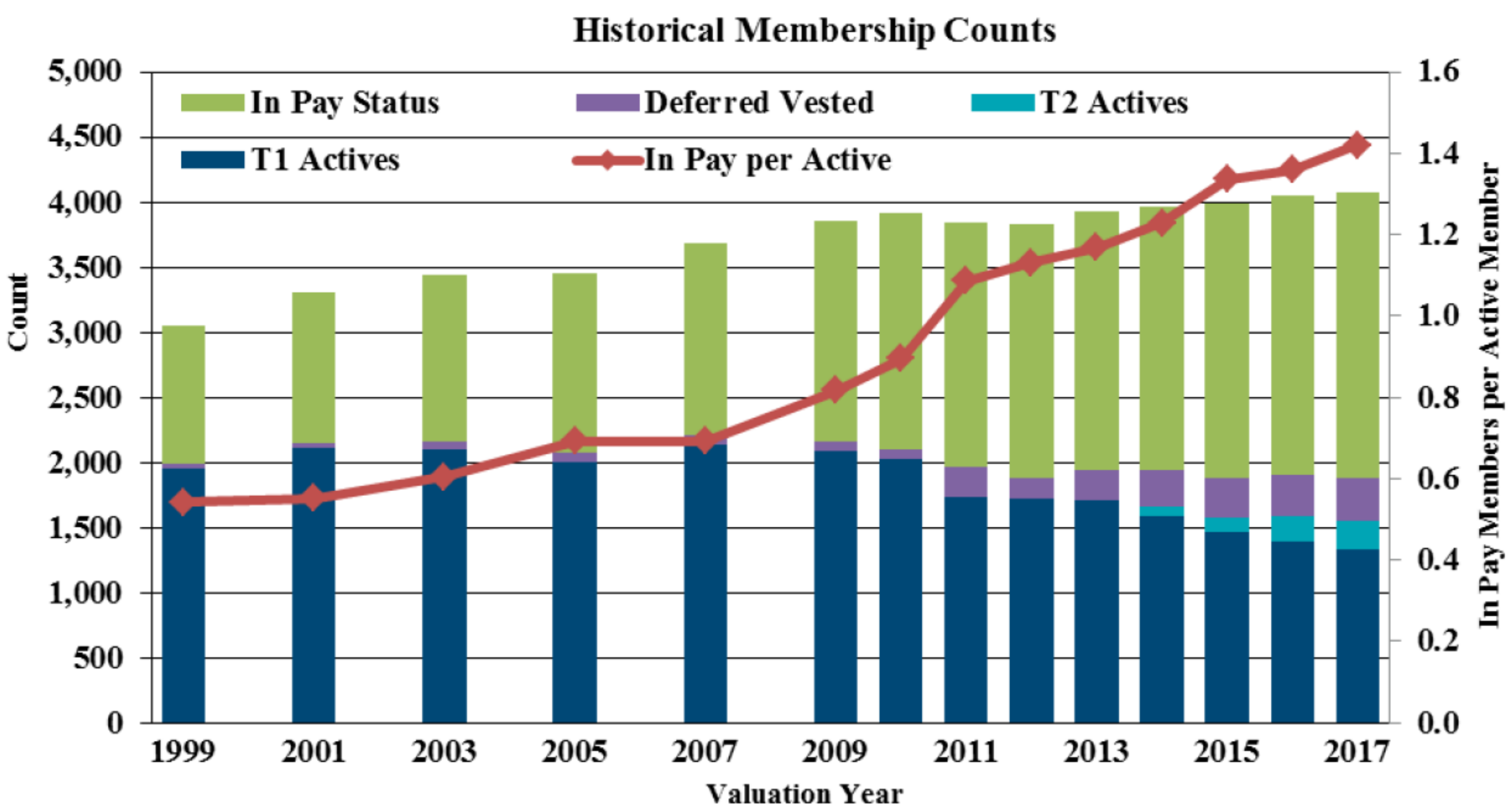
Police and Fire and Federated Pension Plans' Funded Status Has Decreased Over the Past Ten Years



Source: Federated City Employees' Retirement System and Police and Fire Department Retirement Plan Actuarial Valuations as of June 30, each year

Note: Funded status calculated using the actuarial value of assets, which differs from the market value as gains/losses are recognized over five years to minimize the effect of market volatility on contributions

Ratio of Active Employees to Retirees Police & Fire



Data from June 30, 2017 Actuarial Valuation

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Ratio of Active Employees to Retirees-Federated

Data from June 30, 2017 Actuarial Valuation

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How Much Has Been Promised?

What do we owe?

