REPORT TO COUNCIL 23
City of Sacramento

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PUBLIC HEARING
June 8, 2006

Honorable Mayor and
Members of the City Council

Subject: Overview of California Public Employee Retirement System (CalPERS) and Sacramento City Employees Retirement System (SCERS)

Location/Council District: Citywide

Recommendation:

Direct the City Treasurer to report monthly SCERS actual investment results compared to the SCERS actuarial earning assumptions to Council for information, and

Authorize the formation of a Retirement Plan Reporting Committee, internally staffed, for the purpose of briefing Council on the adequacy or the impacts of proposed changes in benefits, demographics, economic or non-economic impacts on the City's SCERS or CalPERS defined benefit plans

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Department: City Treasurer

Division: City Treasurer

Organization No: 0900

Summary:

Economic, non-economic and demographic changes are occurring and the outcome appears higher costs for retirement benefits. The City's two plans, SCERS and CalPERS may face higher costs.

The demographics of the SCERS plan reveal, the SCERS plan is presently 100% funded, whereas the PERS plan is 88% funded. There have been no City (unfunded liability) contributions made, or increases in the City's normal rate during the 14 year period ending June 30, 2005 and the City General Fund has saved more than $100 million in SCERS contributions that were programmed to be made. City contributions to PERS however, for normal contribution, have increased over this time period.

SCERS is a "closed end" pension plan (no new members) and major changes have occurred in the investment market place in recent years. Further, proposed changes in accounting and reporting of health insurance costs for both SCERS and CalPERS City employee's pension plan are currently under review by City staff. It is possible and likely that future pension cost increases will occur for.

A retirement plan reporting committee comprised of city staff from Finance, Human Resources and the City Treasurer's Office could be formed to advise Council of pending changes to pension plans and their potential for City budget impacts. Particularly, City Treasurer's staff should report SCERS investment results monthly. The effect of prioritizing this review will be to have timely notice to Council on fiscal matters relative to City pension plans and provide adequate planning and time for budget purposes.

Committee/Commission Action: None.

Background Information:

Local, regional and state governments as well as the federal government in the have generally provided their employees with what is referred to as a "Defined Benefit" pension plan as opposed to a "Defined Contribution" pension plan as an employee benefit.

Defined Benefit

Very briefly, a defined benefit plan guarantees an eligible employee a percentage of their final compensation, the percentage of which is based on the years of service the eligible employee worked for the employer. The employee generally pays a percentage of their pay into the plan as a contribution. The employer makes a normal payment into the plan, and the employer must also make any additional payments into the plan which are required to fund the pension plan so the plan can provide all eligible employees with their guaranteed pensions.

The employer retains an Actuary to determine the required payments and the adequacy of the pension plan to meet future obligations. Although the role of the Actuary appears simple, it is none the less a highly complex and sophisticated process that is both quantitative and qualitative in nature. Further, other demographic changes such as retirement date, life changing social conditions will occur. In its simplest terms an Actuary estimates the number of eligible employees by retirement dates, their future income changes and their mortality to determine the liability of the plan. Additionally, the Actuary estimates the future contributions to be made by the employees and employer and then applies an investment earnings rate to determine the funding available to meet the liabilities. Depending on the demographics of the plans, the calculations are made for terms up to 50 years from the current date. Although actuarial science is precise and reasonable for predicting future demographic and economic changes, events in recent years have shown such plans to have significant shortfalls or unfunded liability, which will require employers to make greater payments to keep the plans funded.

Further, with recent escalating health insurance costs, concern has been raised regarding an employer's ability to meet future health insurance costs for retirement plan members. The Governmental Accounting Standards board (GASB) has issued two regulations which are designed to have government employers calculate and include future health insurance costs along with pension and benefit calculations. Historically, government employers have paid these costs on a "pay as you go" basis. The impact of the proposed regulations may be to calculate these costs similar to pension costs and identify the method as to how and when these costs will be included. Although the City of Sacramento is presently studying options to cover the new regulations, it should be considered that this demographic change will increase employer costs for employee plan members.

Defined Contribution: Defined Contribution Plans are plans in which generally only the employees make a deposit into the plan (in certain cases an employer will also make a contribution). Generally the employee deposits and investment income earnings are income tax free until an employee retires and draws the funds down. At the authorized eligible date employees are permitted to withdraw their defined contribution balances based on their life expectancy and only to the amount available. Defined contribution plans do not have the funding issues and liabilities for employers as do defined benefit plans. Examples of defined contribution plans are IRAs and deferred compensation plans (totally paid for eligible employees) which are authorized by the IRS for employees.

Financial Considerations:

The City of Sacramento has two defined benefit pension plans for employees. The first plan is SCERS and the second plan is Cal PERS. The following are some of the Financial and Demographic differences in the plans.

The City of Sacramento Benefit Plan Comparison			
	SCERS		**CalPERS**
Eligible Employees	Closed 1978		All Career Employees.
Retired Members	1,461		1,186
Active Members	192		4,285
Average Age	56		40
Average Years of Service	28		11
Plan Funded (define)	100%		88%
Actuarial Earning Assumption	7.25%		7.75%
Inflation Assumption	3.00%		3.00%
Plan Funded Ratio	100%		88%

An analysis of the two plans reveals no new City employees are entering SCERS. However, the average age of active members (56) combined with the fact that there are only 192 eligible City employees remaining, signals the SCERS plan is quickly moving toward a payout phase, However, this payout phase will continue for at least another

30 years. Conversely, the City employees in the CalPERS plan have a younger average age and new employees may continue to enter the plan, thus indicating, the plan should grow for years.

In recent years with the advent of "hedge" funds and "private equity" funds following the debacles of Enron and other companies acting in imprudent fashions, a number of the publicly traded companies have gone private. The growth in private equity funds to invest in these situations is such that a change in traditional investment results has occurred.

Currently the growth of private equity funds, which are generating premium investment returns, require an investment commitment of 10 years or longer. Likewise investment returns from the Real Estate Market have been particularly strong. However, as with private hedge equity funds the ability to earn these returns require investment commitments of 10 years or longer.

Clearly, these types of investments require time commitments that are not prudent for SCERS given its plan demographics. However, these investments are prudent for CalPERS funds which do not face the same time constraints. Therefore in the future it might be expected that CalPERS investment returns will exceed SCERS.

With the changing demographics of the SCERS funds i.e., no new contributions, interest, dividends and principal being paid to retired members, the investment strategy for SCERS must be more conservative than for CalPERS. In many ways the SCERS plan can be viewed as one similar to a mature individual entering the retirement phase of their life whereas CalPERS could be viewed as one similar to an individual just starting into the adult phase of their life. The investment choices and needs of one in the retirement phase is more risk adverse.

Presently, the SCERS actuarial earning assumption at 7.25% (which was reduced June 30, 2005) reflects the fact that SCERS will not be investing in private equity or real estate. CalPERS currently uses an actuarial earning assumption of 7.75%. It will be necessary to monitor future investment returns, particularly for SCERS to ascertain if the SCERS plan will stay fully funded. Should future earnings from SCERS or CalPERS not meet actuarial projections it may be necessary to increase City contributions to the plan(s). Further, should retirement benefits be increased, or inflation exceed 3% or plan members live longer than mortality estimates additional contributions will be required by the City.

Finally, funding retiree health insurance, resulting from changes such as those recommended by GASB45, may also cause increases in the City's payments for employee benefits for both CalPERS and SCERS.

SCERS investment results are available monthly whereas CalPERS investment results are available annually.

Historically City Finance staff or Human Resources have monitored and reported CalPERS actions to City Council. City Treasury staff report SCERS investment results monthly to the Administration, Investment and Fiscal Management (AI&FM) Board. The AI&FM Board reports SCERS plan results to Council annually. However, Treasury staff could brief Council monthly on investment returns.

While we have given you some of the technical explanations, perhaps an easy way to illustrate the impact of interest changes for SCERS would be:

- If the actual rate of return is ¼ of 1% lower than the actuarial assumption (7.25%).a shortfall of $1.6 million would be created. This would require a General Fund contribution of $1.6 million to remove the shortfall.
- Conversely, if the actual rate of return is ¼ of 1% higher than the actuarial assumption (7.25%) a surplus of $1.6 million would be created.

Given the potential costs to the City for demographic, economic and non-economic changes, it would be appropriate for City Council to appoint a Retirement Plan Reporting Committee to routinely advise Council of earnings of plan results and proposed changes. The committee could include staff from Finance, Human Resources and City Treasurer. SCERS Investment results should be reported monthly to anticipate future City contributions if necessary.

Environmental Considerations: NONE

Policy Considerations: NONE

Emerging Small Business Development (ESBD): NONE

Respectfully Submitted by: Berke
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Approved:

THOMAS P. FRIERY
City Treasurer