$8.4 billion accrued liability for pensions (MVA)

$1.3 billion accrued liability for retiree healthcare

$9.7 billion

How much do we have?

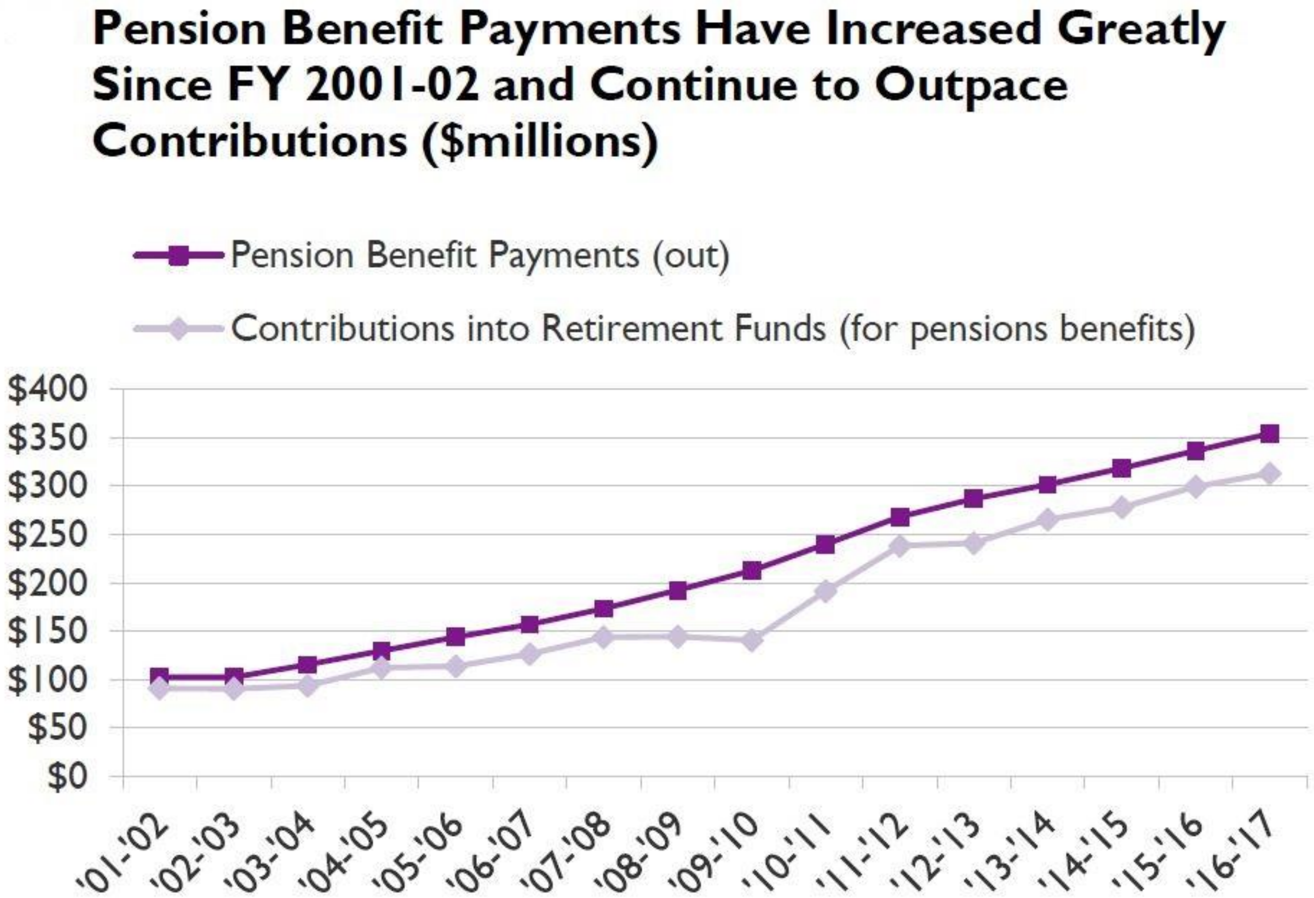
$5.3 billion held in trust for pensions (MVA)

$0.4 billion held in trust for retiree healthcare

$5.7 billion

Source: 6/30/17 Actuarial Valuations (Federated valuations and PF OPEB valuation are preliminary)

Increasing Retirement Costs



Source: City of San José Federated City Employees' Retirement System and Police and Fire Department Retirement Plan CAFRs

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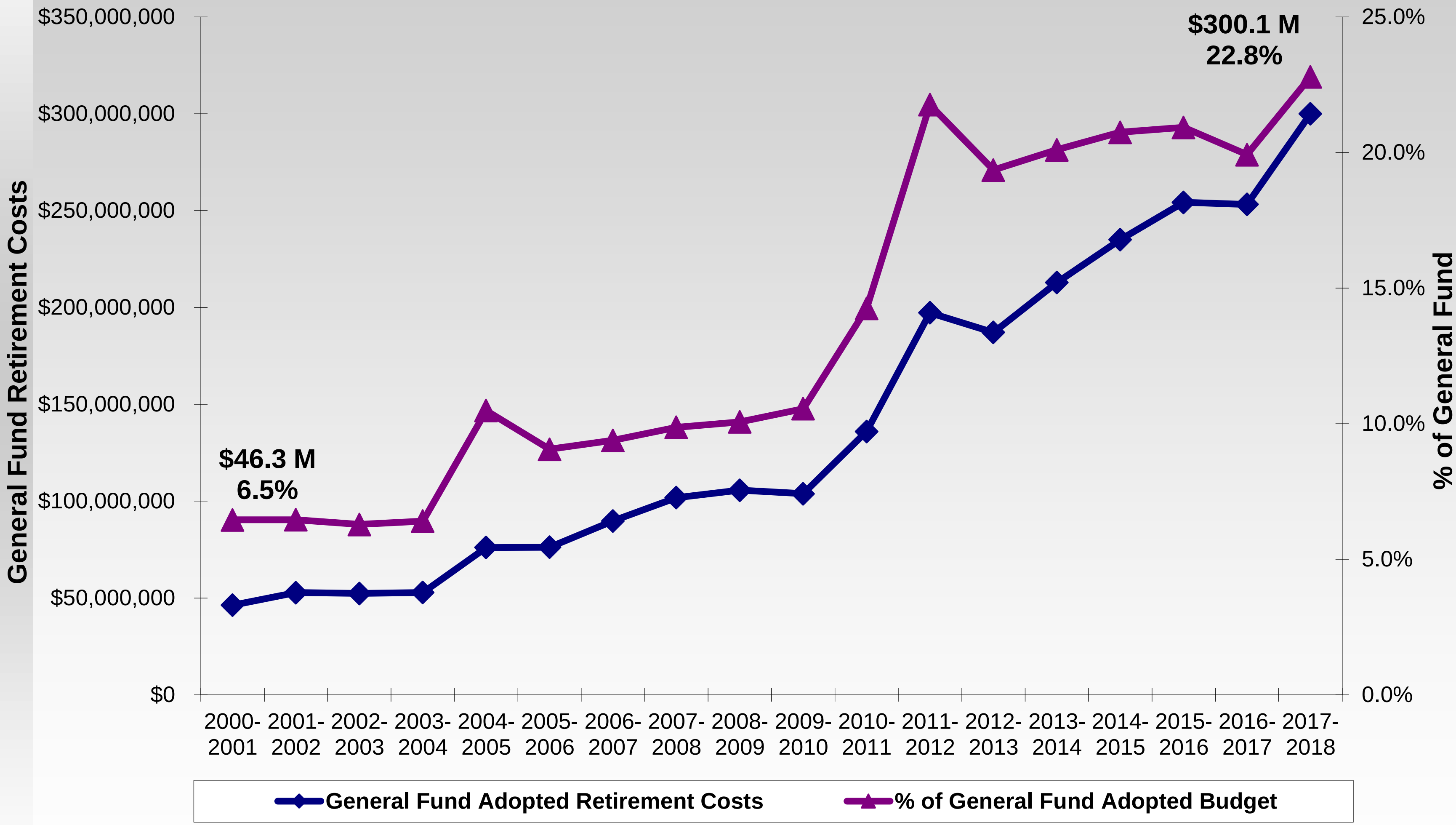
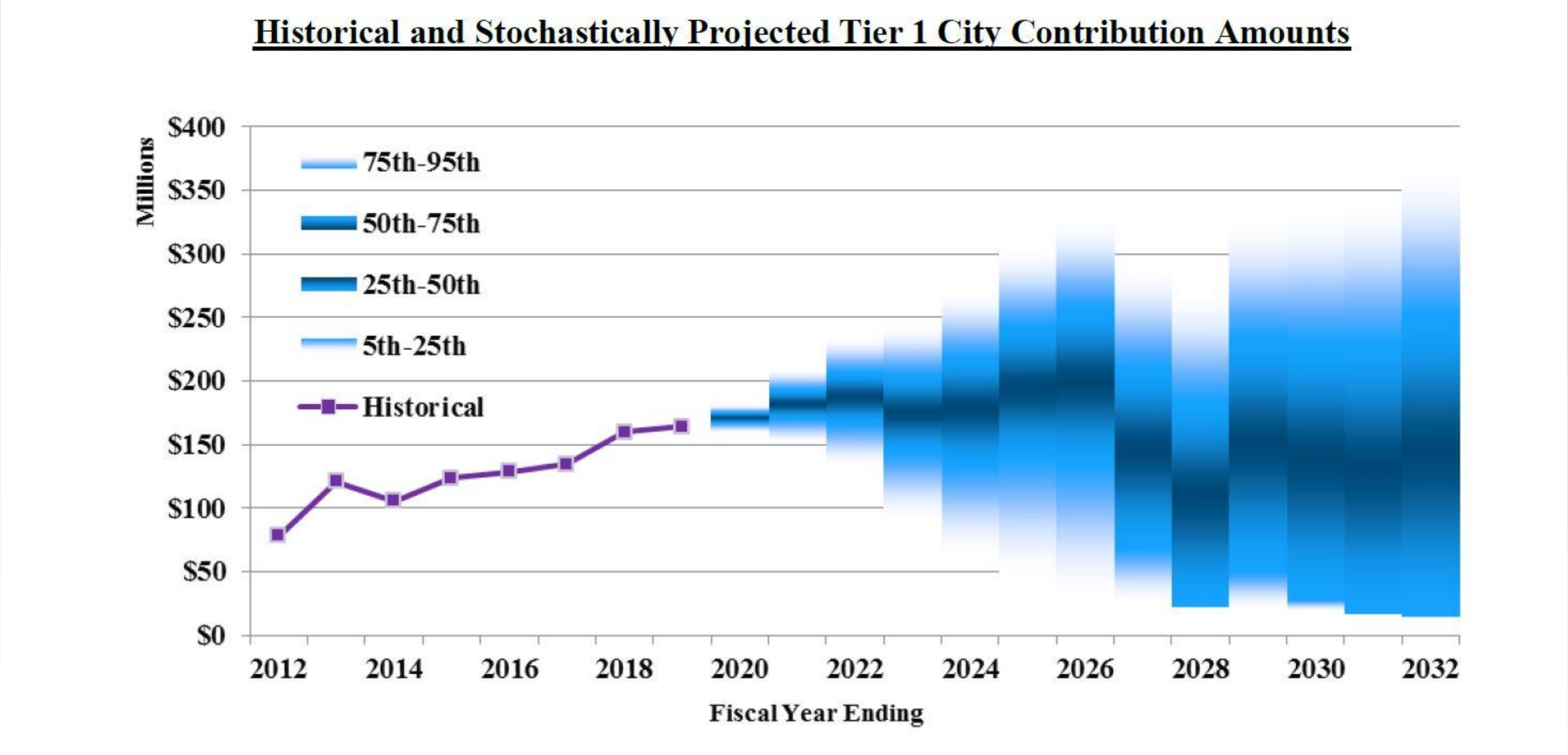
GENERAL FUND BUDGET – HISTORICAL PERSPECTIVE
Escalating Retirement Costs



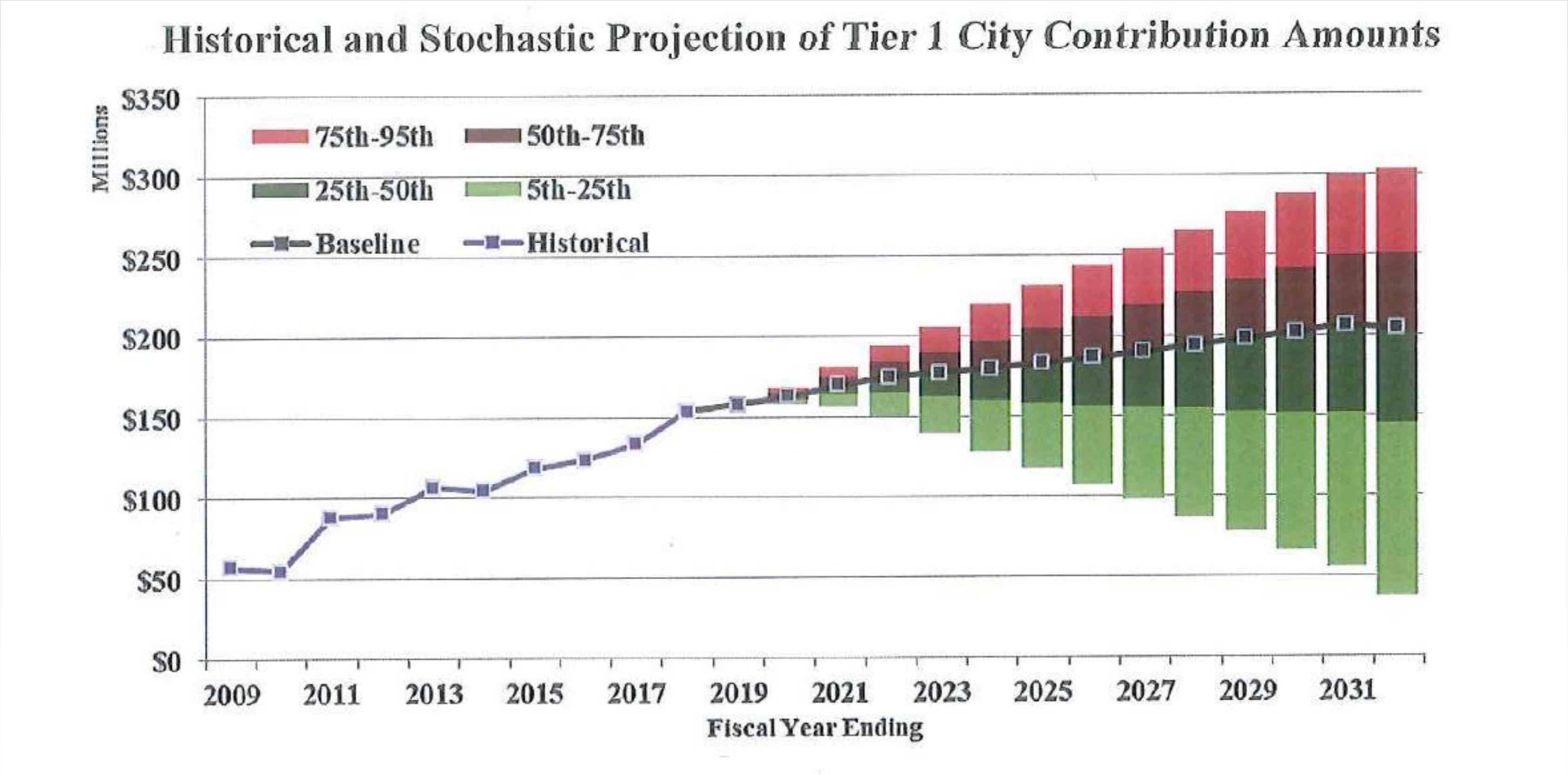
Source: Budgeted Retirement Costs Updated February 2018

Historic and Projected City Contribution Amounts – Police and Fire



Data from June 30, 2017 Actuarial Valuation

Historic and Projected City Contribution Amounts – Federated



Data from June 30, 2017 Actuarial Valuation

Next Steps

- Provide information memo on actuarial valuations to Council
  - A presentation on the valuations will be made to Council in April
- Joint study session with Federated and Police & Fire Board during a May Council meeting
  - Topics to include budget forecasts, contribution rates, actuarial assumptions, investment returns, and funded status

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Questions and Discussion

Definitions

Actuarial Assumption: *an estimate made for the purposes of calculating benefits*

Actuarial Valuation: *a type of appraisal which requires making economic and demographic assumptions in order to estimate future liabilities. The assumptions are typically based on a mix of statistical studies and experienced judgment.*

Actuarial Liability: *the liability for benefits earned for which assets have not yet been accrued.*

Actuarial Value of Assets (AVA): *Value of assets smoothed over a five year period.*

Amortization: *Paying off of debt with a fixed repayment schedule in regular installments over a period of time (ie: a mortgage).*

Annual Required Contribution: *Amount of money needed to finance the pension plan (Normal Cost + Amortization of Unfunded Liability)*

Assets: *accumulated amount of funds contributed to a system that is used to pay for future benefits. This can also include investment earnings.*

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Definitions

Defined Benefit: *Benefit regardless of amount of money contributed and investment performance of retirement fund*

Defined Contribution: *Benefit determined by amount contributed and investment performance*

Guaranteed Purchasing Power (GPP): *Benefit designed to ensure that retired members have 75% purchasing power of their original pension benefit. A line item on the February pension check.*

Liabilities: *difference between the total amount due and the actual amount of money the company has on hand to make those payments*

Normal Cost: *the cost of benefits accrued in the current year*

Market Value of Assets (MVA): *Current value of all assets (point in time, not smoothed over 5 years)*

Unfunded Accrued Liability (UAL): *The difference between the actuarial accrued liability and the actuarial value of plan assets on hand. This is the unfunded obligation for past service.*

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